Miracle on the Han River Part II, or Regression to the Mean? South Korea’s Economy in Transition

By Yoon-shik Park

The government-led model of economic growth that South Korea adopted after the Korean War saw it transform from utter poverty to First World status more rapidly than any other country in modern history.

But the growth engines are sputtering, and South Korea now looks perilously close to following the path of Japan in the 1990s to an era of ‘lost decades.’ The government must reform the economy radically to avoid that fate, writes Yoon-shik Park.

DURING THE two and a half centuries from 1700 to 1952, Asia’s economy shrank in relative terms from three times that of the combined Western economies to just one-third. The region then embarked on a race to catch up with the West during and after the Korean War of 1950-53, when Japan first blazed new trails in industrialization and launched a robust export drive. From the 1960s onward, the four Asian “tiger” economies — Hong Kong, Taiwan, Singapore and South Korea — followed. From the 1970s, they were joined by the so-called tiger cubs — Thailand, Malaysia, the Philippines and Indonesia. China, of course, soon joined in.

In 1951, Japan’s gross domestic product was less than one-twentieth of US GDP and only one-third that of the UK. But over the next three decades it grew at a rate of almost 10 percent per year, until by 1980 it was twice that of the UK and almost half that of the US, making Japan’s economy the second-largest in the world.

South Korea replicated the economic success of Japan, although its growth drive started more than a decade later. During the Korean War, the already poor agrarian economy was utterly devastated and infrastructure severely degraded. Occupying only 0.07 percent of the earth’s landmass and with not a single drop of crude oil or other mineral resources, South Korea had to rely on food aid from the US for survival. Per capita income was only $89 in 1961, 101st out of 125 countries surveyed that year by the World Bank; it was ranked alongside such countries as Togo, Uganda and Bangladesh. As late as 1965, South Korea was poorer than India, with a per capita GDP of only $106 compared to $121 for India. But over the next 48 years, that grew by a factor of 313 until in 2013 it stood at $33,200 (on a purchasing power parity basis), while India was only $4,000, or 33 times higher than in 1965.

The stellar achievements of many Asian economies have caused a sort of “Asiaphoria,” with some seeing the recent economic slowdowns in Japan and South Korea as temporary aberrations. Many South Koreans were therefore receptive to the recent call by President Park Geun-hye for a second “Miracle on the Han River.” Respected international organizations such as the World Bank, the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) have also published rosy long-term economic growth forecasts for many Asian countries. We have to be mindful, however, of economic forecasting errors in the past half-century that resulted from excessive extrapolation from past performances. Growth rates of fast-performing economies have been found to drop, often sharply, toward the long-run global average of about 2 percent per year.

SOUTH KOREA’S SLOWING ECONOMY

In recent years, the South Korean economy has slowed down, mirroring Japan’s experience. The average annual economic growth rate was 9.2 percent in the 1970s, 9.8 percent in the 1980s and 6.6 percent in the 1990s. But growth fell to 4.2 percent in the 2000s. The picture is even worse in recent years, with its economy only growing by 3.7 percent in 2011, 2.0 percent in 2012 and 2.8 percent in 2013. Many South Korean industrial giants such as Samsung and Hyundai have increasingly moved their new investments abroad to low-cost regions such as South Asia and Eastern Europe. Between 1995 and 2010, South Korea’s largest manufacturing firms shifted 17 percent of their production overseas.1 As a result, total domestic employment in such companies fell by 2 percent annually, and the share of Korean workers employed at large South Korean companies fell by a third, from 18 percent to 12 percent.

Due to South Korea’s deteriorating competitiveness, foreign direct investment (FDI) has worsened in recent years. FDI outflows rose from $6.1 billion in 1997 to $35.1 billion in 2013, an increase of 470 percent, while FDI into South Korea rose from $6.9 billion to $14.5 billion, or only 108 percent. In 2013, the level of FDI into Korea was just one-fifth that of Singapore, which is smaller than Seoul. South Korea attracted less FDI in 2013 than Thailand, Indonesia or Malaysia. While South Korean wages are relatively high compared to competitor nations, a study by the Conference Board in the United States found that South Korea’s hourly labor productivity stands at 48 percent that of the US, ranking 30th in the world, even lower than Greece. Reflecting the deteriorating business environment, 40 percent of Korea’s top 30 chaebol firms found their operating income falling short of covering even their interest expenses in the past two years.

A 2014 World Economic Forum survey shows South Korea’s international competitiveness falling to 26th, the lowest in 10 years, while other Asian countries have retained higher rankings, including Japan (6th), Hong Kong (7th), Taiwan (14th) and Malaysia (20th). The South Korean banking system ranked especially poorly at 122nd, while the entire Korean financial system fell to the bottom of the list at 144th, with the return on assets of South Korean banks at only 0.38 percent, the lowest in Asia and outperformed by Kenya (24th), Ghana (62nd) and Uganda (81st).

LESSONS FROM JAPAN

The drastic South Korean slowdown has raised the possibility that it might end in South Korea experiencing “lost decades” similar to Japan over...
The past 20 years. After real growth of almost 10 percent per year in the 1950s and 1960s, and close to 5 percent per year in the 1970s and 1980s, the Japanese economy has slowed to an average of just 0.8 percent per year since 1996. This began with a bursting of the real estate bubble in the 1990s, which led to an asset-price freefall and price deflation, which then led to sharp declines in income and consumption that encouraged further economic depression and price deflation; it is a well-known vicious cycle.

When Prime Minister Shinzo Abe took office in December 2012, he adopted “Abenomics” to combat the economic malaise. Its three “arrows” seemed a bold move to restart the growth engine. The first arrow was aggressive monetary easing. The Abe administration was convinced that insufficient monetary easing had caused the Japanese economy to sink into chronic deflation. In response, Abe named as his new central bank governor Haruhiko Kuroda, then the president of the Asian Development Bank and a vocal proponent of aggressive monetary easing. The second arrow consists of structural economic reforms to spur growth in the private sector through drastic deregulation and liberalization of the entire economy, especially reducing the influence of government in various sectors. This will require a fundamental change in the traditional role of government in the economy, and even optimists concede that drastic deregulation and other reforms will take years to implement and even longer to have any real effect on economic growth.

So far, Abenomics has been disappointing. Japan’s big sales tax increase in April 2014 had a severe impact on the economy as people rushed to spend money before the rise took effect, resulting in a subsequent crash in consumer spending. More troubling has been a broader economic slowdown since Abenomics was launched.

The Japanese economy experienced virtually zero real growth between mid-2013 and mid-2014. Despite aggressive monetary easing, wage rates remain depressed because the labor market dynamics have changed. In Japan, baby boomers are now retiring and taking the best-paid jobs with them. Their replacements are far more likely to be part-timers, contractors and other lower-wage workers.

Even though the yen has depreciated significantly since the beginning of Abenomics, the impact on Japan’s trade balance has been not as positive as before. The reason is that after the Fukushima nuclear accident in 2011 Japan became a net importer due to increased imports of oil and gas. Yen depreciation has thus caused the real income of the average Japanese to fall.

There has also been a fundamental shift in the manufacturing sector, as Japanese companies make more products abroad. Thus, paradoxically, a weaker yen has made the trade deficit bigger, not smaller.

A SECOND MIRACLE ON THE HAN RIVER?

Since taking office in early 2013, President Park has looked for a formula to ignite her vision of a new Han River miracle. On the first anniversary of her inauguration, Park announced a Three-Year Plan for Economic Innovation, making the government’s active role in the initial years of economic development was generally positive, but this is now far outweighed by its negative side-effects.

The main challenge facing the South Korean economy now is the intrusive presence of the government, the undesirable legacy of the 1960s to the 1980s. The government’s active role in the initial years of economic development was generally positive, but this is now far outweighed by its negative side-effects.

South Korea’s economy and society have been suffering from the pervasive influence-peddling and outright corruption of present and former government bureaucrats, known in South Korea as the “Mofia” (a play on the words Ministry of Finance and mafia). The mofiosos occupying plum jobs at major financial institutions after their retirement from government have been largely blamed for the backward state of the banking and financial system. The same is true for other sectors of the economy where former government bureaucrats hold sway.

Unless the government’s drive to radically restructure the economy bears fruit, it is not just possible but perhaps probable that the South Korean economy will indeed follow the example of Japan and experience “lost decades” as well.

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