



South Korea braves the knowledge economy

By Scott B MacDonald

NEW YORK - In the early 21st century, the service sector is at the commanding heights of the global economy. Every major advanced economy is dominated by services, ranging from finance and insurance to retail and business solutions.

Commercial service exports accounted for US\$2.4 trillion in 2005, a number that is only expected to grow. Even among the merchandise export sector, services have become an exceedingly critical element, providing greater cost efficiencies in terms of inventory control, sales and advertising. That is creating what can be called the "manufacturing-services continuum", a phenomenon particularly visible in South Korea, which is certainly advancing in this direction. However, as Korea is now finding out, the shift into a knowledge-based economy, the apex of the service sector, is a challenging process, with both high risks and rewards.

In a global economy defined by the Internet, just-in-time delivery and inventory control, South Korea has carved out a place as a leader. Indeed, South Korea has set itself the ambition of becoming a knowledge-based economy, and can already point to some hard-won successes. As US Ambassador to Korea Alexander Vershbow stated this month: "Korea is at the cutting edge of the global information revolution, leading the world in such measures as broadband penetration, mobile-phone subscriptions, and Internet use."

But this was not always the case. Starting with a war-torn country in 1953, and having lost key natural resources and industrial infrastructure to the North, South Korea embarked on a long-term policy of savings, export-led growth, and industrialization. This was achieved by close cooperation among government, state-owned or -directed banks, and large, often family-owned conglomerates (the future *chaebol*). Labor was either co-opted or coerced, and domestic demand for consumer goods was given only secondary attention.

By the early 1960s, South Korea was beginning to enjoy rapid economic growth, a rising per capita income, and an export sector expanding into key international markets. Advances on making South Korea an industrial giant continued through the 1970s and 1980s, despite oil crises and a succession of political crises both with North Korea and within the South, which eventually promoted a very gradual opening of the system to allow elective government.

In 1996, South Korea became only the second Asian nation behind Japan to join the Organization for Economic Cooperation and Development (OECD). Despite the financial crisis of 1997-98, South Korea recovered and joined the trillion-dollar club of economies in 2004, a notable achievement for an economy that was at roughly the same level as Ghana and Sudan as recently as 1960.

While heavy industry was the backbone of the South Korean economic miracle, the service sector has gradually gained dominance. Services account for 55% of the country's economy, with industry taking up 40% and agriculture rounding out the rest. In terms of employment, some 67% of the labor force works in services.

One key element of Korea's export machine is the ability of its companies to integrate technology and other services into the productive process. That is a factor that has kept this East Asian economy ahead of many other others, including China and India.

Considering the lack of natural resources, South Korea has created a world-class economy by placing an emphasis on education, especially in the development of a technologically literate population, something essential in a period of globalization and innovation. Indeed, according to the OECD, South Korean students have one of the highest educational levels internationally in reading, mathematics and science. This is reflected in the country's 98% literacy rate.

Korea has also made other advances in terms of being a globalized, more service-based economy. Although there remains a high degree of sensitivity to foreign ownership (as there is in many nations), a survey by the Korea Center for International Finance revealed that foreign investors held 39.7% of locally listed Korean companies at year-end 2005, the eighth-highest ratio among 33 major nations. This is a revealing statistic, considering that in the period before the 1997-98 financial crisis, foreign shareholding of Korean companies was limited to a ceiling of 33%.

Yet South Korea's transformation into a fully knowledge-based economy is far from complete. Challenges clearly remain. Although services constitute the largest part of the economy, they have remained roughly at the same percentage of gross domestic product (GDP) since 1990, a smaller figure than in the United States, Japan and the more significant European economies.

One sector that is receiving considerable attention is the financial sector. It is widely recognized inside South Korea that it is important to develop the financial-services sector further if the country is to achieve a more knowledge-based, service-oriented economy.

As the earlier mentioned Korea Economic Institute report noted: "Financial-services development will also create new and better jobs, help to offset job losses in manufacturing, and raise Korea's long-term growth potential. Along these lines, the Korean government introduced in 2006 the Capital Market Consolidation Act (CMCA). According to the government, the CMCA (which is expected to come into effect in 2008) seeks to improve the international competitiveness of the country's non-bank financial institutions, make South Korea the financial hub of Northeast Asia, liberalize the financial-services sector to make it an economic growth engine, and improve the viability of the overall services sector to reduce South Korea's over-reliance on manufactured exports for growth.

South Korea's ambitions to transform the economy further into a more knowledge-based reflect the stark realities of being a key player in a globalized economy. At the same time, the process is difficult.

There is a pressing need for labor reform. According to the World Bank, the cost of firing a regular worker in South Korea is more than twice as high as the average for advanced countries. This has led to a bifurcated labor market, with one group of protected regular workers and a growing number of irregular workers (temporaries, contract workers and the like) who are less protected. As Moody's Investors Services noted of this development (April 2006 report): "Strong employment protection and high labor costs for regular workers have prompted firms to employ [irregular] workers, who now comprise almost 40% of employed persons but earn only 60% of regular workers' compensation."

Another concern is that for a more service-oriented economy to thrive, small and medium-sized enterprises (SMEs) are critical. Along these lines, there is a pressing need to loosen lending regulations to SMEs (in particular laws pertaining to defining collateral). In many advanced economies in North America and Europe, SMEs have played an important role in deepening the process of creating a diversified and deep service sector.

South Korea is in the process of another round of economic and societal change related to structural transformations that are taking the country further along the path of the manufacturing-services continuum. In simple language this means it is slowly moving toward a more knowledge-based economy.

The democratic nature of South Korea's political system provides a hearty public forum about the country's future, which in itself is important. This allows an airing of discontent over speculation, the implications of foreign investment, the accrual of wealth via real estate, and how to create more transparent and open business practices among major conglomerates. It also helps to maintain some sense of urgency over the need to maintain reform if Korea is going to develop into a more full-fledged knowledge-based society.

The process of change is always difficult, but South Korea has demonstrated a track record of accomplishments, sometimes against considerable odds. It will need to do so again to succeed in its current transition.

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The previous article describes South Korea's ascent to a knowledge based economy. The article describes under what conditions S. Korea started its economic development, where it currently is and what needs to be done to continue to grow its economy.

*Create a flow chart that shows how South Korea's economy has developed. The flowchart should have three major segments with subheadings **Past, Present, Future**. Each segment should include the major factors of South Korea's economic development.*

Using the flowchart write a paper that compares and contrasts the development of South Korea to that of the United States.