



KOREA'S ECONOMY

VOLUME 30

a publication of the Korea Economic Institute of America
and the Korea Institute for International Economic Policy



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ISSN 0894-6302



CONTENTS

KEI Board of Directors	II
KEI Advisory Council	III
Preface	V

Overview and Macroeconomic Issues

Lessons from the Economic Development Experience of South Korea	1
<i>Danny Leipziger</i>	
The Role of Aid in Korea's Development.....	7
<i>Lee Kye Woo</i>	
Future Prospects for the Korean Economy.....	27
<i>Jung Kyu-Chul</i>	

Building a Creative Economy

The Creative Economy of the Park Geun-hye Administration	35
<i>Cha Doo-won</i>	
The Real Korean Innovation Challenge: Services and Small Businesses	47
<i>Robert D. Atkinson</i>	
Spurring the Development of Venture Capital in Korea.....	55
<i>Randall Jones</i>	

Economic Relations with Europe

Korea's Economic Relations with the EU and the Korea-EU FTA	65
<i>Kang Yoo-duk</i>	
130 years between Korea and Italy: Evaluation and Prospect.....	73
<i>Oh Tae Hyun</i>	
2014: 130 Years of Diplomatic Relations between Korea and Italy	81
<i>Angelo Gioe</i>	
130 th Anniversary of Korea's Economic Relations with Russia	87
<i>Jeong Yeo-cheon</i>	

North Korea

The Costs of Korean Unification: Realistic Lessons from the German Case	93
<i>Rudiger Frank</i>	
President Park Geun-hye's Unification Vision and Policy	101
<i>Jo Dongho</i>	



OVERVIEW AND MACROECONOMIC ISSUES

LESSONS FROM THE ECONOMIC DEVELOPMENT EXPERIENCE OF SOUTH KOREA

By Danny Leipziger

Abstract

The paper reviews some of the key aspects leading to Korea's remarkably successful economic transformation, including its consistent and aggressive pursuit of export-led growth, its investments in basic services and housing, its enviable record in human capital development and skills acquisition, its regional development policies, its strengths in planning and implementation, and its concerns about societal issues like equitable growth. The second part of the paper looks at some of Korea's challenges for the future. In this area, some concerns are raised about demographic constraints, the alarming increase in household debt and dearth of household savings, issues of energy policy, trends in the distribution of income and wealth, and a possible need for institutional revitalization. The aim of any reforms is to position Korea well for the future and to maintain its economic position and the wellbeing of its citizens.

Introduction

Korea's economic success has created a large industry of researchers who have attempted to explain and extol the virtues of Korea's economic rise. These efforts have also led to attempts at generalizing lessons and providing advice to other countries. Of course, these lessons fall into two groups: those that are very specific to Korea's economic situation and circumstances and those that are less intrinsically connected. Even in the latter group of factors, however, there must be recognition that policy formulation is only part of the story and that implementation plays an even larger role than the design of smart policies. Even those countries attempting to undertake efficacious policies may fail due to institutional weaknesses. Hence, there is a lot to learn from the development experience of South Korea.

Rather than dwell on some of the better known policy areas, however, that have been amply explored, such as the export-driven growth model, the *chaebol*-led industrialization path and the use of subsidized credit, or the repatriation of skilled professionals and adaptation of high-end technologies, in this essay the focus will be on aspects of economic policy that can be seen as inclusive. In other words, we will concentrate on those policies that led to broadly shared economic growth and wholesale improvements in the well-being of a large swath of the population. Formerly dubbed equitable growth and more recently inclusive growth, the point is that economic growth without a sharing of gains leads to exploitive societies and minimal welfare gains for the majority of the population.

This Korean experience of inclusive development is highly relevant today in light of the attention drawn to increasingly skewed distributions of income and wealth in many developed and emerging market economies. Given the evidence that many non-inclusive economic outcomes can be self-perpetuating since economic opportunities are limited and economic power perverting, it is even more instructive to learn about the way in which income gains were shared in an economy such as Korea's, namely, an economy that grew so phenomenally over many decades and escaped the economic devastation and rampant poverty that plagues so many other countries.

Six Lessons on Inclusive Growth

First and foremost, the Korean experience shows how the shift from an agrarian economy to a manufacturing-led economy went hand-in-hand with large-scale productivity gains. The W. Arthur Lewis hypothesis about surplus labor was seen in reality in the shift to labor-intensive production in 1960s Korea. Indeed, even though the process entails copying of production methods of more advanced countries like Japan, the efficient use of factor endowments, namely basically educated and motivated labor, led to large gains in employment, output and incomes. Indeed, it was only the vestigial use of subsidies that

kept the rural labor force from declining even more rapidly than it did. The shift to urban settings involved huge gains in productivity per worker, and the accumulation of capital and use of technology further magnified these gains. The results were spectacular, namely, a drop in the rate of absolute poverty from close to 30 percent of the population in 1970 to one-third that level a decade later. So lesson one was that to increase the earnings of workers, one needs to employ them in higher value-added endeavors, empower them with capital, and enhance their productivity with newer technologies.

New urban work forces can either live in shanty towns, the *favelas* of Brazil and the slums of Lagos, or they can be housed in some fashion. Whether it was company housing at first or later on public housing projects, South Korea, similar to both Hong Kong and Singapore, decided that government-supported housing was an essential ingredient of urban development. Inclusive development cannot proceed when the poor and the working poor lack assets, and one of the key assets in a dynamically growing economy is housing. Countries lacking the fiscal resources to provide adequate housing will in the end be creating urban sprawl, degradation and slums. The inability to provide basic public services, such as water and electricity, not only reduces living standards, but also creates health problems and fewer opportunities for upward mobility. Lesson two, therefore, is for governments to invest in public services and to deal with urban housing demands in a proactive manner. South Korea did this and other East Asian economies ranging from Thailand, Malaysia, Vietnam and China have done so as well, with recognized successes in distributional measures of income.

Education provides the great equalizing element for societies that are concerned with issues of economic opportunity. Governments do not always see investments in education as being beneficial for the individual household; they often do so for larger national economic reasons, such as to create a more skilled workforce. Nevertheless, the interests of the public and private sectors can overlap as seen in the significant public investment in education in South Korea that was matched by prodigious private investment by families in the education of their children. Researchers often marvel at the high educational achievement achieved with modest investment levels (as a percentage of GDP). What they fail to appreciate is the investment of private monies in education that provided almost as much effort as did government in the education challenge. In order to promote inclusive or more equitable growth, lesson three is to level the playing field with high-quality public education, with accountability by the school system and the strong involvement of parents. Similar to Finland and Singapore, and others scoring well on global examinations, Korean teachers were held in high esteem by society and education was seen as a universal goal of all those involved. Additionally the high levels of literacy

achieved in the 1950s and 1960s provided the building block for a trainable workforce. This latter point is critical since a rapidly growing economy such as Korea in the 1970-1990 period witnessed rapid changes in industrial composition, a phenomenon requiring a malleable work force.

Not all urban driven development forces can capture all comers, however. Hence, South Korea did engage in some redistributive policies. These were less of the welfare type, inasmuch as pure transfer programs came rather late in the game in Korea, and more of the targeted investment variety, namely, disproportionate level of investment in rural areas and in depressed areas. The Saemaul Movement was one such program begun in the early 1970s and continued through the 1980s. Broadly speaking, it was a rural modernization and development program, aimed at those left behind by urbanization. It was accompanied by excessive (over-weighted) investment in provinces such as Cholla, known to be lagging. While it is true that some pro-agricultural policies were distortive and costly, the basic sense was that the poorer groups should not be left “too far behind.” This is the sense of inclusive growth and it provides lesson four, namely, excluded or disadvantaged groups may need extra effort, more resources, and special programs to be able to benefit from the general societal gains that may elude them.

The fifth basic lesson that has important ramifications for the future pattern of economic growth revolves around planning, monitoring and evaluation. Beginning with President Park Chung-hee, the role of the government in economic planning, including Five Year Plans and the coordinating role of the Economic Planning Board; the extensive monitoring of export production versus national targets and the use of subsidized credit to generate export revenue; and the importance placed on evaluating the efficacy of policy interventions all led to a culture of accountability. Knowing how economic progress is occurring, who was left behind, how Korea was stacking up versus its competitors, these were all part of the accountability culture that enabled policymakers at first and politicians later on to track economic progress and the distribution of gains. This is not to say that equitable distribution of income was a national objective, since it clearly wasn't, or that Korean elites didn't gain enormous economic power, which they did; but rather to argue that the data was always available to show how national income was being generated and captured and outlandish gains were usually frowned upon and often punished, especially in the high growth decades.

It is natural, some would argue, that the distribution of income and more so the distribution of wealth will become more uneven as countries become richer, and this has been the case in Korea as well. Once a certain level of development has been achieved, in the case of Korea, joining the OECD or the club of advanced economies, greater efforts are needed both on the side of active redistribution of income as well as in

ways to discourage the perpetuation of wealth and the lack of opportunity of the average citizen to succeed. This process has preoccupied South Korea in the course of the last decade and a half. Some efforts have been exerted to show that the elites should not dominate; however, these efforts have been weak and largely ineffective. They took the form of a ban on private tutoring, the closure of the prestigious Kyonggi High School that grounded many of Korea's top academics and bureaucrats, a few celebrated corruption cases, debates on tuition and the like. Nevertheless, the distribution of income pre-tax and post-tax is not that different and Korea seems quite a ways from the social democratic model of Europe according to OECD data. Hence, the sixth and final lesson is that complacency is not advisable when dealing with rapidly enriching countries, since the accumulation of wealth goes hand-in-hand with the exercise of economic power, especially when regulation and institutions cannot keep up with the politics of power. In this sense, Korea is no different than other OECD countries that have witnessed the same pattern of concentrated economic power.

What Next for South Korea?

While Korea's remarkable economic growth trajectory provides many lessons for others seeking to escape poverty and maximize their economic potential, unfortunately there are fewer countries that can provide lessons to Korea as an advanced economy seeking to find a new equilibrium as a just and more equal society. Recent years have tended to show Korea as rudderless in this new world.

True, Samsung TVs now dominate global consumer preferences and Hyundai and Kia are setting new records as cars of choice. Still, Korean public sentiment is distinctly unhappy, despite per capita incomes of \$27,000 and material gains that were considered unattainable in 1960 or even 1980. Korea has confounded the critics. It lacked the size of a China. It lacked the resources of a Malaysia. It lacked the location of a Singapore. It didn't rely on foreign direct investment. It delayed domestic consumption until investment needs were accommodated. It deferred welfare programs until they were fiscally affordable. Korea did so many things well that it has created the impression and expectation that the country will always find the correct path. In reality, however, Korea now needs to hear new voices of advice and needs to generate a new collective view on its own future.

Some Policy Suggestions for the Future

It may be presumptuous to offer advice to a country that has been so eminently successful. Nevertheless, sometimes, outside advice can be useful in clarifying what many know but that few can openly articulate. Policymakers long accustomed to dealing with long time horizons are now forced by politics

to deal with the immediate, situations repeated throughout the advanced economies. The long-run planning, monitoring and evaluation strengths are eroding and with it better policy choices are often ignored. So here are a few possible policy lessons to smooth Korea's future and maintain the great strengths and hard-won gains of the past.

Although many may dispute the necessity of continuing to generate incremental economic growth, societies' desires for more public goods and better public services as well as increasing longevity make economic growth indispensable. In the case of Korea, declining fertility and almost absent immigration are creating a long-term problem. Capital and technology with a declining labor force as now seen in Korea leads to lower long-term growth. Moreover, the lower rates of total factor productivity seen in services as compared to manufactures further lowers potential growth rates. To spur future growth, women need to be encouraged to remain in the labor force and this requires changes in cultural attitudes, better and more affordable child-care and a number of other labor market reforms. This is the first priority if Korea is to avoid being the next Japan, namely, hamstrung by demographics and condemned to eventual economic decline.

Second, household savings have almost disappeared and household indebtedness has risen astronomically. While the promotion of domestic consumption was once seen as a necessary policy to break the total growth dependence on exports and investments, it is now a drag on the economy. Much of household debt is due to poor mortgage markets and short-term, high cost mortgages. Mortgage reform is a major priority that requires government action. This is more important than becoming a financial center in Asia, and in fact, might spur that development. Without mortgage reform, consumption will suffer, birth rates will not rebound, and public confidence and perceptions will suffer. It is noteworthy that Korea ranks poorly on indices of happiness, while economic progress has been so astounding positive.

Third, energy policy needs to be reviewed. While public transportation investments are excellent, congestion and pollution pose significant challenges. It is ironic that Korea is so advanced in the export of sustainable energy sources, whether wind turbines or the development of electric cars, when, at the same time, Korea's GDP is so energy intensive and so carbon-dominated. Thinking of sustainable economic activity means that these issues need to be addressed immediately. Innovation and other measures cannot substitute for realistic energy pricing. There are lessons from Europe that can usefully be applied in the realm of energy efficiency. Increasingly we are coming to realize that a truly advanced economy is a clean economy as well.

Fourth, one cannot ignore issues of income inequality for long. Korea has been lucky, as noted earlier in the essay, to generate a participatory and shared economic growth model. But that model, based on massive employment generation, is fraying. Wages have increased in the service sector, now the dominant portion of GDP, while productivity is lagging. As costs rise, real incomes of the middle class will suffer the same declines seen in most OECD economies. At the same time, redistribution efforts are not sufficient to offset the natural accumulation of wealth, which perpetuate greater inequality and concentration of wealth.

Fifth, there is need for a re-invigoration of institutions that help guide and manage the economy and other aspects of society. In order to deal with long-run challenges in a non-political fashion, institutional reforms are needed. Some countries, notably Chile and Singapore, have been able over the years to create bi-partisan commissions to deal with issues of pensions, health care and other social programs that require long-term planning and implementation. Insofar as the set of policy priorities now has expanded beyond export diversification and macroeconomic management, the role once played by the Economic Planning Board needs to be mirrored in many other spheres of public policy. Short-term decision-making runs the risk of policy reversals and policy expediency. These were never characteristics of Korean policymaking in the past.

How to Use Korea's Legacy Strengths for the Future

One of the big advantages of Korea's economic history is that it has accomplished the very difficult and hence is well positioned, under the right circumstances, to deal with the new set of challenges. Its disadvantage is that given so rapid a trajectory, the public does not remember the food shortages, 57-hour work weeks, and fear of failure of the 1960s. A major public relations campaign is needed to re-inculcate Korean traditional values. Moreover, Korea's organizational skills and abilities to work across the public and private sectors can be mobilized to deal with the challenges of the 2015-2030 period.

In order to bring public and private priorities into better sync, corporate governance reform would seem important. Whereas government used to be the financier of the private sector, the shoe is now on the other foot and the corporate sector needs to align its growth and profit motives with other aspect of societal policies. To give a prime example, take the role of women in Korean corporations. Wage differentials are enormous, the glass ceiling for women is absolute, and talented women are forced into their own businesses or into low-paying jobs. Advancement is limited and marriage and child-rearing are impossible to reconcile with corporate responsibilities. One

need only look at public and corporate policies in countries like Sweden to see how incentives can help maintain birth rates and provide for a more gender equitable and harmonious society. A national program involving the *chaebol*, public sector entities and non-governmental actors should be launched. The same drive that was once given to exports should be aimed at producing larger Korean families.

Energy pricing is another “low-hanging fruit.” Korea could be a leader in electric car manufacturing for its own national market. It has the technology. It has a superb transportation grid. It has public support for energy efficient solutions, yet it has a paltry record in terms of sustainable energy policy. Again a public-private effort is required, with carrots and sticks, to make major changes in energy usage. There may be an issue of equity involved as well, but congestion taxes on the wealthy that help finance major new energy investments and cross subsidies can encourage smarter energy choices. Not only is this do-able, it is also a long-run, pro-growth policy.

The creation of a public agency to manage long-term investments should be a priority. It needs to be set above political influence. The roles of the Bank of Korea and of the Competition Commission also need strengthening to ensure their independence across political cycles. These independent entities can ensure greater institutional strength and they can garner public support if they are seen as being apolitical. Many of the long-standing policy challenges have been recognized by Korean thinkers and academics, but haven’t been dealt with because of political considerations. The big strength of Korean policymaking in the past was its ability to create a long-term vision accompanied by long-term planning and solid implementation. These virtues could serve Korea well as it attempts to deal with its current set of challenges.

Conclusions

There are many areas of economic policy in which Korea set the standard in the course of four decades, 1960-2000. During that period, incomes per capita snowballed and Korea went from a manufacturer of the lowest value-added products to the global leader in electronics, appliances and automobiles. No other country in the course of the last half-century has done as well and even China’s remarkable rise does not detract from the Korean success story because of China’s size and the

unusual and predominant role of state capitalism. In the case of Korea, government was able to use the state to create world-class private global corporations and then to withdraw into a more traditional regulatory role. Among OECD countries, Korea stands out as the prime exemplar of a state-incentivized growth strategy leading to unbelievably rapid increases in per capita income.

Korea was a global leader in the use of think tanks and economic information. Of course, each corporation now boasts its own economic research group; however, the role of the Korea Development Institute and of the economic leaders that it spawned still stands out today. Being able to adapt the best of economic thinking into practical and usable policy advice that could work in Korea was a remarkable feat. This strength still exists; however, now national expertise needs to be blended with global knowledge in ways that may seem unfamiliar to Korean policymakers. The efficient use of international experts to bring in fresh perspectives may add value to decision-making in the 21st century.

Public policy in Korea was managed by a coterie of officials who were empowered to do national service, respected, and perhaps feared at times, since they commanded such political support. This kind of power can be misused, and in some instances it was, but overall, Korea stands out among a handful of countries in which public policy was well executed and successful. At times controversial, or excessive, such as in the heavy and chemical industry phase of industrial policy promotion in the 1980s, public policy was nevertheless well coordinated and efficiently executed with a common understanding among all the economic agents involved as to what the ultimate goal was. The Korean proverb of always “camping with your back to the water” was an indication that failure was not an acceptable outcome. History has shown that success was the ultimate judge of Korea’s efforts, and it can remain so going forward.

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