State of the World Economy, 2011-2012:

Whither or Wither?

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On November 18, 2010, the U.S.-Korea Institute at SAIS and the Korea Institute of Finance, sponsored by the Asian Studies Program at SAIS and the *JoongAng Ilbo*, hosted the one-day conference, “State of the World Economy, 2011-2012: Whither or Wither?” at the Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, D.C.

This volume contains the speeches and papers that were presented that day and subsequently further refined by the authors to reflect discussions during the conference.

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Implications for the Future of the Korean Economy

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Recent Global Financial Crisis and the Korean Economy

The recent global financial crisis pushed the world economy into the most severe turmoil since the Great Depression of the 1930s. During the five years prior to the crisis, the world economy enjoyed the so-called goldilocks condition of "not too hot and not too cold," with the average annual growth rate of almost 5% and the inflation rate of only 2%. However, the crisis caused the world economic growth rate to tumble to 2.8% in 2008 and -0.6% in 2009. Total global losses from the financial crisis are estimated at $40 trillion, equivalent to more than two-thirds of the 2009 world GDP, including the loss of $35 trillion in publicly traded corporate equities and $5 trillion in home equity and unincorporated or privately listed businesses (Greenspan 2009). In terms of foregone output, the net present value cost of the crisis is estimated at anywhere between one and five times the annual world GDP (Haldane 2010). According to the IMF (2009), global credit losses by investors are estimated at $4 trillion, three-quarters of which were borne by banks and the rest by non-bank investors.

The Korean economy is highly vulnerable to external shocks, and it also suffered greatly in the aftermath of the crisis. The growth rate of the Korean economy declined from 5.2% in 2006 and 5.1% in 2007 to only 2.3% in 2008 and 0.2% in 2009. The exchange rate of the Korean *won* depreciated from 1,050 *won* per U.S. dollar in August 2008 to 1,570 *won* per dollar in March 2009, implying a *won* depreciation of 36%. The KOSPI composite stock index fell from over 2,000 just before the crisis in the autumn of 2008 to below 900 in October 2009. Reflecting the global decline in the trade volume during the financial crisis, Korean exports in the first quarter of 2009 were 25% lower than in the same quarter of 2008.

The Korean economy is especially vulnerable to external shocks due to its openness. The foreign trade volume is equivalent to 85% of Korea's GDP, almost double the world average of 43% and much higher than that of Japan (30%) and China (50%). As the global economy suffered from the financial crisis, first the Korean exports were immediately affected and then the export-dependent economy suffered subsequently. Furthermore, the Korean financial markets have been completely open since the Asian financial crisis of 1997–98, exposing them to the international hot money flows. Along with other countries, such as Australia and New Zealand, Korea has become a target of international currency carry traders exploiting its relatively large and free financial markets.

For these reasons, Korea's economic prospects are also closely linked with the prospect of global economic recovery from the recent financial crisis. The speed of the Korean recovery depends on how well the world community deals with the root causes of the crisis. But there has been some confusion and misunderstanding about the true origins of the crisis.

Real Causes of the Recent Financial Crisis

Several macroeconomic missteps have been blamed for causing the recent global financial crisis. For example, some have argued that the global imbalance has been magnified by prolonged low savings and high consumption in the United States, causing the accumulation of massive foreign exchange reserves in East Asian countries and others. These surpluses were promptly recycled back to the United States prior to the crisis, resulting in the excessive liquidity and low investment returns that, in turn, encouraged risky investment behaviors among Wall Street bankers. The U.S. Federal Reserve under Chairman Alan Greenspan has also been blamed for contributing to a prolonged period of excessive liquidity because of its liberal monetary policy in the wake of the 2000–01 tech-stock collapse and the subsequent 9/11 disaster. Also, the root cause of the U.S. subprime mortgage crisis has been traced by some to the over-enthusiastic drive by both Democrats and Republicans in Congress to promote home ownership, even among low-income households, by forcing American banks to make mortgage loans to poorer neighborhoods by enacting such laws as the Community Reinvestment Act. Others have also blamed excessive Wall Street greed for the crisis, ignoring the fact that free-market capitalism has always operated on the basis of profit motives. Greed in Wall Street or even in Main Street has been there all along, but it has not always triggered financial crises.

While the above factors may have played a supporting role in the recent global financial crisis, they were certainly not the primary causes of the crisis. The root cause of the international financial crisis was the abuse of various complex financial techniques and new investment instruments that have been developed in recent decades. The world financial markets have experienced a sharp acceleration in the pace of financial innovations over the years. Major innovations have emerged in the fields of new financial products, funding and investment tools, and trading and risk-management techniques. Both the richness and the complexity of these new financial products and techniques bear testimony to the robust spirit of financial innovation that has pervaded international financial markets since the 1960s. While these innovations have improved market efficiency in general, some of them have been misused and abused by a certain group of market participants out of ignorance and/or outright greed.

The modern history of international finance has really been driven by a series of innovations. Global financial markets have thrived on the wings of the animal spirit of innovations. Financial innovation involves more than development and diversification of new borrowing sources. It affects the entire range of financial intermediation, both domestic and international. In fact, the variety of services offered by financial intermediaries has not only been on the asset side, but has been equally impressive on the liability side of balance sheets. Liability management of modern financial institutions has become an important part of their integrated approach to financial intermediation (Buljevich and Park 1999).

In recent decades, the pace of financial innovations has accelerated precipitously, which, in turn, has driven the explosive growth in both the size of global financial markets and its array of new financial products and techniques. As of mid-2008, the outstanding volume of worldwide debt securities (cash market instruments) stood at $87 trillion, or 150% of world GDP then. On the other hand, the total outstanding volume of derivatives such as swaps, futures, options, and forwards (in terms of their notional principal amounts) amounted to about $700 trillion, and the daily volume of foreign exchange trades stood at $4 trillion. The value of foreign exchange trading has risen sharply relative also to the global trade volume, from 11 times global trade in

1980 to 73 times today. Such a gigantic global financial market, far higher in magnitude than the real sector of the global economy with the world GDP of $58 trillion in 2009, is run by hordes of global financial institutions, many of which operate around the clock across the entire 24-hour time zones. The old adage, of "the sun never sets on the British Empire" is now replaced by a new reality of "the sun never sets on the Citibank or Credit Suisse or Goldman Sachs, etc."[1] In the United States as in other developed countries, the financial sector's gross value-added (GVA: the value of gross output that a sector produces less the value of intermediate consumption) has quadrupled from about 2% of GDP in the 1950s to about 8% today (Haldane, Brennan, and Madouros 2010). There has thus been an increasing "financialization" of the economy.

Within the financial sector itself, there has been a fundamental change in its main business model. Financial market securities leapfrogged in volume over traditional bank credits. In the United States, securitized debt grew nearly 50-fold from 1980 to 2000, compared to a mere 3.7-fold increase for bank loans. Financial institutions have invented a dizzying array of all sorts of tradable securities, including a host of complex, opaque synthetic securities. The power of Wall Street was also shifted in the process from the traditional investment bankers relying on fee incomes to a new breed of traders betting an ever-growing amount of their bank's own funds as well as clients' funds in the trading pits. Wall Street's new "masters of the universe" are no longer the legendary deal makers but fearless trade warriors betting tens of billions of dollars and raking in tens and hundreds of millions of dollars in profits. In the brave new world of finance dominated by trading, and especially proprietary trading with bets using banks' own funds, the concept of long-term clients has degenerated into mere "counterparties." Modern-day financial legends such as George Soros and many hedge-funds captains all made their billions from the trading side of finance, not in corporate finance or traditional investment banking. This tectonic shift in the finance industry is showcased by Goldman Sachs, whose assets have skyrocketed from mere $100 billion in 1995 to $1.1 trillion in 2007 while raking in billions of dollars in trading profits. Its top management ranks are almost exclusively from the trading floors instead of the investment banking business. This shift is symbolized by the new 43-story headquarters building of Goldman Sachs, which has no less than six massive trading rooms, each larger than a football field.

Thus, a careful observer has to conclude that the recent financial crisis was primarily the direct result of the abuse of some of the complex and opaque trading instruments, most of which were too esoteric and technical to be comprehended correctly by either government regulators or academic economists. Many crises are often a byproduct of the cycle of financial innovations. First, new sophisticated financial products or techniques are developed and utilized exclusively among the few early innovators, to their great advantage. At the second stage, as the innovation is copied and spreads to a wider circle of market participants, some of the participants start to abuse them, out of either ignorance or outright greed. At this stage, regulatory authorities have not caught up with the full implications of the new innovation, and there appears a regulatory vacuum as far as the new innovative product or technique is concerned, which tends to embolden the early abusers to push the envelope to an extreme limit. At the next stage, such abusive practices are further copied and imitated by a wider circle of market participants, resulting in a full-blown crisis. At the final stage, both government authorities and general market practitioners start to take corrective actions, including introduction of new regulations and new supervisory tools. By this time, however, the damage has already been done to a significant sector of the economy.

1 In fact, the advertising slogan of Citibank, "Citi never sleeps!" is quite an accurate description of today's global financial institutions.

Financial innovations have not only generally increased the size and complexity of global financial markets but have also contributed to new ways to enhance income for market participants. As a result, the financial sector has experienced explosive growth in recent decades. U.S. financial assets exploded in size from around 400% of GDP in 1960 to 950% of GDP by 2007. There has been an especially sharp increase in securitized debt, which rose 50 times between 1980 and 2000. The share of the profits of the U.S. financial industry rose from 10% of the total corporate profits in the early 1980s to over 40% by 2007, even after Wall Street had paid out salaries and bonuses amounting to 60% of net revenues (Woolley 2010). Along with the rapid expansion of the financial services industry, there was a radical transformation of the U.S. financial system during the past six decades. The 1933 Glass-Steagall Act separated commercial banks from investment banks in the United States. Therefore, commercial banks relied mostly on deposits to fund their loans and investments to generate income, while investment banks depended on stock brokerage commissions as their main source of revenue. However, the so-called May Day financial deregulation in 1975 removed fixed stock brokerage commission rates, pushing investment banks in Wall Street to look for alternative revenue sources. Consequently, investment banks started to leverage their capital up to 30 or more times to engage in proprietary trading and private equity investments. They also developed and traded esoteric financial products, known as structured financial instruments such as CDOs (collateralized debt obligations) and CDS (credit default swaps), for a high risk–high return strategy. This strategy had worked fine until 2006, when the total bonuses at Wall Street firms amounted to $62 billion!

Esoteric Structured Financial Products and the Financial Crisis

The seed of the recent crisis was planted several decades ago in the financial industry's attempts to create new lucrative trading instruments when the Government National Mortgage Association (GNMA, known as Ginnie Mae) pioneered securitization of mortgage loans in 1970, by bundling hundreds and thousands of long-term mortgage loans into marketable bonds known as mortgage-backed securities, or MBS. MBSs are so-called pass-through securities, which are new types of bonds whose investors retain ownership interest in the collateralized assets, which in this case are home mortgage loans. The emergence of the MBS market injected new liquidity into the entire mortgage loan industry, as many mortgage lenders were able to sell their long-term mortgage loans to Ginnie Mae and other Wall Street firms that specialize in pooling and securitizing these mortgage loans. In the process, the original mortgage loan lenders could then make more new mortgage loans with the fresh cash that they obtained by selling the earlier mortgage loans to Ginnie Mae and Wall Street bundlers.

Mortgage loan securitization was given an added impetus when, in 1983, the Federal National Mortgage Association (FNMA, known as Fannie Mae) came up with the first collateralized mortgage obligations (CMOs). Unlike MBS, CMOs are so-called pay-through securities, where the investors of these securities do not have any ownership interest in the mortgage loan collaterals, but their new securities (CMOs) are serviced by the cash flows generated by the collateral assets. In other words, while pass-through securities such as MBS are certificates of ownership in the collateralized assets such as mortgage loans, pay-through securities such as CMOs are simply collateralized debt obligations whose debt service is provided by the cash flows generated by the collateral pool. The added advantage of new securities such as MBS and CMOs lies in the fact that they can be issued in different tranches categorized by the

degrees of risk exposure, with the safest tranche usually accorded the highest credit rating of triple-A; the lowest tranche, known as the "toxic materials," is normally unrated due to its high credit risk, but carries very high yields.

Securitization soon spread from home mortgage loans to other financial assets such as commercial mortgage loans, auto loans, credit card receivables, equipment leases, home equity loans, manufacturing loans, student loans, and others. By early 2007, 53% of all non-financial debt in the United States was securitized, compared to only 28% in 1980. By the end of 2006, the outstanding volume of securitized instruments in the United States alone reached over $9 trillion, composed of $7 trillion in MBS and CMOs and $2.1 trillion in other asset-backed securities (ABS). The widespread practice of securitization has enriched the financial markets all over the world, allowing a number of homeowners and other market participants a greater access to lower-cost credit that would otherwise have been unavailable. Securitization provides a "secondary" market for traditional illiquid bank loans and other financial assets, thereby pushing down borrowing costs for consumers and companies alike. There have been other systemic gains as well. Subjecting bank loans and other debt to valuation by capital markets encourages the efficient use of capital, and the broad distribution of credit risk through securitization reduces the risk of only a few creditors shouldering all the credit risk.

While securitization all over the world has in general made a positive contribution to global financial markets, it has also implanted a seed of abuse and misuse. The popularity of MBS and CMOs has provided major market players such as Wall Street firms and credit rating agencies a great opportunity to increase fee income by bundling all kinds of debt instruments into various tranches of securities, some of whose upper tranches can carry prime credit ratings to satisfy the investment requirements of many institutional investors such as pension funds and insurance companies, while the lower-rated tranches carrying higher yields prove attractive to such risk takers as hedge funds and other specialized investors.

Securitization has become a major source of fee income for those institutions connected to its business, such as loan originators (mortgage lenders and mortgage brokers), Wall Street firms acting as underwriters and placement agents for newly created securities, large commercial banks and insurance companies acting as credit enhancers for the securitized instruments, credit rating agencies with more ratings business, and investors eager to pick up additional yields by obtaining exotic new securities. In order to satisfy the growing demand by Wall Street for new mortgage loans that have become the most crucial raw materials (i.e., collaterals) for the securitization process, originators of mortgage loans became bolder and more risk-taking by expanding into even subprime mortgage loans. The subprime mortgage market in the United States barely existed 10 years ago, but it exploded in recent years prior to the financial crisis, with a total outstanding volume of $2.5 trillion in subprime mortgage loans.

Mortgage loans have been the traditional raw materials (i.e., collaterals) for MBS and CMOs, but the securitization industry, ever hungry for more business, launched in late 1990s the CDOs, whose collaterals are not just new mortgage loans but also already-existing MBS, CMOs, and ABS backed by mobile home loans, car loans, airplane leases, and credit card receivables, as well as other CDOs and even derivatives linked to these mortgage securities, known as credit default swaps or CDS. The main advantage of such CDOs over conventional MBS or CMOs is that they do not need a supply of new mortgage loans, since their raw materials (collaterals) need not be confined to new mortgage loans as in the case of MBS and CMOs. Thus, Wall Street was able

to create a brand new category of securities in the form of CDOs utilizing as collaterals existing securitized instruments or even derivatives linked to them, while in the process making huge sums of additional fee income.

Whereas the first-generation CDOs utilized as collaterals such assets as mortgage loans, MBS, CMOs, and ABS, the next development was the creation of the notorious "CDO squared" and the occasional "CDO cubed," which repackaged the hard-to-sell mezzanine CDO tranches as collaterals to create more AAA-rated CDO bonds. Finally, the latest, third-generation CDOs, known as "synthetic CDOs," were created by Wall Street, significantly altering the evolution of the CDO market, opening the door to rampant market abuses, and resulting in the eventual collapse of the huge securitization market, triggering the global financial crisis. Rather than relying upon cash assets, such as bonds and loans as collaterals, synthetic CDOs are created from pools of CDS, which are derivatives similar to insurance contracts protecting against certain credit risks. The use of CDS as collateral pools in CDOs could give the same payoff profile as cash assets but did not require the upfront cash funding for buying the traditional collateral asset pools. Furthermore, using CDS as opposed to cash bonds gave CDO managers in Wall Street the freedom to securitize any cash flows without the need to locate, purchase, or own the specific collateral asset pools prior to CDO issuance. With the development of synthetic CDOs, the CDS market became even more valuable to Wall Street, and the volume of both CDS and CDOs experienced an exponential growth.

In their heydays, CDOs were the investment of choice for numerous asset managers and investors, since they carried both sterling credit ratings and excellent yields, much higher than comparably rated corporate bonds.[2] During the post-9/11 period, of the relatively low interest rate and excess liquidity, there appeared among investors intense competition globally for extra yield. CDOs were the perfect investments of choice among asset managers hungry for higher yields to stay competitive. They were eagerly bought by major investors around the world, such as pension funds, mutual funds, hedge funds, and commercial and investment banks, including some of the largest and most sophisticated financial institutions. However, when the real estate bubble finally burst and the subprime mortgages started to default, there was massive downgrading of CDOs and other structured financial products, which led to huge write-offs by financial institutions around the world, thus triggering the financial crisis. The adverse impact of the global financial crisis soon spread to Main Street, pushing the global economy into the Great Recession. The world economy is still suffering from its after-effects.

Resilience of the Korean Economy and Its Recovery

The abuse of some of the most sophisticated financial practices eventually led in September 2008 to the collapse of Lehman Brothers, the fourth-largest investment bank in Wall Street at that time, with over $700 billion in total assets and $740 billion in outstanding derivatives contracts with more than 5,000 counterparties around the world. As the global financial crisis spread to Main Street, it triggered the collapse of global trade. Korean exports in the first quarter of 2009 were 25% lower than in the same quarter of 2008, and the trade-dependent Korean economy contracted by 5.1% in the fourth quarter of 2008. As global deleveraging intensified in the aftermath of the crisis, the comparatively liquid Korean financial markets allowed speculative

2 The reason for this is too complicated to be explained properly here. For a detailed explanation of the reason, see Park 2009.

and other foreign investors to unwind their investments more easily than in other less liquid market countries. Capital outflows from Korea amounted to 5.5% of Korea's GDP during this crisis, which was higher than at the time of the Asian financial crisis of 1997–98, resulting in a sharp depreciation of the Korean *won* and the collapse of the Korean stock market. The Korean foreign exchange reserves also fell from over $260 billion to about $200 billion during the crisis. To counteract these capital outflows, the Korean government entered into currency swap agreements with the United States ($30 billion), China ($30 billion equivalent in *yuan*), and Japan ($20 billion equivalent in *yen*). Consequently, the Korean risk premium subsided, with the Korean CDS premium declining from almost 700 basis points at the peak to the pre-crisis level of about 100 basis points.

The Korean government also embarked upon an unprecedented level of fiscal stimulus efforts equivalent to 3.7% of GDP in both government spending and tax cuts, and the Bank of Korea reduced the policy rate from 5.25% in October 2008 to the all-time low of 2% by February 2009. Fortunately, the bitter experience of the earlier Asian financial crisis has taught both Korean banks and corporations to be conservative in their financial management. The Korean banking system maintained healthy balance sheets at the time of the crisis, with an 11% risk-weighted capital ratio as compared to the 8% minimum mandated by the Basel Committee on Banking Supervision. Unlike the Asian financial crisis of 1997, when Korean companies carried an average debt/equity ratio of over 400%, their balance sheet in 2007 showed an average debt/equity ratio of just over 100%.

The Korean economy has since rebounded impressively from the world's Great Recession in the second half of 2009. In the fourth quarter of 2008, the Korean economy declined by a quarter-to-quarter (q/q) seasonally adjusted annual rate (SAAR) of 16.8%, but the subsequent recovery has solidified, with economic growth averaging 7.4% of q/q SAAR in the first half of 2010 in what has so far been a classic V-shaped recovery. The Bank of Korea projects the Korean economy to grow by 5.9% in 2010, while the IMF's latest projection (IMF 2010b) indicates a growth rate of 6.1%. Such an impressive recovery is fueled to a large extent by the quick rebound in Korean exports, which are likely to increase by 23% this year compared to a decline of 14% in 2009. Last year, Korea also became the ninth-largest exporter country in the world. The performance of large Korean *chaebol* firms has been especially impressive. For example, the total operating profit of Samsung Electronics Company last year was about $8.5 billion, which was larger than the combined profits of the nine largest Japanese electronics firms, such as Sony and Toshiba.

Diversification of the Korean exports markets has also contributed to the resiliency of the Korean recovery. From the undue reliance in the past on the United States for exports, Korean firms have diversified their export markets in recent years. Now, the fast-growing China is the largest export market for Korea, accounting for 24% of the total Korean exports in 2009, followed by 13% for the European Union. The North American market, including the United States, now accounts for only 11% of the total Korean exports, the same share as that of 10 ASEAN countries, and Japan's share is only 6%. The fact that developing countries now account for over 70% of total Korean exports has been especially positive for the Korean economic recovery, as some of the major developing countries, such as China and the ASEAN countries, have experienced the fastest economic growth rates since 2009, with China's GDP growing at 9.1% last year.

Barriers to Korea's Economic Growth Potential

Korea's economic performance in the aftermath of the global financial crisis has been impressive, exhibiting a solid V-shaped recovery. However, the long-term trend of the Korean economy is not as bright as it used to be. The Korean economic growth rates have materially slowed down over the past two decades, from the annual average growth rate of 6.2% in the 1990s to 4.3% in the 2000s. A recent study by the Korea Chamber of Commerce and Industry projects a steady decline in Korea's economic growth potential from the current 4% to only 2–3% in the coming decade. Korea's population trend is also not encouraging. The Korean birth rate has steadily declined to one of the lowest among the OECD countries, with a fertility rate (children per adult woman) of only 1.2 in 2009 from 1.6 in 1990, which is well below the replacement rate of about 2.0. At the same time, the population has been aging rapidly. Those who are 65 years or older account for 11% of the total population this year, and they are projected to increase to 38% of the population in 2050.

One of the main weaknesses of the Korean economy is the fact that, like Japan, which has still not recovered from almost two "lost decades" since the early 1990s, Korea has essentially a dual economy: the internationally competitive export sector on the one hand and the heavily regulated and inefficient nontradables sector, especially the services industry, on the other. The Korean services sector accounts for only 67% of the economy, which is twenty-ninth among 30 OECD countries, and the Korean service sector is also concentrated in low value-added industries, according to a 2009 study by the McKinsey consulting firm. The service sectors of even East European countries account for a higher portion of their economies than in Korea. In most advanced Western European and North American countries, the service sector accounts for about 80% of their GDP, from 85% in the United Kingdom and 84% in the United States to 75% in Germany. The share of employment in the service sector is only 65% in Korea, compared to over 80% in the United States and other advanced countries. The productivity of the Korean service sector is also very low due to excessive regulations and the low operating scale of most service firms, according to the McKinsey study. Despite solid performance in the merchandise trade, Korea chronically has suffered huge trade deficits in services since the 1990s.

One classic example of such a poor state of the services sector is the medical services industry, where the high quality of Korean medical personnel such as doctors and nurses is generally well recognized internationally. Despite repeated attempts over the past five years, including direct interventions by the Blue House, to introduce for-profit hospitals that can attract many affluent foreign medical tourists from the increasingly affluent middle and upper classes in China and other Asian countries, the government has still not been successful due to the entrenched opposition by various interest groups. Corruption in Korea is also still high, especially at the lower reaches of the government, where the population has to interact with various government officials due to a host of petty regulations. According to the 2010 Corruption Perceptions Index (CPI) published by Transparency International, Korea ranks thirty-ninth out of 178 countries surveyed. In the report, Korea is ranked way below such countries as Uruguay, Dominican Republic, and Slovenia, and it ranks even below the African nation of Botswana. Early this year, a Korean college lecturer committed suicide, leaving behind a bitter letter in which he described how he had been approached by some colleges to pay $150,000 to $300,000 to be promoted from a simple low-pay lecturer status to a regular faculty member. Having lived for over 40 years in the United States and having spent his entire teaching career at American universities alone, this author has no direct personal knowledge about the truth of such ugly and

shameful rumors, but similar stories have been heard on some occasions.

Then, in a *Chosun Ilbo* column on December 22, 2009, Sang-hoon Yang, a highly reputable Korean journalist, reported the case of one of his close personal friends. This small businessman friend wanted to expand his factory, and he even received the personal blessings from the governor of the province where the factory was to be expanded and thus more people to be employed. But he was repeatedly rebuffed by lower-level officials who openly demanded bribes amounting to several hundred thousands of dollars. After 11 months of fruitless attempts to obtain the construction permits in the honorable way, this businessman finally gave up and sold off even his existing factory. Then, he asked his son not to serve in the Korean army and instead to go abroad to study and to get an immigrant visa there.

The volume of foreign direct investments (FDI) in Korea has also steadily decreased in recent years. Last year, the net FDI in Korea declined by almost 60% compared to the previous year, with the FDI amount now falling back to the level achieved almost 15 years ago. In fact, many large Korean multinational firms such as Hyundai Motors and Samsung Electronics have aggressively expanded their direct investments abroad for strategic reasons, such as better market access and lower labor costs. At the same time, many small and medium-sized enterprises (SMEs) have also relocated their factories in low-cost countries such as Vietnam, Indonesia, Cambodia, and the Philippines. Despite the generally high youth unemployment rate in Korea, the young working-age Koreans are reluctant to get jobs at SMEs, where mostly manual laborers are needed. In desperation, these SMEs are forced to hire immigrant workers, some of whom are without proper work permits in Korea.

The true number of the unemployed in Korea may be much higher than the official statistics indicate. Government data, as reported in the *Joong-ang Ilbo* on January 18, 2010, suggest that the total number of unemployed in Korea stood at less than 900,000 last year, but the true figure is claimed to be more than four times higher at four million, if one includes also those working less than 18 hours per week, temporary workers, the discouraged workers not looking for jobs anymore, those studying and preparing for targeted professions later, and so on. Almost half of recent college graduates are effectively unemployed, according to labor experts.

Despite superficial impressions held by some foreigners, including President Barack Obama, regarding the efficiency of the Korean education system, the reality is quite different. It is well recognized by Koreans themselves that the Korean education system focuses too much on passing tests rather than nurturing creative and independent thinking. Many concerned Koreans consider it not an accident that no Korean so far has won a Nobel Prize in the science field, while Japan has 16 such winners already. Large Korean multinational firms have responded to this challenge of the dysfunctional education system in Korea by aggressively recruiting international staff, including overseas Koreans. Currently, 45% of the workforce at Samsung Electronics Company is international staff, and the company plans to raise it to 65% by 2020. The official education system for primary and secondary school children is especially dysfunctional, forcing most students to supplement their regular schooling by private, after-hours private tutoring. The cost of this extra after-hour schooling is estimated to have increased from 1.5% of the average household income in 1985 to 7.8% in 2007. It is a common sight at the Korean airports to spot school-age children, some as young as primary school age, who are leaving home and going abroad to study in foreign, preferably English-speaking, countries, to attend schools there. Even in the Washington suburbs, one can easily come across these young Koreans attending schools

here alone or chaperoned by their mothers, leaving their fathers in Korea to earn the money to support their children's education overseas.

Foreign observers, especially those at multilateral financial institutions such as IMF, World Bank, and Asian Development Bank, tend to paint a generally optimistic picture of the Korean economic prospect. It may be partly political, since these multilateral institutions need some successful examples as the fruits of their six decades of development aid around the world. This could be part of their efforts to showcase their good work in the face of the growing "foreign aid fatigue" among both the general population and policy makers of donor countries. Korea can be genuinely pointed out as one country that has successfully graduated from the aid recipient status to become a donor nation.

However, the relative position of the Korean economy in the world has steadily declined from the eleventh-largest economy of the world in 2003 to the fifteenth now. According to the 2010 Nation Brands Index (NBI) compiled by Anholt-GfK Roper, Korea ranks only thirty-third out of 50 countries studied.

Medium-Term Prospect

The latest projection by the IMF (2010a) indicates that the Korean economy is to grow at around 4% annually during the next five years, with the per capita GDP reaching $28,486 in 2015 from $17,071 in 2009. According to a study of past major global financial crises, the adverse impact on the economic growth rate tends to last about ten years after a major crisis, with a median post-crisis GDP growth decline of about 1% in advanced countries compared to the pre-crisis ten years. The post-crisis unemployment rate also tends to be about 5% higher than in the pre-crisis decade (Reinhart and Reinhart 2010). As an open economy, Korea's economic prospects are closely tied to those of the world economy. As the global economic growth rate is likely to slow down in the coming decade compared to the pre-crisis decade, the Korean economy is confronted by a challenging prospect indeed.

Certainly, Korea has come a long way from 1960, when the per capita GDP was around $100, which was much lower than that of many South Asian and even some African countries at that time. Thus, one should not minimize such a monumental achievement of the Korean people. How has this amazing achievement been possible? Without doubt, it took lots of sweat, tears, and, yes, even blood shed during the brutal Korean War of 1950–53. Two fundamental questions at this point, though, are: does this success prove that Koreans are smarter than others? And are Koreans genetically predestined to belong to an advanced industrialized country in the twenty-first century? The answers to these two questions are obvious or even self-evident: Koreans are no smarter than any other race on the globe, and so Korea is not predestined to become an advanced industrialized country. Korea's past success is simply a case example of historian Arnold Toynbee's "challenge and response" theory. According to Toynbee, the great ancient civilizations of China, Egypt, and others did not rise in the fertile and temperate paradise lands. To the contrary, their habitats were in general severely challenging to the settlers, with periodic floods as in the Nile Delta region, harsh winter weather as in the Yellow River basin of China, or other adversities. Those early European immigrants who had settled on the warm and fertile Carolina coasts of the United States disappeared without leaving a trace, while those who had

settled in New England fighting harsh winter weather were able to flourish eventually.

Koreans faced a brutal survival challenge of both the Korean War and the subsequent abject poverty in the 1950s and 1960s. Koreans understood at that time that unless their economy became strong and self-sustaining, they could be easily swallowed up any time by communist North Korea. This survival challenge triggered on the part of the Koreans a fierce response of nation building and industrialization through sweat and tears. The same is true for the other Asian tiger economies of Taiwan, Hong Kong and Singapore. Taiwan and Hong Kong were peopled by the hardy refugees from communist China, and they could also be annihilated by Chinese communists at any moment unless they became both economically and militarily strong and self-sufficient. In a similar fashion, Singapore was originally a poor fishing village peopled by wretchedly poor and uneducated Chinese coolie refugees from southern China. This small city-state with no natural resources and not even their own drinking water source became independent in 1965 from the Muslim Malaysia in the north, and was threatened by the largest Muslim country in the world, Indonesia, in the south. Their only chance to survive as a nation and as a people was to develop their economy into a strong and independent nation. The success of these four Asian tiger economies does not prove that they were the countries of supermen, but rather that they were twentieth-century examples of Toynbee's "challenge and response" theory.

The greatest challenge to the Korean economy now is whether the Koreans can maintain those frontier spirits born during the early era of sweat and blood. Another challenge for Korea is how to transition the country successfully from a government-led economy to a truly market-led one. Right now, the government is too strong and too intrusive in Korea, often stifling the entrepreneurship and creativity of businessmen. Companies are struggling under mountains of regulations, and the government tries to micromanage the economy. The public sector in Korea is still too pervasive, but it is very difficult to privatize state-owned enterprises (SOEs) due to the fierce resistance by militant labor unions and other entrenched interest groups. The current Lee Myung-bak administration initiated an energetic drive in 2008 to privatize 40 of the nation's 400 SOEs. So far, though, not a single SOE has been privatized during the Lee Myung-bak administration despite repeated efforts by the Blue House.

The precondition for a truly modern and industrialized Korea must be to reduce the power of the Korean mandarins, who are generally smarter and better educated than most businessmen. These Korean mandarins have on their side the history of successful management of the Korean economy over the past five decades. Major milestones on the path toward the recent Korean industrialization were both planned and initiated by the mandarins. The Seoul-Busan Expressway, the Pohang Iron and Steel Corporation, prosperous shipyards in Gojae Island, the Masan-Changwon heavy industries center, the Gumi electronics complex, and even Hyundai automobile plants in Ulsan: these and other symbols of successful Korean industrialization during the past several decades make it extremely difficult for Korean mandarins to relinquish their old habits of micromanaging the economy.

But the world has changed, and the international economy has shifted. Today's cutting-edge global businesses require both nimbleness and real-time monitoring of fast-moving markets around the world that no desk-bound Korean mandarins, how smart they may be, can successfully manage.

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