The Korean Economy *Past, Present, and Future*
An Interview with Marcus Noland

Marcus Noland (PhD, Johns Hopkins University) is a Senior Fellow and the Executive Vice President and Director of Studies, Peterson Institute for International Economics, where from 2009 through 2012, he served as the deputy director. Noland is also a Senior Fellow at the East-West Center. He has held teaching or research positions at places such as Yale University, Johns Hopkins University, University of Southern California, Tokyo University, the Korea Development Institute, and the East-West Center. Noland has written extensively on the economies of Japan, Korea, and China. He won the 2000-01 Ohira Memorial Award for his book Avoiding the Apocalypse: The Future of the Two Koreas. *Noland has also served as an occasional consultant to the World Bank and the National Intelligence Council and has testified before the US Congress on numerous occasions.*

Past

Lucien: *Marcus, thanks for doing the interview. According to most accounts, even as late as early 1961, the Republic of Korea was seen as a place that was unlikely, at best, to experience significant economic growth. Assuming my impression is correct, what perceived and/or real obstacles to growth caused so many experts to think of the ROK as an economic "basketcase"?*

Marcus Noland: During Japanese colonial occupation, the northern part of the Korean peninsula was more industrialized; the South was the breadbasket. At the end of the Second World War, when the peninsula was partitioned, levels of per capita income and human capital in the North exceeded those attained in the South.

In 1950, North Korea attacked South Korea in a bid to forcibly unify the peninsula, drawing the United States and China into the conflict. Most of the capital stock was destroyed as armies from both sides twice traversed nearly the entire length of the peninsula.

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For the next decade, policy under South Korean President Syngman Rhee emphasized preservation of his rule over economic prosperity. Economic policy could be summarized as the "three lows": maintenance of a low price for grain (mainly to court urban residents who could most easily challenge the regime); a "low," that is an overvalued, exchange rate; and low interest rates. The latter two conditions created excess demand for foreign exchange and bank loans, respectively, which then created political opportunities for distributing rents (as well as incentives for corruption). The low interest rate policy also discouraged saving and capital accumulation.

Foreign soldiers needed some local currency to purchase goods in the local economy. The host government (South Korea) made a local currency transfer (in this case, *wŏn*) to the troops' sponsoring entity, which agreed to pay back this advance. From the narrow standpoint of repayment, it was in South Korea's interest to maintain an overvalued currency (and thereby maximize the hard currency inflow from the United States and United Nations), though it hurt the country's international competitiveness and ultimately made it even more aid-dependent. The "three lows" may have been good politics, but they were lousy economics.

Lucien: *General Park Chung-hee's May 1961 coup that brought his government to power is now considered to be an important precursor of the ROK's subsequent economic development. Leaving aside Park's authoritarian politics, which will be addressed in the second segment of this ROK Focus Series, what are some of the major reasons, in your opinion, the Park government apparently dramatically succeeded in lifting the ROK from the economic doldrums when his major predecessor failed?*

Marcus Noland: It is not widely appreciated how Park Chung-hee lacked any conventional basis for establishing legitimacy. As a former officer in the Japanese army, he could not lay claim to nationalist credentials. Coming from a poor, rural background, he was not a member of the *yangban* (gentry) class and could not position himself as the heir to a traditional ruling lineage. He had overthrown a US-backed government (the last coup in Korea was in 1392), and having been involved in a late 1940s network of communist cells within the ROK Army (he was later pardoned), he was regarded as politically suspect by the United States. He sought legitimacy through economic development and his ability to defend the country against Northern aggression. Readers might want to check out the newsreel-type propaganda footage now available on YouTube. Park's twin arguments for legitimacy—national security and economic development— are repeatedly emphasized.

While economic performance under Syngman Rhee was not outstanding, considerable change had occurred beneath the surface. Encouraged both by the United States and by its rivalry with North Korea, the government redistributed the mostly Japanese-owned agricultural land to its tillers. Public education was expanded. American aid made overseas education and training possible for thousands of South Koreans.

The key trigger was Park's reversal in 1963 of the "three lows" strategy. After two years of poor economic performance, the military government unified the existing multiple exchange rate system, devalued the currency, raised the real interest rate, and initiated a series of wide-ranging reforms. The domestic saving net of aid began rising rapidly. Domestic investment

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began rising even faster. International trade started expanding. An agricultural revitalization movement was launched. Having grown 3.4 percent annually between 1953 and 1962, growth accelerated to 8 percent a year in the following decade For forty-five years starting in 1963, the economy averaged over 7 percent growth annually.

In 1963, primary products such as agricultural produce accounted for more than half of South Korea's exports, with human-hair wigs the third-leading item. A decade later, South Korea's exports were dominated by manufactures such as textiles, electrical products, and iron and steel; only one primary product category, fish, made the top ten. Today, South Korea's merchandise exports are concentrated in motor vehicles and telecommunications equipment, and the country generates increasing cultural exports, typified by PSY and his "Gangnam Style."

Lucien: *The ROK had some significant problems in the Asian financial crisis of the mid-1990s. Why was this the case, and what kinds of change (if any) did policymakers implement to lessen the probability of another meltdown?*

Marcus Noland: Under Park Chung-hee, the South Korean economy followed Japan's reasonably well-defined industrial path. But problems arose as South Korea approached the international technological frontier. The old development strategy of imitating the prior trajectories of more advanced economies was no longer adequate, which put a heightened premium on the ability of corporate managements and their financiers to discern emerging profit opportunities. But decades of state-led growth had bureaucratized the financial system and created a formidable constellation of incumbent stakeholders opposed to liberalization and a transition toward a more market-oriented development model.

The financial sector liberalization undertaken in the early 1990s was less a product of textbook economic analysis than of parochial politicking. It created unintended incentives for short-term bank borrowing and left the economy vulnerable to a variety of negative shocks. In 1997, in the context of the broader Asian upheaval, South Korea experienced a financial crisis with net cleanup costs that eventually amounted to 16 percent of national income.

The 1997–98 crisis, though triggered by external events, was largely a product of internal problems, relating at base to a weak system of corporate governance, a dysfunctional financial system, and poor labor relations. In its aftermath, South Korea undertook considerable reforms, most evidently in the financial sector. Prudential regulation was strengthened through the creation of the Financial Supervisory Commission and the introduction of new regulatory practices, approaches, and standards. In the corporate sector, South Korea experienced what was at the time the largest corporate bankruptcy in history (Daewoo) and came close to another (Hyundai), but the *chaebŏl* (family-dominated conglomerates) embarked on a process of restructuring, encouraged by market forces, political prodding, and legal changes. In the labor market, the government greatly broadened and strengthened the social safety net. All in all, in the period following the 1997–98 crisis, South Korea arguably made better progress on economic reform than the other heavily affected Asian crisis countries, or Japan, for that matter.

Present

Lucien: *What are some of the ROK's current economic strengths, and what sectors of the economy are in trouble, in your opinion? The ROK appears to be following in Japan's footsteps regarding increasingly low fertility rates. What, if any, serious possible policy options are being considered in the public or private sectors to address this phenomenon in ways that might lessen the negative economic ramifications of low birth rates?*

Marcus Noland: While in comparative terms South Korea largely avoided the worst of the recent global financial crisis, it did not escape unscathed. Experiencing a sudden stop in capital flows following the collapse of Lehman Brothers, peak-to-trough the wŏn plunged 43 percent against the US dollar. In part due to this recent history, South Korea has introduced measures to control cross-border capital flows and has been pushing the idea of international financial "safety nets" in the G-20.

Economists normally ascribe long-run growth to the availability of basic inputs to production, such as labor and capital, together with productivity increases. In the case of South Korea, during its high-growth period, it benefited not only from the general openness of the world economy but also from a rapid expansion of the labor force and a relatively low number of dependents per worker, combined with a significant increase in the educational level of the workforce. Those favorable demographic factors are now reversing, however. In 2010, the "core productive population," aged twenty-five to forty-nine, fell for the first time. Under current trends, South Korea's dependency ratio will begin rising within the next decade; and by 2030, population size will begin to decline, falling below its current level by 2040.

Whatever the specifics, considerable evidence suggests that South Korea faces a real problem with respect to service sector productivity—and the magnitude of this problem is growing.

If the forecasts prove broadly correct, they imply increases in health and pension burdens, which will in turn necessitate adjustments in South Korean policies and practices, such as increasing the retirement age, improving the efficiency of delivery of health care and retirement services, and utilizing female labor—especially educated women—more efficiently. South Korea, which among the members of the Organization for Economic Cooperation and Development (OECD), the club of rich industrial democracies, has some of the most restrictive immigration policies, may have to reconsider them as well in response to changing demographics. South Korea's demographic bonus could turn into a demographic onus.

Investment has not returned to levels prior to the 1997–98 crisis, though in this respect South Korea is not alone; investment in other crisis-affected Asian economies has never fully recovered, either. This pattern may reflect overinvestment during the 1990s boom; long-term falling profitability as capital is accumulated; a possible reduction in business confidence associated with increasing demands for "economic democracy;" and a consequent reluctance by the business sector to make irreversible commitments, which, after all, are what investment represents. Labor market regulations, which make it difficult to fire permanent workers once they are hired, further reinforce caution with respect to capacity expansion.

Under such circumstances, squeezing the maximum productivity out of labor and capital inputs is essential to maintain growth. South Korea faces important competitive challenges posed by its intermediate geographical position between low-wage China and high-technology Japan.

One can conceptualize the process of productivity advancement as encouraging innovation in emerging sectors or activities while at the same time terminating practices that discourage productivity in existing activities. South Korea falls badly behind in the heavily regulated service sector, where the greatest opportunities for productivity increase lie.

Productivity in the South Korean service sector lags behind that of the industrial sector, and this divergence is far larger in South Korea than it is in most other OECD countries. In fact, estimates by the International Monetary Fund and the Hyundai Research Institute indicate that while total factor productivity growth, a concept that measures productivity increase taking the application of both labor and capital into account, has been rising at a rate of 3-4 percent per year outside the service sector over the last quarter-century, productivity in the service sector has actually declined. In fact, according to these calculations, the South Korean service sector is generating less output, once capital and labor inputs are taken into account, than it was in the 1970s. Whatever the specifics, considerable evidence suggests that South Korea faces a real problem with respect to service sector productivity—and the magnitude of this problem is growing. China's rise means that manufacturing is likely to play a smaller role in the South Korean economy in the future, a trend that will be reinforced domestically by the growth of South Korea's elderly population, who tend to consume relatively more services than the population as a whole.

Lucien: *So what can be done?*

Marcus Noland: Financial sector development could increase productivity in that important sector; encourage aggregate saving and investment; increase the allocative efficiency of investment; improve access to capital for productive small and medium-sized enterprises (SMEs); and, by extension, stimulate competition in the economy more generally.

What is likely to prove difficult over the longer term is balancing the need to increase financial integration between South Korean corporations and their foreign counterparts with the proclivity of South Korea, located between the large economies of China and Japan, to impede this process to preserve national corporate autonomy. In the future, the development of large sovereign wealth funds is likely to enhance the salience of these concerns, raising the specter of foreign government-affiliated entities taking over South Korean firms. South Korea has a history of xenophobia when it comes to foreign investment; one hopes that capital controls undertaken in response to the crisis do not morph into more general restrictions on foreign investment.

The role of foreigners is particularly salient in light of the perennial challenges posed by South Korea's industrial structure, which is dominated by a small number of large chaebŏl. Foreign competitors are one potential source of market discipline, which can be imposed on the chaebŏl without resorting to direct regulation, and a potentially positive and constructive force. Foreign investors and the good governance movement are natural allies in promoting more fair and transparent practices in the South Korean corporate sector.

Beyond the financial sector, regulation has long encouraged segmentation of the South Korean labor market into a small cadre of relatively secure and legally protected employees, who are mainly employed by chaebŏl or public enterprises, and a much larger group of part-timers and workers employed by SMEs, who labor under far less secure conditions. This dualistic system is rigid in some respects and flexible in others and offers considerable protection to some workers but few safeguards to others. South Korea could gain from reducing this labor market dualism and segmentation, continuing to rein in highly restrictive regulations that hamper South Korea in international competition, while building legislation to protect the interests of nonregular workers and encouraging the most productive use of labor.

Of course, unification would have benefits as well as costs. Given the extreme militarization of North Korea, a peace dividend would be associated with the reduction of military tensions on the Korean peninsula and the concomitant reduction in military expenditure.

Lucien: *We've been hearing a lot about North Korea lately. What are the implications for the South Korean economy?*

Marcus Noland: North Korea represents the world's largest contingent liability. Unification generally boils down to variants of four scenarios:

- Peaceful, gradual, consensual unification measured in decades. This is the official position of both governments.
- An abrupt German-style collapse of the North and its absorption by the South.
- A violent conflict in which one side prevails.
- A permanent division of the peninsula.

The first outcome is possible though doubtful. The third possibility is horrific and, given the maintenance of deterrence on the peninsula, which has prevented large-scale conflict for more than 60 years, hopefully will not eventuate. That leaves the second and fourth possibilities. Which of these two scenarios prevails revolves around whether North Korea successfully addresses its economic, political, and diplomatic challenges and survives permanently as an independent political entity or whether the multiple stresses that the regime confronts prove unmanageable and it experiences abrupt change, culminating in its absorption by South Korea. Ultimately the key determinant is the capacities of the North Korean leadership. While the rest of the world can influence incentives at the margin, we should not exaggerate how much influence we have on these internal developments.

Whether unification occurs through a prolonged consensual process or more abruptly, as it did in the German case, one can think of two effects. The first is the pure economic impact of integration, and the second is the impact on internal political economy. With respect to the first issue, the key is the magnitude and nature of cross-border movements of labor and capital.

North Korea is arguably the world's most distorted economy. Fundamental reform could have two profound effects: First, exposure to international trade and investment would significantly increase. Second, changes in the composition of output could be tremendous, involving literally millions of workers changing employment. My computer modeling of this process indicates that unification would be accompanied by an increase in inequality in North Korea, albeit in the context of a significant improvement in living standards and a dramatic reduction in poverty.

For South Korea, in pure economic terms, integration of product markets alone is unlikely to have a major impact on the South Korean economy—trade with North Korea would mostly substitute for trade currently conducted with other countries and, given North Korea's small size relative to South Korea, would have a trivial impact on South Korea.

Integration of labor and capital markets is a different matter, however, and could have a profound effect on the South, depending on how fast North Korea could absorb new technology, how much labor would be permitted to migrate from the North to the South, and how much capital would be invested in the North.

A critical variable affecting virtually every issue of interest would be the magnitude of cross-border labor migration from North to South. Migration would act as a substitute for capital transfer. The more people are allowed to migrate, the lower the amount of capital investment necessary to reconstruct the North Korean economy.

My research suggests that under a scenario of moderate, controlled, cross-border migration, and rapid convergence in North Korea toward South Korean levels of productivity, bringing the level of income in North Korea to half that of the South would require a decade and well over $1 trillion (roughly equal to South Korea's annual national income).

Such a process would be accompanied by a mild slowing of the South Korean growth rate, a rapid acceleration of the North Korean growth rate, and an increase in peninsular output relative to the continued division of the peninsula.

Within South Korea, income would shift from labor to capital and within labor, from relatively low-skilled to relatively high-skilled labor. If one assumes that highly skilled people are the predominant owners of capital, then this implies that unification will generate increased income and wealth inequality in South Korea, absent some compensatory government policies.

Of course, unification would have benefits as well as costs. Given the extreme militarization of North Korea, a peace dividend would be associated with the reduction of military tensions on the Korean peninsula and the concomitant reduction in military expenditure.

Put crudely, the economics come down to the movement of Southern money north or the movement of Northerners south.

The risk for South Korea associated with engagement is not the creation of symmetric dependency, as is sometimes alleged. The process of economic integration would create highly asymmetric dependency in favor of the South. The real threat to the South of economic integration lies elsewhere. The South Korean economy has problems with nontransparent and corrupt government-business relations, as documented by the nightly news, as well as more systematic cross-national surveys produced by the World Bank, Transparency International, and others. In the North, there is no real difference between the state and the economy. Any large-scale economic integration between the North and the South will be by its very nature a highly politicized process, and the expansion of the government's role in the South Korean economy that would accompany this process could be a setback for the quality of governance.

Lucien: *Thanks for an excellent interview!* ■