The way forward for the Korean economy

Higher costs, slower growth and freer trade

INSIGHT INTO KOREA (1)

This year marks the 20th anniversary of the June 10 civil uprising of 1987 and the 10th year since the outbreak of the Asian financial crisis in 1997. We have prepared a series of contributions from prominent foreign scholars to analyze the significant changes that Korea has undergone during the past two decades. We hope our readers can gain some insights into the nation's future from these articles. — Ed.

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By Barry Eichengreen

Korean growth is one of the great economic success stories of the past half century. Yet almost from the start, Korean observers voiced doubts about its sustainability. In the 1970s it was common to question the efficiency of investment in the heavy and chemical industries. The 1980s started with a recession and concluded with a wage explosion, both of which were seen as evidence that the economy was losing momentum. The first half of the 1990s featured policies of economic opening motivated by the belief that a cosseted economy was incompatible with sustained productivity growth, and the second half of the 1990s was then dominated by the financial crisis. Now the decline in growth rates from the high to the mid-single digits raises yet further questions about the performance of the economy.

My point is that there is nothing new about the current sense of angst. (Just why I use this particular word, derived from Middle High German, meaning "a feeling of anxiety or apprehension, often accompanied by depression," will become clear later.) The tendency to emphasize problems rather than achievements may be a national personality trait. But this preoccupation with problems may encourage excessive pessimism about future prospects.

Discussions of why Korea isn't growing faster start with the fact that the investment/GDP ratio has fallen from nearly 40 percent in the mid-1990s to barely 30 percent today. There is of course no shortage of explanations for this decline in investment. To start with, competition in assembly operations and manufacturing generally from low-cost China has encouraged Korean firms to invest abroad rather than at home. And there has been much such foreign investment, by small and medium sized Korean corporations as well as the large ones.

But while there is an incentive for Korean firms to invest in processing and assembly facilities in China, there is also an incentive for foreign companies to invest in Korea in facilities for the production of the machinery, equipment, and technology that this country exports to China, and in factories for producing here the parts and components that then undergo final assembly there. In other words, while Korea should undertake more foreign investment, it should also receive more foreign investment, because its economic structure and technological sophistication complement China's.

It is sometimes said that the riskiness of investment has risen. Before the crisis, firms believing that their survival was guaranteed by the government invested with abandon. But in fact there were always bankruptcies. The Donglip Group, the ninth largest chaebol in the 1960s, was allowed to go bankrupt. Dongmyung, the chaebol built around the world's largest producer of plywood, went bankrupt in 1980. And then, of course, there were Hanbo and Kia.

It is said that the macroeconomic environment is less certain now that the economy has been deregulated. Again, I am not convinced, for if you look back at Korean history you see that the economy was always volatile. Uncertainty was always considerable, whether we are talking about 1979, or 1987, or 1993. Anyone who was engaging in high levels of investment in the belief that the returns were certain was deluding himself.

The alternative is that the lower levels of investment we are now seeing in Korea are normal: they are a consequence of economic maturity. As the high-growth period ends, a lower level of investment is needed to sustain profitability. Failure to recognize this fact can explain why investment rates remained high in the first half of the 1990s and the financial crisis then followed. Of course, one must then explain why managers were so slow to acknowledge the need to gradually reduce investment rates. The explanation lies in the Korean system of corporate governance, in which outside investors had limited ability to monitor and discipline managers who had their own private agendas. But the financial crisis then led to improvements in shareholder rights and corporate governance generally that prevented blockholders and managers from engaging in empire building. Again, the implication is that the decline in investment we are now seeing is an entirely natural phenomenon.

If low investment is not the cause, then what is? In my view, the main reason why Korea isn't growing faster is the difficulty of restructuring the economic and social system. An economic and social model is a system of interlocking parts. The operation of each component complements the operation of the others, enhancing the efficiency of the larger mechanism.

Once upon a time, the mechanism worked smoothly. Korea's bank-based financial system was aptly designed for plowing resources into established industries using known technologies. A labor market in which workers enjoyed employment security but relatively little autonomy worked well when growth depended on providing workers with vocational training and familiarizing them with standardized technologies. An industrial structure dominated by large firms was well suited to a period when technological change meant importing technologies offering economies of scale and scope. Government policies emphasizing savings and extending investment guarantees fit the bill when the task for growth was to expand capacity in industries using established technologies rather than to develop new products and processes.

Critically, the different components of the Korean system complemented one another. By providing steady finance to established industrial clients, the banking system facilitated the provision of vocational training and enhanced the stability of employment, irrespective of fluctuations in the cash flow of the borrowers. Strict regulation of the labor market in turn made lending decisions easier for the banks. Government guarantees allowed them to disregard the weaknesses of their borrowers.

Now, as the economy approaches the technological frontier, capacity to innovate becomes more important. Korea's bank-based financial system has to give way to securities markets and venture capital, which are better at taking bets on unproven technologies. There is the need for more small and medium sized firms, which are the sources of radical new technologies, and for more turnover in the labor market, as firms are born and die. Government's role is no longer to encourage investment generally but to subsidize activities like R&D and tertiary education.

But though reforms are complementary, there is no all-powerful social planner to implement these various changes simultaneously. The different components making up the mechanism evolve at different rates. They are reformed at different speeds. In Korea, financial market reform has gone faster than industrial restructuring. The reorientation of government policy has lagged. During this transition the Korean model has functioned less smoothly. And, consequently, growth has lagged.

Can the country do better? Here I want to point to an answer by considering the experience of another economy, namely Germany. (Now you know why in my introduction I referred to the Korean sense of "angst.") We are used to thinking about Germany as a slowly growing economy suffering high unemployment. In fact, Germany is currently one of the fastest growing economies in the euro area, and its rate of per capita income growth is fully half a percentage point faster than that of the United States. Its exports are up by nearly 50 percent since the beginning of the decade.

Germany has done this by undertaking far-reaching economic reforms, as a result of 15 years of very serious economic problems which broke down political resistance. There developed a consensus on the need to remake the economy. That consensus encompassed both the political left and right; it was the socialist-led government of Gerhard Schroeder that pushed through some of the key reforms.

Another force in this process was the creation of a free trade area with Eastern Europe as a result of the admission of the so-called accession economies to the European Union. Poland, next door to Germany, has an abundance of high-skilled, low-cost labor. Its accession to the EU gave companies the opportunity to move east if German workers didn't moderate their wages and if the unions resisted more flexible labor-market arrangements. Free trade with Poland and the rest of Eastern Europe also allowed German companies to restructure in efficiency-enhancing ways. They could outsource the production of standardized parts and components and simple assembly operations, while building up research, development, and precision manufacturing at home. The effects on German competitiveness have been strongly positive. The Bundesbank has studied whether investment by German firms in Poland and other Eastern European countries "hollowed out" the German economy. It concluded that the availability of this low cost platform for assembly and for the production of standardized components in fact made Germany more attractive as a destination for inward FDI by foreign companies.

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Another key is that there has been sufficient time in Germany to reform the entire range of arrangements — financial markets, labor markets, government policies — so that the new arrangements fit together in complementary ways. Capital markets have taken over: the share of bank loans in financing has declined from 80 percent at the beginning of the 1990s to less than 50 percent today. On the side of the labor market, unemployment insurance contributions were reduced and wage negotiations were decentralized, allowing for greater wage differentiation in firms facing international competition. Corporate tax rates were slashed, and small companies were exempted from corporate taxes entirely.

One shouldn't overstate the consequences, but there is no question that reforms are producing results. Unions have moderated their wage demands. Firms have restructured and shed redundant labor. The result has been a fall in unit labor costs in manufacturing by almost 10 percent since 2003. Hence the export surge, defying the rise in the euro (which, it should be noted, rivals the rise of the won). There has also been a considerable increase in manufacturing investment.

A number of the lessons carry over. Korea needs to moderate wages and enhance the flexibility of labor markets in order to take advantage of new opportunities. It should recognize and accept the positive productivity effects of shifting standardized parts of the production process to lower-cost countries. It needs to exploit the complementaries between different reforms.

Let me conclude with some final thoughts on the U.S.-Korea FTA and on foreign direct investment in Korea.

In Europe, the positive productivity effects of the single market flow not simply from the scope it affords for regional supply chains but also to the intensification of product market competition. Firms faced with more intense import competition have to shape up or die. European scholars have studied this process intensively; they find that the increase in efficiency due to the intensification of product market competition is greatest among firms with principal-agent problems. By contrast, there is much less evidence of an effect where managerial control and ownership are closely aligned. This suggests that more intense product market competition can be especially helpful in Korea, where problems associated with the separation of ownership from control have long been noted.

More intense product market competition will similarly be one of the effects of the U.S.-Korea FTA. Pharmaceuticals, chemicals, advertising, and media will all face stronger foreign competition. Thus, the FTA will sharpen the incentive to boost productivity and better align ownership with control.

The FTA should also spur additional U.S. investment in the electronics industry and in banking, insurance, brokerage, asset management and accounting in Korea. This is yet another mechanism for ratcheting up product market competition and stimulating greater productivity.

So I am optimistic about Korea. The fundamentals, from macroeconomic policy to human capital formation, are strong. Life alongside to a rapid-growing, immensely-large, low-wage economy like China is not easy, but it affords opportunities for an economy like Korea specialized in the production of electronic components, machinery and equipment. Exploiting those opportunities will require further restructuring. There will be additional offshoring of the production of standardized components and assembly operations and more specialization at home in R&D, design and precision manufacturing. The U.S.-Korea FTA and the continued liberalization of inward foreign investment strengthen the incentive for Korean firms to move in this direction. It is not surprising that recent rates of growth have been disappointing, since restructuring is disruptive to the status quo. But there is also the promise of better things going forward.