

## Seung Park: Swiftly changing economic environment in Korea

Speech by Dr Seung Park, Governor of the Bank of Korea, at the Asia Society, New York, 3 June 2004.

\* \* \*

### Introduction

Mr. President,  
Distinguished members of *the Asia Society*,  
Ladies and gentlemen,

I am delighted to stand before you here today as the guest of *the Asia Society*. It is a great privilege to have this opportunity to speak to so many leading members of New York's business community, and a pleasure to see your great interest in the Korean economy. Let me at this point voice my deep gratitude to the President of *the Asia Society*, *Nicholas Platt*, and to all of those involved for inviting me to address you today.

In the almost fifty years since it was founded in 1956, *the Asia Society* has played an invaluable role in building up the cooperation and furthering the flow of ideas, people and investment between the countries of Asia and the United States. Indeed, it has contributed to no small degree to the astonishing economic development of Asia today.

Members of *the Asia Society*,

I salute your achievements and congratulate you wholeheartedly upon the success of *the Fourteenth Asian Corporate Conference*, held recently in Seoul.

I would like to speak to you today about the swiftly changing economic environment that Korea is now confronting and about our responses to it. My focus will be on the hollowing-out of manufacturing.

### The hollowing-out of Korean manufacturing

The hollowing-out of Korea's manufacturing sector, as many of you will be quite aware, is now proceeding at a very fast pace.

Korean companies are reluctant to make domestic investments in manufacturing. In contrast, they are undertaking many new investment projects abroad and are increasingly relocating domestic production lines overseas. Last year, facilities investment in Korea shrank by 1.5% while, in striking contrast, Korean direct investment in China rose by more than 40%. A recent survey found that more than 30% of Korean small and medium-sized enterprises, SMEs, were either actively planning direct investment projects abroad or had a preference for investing overseas. In the case of export-oriented firms, this figure rose to more than 50%. More than one million jobs have been created by the ten thousand or so Korean enterprises that have set up businesses in China. At the same time, the rate of unemployment among people in their twenties in Korea has reached a high level of above 7%.

Inward direct investment by foreign companies, meanwhile, has also fallen off. Flows of foreign direct investment into the Korean manufacturing sector stood at 2.9 billion dollars in 2001, but this figure has continued to shrink since then, reaching 2.3 billion dollars in 2002 and just 1.7 billion dollars last year.

Owing to this reluctance to invest in the country on the part of both home and foreign businesses, we are witnessing the polarization of Korean industry and so-called jobless growth. Businesses involved in the high-tech sector, exporters and large companies are now generally showing fast rates of growth. On the other hand, companies in old technology sectors and SMEs dependent on domestic demand are becoming less and less competitive. What this means is that, with the contraction of the labor-intensive industries, in which SMEs predominate, there are fewer new job opportunities opening up even though GDP may be growing.

What has brought about this state of affairs is the tectonic drift taking place in the locus of global manufacturing activity. You will all, I think, be familiar with how the dynamic core of global manufacturing moved in the 1960s from the United States to Japan, and in the 1980s from Japan to the newly industrializing economies including Korea. Since the early 1990s, it has been shifting to

China and, as a part of this process, Korea is experiencing the hollowing-out of its own manufacturing sector.

### **Earlier hollowing-out of U.S. and Japanese manufacturing**

Each of these shifts in the locus of world manufacturing production, that is to say these processes of the hollowing-out of previous manufacturing bases, has had its own distinct characteristics. Even so, there has been a common thread running through them all, which is that their root causes have lain in losses of competitiveness due to high costs and low efficiency. U.S. wage levels back in the 1960s were four times higher than Japan's. In contrast, the rate of manufacturing productivity increase in the U.S. was less than one fifth that in Japan. Later, as wages, house prices, and land prices were continually rising in Japan from the early 1980's, while manufacturing productivity growth was only one half that of Korea's, Japan also began to experience fade-out in its manufacturing.

However, I should point out that when the process of hollowing-out was underway in the U.S. and Japan, the scales of the economies to which the torches were being passed were relatively small. To be exact, the Japanese economy was only one fifth the size of the U.S. economy in the 1960s, and the scale of the Korean economy was just one fifteenth that of Japan in the 1980s. The new manufacturing centers in these cases, therefore, had relatively small capacities for absorption. What is more, protectionism was a part of the predominant economic framework in those days. Various institutional devices could, therefore, be drawn upon to protect a country's industries.

This meant that the hollowing-out of manufacturing in the U.S. and Japan took place only gradually, leaving companies and government with sufficient time to respond appropriately. In the U.S., notably, industries faced with declining competitiveness did not shift their production facilities offshore but instead underwent rational processes of adjustment involving mergers and acquisitions, shifts of specialization and closures. To my mind, deindustrialization or a shift to a focus on services, better describes this process in the U.S. than to refer to it as a "hollowing-out of manufacturing". In the 1980s in Japan, similarly, efforts aimed at business rationalization went hand in hand with the simultaneous pursuit of product quality enhancement, the development of cutting-edge technology and the upgrading of industrial structure.

In this respect, the hollowing-out of manufacturing at first posed challenges to both the U.S. and Japan, but eventually served as opportunities for these countries to strengthen their economic order and upgrade their industrial structures.

### **Differences between the current hollowing-out of Korea and two previous cases**

The hollowing-out of Korean manufacturing that we are facing today is a part of the phenomenon of tectonic drift of world manufacturing to China. The high costs and low efficiency of the Korean economy, which has drained its competitiveness, has also played a large role.

Korea's curse of high costs and low efficiency dates back to the second half of the 1980s, when per capita national income reached the level of semi-developed countries. In the transition to a democratic society, long suppressed popular aspirations for higher living standards erupted, while at the same time asset price inflation led to the formation of real estate and stock market bubbles. Above all, after 1990, wages in manufacturing rose at an annual average rate of 11%, the fastest pace among all OECD members. So in one bound, Korea has become a high wage economy. Korea's wage levels are ten times those of China nowadays, and are also rather high compared to countries like Singapore, Hong Kong and Taiwan that are similar to Korea in terms of the stage of economic development.

What is more, Korea finds itself in a situation where its other social costs are also high. This comes as a result of not just the high real estate prices and heavy private spending on education, but also an endemic climate of confrontation between labor and management and the influence of vested interest groups. Meanwhile, in stark contrast, manufacturing productivity growth in Korea has been no more than one half that of China since the late 1980s.

The story does not end there. The environment in which this hollowing-out of Korean manufacturing is proceeding is very different from that which faced the U.S. and Japan.

Firstly, in contrast to what happened in the U.S. and Japanese cases, the economy to which the base of manufacturing is moving from Korea is one that is already much larger in scale and so has a huge capacity for absorption. The Chinese economy is now more than twice the size of Korea's. In addition,

it is showing the highest rate of growth worldwide, and so the gap between them in terms of economic scale is likely to widen.

Secondly, I should point out as well that the gap between Korea and China in terms of costs is much greater than what we saw in the cases involving the U.S. and Japan in the past. Whereas U.S. wages were four times those in Japan in the 1960s, and this ratio was much the same when the manufacturing base shifted from Japan to Korea in the 1980s, the difference between Korean and Chinese wage levels is now ten to one. Transportation costs in China are only one half those in Korea and the corporate tax rate in China is 15%, much lower than Korea's 27%.

Thirdly, in contrast to the previously prevailing mood of protectionism, the predominant current that has spread around the whole world is that of openness.

Under these circumstances, once the process of a hollowing-out of manufacturing is set in motion, the pace of its spread and development can only get faster. The effects that this has on society as a whole can then come to be almost destructive in their force. For textiles, footwear and white electric goods, the process of hollowing-out is already so far advanced that the major part of production by Korean firms now takes place in China. Even in sectors where hollowing-out is still in the early stages, its speed is rapidly gathering pace. I'm thinking here of sectors like computers, telecommunications, steel, chemicals and machinery, which are midway on the technological development ladder. As an example, about two years ago when I went to China, you could hardly see a locally produced mobile phone. Handsets imported from Korea were a big hit on the streets at that time. Today, however, China has already emerged as the world's largest producer and exporter of mobile phones.

### **Korea's policy options in dealing with the hollowing-out**

The hollowing-out of Korean manufacturing is taking place so fast and across such a wide spectrum that our firms and government have little time to spare. It has become a critical challenge to the Korean economy. Will the hollowing-out of manufacturing derail the Korean economy, or can we take advantage of it like the U.S. and Japan by turning it into an opportunity for a further quantum leap? The answer will depend upon how the Korean people react.

To embrace this challenge and exploit it as an opportunity to press forward the development of the Korean economy, the Korean people and its government should commit themselves to four major endeavors.

Firstly, we must set out to constantly strengthen economic cooperation between South and North on the Korean Peninsula. This will give us some short-term relief by softening the blow represented by the hollowing-out of manufacturing. South Korean firms should relocate their labor-intensive industrial facilities not just in *the Kaesung Industrial Complex*, which is now being constructed, but throughout the whole of North Korea. This will breathe new life into Korean enterprises whose competitiveness is now on the wane, and SMEs in particular. Within *the Kaesung Industrial Complex*, wage levels will be fifty-seven and a half dollars a month, which is lower than those in China. Land prices too are very reasonable, and the highest level of corporate tax rate will be only 14%. So there is a very good case for Korean firms to take full advantage of these points by relocating production to North Korea rather than to China or Vietnam.

Brisk economic cooperation between North and South is also very important in terms of preparing for national reunification. Now many of North Korea's industrial facilities are in a decrepit state. If they were to be exposed to the blast of open competition, there would be no option other than to scrap them entirely. Research institutes tell us that if reunification were to take place abruptly under these circumstances, with the coming down of the walls dividing the peninsula, several million North Koreans might be forced to flood into the South seeking refuge. This could lead to a national disaster. In this respect, strengthening South-North economic cooperation is obviously a much more desirable option.

Secondly, we need to rectify the high costs and low efficiency that now characterizes Korean society. It is vital to reach a social consensus on improving the climate of labor-management relations and removing the rigidities of the labor market. On the basis of this consensus, we should then work for wage stability. We also have to start to reduce the burden of other social costs. This involves bringing down housing purchase and rental costs through stabilizing house prices. It means educational reforms to cut the exorbitant level of spending on private tutoring. It also implies lowering the costs of the political system by allowing a more productive style of politics to take hold. We should also seek

ways to reduce the loss of efficiency caused by the tendency to collective egotism, often found in large-scale national investment projects.

Thirdly, we will push forward still more passionately in upgrading the industrial structure and improving corporate competitiveness. We have to revitalize the manufacturing sector with a new focus on advanced technology areas generating high value-added, such as the IT industry. At the same time, we must also promote deindustrialization or service-oriented industrialization, while giving every encouragement to our financial, logistical, cultural and knowledge-based industries. The share of manufacturing drops in any economy as it moves into a more mature stage of development, while that of the service sector rises. In terms of its weight in their economy, the manufacturing sector peaked in the U.S. in 1953, in Japan in 1970 and in Korea in 1988. It then showed a steady decline in each case. By upgrading its industrial structure in this way, Korea can avoid competing head-on with China, which has huge reserves of low-cost labor, and can instead build up a complementary relationship with it. Some form of support will of course be necessary for the sunset industries that are no longer competitive, in order to assist their friction-free market exit through mergers and acquisitions, change of business lines within the country, or relocation overseas.

Last, but by no means least, we need to promote even more strongly the liberalization and openness of the Korean economy. Earlier this year, Korea concluded, not without difficulty, a free trade agreement with Chile. But it is absolutely essential for us to ensure a degree of openness that is on a par with that of Singapore, through expanding FTAs not just with Chile but with the U.S., the European Union, Japan, China, members of ASEAN, and other Latin American countries. In parallel with this, we need to give a dynamic boost to foreign investment in Korea, by creating an environment in which people from all around the world can do business as freely in Korea as in Dubai or Singapore. Outward investment by Korean-based enterprises and their relocation of their production facilities overseas should also be viewed positively and made as simple as possible. Furthermore, by promoting deregulation in the areas of finance and transportation, the country will be able to achieve its great ambition of becoming a financial and logistical hub of North-East Asia.

## **Concluding remarks**

Distinguished members of the *Asia Society*,  
Ladies and gentlemen,

The hollowing-out of manufacturing that is now taking place in Korea can perhaps be thought of as an unavoidable stage on the road to economic maturity, a bit like the acute growing pains of adolescence. Having said this, I must admit that not all economic agents in Korea are finding it easy to adapt to this hollowing-out of manufacturing, because it is taking place so fast and its ripple effects have such awesome destructive power.

Seen in this light, the hollowing-out of manufacturing may well appear threatening to the Korean economy in certain respects and in the short term. Looked at calmly overall and taking a longer-term view, however, the process brings fresh opportunities for the Korean economy's upgrading and development. In other words, it is challenges like these that spur on the Korean economy to still more energetic advances.

You will all, I think, be familiar with how Korea achieved the '*Miracle of the Han River*', emerging phoenix-like as a member of the OECD from the ashes of the Korean War. Korea was again able to overcome within a short period of time the currency crisis with its threat of a debt moratorium in 1997. The Korean nation has repeatedly shown itself to have deep reserves of strength to draw on in times of crisis, when it unites as one. The stronger the challenge, the more dynamic vital energy the nation has been able to summon up, to respond even more resolutely.

To turn the challenge facing the Korean economy into a great opportunity, the Korean people and government should now go through a process of wide-ranging social reform founded upon the transformation of the structure of popular consciousness. The difficult problem of society's high costs and low efficiency can and will be solved through educational renewal, the reconfiguration of politics, cooperation between labor and management, and restraint from collective egotism. Along with this, globalization will be encouraged through moderation of the mood of anti-globalization and animosity to openness that still lingers on in some areas of Korean society.

I am convinced that once Korea has traversed the hollowing-out of manufacturing, it will move on to become a much more mature advanced society. Let us suppose that it is indeed able to maintain

stable growth at the 5% level annually, by turning the present changes in its environment into opportunities for enlarging its growth potential. Then, about ten years later, the country could look to the '*New Miracle of the Han River*', achieving per capita income of 30,000 dollars and joining the ranks of the ten largest economies worldwide.

Mr. President,  
Distinguished members of *the Asia Society*,  
Ladies and gentlemen,

Drawing my remarks to a close, I should like to give my deep thanks to all of you here today for your keen interest in the Korean economy. It is my great hope that as true friends of Korea you will not hesitate to give your suggestions and advice about the best way forward for the Korean economy.

Thank you for listening so attentively.