


# Opinions

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## Time to Confront Structural Problems in the Korean Economy



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Korea's economic growth has slowed down significantly since the Asian financial crisis. The five-year average GDP growth rate was 7.9 percent during 1991 to 1995, while it was 4.5 percent for 2001 to 2005 and 3.8 percent from 2006 to 2010. This slowdown is closely linked to that in domestic demand. In particular, after the burst of the credit card lending boom in the 1999-2002 period, growth in domestic demand has been close to zero or even negative. Considering the fact that GDP is the sum of domestic demand and foreign demand, these empirical facts suggest that Korea's economic growth has been entirely driven by the export sector since 2002. They further suggest that the same forces contribute to the slowdown both in GDP growth and in domestic demand.

On the other hand, the magnitude of export growth has been high for the past 30 years. It is on average higher than 10% and confirms a well-known characteristic of Korea's economic growth: being driven mainly by exports. More importantly, the contribution of exports to GDP growth has not changed much since 1980: for example, the five-year average of the contribution was 3.9 percentage points from 1991 to 1995, while it was 3.6 percentage points during 2001 to 2005 and 3.8 percentage points during 2006 to 2010. These additional pieces of evidence indicate that one of the same causes for the slowdown in both GDP growth and domestic demand growth is related to the fact that ripple effects from the export sector have been dampened.

*Why have spillovers from the export sector disappeared since the Asian financial crisis?*

Let me begin by presenting one empirical fact to find out the answers to this question. In the data, the proportion of domestic value-added components of exports has been on a downward trend since 1995: recording around 76% in 1995 and roughly 60% in 2009. This phenomenon is common across industries in Korea: the proportion of domestic value-added content has decreased substantially across almost all industries in Korea. This suggests that the contribution of Korean exporting firms to domestic production has declined because those firms have been significantly using foreign production chains. Interestingly, this phenomenon is not limited to Korea. For example, most OECD member countries have used less domestic value-added components since the mid-1990s. In this sense, the phenomenon can be related to the effect of the widespread use of global value chains: if domestic exporting firms extensively use global value chains, the contribution of domestic value-added components to gross exports is likely to drop. However, the decrease in the proportion of domestic value-added contents of exports in Korea is also related to some other factors distinguishable from other OECD members and that significantly affect the ripple effects of export growth.

Let me now present the two factors which hinder the spillover effect of export growth. First, small and medium-sized firms' contribution relative to large-sized firms to exports has decreased substantially in Korea. Apparently, this downward trend is linked to the downward trend of the relative labor productivity of small and medium-sized firms to large-sized firms. For example, the average ratio of value added per worker in small and medium-sized firms to that in large-sized firms during 2002 to 2006 was around 39.4% and the average ratio further decreased to around 34.5% during 2007 to 2010, according to data from the Financial Statement Analysis issued by the Bank of Korea. The combination of these two pieces of evidence implies that large-sized Korean exporting firms may have extended to purchase for-

oreign intermediate inputs for their final export goods using global value chains because of low productivity in small and medium-sized firms in Korea.

In addition, relative labor productivity is much lower in Korea than in other OECD member countries, suggesting that not only Korean exporting firms but also foreign firms do not have an incentive to engage in trade with small and medium-sized Korean firms through global value chains. So, the impact of global value chains on the Korean economy is asymmetric between small and medium-sized firms and large-sized firms in Korea. This implies that export growth induced by large-sized Korean firms may not substantially spill over to other sectors such as the service sector, which in Korea consists of a considerable number of small and medium-sized firms.

Second, the relative labor productivity of the service sector to the manufacturing sector has been declining: for example, the ratio of labor productivity of the service sector relative to the manufacturing sector decreased from 62% in 2002 to 47% in 2012. In addition, the service value-added components to manufacturing exports are much lower in Korea, compared to the OECD member countries: they are close to the minimum of all OECD member countries except for electrical equipment as of 2009. Analogous to the first reason, this lower productivity induces those firms in the service sector to fail to exploit the benefits from engaging in global value chains and dampens the ripple effects from large-sized firms' exports. The share of the service sector in total employment has been growing since 1993: it was 62.3% in 1993 and 74.1% in 2012. Note also that that small and medium-sized firms account for about 80% of output and 90% of employment in the service sector. This suggests that the productivity gap between the two sectors is closely linked to the productivity gap between small and medium-sized and large-sized firms.

*Why has the relative productivity gap between small and medium-sized firms and large-sized firms increased since the Asian financial crisis?* Although more studies should be conducted to answer to this question, one thing for sure is that the answers must be found in the structural problems of the Korean economy.

First, apparently, large firms restructured, shedding labor and investing abroad, and thus regained competition, after the financial crisis. On the other hand, small and medium-sized firms fell behind: the regulatory environment disfavored growth of new industries and the service sector, rendering a good part of factors of production idle. Second, dualism in labor mar-

kets may have negatively affected firms' total factor productivity (TFP). Although we need to obtain more evidence on this issue, the key reasoning goes as follows: as the firing cost gap between permanent and temporary workers increases, firms tend to less likely convert temporary workers to permanent workers and to reduce the on-the-job-training investment for temporary workers. Knowing this, temporary workers tend to make less effort. In turn, a firm's TFP (which combines the productivity of both temporary and permanent workers) will decrease. Therefore, to the extent that the share of temporary workers is larger in small and medium-sized firms than in large-sized firms, dualism may contribute to the productivity gap.

These structural problems curbed the ripple effects from export growth—mainly driven by large-sized firms—across several dimensions of the Korean economy. Although large-sized firms have substantially increased their sales in foreign markets, they have also substantially increased the use of foreign value-added components. Unless we confront the structural problems of the Korean economy, the productivity gap between small and medium-sized firms and large-sized firms will end up increasing income inequality and will become more persistent across several channels such as a vicious cycle of the asymmetric accumulation of higher quality human capital due to the increase in wealth inequality induced by higher income inequality. [KIEP](#)