

Renewing the South Korean Economic Miracle

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South Korea's incoming president, Park Geun-hye, takes over a country that has been a global role model for economic development. But with the economy slowing, it has become a model in need of renewal.

The so-called Miracle on the Han River took root with the reforms initiated by Park's late father, Park Chung-hee, the country's ruler for much of the 1960s and 1970s. A measure of South Korea's success is that it was the first country to make the transition from recipient of aid from Organization for Economic Cooperation and Development to donor, with per capita gross domestic product today exceeding \$30,000 in terms of purchasing power parity.

But the growth formula that long underpinned South Korea's success, a form of state-guided capitalism that focuses on export-led manufacturing, is no longer working for many South Koreans. GDP has nearly tripled over the past 20 years, but with real wages rising at less than half this rate, growth has become decoupled from the fate of ordinary citizens.

More than half of middle-income households spend more each month than they earn. The signs of social distress are multiplying. South Korea's divorce rate has doubled, fertility rates have fallen to the fourth-lowest among advanced economies, and the suicide rate is the highest in the OECD.

South Korea is troubled for two key reasons. First, although some parts of the economy reached advanced industrialization in record time, other parts — and institutions — are struggling to catch up. Manufacturing conglomerates such as Hyundai, LG and Samsung have morphed into highly productive global giants, whose growth creates fewer high-quality jobs at home than before.

Employment at the country's largest companies is falling, and the share of South Korean jobs at such companies has dropped by one-third since 1995.

But South Korea does not have a well-developed service sector to provide a new source of high-paying jobs. Worse still, service industries are falling farther behind large manufacturers in terms of productivity and wages.

This leads to the second challenge: the dire financial straits of middle-income households. Many families now face stagnating wages, owing to the kinds of jobs now available, but are determined to cling to a lifestyle they can no longer afford. Families with children are engaged in an escalating "educational arms race," devoting large shares of their income to private education and tutoring to prepare children for entrance into elite universities and a shot at a secure job at a major corporation.

Middle-income families also insist on buying homes despite the highest multiple of home price to income among advanced economies and a housing-finance system that imposes high borrowing costs. South Korean women still drop out of the labor force when they marry or have children. Only 38 percent of families have two wage earners, half the OECD average.

One of the most pernicious effects of the squeeze on middle-income households and the cost of the educational arms race is a voluntary one-child policy, which has reduced the country's fertility rate to 1.2 births per woman, among the lowest in the industrialized world. The population is aging at an accelerating rate, and the net flow of working-age citizens into the labor force has turned negative.

Without action, the economy faces the threat of declining consumption and even shrinking output. South Korea badly needs measures to relieve the stresses on middle-income finances and a new growth formula based on a globally competitive service sector and entrepreneurial small and medium-size, or SME, businesses that create well-paying jobs.

Major reforms are necessary to help middle-income families escape crushing monthly payments for housing and education. Housing payments are higher because mortgages are of short duration (an average of 10 years) and tight loan-to-value restrictions force borrowers to seek additional higher-cost loans from second-tier deposit institutions and nonfinancial companies.

These conditions need to change. Because banks would need to accept higher risk, a secondary market for mortgages is necessary. Policymakers should also consider measures to reduce

demand for home ownership, including relaxing regulations on investment by insurance and other companies in residential housing, thereby creating better rental choices for middle-income households.

South Korea also needs to improve its public schools, particularly at the secondary level, and significantly upgrade vocational training. Families invest in private education because they fear that the public education system will not get their children into elite universities and good jobs. "Meister" high schools, introduced in 2010 specifically to prepare young people for high-skilled jobs, are a positive step.

Aggressive development of services such as transportation, retail and restaurants — which today are dominated by low-productivity, low-paying local businesses, many run by sole proprietors — is another imperative. South Korea has excellent opportunities to build up health care services and compete in the global medical-tourism business. Other tourism, too, can expand to provide fuller advantage of cultural and sports attractions. In financial services, the government should aim to produce three to four regional champions.

Finally, Koreans must relearn the entrepreneurialism that built the chaebol, the family-owned industrial conglomerates that powered the economy's development. Today, South Korea has many small family-owned businesses but few entrepreneurs.

Fostering a more dynamic, innovative SME sector that will produce tomorrow's globally competitive large companies requires removing disincentives to growth, such as the inheritance-tax exemption for family-owned businesses, which rewards owners for keeping their businesses small. A bankruptcy system that allows entrepreneurs to survive the inevitable failures that accompany innovation is also needed, as are stronger protection of intellectual property and improved access to equity finance.

Park takes over at a pivotal point in South Korea's history. The new government needs to take the pragmatic steps that can overcome the limitations of today's economic model and save the country from declining growth, higher unemployment and rising inequality. The task is no less than to achieve South Korea's second miracle on the Han River.

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