Korean Economy:
Crossing Lower-High Income Syndromes

12th INDIA-KOREA DIALOGUE

October 23-24, 2013, New Delhi

Choong Yong Ahn, Ph.D.
Foreign Investment Ombudsman /
Distinguished professor, Chung-Ang University /
Former Chairman, Presidential Regulatory Reform Committee
cyahn@kotra.or.kr / cyahn@cau.ac.kr
Order of Presentation

I. Recent Economic Performance

II. Lower-High Income Syndromes but Still Strong Macro Fundamentals

III. “Creative Economy” vs “Fair Economy”

IV. Searching for New Engines of Growth: Examples

V. Implications
## Korea’s Economic Growth Indicators and Exchange Rates

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP (US$ one trillion)</th>
<th>GDP (KRW trillion)</th>
<th>Annual Growth Rate of GDP (KRW)</th>
<th>Growth Rate by Sector (%)</th>
<th>Nominal Exchange Rate* (KRW/US$)</th>
<th>Per Capita GDP (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>505</td>
<td>6,514</td>
<td>4.0</td>
<td>1.6</td>
<td>2.4</td>
<td>4.7</td>
</tr>
<tr>
<td>2002</td>
<td>576</td>
<td>7,205</td>
<td>7.2</td>
<td>2.2</td>
<td>8.4</td>
<td>7.7</td>
</tr>
<tr>
<td>2003</td>
<td>644</td>
<td>7,671</td>
<td>2.8</td>
<td>5.4</td>
<td>5.4</td>
<td>1.7</td>
</tr>
<tr>
<td>2004</td>
<td>722</td>
<td>8,269</td>
<td>4.6</td>
<td>9.1</td>
<td>9.9</td>
<td>2.4</td>
</tr>
<tr>
<td>2005</td>
<td>845</td>
<td>8,652</td>
<td>4.0</td>
<td>1.3</td>
<td>6.1</td>
<td>3.5</td>
</tr>
<tr>
<td>2006</td>
<td>951</td>
<td>9,087</td>
<td>5.2</td>
<td>1.5</td>
<td>8.0</td>
<td>4.4</td>
</tr>
<tr>
<td>2007</td>
<td>1,049</td>
<td>9,750</td>
<td>5.1</td>
<td>4.0</td>
<td>7.1</td>
<td>5.1</td>
</tr>
<tr>
<td>2008</td>
<td>931</td>
<td>10,265</td>
<td>2.3</td>
<td>5.6</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>2009</td>
<td>834</td>
<td>10,650</td>
<td>0.3</td>
<td>3.2</td>
<td>1.5</td>
<td>1.2</td>
</tr>
<tr>
<td>2010</td>
<td>1,014</td>
<td>11,733</td>
<td>6.3</td>
<td>4.4</td>
<td>14.7</td>
<td>3.9</td>
</tr>
<tr>
<td>2011</td>
<td>1,115</td>
<td>12,352</td>
<td>3.7</td>
<td>2.1</td>
<td>7.3</td>
<td>2.6</td>
</tr>
<tr>
<td>2012</td>
<td>1,130</td>
<td>12,725</td>
<td>2.0</td>
<td>0.6</td>
<td>2.2</td>
<td>2.5</td>
</tr>
<tr>
<td>2013</td>
<td>1,259*</td>
<td>-</td>
<td>2.8*</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

* Preliminary estimate

> Per capita income has stagnated at US$ 20,000 level in the past 8 years.
## Korea’s External Sector Performance

<table>
<thead>
<tr>
<th>Year</th>
<th>Export (US$ million)</th>
<th>Import (US$ million)</th>
<th>Trade Balance (US$ million)</th>
<th>Foreign Exchange Reserve (US$ 100 million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>151,172</td>
<td>138,143</td>
<td>13,029</td>
<td>1,028.2</td>
</tr>
<tr>
<td>2002</td>
<td>164,190</td>
<td>148,987</td>
<td>15,203</td>
<td>1,214.1</td>
</tr>
<tr>
<td>2003</td>
<td>199,692</td>
<td>175,664</td>
<td>24,028</td>
<td>1,553.5</td>
</tr>
<tr>
<td>2004</td>
<td>260,143</td>
<td>220,482</td>
<td>39,661</td>
<td>1,990.7</td>
</tr>
<tr>
<td>2005</td>
<td>289,873</td>
<td>257,016</td>
<td>32,857</td>
<td>2,103.9</td>
</tr>
<tr>
<td>2006</td>
<td>336,494</td>
<td>305,061</td>
<td>31,433</td>
<td>2,389.6</td>
</tr>
<tr>
<td>2007</td>
<td>389,569</td>
<td>352,439</td>
<td>37,129</td>
<td>2,622.2</td>
</tr>
<tr>
<td>2008</td>
<td>434,652</td>
<td>429,481</td>
<td>5,170</td>
<td>2,012.2</td>
</tr>
<tr>
<td>2009</td>
<td>358,190</td>
<td>320,324</td>
<td>37,866</td>
<td>2,699.9</td>
</tr>
<tr>
<td>2010</td>
<td>461,445</td>
<td>421,362</td>
<td>40,083</td>
<td>2,915.7</td>
</tr>
<tr>
<td>2011</td>
<td>551,765</td>
<td>520,105</td>
<td>31,660</td>
<td>3,064.0</td>
</tr>
<tr>
<td>2012</td>
<td>552,565</td>
<td>514,228</td>
<td>38,338</td>
<td>3,269.7</td>
</tr>
</tbody>
</table>

Unit: US$ million

Continued trade surplus in the last decade helped accumulate F.E. reserve.
“Lower-High Income” Syndromes: Challenges to Cross “the Final Threshold”

- **World Bank Income Group Classification in 2011**

<table>
<thead>
<tr>
<th>Income Group</th>
<th>Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low income group</td>
<td>below US$ 1,005</td>
</tr>
<tr>
<td>Lower-middle income group</td>
<td>US$ 1,006-3,975</td>
</tr>
<tr>
<td>Upper-middle income group</td>
<td>US$ 3,976-12,275</td>
</tr>
<tr>
<td>High income group</td>
<td>Above US$ 12,296</td>
</tr>
</tbody>
</table>

- **Per Capita GDP has fluctuated US$ 20,000 levels over the past 6 years**

☞ For the first time to record 2% growth p.a. over 2 years, 2012 and 2013, in a row except the 2008 global financial meltdown period.

☞ Syndromes:

1. Job-less growth in manufacturing sector caused an on-going chronic unemployment.
2. Shrinking middle income class
3. Low birth rate and rapidly aging population
4. Income polarization and rising popular demand for broader welfare spectrum
5. Ideological divide: labor unions and large conglomerates, low income vs high income group
6. Relocation of industrial sites abroad as domestic wages rise
Korea Is Faced with Long Term Structural Challenges to Economic Growth

Declining Birth Rate (# of babies per woman)

Widespread Household Deficit

Maturing GDP growth

Manufacturing job creation

Source: BOK, FSS, National Statistics Office, McKinsey Global Institute
## Declining G.R. of Potential GDP, Factor Stocks, and Stagnant TFP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential GDP</td>
<td>7.9</td>
<td>7.0</td>
<td>4.5</td>
<td>3.8</td>
</tr>
<tr>
<td>Capital stock</td>
<td>5.1</td>
<td>4.6</td>
<td>2.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Labor stock</td>
<td>1.4</td>
<td>0.9</td>
<td>0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Total factor</td>
<td>1.4</td>
<td>1.5</td>
<td>1.7</td>
<td>1.7</td>
</tr>
</tbody>
</table>

Unless Korea reverses the sharply declining trend of potential GDP, Korea may remain a stagnating economy at around US$ 20,000 for many years.
GINI coefficient for urban households over time shows a gradual improvement until the mid-1990s but a drastic deterioration during Asian financial crisis.

Source: KOSIS DB, the Bureau of Statistics of Korea
Income polarization had worsened sharply every time Korea was hit by external shocks such as Asian and global financial crisis.

Source: KOSIS DB, the Bureau of Statistics of Korea
Shrinking the middle income group
Household Credit Outstanding: A Potential Time Bomb

- Household credit divided by disposable household income
- Household credit divided by GDP

A serious warning as a time bomb against financial and macro instability and domestic consumption decline by rising debt service burden

Source: Ministry of Strategy and Finance, Korea
Forecasts of the Tax Revenue and the Tax Expenditure to GDP

Still lower than OECD average, total volume of consolidate fiscal debt is expected to bulge beginning in 2023~2024 if the current trend continues.
Korea’s Outbound and Inbound FDI

- There has been an increasingly widening gap between outbound and inbound FDI since 2006 and onward.
- Promotion of inbound quality FDI is very urgent.

<table>
<thead>
<tr>
<th>Year</th>
<th>Outbound FDI (Actual : A)</th>
<th>Inbound FDI (Arrived : B)</th>
<th>Inbound FDI (Notified)</th>
<th>B-A</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>4.0</td>
<td>3.8</td>
<td>9.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>2003</td>
<td>4.8</td>
<td>5.1</td>
<td>6.5</td>
<td>0.3</td>
</tr>
<tr>
<td>2004</td>
<td>6.7</td>
<td>9.3</td>
<td>12.7</td>
<td>2.6</td>
</tr>
<tr>
<td>2005</td>
<td>7.3</td>
<td>9.6</td>
<td>11.6</td>
<td>2.3</td>
</tr>
<tr>
<td>2006</td>
<td>11.7</td>
<td>9.1</td>
<td>11.2</td>
<td>-2.6</td>
</tr>
<tr>
<td>2007</td>
<td>22.6</td>
<td>7.9</td>
<td>10.5</td>
<td>-14.7</td>
</tr>
<tr>
<td>2008</td>
<td>23.9</td>
<td>8.4</td>
<td>11.7</td>
<td>-15.5</td>
</tr>
<tr>
<td>2009</td>
<td>20.2</td>
<td>6.7</td>
<td>11.5</td>
<td>-13.5</td>
</tr>
<tr>
<td>2010</td>
<td>23.1</td>
<td>5.3</td>
<td>13.1</td>
<td>-17.8</td>
</tr>
<tr>
<td>2011</td>
<td>26.5</td>
<td>6.4</td>
<td>13.7</td>
<td>-20.1</td>
</tr>
<tr>
<td>2012</td>
<td>23.2</td>
<td>10.4</td>
<td>16.3</td>
<td>-12.8</td>
</tr>
</tbody>
</table>

(Unit: US$ billion)
In the middle of turbulent global depression, Korea’s sovereign ratings have been stabilized although temporary downgrade have occurred.

Korea stood apart from the regional trend of capital outflows and currency depreciation, underlining the importance of strong fundamentals and credible policy frameworks in the face of global liquidity shocks. (IMF. October)
Korea’s Active Participation in Diverse Mega Intra-Regional Integration Paths in the Asia-Pacific Rim for Sustainable Growth

- Korea has multi-track effective FTAs including K-U.S., K-EU, K-ASEAN, K-India.
- Korea is likely to declare soon its joining TPP.
- Korea is also likely to push actively the RCEP.
- Korea enters the second phase of Korea-China FTA.
- Korea also push the C-J-K FTA.

☞ Korea should join TPP and help its convergence with RCEP toward an open Asia-Pacific economic community.
Korea should join TPP and help its convergence with RCEP

INDUSTRY & POLICY

Ahn Choong-yong
Distinguished Professor, Chung-Ang University

The economic landscape of the Asia-Pacific rim appears to be undergoing a rapid transition due to two ongoing, intra-regional, mega economic-bloc movements. One is the U.S.-anchored Trans-Pacific Partnership Agreement (TPP) with 11 other participating economies, including the initial member states of 2005 (Brunei, Chile, New Zealand and Singapore) and those that entered later (Australia, Canada, Japan, Malaysia, Mexico, Peru and Vietnam). The other free trade initiative is the Regional Comprehensive Economic Partnership (RCEP), which includes ASEAN and its six FTA partners (Australia, China, India, Japan, Korea and New Zealand).

The proposed TPP accounts for 38 percent of global GDP and 30 percent of global trade and aims to be concluded under President Obama's priority agenda within the year or by June 2014. On the other hand, the RCEP, with a combined GDP of about $17 billion, would create the world's largest trade bloc and account for 40 percent of global trade. Negotiations will maybe conclude by the end of 2015. China has recently been very enthusiastic about concluding the RCEP deal as soon as possible.

In a larger sense, all the negotiating members, except India, of both the TPP and RCEP, which are an intersection of seven economies, constitute the Asia-Pacific Economic Cooperation (APEC) entity. This body envisions a free trade-oriented Asia-Pacific community.

In 1994, all the APEC leaders at Bogor, Indonesia, adopted the Bogor goals, which aim for free and open trade and investment in the Asia-Pacific by 2010 for developed economies and by 2020 for developing economies. Although the APEC process has been slow, the U.S., China and Japan have been fully committed to APEC's Asia-Pacific community, specifically a Free Trade Area of the Asia-Pacific (FTAAP).

Some commentators view the TPP as a part of the U.S.' pivot policy to check the rapid rise of China's hegemonic power in Asia. Following the successful conclusion of the KORUS FTA, Korea began negotiating a bilateral FTA with China, to enter the second phase for a high-quality and comprehensive FTA.

Simultaneously, Korea was also invited to join the TPP negotiation rounds by the U.S. after the conclusion of the KORUS FTA.

Given these various integration paths, what position should Korea take? Above all, Korea should not hesitate to join the TPP negotiations for not only its own national interest, but also the eventual integration of the TPP and RCEP toward the FTAAP.

It is true that Korea became the first significant economy to have an effective FTA with the EU in 2011, the U.S. in 2012, ASEAN and many medium and smaller negotiating economies of the TPP, except Japan. So, it may be easy for Korea to join the TPP process.

But if we miss the chance to be a founding member of the TPP, which appears to focus on the next generation of trade rules, Korea will have to pay high entrance fees in the future and accept an agreed-upon framework without being able to negotiate for its best interest. In other words, Korea cannot afford to take a wait-and-see approach.

In contrast to its hitherto active pursuit of multi-track FTAs, Korea has been silent about mega trade deals in the Asia-Pacific. We have been concerned about China's response to our joining the TPP, as China is Korea's number one trading partner and most favored destination for outbound foreign direct investment. China is also a strategic and influential partner of Korea's for the prevention of North Korea's nuclear ambitions.

Recently, some Chinese scholars suggested that China needs to join the TPP or even establish a bilateral FTA with the U.S. for sustainable growth. In recent years, China and the U.S. have become increasingly interlocked in terms of trade and China's purchase of the lion's share of U.S. treasury bills.

The more the two countries play a zero-sum hostile game for the sake of hegemonic leadership, the more unlikely it is that the APEC goals in the Asia-Pacific rim economies will be realized. By actively joining the TPP and RCEP, and through Korea-China FTA negotiations, Korea could facilitate a convergence of the two mega trade deals by bringing China into a better market-disciplined economy with IPR and investor protection, global labor standards and more.
1. Creative economy means “a range of economic activities which are concerned with the generation or exploitation of knowledge and information” and is “revitalizing manufacturing, services, retailing and entertainment industries” by Hawkins (2001)
   - eg. advertising, architecture, art, crafts, design, fashion, film, music, performing arts, publishing, R&D, software, toys and games, TV and radio, and video games

2. IT-based fusion with non-IT industries, led by two key trends: Integration and Convergence
   - eg. Samsung and LG to reinvest 20 software centered companies

3. New Idea → Venture business
   - eg. Bee’s poison needles for skincare ⇒ extraction of bee’s poison for medicare

4. Creative economy starts from new ideas.
   - Breaking and mixing ideas and things in unconventional ways create new ideas.
   - The well-developed legal system such as patents and copyright is mandatory.
   - Failure and success need to be treated equally.

5. A key issue: How to create angel funds to finance the high risk and high return projects and to minimize “moral hazards” in designing financing?
1. Fair trading among intra-subsidiaries of big conglomerate: Regulation is placed on transaction volume and transfer pricing mechanism.

2. Equal footing transactions between big companies and outsourced SMEs

3. Minimizing underground economic activities towards transparency and fiscal revenue

4. Corporate Social Responsibility has been emphasized.

5. Inclusive growth and shared growth in favor of SMEs and small shops have been a priority while “suppressing” big conglomerates.
   - Big conglomerates tend to take “wait and see attitudes” while delaying investment projects.
Example New Engines for Growth: Financial Sector Development

Market Cap / Nominal GDP (%) – 2012e

- Engine for GDP growth
- Creator of high value jobs
- Create stimulus for SME and priority sector support
- Potential to attract FDI

Source: Citi Investment Research and Analysis Estimates
Korean banking Sector Least Attractive in Asia

Banking Sector ROE and PBR forecasts for 2013

Source: Company, Bloomberg, FactSet, Standard Chartered Research estimates

*PBR: Price to Book Ratio
### Observations

- Sector profitability rapidly and structurally declining
- Low interest and high competition putting pressure on loan/deposit prices
- Credit spreads do not adequately cover inherent risk premium and cost of funds
- Societal view of banks as “public utility” that should not earn “excessive” profits
- Unless trend is reversed, real risk that financial sector will shed jobs and not be able to support economic growth
- Only healthy, innovative and profitable financial firms can make a strong contribution to a vibrant economy and fulfill their social responsibility

### Recommendations

- Develop shared vision for strategic importance of the financial services sector in supporting economic growth, facilitating trade, creating high value jobs, attracting direct investment
- Government, legislators and private sector should lead a joint, bi-partisan effort to develop a long-term roadmap for the development of the financial services sector
- Enable banks to diversify revenues (especially fee income) by selectively removing regulatory barriers (e.g. physical commodities business with end-users, brokerage products, consultancy services etc)
Example New Engines for Growth: Tourism and Pharmaceutical Sector

- MICE is increasingly becoming job creating and highly promising business.
- By 2020, Korea aims to attract 10 million Chinese tourists alone.
- Medi-tourism is a newly emerging industry for Korea.
- East Asia should pursue an early version of “Open Sky Agreement”.

☞ Korea is known as the most ideal place for clinical research.

☞ Global top notch pharmaceutical companies have involved in a “collabornomics”. Korea must develop international cooperation for original drug development beyond current genetic products.
Example New Engines for Growth: S/W, Design, Food Processing, Cultural Commodities, etc.

- Big data management ⇒ International business services
- New fashion ⇒ Korean wave
- Health foods ⇒ New export items
- “Cultural commodities” ⇒ movie films, cartoons, games, comics.

New Ideas ➔ Commercialization

High Risk & High Return
Implications

- Maintaining optimum balancing between increasingly popular demand for broader social welfare and growth inertia with viable entrepreneurial spirit
- A robust “inclusive growth” to enhance SMEs competitiveness and job creation must be pursued.
- Provision of social safety net must receive higher priority
- Yet, a “market friendly animal spirit” must be revived.
- Critical to expand economic cooperations with emerging economies
- Korea and India as likeminded strategic partners need to work together in knowledge sharing and software development in addition to manufacturing linkages in a sustainable win-win framework.
References


Hesmondhalgh, David (2002), The Cultural Industries, SAGE


World Bank, 1993, The East Asian Miracle, Oxford University Press
Q & A

Thank you