Asia in Transition & Implications for Korea*

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I would like to give you a brief tour of what is happening in Asia and what might be some implications for Korea. Such a subject might be a bit broad and "high level", but this is the best way to give you a sense of the overall economic trends in the region and what they might mean.

There are basically four messages. First, we should recognise that while there is a lot of transformation going on in Asia, the world system of globalisation continues at a relentless pace. This must always be emphasised as the background. There is an increasingly integrated fast-paced world out there and we need to be part of it.

Second, China is really driving a lot of the changes right now. Today the centre is China. In the past it was Japan. But now we need to talk about the engine of China in terms of what it is doing to different parts of Asia and what that means. Specifically, while Asian growth rates will continue at a very significant rate over the next 15 to 20 years, it is the next 3 to 5 years that are critical. A lot of the basics and regulations for many industries are going to be put into place over the next 3 to 5 years. So there is a time frame in which companies and countries have to think about in this part of the world.

Third, Korea has a huge role to play in this transformation. We are already part of that process. My only worry is that on Korea's current course and trajectory—in terms of how the government is moving and how the economy is moving—there is a risk we will be on the sidelines. It is always good to look at history. Look at the Philippines in the 1970s. It was seen at the time as very much of a star economy. In fact, Philippine engineers built some of the landing lights and runway facilities at Gimpo Airport. However, that economy has now been sidelined. You do not hear about the Philippines any more. That is the challenge for Korea. We have to 'step up the game' in order to move this country forward.

The fourth point is Korea itself. Korea needs to tap into its wealth, its innovative nature and its raw drive. By doing so, it needs to tackle four specific themes. The first theme could be labeled "getting our house in order". We have to deal with our labour market and the flexibility of our work force. People have been talking about this for years. It has to be dealt with—finally.

Regulation in the service sector is much higher here than in China. Look at the number of "chops", or signatures, it takes to build a retail site in Communist China. It is less than that in Korea. Korea is over-regulated. As well, the capital markets in Korea do not work as effectively as they should. We have some very strong companies here that should be buying more assets in other parts of Asia. But with such a weak stock market,

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* A transcription of a speech given at the Institute for Global Economics' Distinguished Lecture Forum on December 7, 2004.

we don't have the 'currency' (in terms of valuation) to be able to acquire companies as we would like to do. Also, we have the credit card problem. It still casts a spell of gloom over the domestic economy and consumer purchases.

Korea's second theme involves its government. The government sector needs to be revitalised. We see many private sector/public sector partnerships, especially in the UK. Singapore is pursuing them aggressively. Even the new Indonesian government is looking at those. Korea could use some private sector/public sector partnerships.

Korea's third theme is its "hub" initiatives. These "hub" initiatives may go out of favour or may be more of a "theme of the moment". But they are actually quite important. They rally people together, especially industry, and make things happen.

Korea's final theme is the global mindset. There are two aspects to this. First, in Korea, we should think of Asia as our market. China, Japan, Sakhalin and Malaysia are all part of our domestic market. That is how we should be thinking about the world. Secondly, we need to realize it is very important, and it is a good thing, to have foreign direct investment and foreign involvement in our economy. Recent events are a terrible signal to send, for example wanting to restrict the number of foreign bank directors on boards. The newspaper articles on this read by people in London and New York send a terrible signal about Korea. Both domestically and in the region, the global mindset is very important. This sounds like a very soft thing to say, but it is actually quite important in terms of how you look at ambition.

Now, I will try and provide more specifics on each of these points:

1. The global economy is in transition

Since about 1990, the world has been shifting very much from localised, differentiated, split-up economies to a more globally integrated economy. By 2020, most industries and sectors will be globalised, including sectors such as retail and services. This is a relentless force. It is difficult for governments to stop it. It is driven by capital flows.

Cross border equity flows between countries have been increasing at a very significant rate. If you update the numbers in figure #1 to 2003, you would be looking at USD 4.5 trillion worth of cross border flows.

There are two financial hubs in the world today. Those hubs decide where the money should go around the world. They are primarily New York and then London. Most investors in the world are located in one of those two cities. That is where standards are set. You do not see governments get together to set corporate governance standards, or to set up a stock exchange. It is key investors, particularly in the US and the UK, who define the standards. We need to understand that.

More and more stock markets around the world have foreign investor participants. If you look at figure #2, you can see that in Korea it is roughly 44%. In Finland, it is about

56%. Every country in the world that is part of the global system has foreign investors. It is a natural thing and it is a good thing to have in your market.

If you wanted to look at global companies, you could take BMW, ChevronTexaco, Coca-Cola, the Suez Group and Unilever, as shown in figure #3. Under which country would you classify these companies? They do not have a country. These are very much global institutions. If you look at their foreign assets, foreign sales, where their employees are, and so forth, they are all over the world. That is something we see more and more. Some Korean companies are doing this, whether it be Samsung Electronics or LG Electronics. We should see more Korean companies on that list.

Figures #1 through #3 give you a sense of the change in the global system. We continue to integrate. We continue to see more and more capital flow around. We are dealing with a more volatile environment. Those changes will not go away for quite a long time. Look at the Standard & Poor's volatility index as shown in figure #4. You can see that both the average between the lows and the highs between 1980 and 2000 and the highs and the lows themselves have gotten much larger. This is just an indicator of volatility. Those numbers have not been that high since about 1939.

For companies, that means that in this environment the speed of change is increasing. This is a very fast paced environment. The average lifetime of a corporation in 1935 it was about 90 years. At that time, if you set up a company, and if you ran it well, you could imagine yourself running it for 90 years. That has dropped to 15 years. The time you are able to keep your company moving, given all the changes, has dropped significantly.

The same is true for product innovation. Take a look at figure #5. I just picked consumer goods as an example. The amount of product innovation and new products being developed all the time has increased substantially. In 2002 alone, there were some 12'000 new health and beauty aids. These are not major products, but it simply gives you an example of the growth and innovation that is going on in the rest of the world.

So in the background, the world is globalising and moving very quickly with a lot of change. This is not a short-term phenomena. The world will be this way for at least the next 15 years.

2. Transitions & discontinuities in Asia

When we look at Asia, we see a number of different trends. I will first cover the broader economic trends. As shown in figure #6, most of the world's population is in Asia, close to 60%. Figure #7 shows us that we have about 27% of the world's GDP. If you look forward to 2010, most of the growth in the world that will occur on a GDP basis will be in the Asia Pacific region.

When you look at the size of the economies, in 2003 and in 2015, we will see four Asian countries, including Korea, in the top ten. This is shown in figure #8. So by anyone's definition, Asia has not become the periphery, or a "third leg". It has increasingly become the centre of the world.

Another indicator at which to look is the top 1'000 companies in the world as defined by market capitalisation, or stock market value. Today, about 20% of the top 1'000 companies come from Asia, and 90% of those are from Japan. Never forget that Japan is still huge. It is a very important economy. Over the next 5 years, that 20% will jump to 30%, and most of that growth will come from China and India. We are going to see quite a dramatic shift in the number of large corporations coming from this part of the world.

I would like to take you through a list of some of the fastest growing companies in the region. This will not be in detail, but will be an overview of rapidly growing firms. To people in North America and Europe, the speed of growth of these companies is just astounding. First are the Indian companies shown in figure #9: Infosys, Wipro, HDFC Bank, ICICI Bank. On the right side you can see their growth rates, the average annual growth rate of either sales or market capitalisation. You are looking at numbers like 54%, or 24%, or 82% in the case of ICICI Bank. These numbers are unheard of, and the main issue is that there are a lot of companies with such high numbers.

Second are the Chinese firms shown in figures #10 and #11. Look at Haier. It saw 36% growth. It has made major inroads in the furniture and kitchen appliance markets in the US. Look at Huawei Technologies. In the early 1990s, no one would have paid any attention to Huawei Technologies. Now it is directly challenging Cisco in terms of where the company is moving. COFCO is a "green" food services company based in China. It is growing at an average rate of 69% per year. China Mobile is the single largest mobile company in the world. It has been growing at 43% per year. If you talk to the CEO of that company, he has plans to continue to grow at 40% per year. This gives you an idea of the growth rates that these companies are thinking about. We have to get ourselves into that kind of frame of mind.

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We do have some of our own in Korea. Samsung's market capitalisation grew at 47%. That's an incredible story. But let's go back to India, to the drug store industry. Take a look at Ranbaxy in figure #12. If anybody had said five years ago that an Indian company would challenge the likes of Johnson & Johnson or Pfizer, you would have been laughed out of the room. Now, those Indian firms are on the move in North America. The growth rates of those companies are so high they have everyone's attention.

I hope with those few slides, I can give you the impression that this is an area of the world, particularly in China and particularly in India, with very rapidly growing companies. These firms have very high growth rate expectations, much as Korea had in the 1970s and early 1980s.

Trade within Asia and outside of Asia is illustrated in figure #13. Look at the big bar in the middle. Compare that with trade between Asia and Europe or trade between Asia and the US, both of which have grown a little, which is important. But more important is the Asia and Asia trade. This intra-Asia trade is critical. Asia in its own right, from north to south—and even from east to west, to some extent—is much more important than our trade with Europe or the US. This is a very dramatic increase over the last four years. It shows that Asia itself has become a true critical part of the economy, not just a supply centre for the rest of the world.

Figure #14 is actually a page I took from a Seoul Financial Forum presentation. It looks at Northeast Asia as a region. Some 19% of the world's GDP is within a two-hour flight of Seoul. Many Japanese companies, certainly many Chinese companies, and a few Korean companies see this as their market. They do not care too much about the borders. That is why we have to have a global mindset. This area is our domestic market. This is the market in which we should compete.

Most of the big growth in Asia of which I spoke earlier will be coming from Northeast Asia. Northeast Asia is where the really big changes are going to occur. That area includes mainland China, Taiwan, South Korea and Japan.

Let's talk about China. We have heard a lot of stories about growth in China. We've seen some of the company changes. The best way to understand China is through some images. Think of Pudong, the financial neighbourhood in eats Shanghai, about ten years ago. Then think of Pudong today. Or think of Shenzhen five or ten years ago, and then Shenzhen today.

These differences are staggering. The first time I was in Shenzhen driving back to Hong Kong, I looked around. I saw tall, tall buildings. Tall buildings themselves are not a phenomena. The issue for me is the speed with which this economy is moving. The speed at which the Chinese economy moves is staggering.

We always talk about Beijing, Shanghai, Guangzhou and the other coastal cities. It is important, however, to realize that a lot of the growth is actually happening in the tier 2 and 3 cities, as shown in figure #15. These cities are just inland from the coast. These cities have very high aspirations. They want to be the size of Shanghai. So remember that growth is not just a coastal phenomenon. There is a lot of growth going on just inside from the coast.

The other fact you have to realize is that there is brutal price competition in the mainland domestic market. Figure #16 takes the television business as an example. If you look at annual prices from 1997 to 2000, you see they are dropping at an average rate of 19% per year. So there is very fast-growing, brutal price competition which faces anyone doing business in this market.

I will now shift quickly to Japan. These days, we tend to ignore Japan and talk about China. Certainly, China is a fast growing and important place. The fact of the matter is, though, that in 2010 and even in 2015, Japan will still remain the largest economy in Asia, as shown in figure #17. Obviously, there has been stagnation for 15 years. But it is big and will continue to be big.

I believe very much that Japan has a dual economy, as shown in figure #18. There has largely been a domestic economy that has not been that productive. Then there was a very productive export-oriented economy, which includes the Toyotas and Sonys that we all know about

In the last two to three years there has been a pretty significant change going on in Japan. I believe Japan is on the rise. You can feel it. I spend about six days a month in Japan. There is an increased vibrancy in the place, in terms of the restructuring that is going on in that economy. Take a look at figure #19. The push by the government may not seem straightforward, but this government is very much focused on reform, particularly of the postal services and so forth. You see change.

If you look at the number of merger and acquisition transactions (M&As) that have occurred, it has been on the rise. This is shown in figure #20. M&As and hostile takeovers are actually a good indicator of a healthy financial system. They have been increasing over the past few years.

If you look at the amount of foreign ownership, it has actually been going up in Japan. There are more people investing in the Japanese economy. Japan, though it has been dormant for close to 15 years, it is now waking. The giant is waking. It is beginning to move. We are seeing more and more Japanese firms doing business in other parts of Asia. Even the Japanese banks, which you had not heard a peep from over the past five years, are now looking at what they can do in other parts of Asia.

The Association of Southeast Asian Nations (ASEAN), as shown in figure #21, is another area at which we need to look. ASEAN, perhaps partly driven by what is going on in China, seems to be coming together more in terms of an integrated economy. If you look at ASEAN together—which includes 10 countries such as Malaysia, Singapore, Indonesia and the Philippines—it is quite a substantial economy with a lot of opportunities. In particular, Indonesia is a good place at which to look.

India is also going through an inflection point in growth. This inflection point is illustrated in figure #22. India today, or at least in the past couple of years, is very much like China was in 1988. It is about 10 to 12 years behind, in terms of opening and deregulating the economy. They are now opening the economy very much more for people to invest.

If you look at India’s consumers, you see 54 million middle- and high-income households. This is going to grow to 97 million households by 2006. This is a large domestic market. India has a credit card base of 5 million users. This is going to grow at 30% per year. India’s mobile telephone customer base is also seeing major growth. We know India is a huge source of talent. The schools there are graduating over 400’000 engineers per year.

Today, in any sector at which you look, whether it be car manufacturing, telecoms, banks, energy or steel, we in Asia already account for a major part of that industry’s world output. One third of the top 300 banks in the world by market capitalisation are now based in Asia. This is all shown in figure #23.

In fact, financial services, as shown in figure #24, will become a huge opportunity in the region. Financial services in Asia are going to grow by the same amount by which the US financial services market grew during its peak in the 1990s. That is all ahead of us. There are big opportunities there for Korean banks

There will be changes in terms of ownership of companies. Some 60% of listed companies in Asia are controlled by a single shareholder. That typically may mean 5% or 7% average. This is shown in figure #25. Given the fact that age occurs, many of these founders and owners will have to change. They can't live forever. Some 50% of these companies will be going through a leadership transition in the next five years. This also represents significant opportunities for companies as we look forward

Consolidation, including M&As, will increase in Asia. If you look at the banking industry in Asia from 1997 to 2000, 51% of the banks that were on our list in 1997 are now gone. You are going to see this continue in banking in Asia. You are also going to see it in other industries: pharmaceuticals, electronics, autos. There will be more mergers and acquisitions, and consolidation will occur. This is shown in figure #26.

There will be a continued shift toward the private sector. Figure #27 is an overly complicated chart. The only thing to look at is the China section of the bar, at the decreasing bottom section. If you look at the industrial output of China, in 1980 75% of that industrial output was coming from state-owned enterprises. In 2002, it is now 25%. China is not a Communist system, in terms of the way in which business is run. It is one of the most capitalist systems out there. If you look at the numbers for 2004, that 25% has dropped to 20%. China is using the market to drive growth. We are going to see that happening more and more across the region. I could show you a similar chart for Vietnam, which is on the rise.

There are challenges in the region which need to be thought about, however. The non-performing loan (NPL) situation is huge. Right now, China has the most significant NPL issue we have ever seen in our history. In figure #28 we try to illustrate this. Basically, the large black bubble in the top right shows the size of China's NPLs.

Official estimates of Chinese NPLs—and some market players double these numbers—show that they stand at more than two and a half times the equity available in the entire Chinese banking system. That system requires a big cleanup. The way in which the Chinese financial system evolves over the next five years is something we should all worry about. It will not be an easy job for those firms to move those loans from "non-performing" to "performing". This is one of the challenges of which we need to be aware.

Demographics will be a big issue for Asia overall. If you looked in 2001, across Asia overall there were ten working adults supporting one retired person. By 2051, that will be three-to-one. This is shown in figure #29.

It is more important, though, to look at a country like Japan. Take a look at figure #30. Now, I'm sure the government will take some action. It is always dangerous making such long-term forecasts. Even so, demographics are not an easy issue to deal with. If Japan does not do anything about its demographics, it will have a one-to-one ratio. That is a very destabilising situation for many reasons, let alone the personal reasons.

This is something we will have to worry about. This will also become a big issue for Korea. Look at Korea's position in figure #31. We need to think about aging, too, now. How are we preparing for this demographic shift that is going on? Fortunately, we have countries like Vietnam. Vietnam has a huge population of 25- to 27-year-olds. It will be interesting to see the flows of population across Asia and what that means for the region.

3. Korea is at a critical inflection point

With all of that as the background, what do we do in Korea? We are at a point where we may need to make a leap again. Look at figure #32. We cannot stay still. The world is moving fast. We worry because the platform on which we are currently standing is not very strong. We do not have anything approaching the most flexible economic system within Asia, let alone in other parts of the world. Yet we have huge opportunities in front of us. There are many Korean companies that could be playing a strong role as we go forward.

Korea has continued to play in a "boom bust" cycle, as shown in figure #33. We have not gotten out of it. We worry that there may be two choices, or maybe three choices. We hope pursuing one of these choices will take us out of this "boom bust" cycle. We have some ideas about how to do that.

If we do not escape from this cycle, the results will be a lost decade, as occurred in Japan. Look at the "Japan outcome" in the middle of figure #34. Our GDP would go down. We would become increasingly irrelevant over time. More and more Korean people would just leave and not invest. Or, we could be in the continual "Mexico-like" or "Argentina-like" roller coaster, which just keeps going up and down.

We have to be careful about our export industries. Look at China and Korea. Many Korean companies are doing a lot of good business in China. But many of their key exports are now our key exports. We are competing head to head with the Chinese. Our number one export industry is electrical machinery. Guess what? China's number one export industry is now electrical machinery. Take a look at figure #35. The worrying thing is that we have a lot of parallel industries. China is not a country with which we really want to compete on that basis. We need to figure how we can participate in that economy as we move forward.

4. Themes and imperatives for Korea

Labour costs are a serious issue for Korea. We've talked about this a lot. Someone has to do something about it. I am embarrassed to keep talking about it. Surely, I do not fully understand all the dynamics in terms of what has happened with labour. If you look at our labour costs compared to China's, it is obviously dramatically different. Look at figure #36. That is unsustainable if Korean firms want to compete head on with China.

If you compare us on an hourly basis to other parts of Asia, as in figure #37, we are the high cost labour in Asia. Even Singapore and Hong Kong are at better levels than where we are.

I mentioned our stock market earlier on. Figure #38 shows the average market-to-book ratios. This is the valuations you see in the stock market here. This tells you that the KOSPI index, representing Korea, is at the bottom in Asia. We are at the lowest level. Our Korean companies do not get the valuations they deserve. They are significantly discounted. If you took many of our Korean companies and listed them in New York or even Hong Kong and Singapore, they would have a higher valuation. We need to be careful about that. In Australia, you have already seen some Australian companies leave Australia to list in New York to get better valuations.

It's important for Korea that we have a stock market that works properly. Part of the reason for poor valuations is poorly perceived corporate governance, especially among Chinese people. But the main reason why the stock market here does not work properly is that it is seen more as a casino. It's a retail oriented gambling house, as opposed to a place where long-term investors can see a return. There is very little long-term money—pension money—that provides stability. So we get a lot more fluctuations. This is something that is very fixable. Just seven years ago Singapore had a market that was like this in terms of its valuations. They fixed it. Malaysia has had that problem. They fixed it. Many of our neighbours in Asia have fixed this issue. Korea can also fix this.

We know the numbers on foreign direct investment (FDI). Look at figure #39. It shows FDI as a percentage of GDP. It is falling. We need to do more. There are many good companies here. There is a lot of need for more capital to come into our country. Every developed country in the world has a lot of FDI coming in. We need to raise our share of that.

As I mentioned before, we need to think about growth. Figure #40 shows some Asian firms that are thinking about growth. They are all successful, growing companies. I want to talk about one example of an Asian firm that has started thinking about participating in growth: Temasek.

Temasek is a Singaporean investment firm. Some see it as basically "Singapore, Inc." It is effectively looking at ways in which to invest on behalf of Singapore (i.e., pension money) in different parts of the world. Figure #41 is the title page from a magazine article about Temasek. It's a little harsh. I do not think Temasek is gobbling up banks at all. I think what they are doing is participating. Temasek is participating in different parts of Asia. Figure #42 shows some ways in which Temasek is expanding in Asia. Why doesn't Korea do this? Why don't we participate in other parts of the world? Why don't we own gas in Sakhalin? Just because the gas is not in Korea does not mean we cannot own it or participate in it.

There is a lot we could learn from the Netherlands. Look at the Dutch. Look at the number of significant companies they have in major sectors: financial services, oil, engineering, etc. The population is only 16 million, and to have three of the largest banks in the world is pretty impressive. That didn't happen by happenstance. There was some organisation to that. Look at the role the Netherlands is playing in energy. Even though they do have the North Sea and so forth right there, they also own assets in other parts of the world.

Look at Chinese companies today. The single biggest priority of the rapidly growing Chinese companies is mergers and acquisitions. Chinese energy firms have deal teams in 15 different countries trying to buy energy companies. They are buying in Indonesia. They are buying Noranda, a copper mining company, in Canada. They are buying food companies in Brazil. Look at the number of trips politicians have made between Brasilia and Beijing. The Brazilian president has been to China more than any other national leader. If you look at the Chinese leaders, they also spend a lot of time in Brazil. Chinese companies are buying assets elsewhere.

It is very important for Korean companies to think about the role they could play in this rapidly changing world. They need to think about their market. Their market is not just in Korea. It's outside Korea as well.

Today, many Korean companies are not investing. This is a big worry. Look at the cash reserves of the top 50 Korean companies. It has been increasing. People are not investing. This is shown in figure #43. I do not know if managers are too nervous, or if there are regulations. Perhaps there are restrictions about what the *chaebol* can or cannot do. The point of the matter is that not enough Korean companies are investing in growth, going forward. We need to fix that. We have wealthy, highly talented companies that need to be doing things. Something needs to be done about this or else we will not have a vibrant system.

I wanted to talk a bit about private sector/public sector partnerships. Look at the government in Korea, the different ministries and agencies, and what the government owns and what they do not own. It is time for a change. The UK has been spearheading what are called private sector/public sector partnerships. Even in industries like health care, which has a strong social set of objectives, many parts of the business can be done by the private sector. Take a look at figure #44. That creates efficiency and allows for more innovation to occur in those markets.

In Korea, we could use a heavy dose of that. We have very talented people in the government. But I do not think they have been allowed to dream or stretch in terms of what they want to do. They are restricted in what they can and cannot do. Private sector/public sector partnerships are one way to fix this issue. Singapore has put a real push on this. Even Indonesia, with its new government, is looking at this as a vehicle to try to revitalize what they are doing. Why not Korea?

As an indicator of what Korea could be doing, look just within the UK. Figure #45 gives you an idea of the sectors in which these partnerships have taken shape, as well as the number of deals in each sector. Health, education and defense are at the top in terms of number of deals. There are a lot of private sector people involved in building the aircraft carriers for the Royal Navy. The same is true for environment issues. This is an area for opportunity and change for Korea.

I will now end with an article from page two of *The Financial Times* last week. Please look at figure #46. This is a signal that is really unfortunate. It's probably exaggerated, or not well understood. But the point is, what will an investor in one of the two hubs I mentioned earlier—New York and London—think when reading the top Asia-Pacific headline on page two of *The Financial Times*? Korea is not excited about having foreign direct investment. That is the message. This message flies out. That is unfortunate. We need that. We need FDI. We also need to be investing outside ourselves, and we need foreign direct investments to come in.

We have to be very careful about our image. We have China growing at 9% a year. We have Vietnam coming up on the scene. We have India moving through. Investors have many choices. Korean investors, too, by the way, also have many choices about where they go. We have to be very careful about the image we have.

As a final page, please look at figure #47. This is an indicator of investor interest. It gives you a view of the vibrancy and potential of an economy. McKinsey has a panel of 15 private equity companies and institutional investors. They represent a good chunk of leading edge investors in Asia. We asked them to rank destinations. It's not very sophisticated, but we ask them to do this on a regular basis. Where would you put most of your money?

In 2002, Korea was actually at the top of the heap. There were huge opportunities. It was followed by China, Taiwan, India and Japan.

In 2004, China is first. When you look at the number of people seeking opportunities, China is top. In fact, I worry it is a bit of a bubble to some extent. There are so many people looking at opportunities in that market. India has popped up as a major market. Japan is now on the rise. There are many, many more people looking at opportunities in Japan, particularly looking given the performance of a number of major deals. Taiwan is still there.

At the bottom is Korea. It is ranked equal to Vietnam. Vietnam is coming up onto the radar screen. It has a lot of potential. A lot of people describe Vietnam as an "old Korea". When you look at Vietnam, you are looking at Korea in the 1970s and 1980s. I would love to participate in that growth.

I will end on that note. We see a lot of change in the world and Asia. This is not temporary. This is a fundamental shift in the world's economic system, much as it was at the turn of the last century when the US economy developed. We are seeing a major shift.

There are huge opportunities for Korean companies and for Korea to play a role in that market. But we are not taking advantage of it as much as we could. We are insiders in Asia, and yet there are others participating inside this market much more actively. Hopefully we will be able to take advantage of some of this opportunity over the next few years.

Questions & Answers

Q A couple of times during your presentation, you mentioned the possibility of China being a bubble. If something happens to that bubble, will it be fairly easily repairable? Do you expect a burst in the bubble to have a very long-term effect?

A If the bubble does brake, I'm going to pray. It would have huge repercussions on many economies, like Japan's. A lot of the Japanese revival has been driven by growth in China. China has now become the major export market for Japan.

However, if there is a Chinese bubble, it is not irreparable. There will be a couple of years of restructuring, and then the machine will keep moving. The thing about China that makes me feel positive is that most of the growth in China is domestically driven. Foreign direct investment represents a huge amount of money, at over USD 50 billion per year. But if that dried up and went to zero, the Chinese economy would keep moving. There is a domestic transformation going on. Consumption and infrastructure drive that economy. They are building 43 new airports over the next five years. They are building over 10'000 kilometres of road over the next five years. These are major infrastructure projects. The underlying strength of the economy is strong.

But I worry about politics. What happens if there is a political issue or a political repercussion? Can the government maintain control if the growth rate drops for a couple of years? That's the challenge.

Q How soon do you think the Chinese economy will become the largest economy in the world? How will that influence or affect a united Korean economy?

A Our own view is that by 2030, even with bumps in the road, China will become the largest economy in the world. Goldman Sachs has an estimate of around 2040. Within this generation's lifetime, China will become the dominant economy in terms of size.

Q China's problems are hidden by its high growth rate. When growth slows, social and political problems will arise, the NPL issue will come out, unemployment will rise, and there will be many social problems. As I see it, China is somewhat similar to Korea in 1988. In 1988 we hosted the Olympic games. The reason why the Chun government at that time accepted the so-called "demand" for democracy was because it wanted to have the Olympics the following year. China is in a similar situation. They want to make the

Beijing Olympics a big success. That will tie their hands. The timing is somewhat similar.

So social and political problems, the demand for democracy, labour unrest and other issues should all appear over the upcoming years. Those are very serious problems. This does not mean that China will collapse, but that the period will be very long. What do you think?

A China's rise will be a bumpy road. Both the Olympics and the expo in Shanghai in 2010 has everyone focused. There is one thing I would say that is a little bit different from the Korean situation in the late 1980s. There are a lot of analogies, but there is one thing that is different: China has sheer internal size.

The amount of business that can be done as more and more people come out of poverty is amazing. People will no longer earn USD 2 per day. A lot of people are shifting out of that sort of income. Look at the consumer goods that will be produced and bought within China. Forget about imports and exports. You can see quite a robust closed domestic economy.

Financial regulators have to be careful about opening the economy. If they open the Chinese economy and allow capital to flow out before these problems are fixed, we could have major, major problems. To give you an example, 2% of the depositors in the Chinese banking sector today hold 60% of the deposits. That is not a very Communist system. There are a few very wealthy people, who hold most of the money. Those depositors are not very happy with the services they get from the big Chinese banks. If you opened up that financial system, or if the foreign competition got too good, and if you moved the money out of that system, those insolvent banks would collapse. They would not have the liquidity to survive. So the key for financial regulators is to learn about how quickly or slowly to liberalise that market. If they can keep the market more or less domestic for some time, they will be able to move toward openness with less turmoil.

In terms of politics and the cry for democracy, I'm not too sure where that is. But wherever it is, the rich/poor issue is much more important. There is an income disparity between people in the west and the east. But, again, the central government is very much aware of that. It is trying to shift more money into poorer parts of the region.

Lastly, I worry about Taiwan. I worry about the conflicts that could occur. Lee Kuan Yew, Singapore's long-serving prime minister, came and spoke to our organisation a while back. In his view, on a scale of 1 to 10 of danger—10 being war and 1 being peace—Taiwan has gone from a 2 to a 6.

The worry is that mistakes may be made. Both groups get each other into a mode of threatening or posturing. The Chinese have basically said they would invade if Taiwan were to declare independence. Some people say Taiwan may declare independence immediately prior to the Olympics. That is really an area of instability.

Q First, you emphasised the need to further develop and expand Korean businesses so that they become global players. You are well aware of the continuing political and policy debate over the regulatory system in Korea, vis-à-vis the business conglomerates or *chaebol*.

The business sector—the *chaebol* sector—has complained. It feels that all these regulations have put it at a disadvantage in terms of competing with foreign multinationals. Those companies feel that regulations prevent them from becoming global players. One particular regulatory issue is very controversial: the restriction on the total amount of equity investment that can be made by a subsidiary of a big business. What is your view and position on this debate about whether to, and how to, regulate the business conglomerates?

Second, we keep talking about and discussing the issues facing the big conglomerates. But actually 90% of employment is generated in the small- and medium-sized enterprises (SMEs). We have what you can call a bipolarisation phenomenon. The export sector led by big businesses is doing very well, but it is hardly generating any domestic employment. Then we have the remaining domestic market-oriented sector, which is very much depressed. This is where the SMEs are the leading participants. What, in terms of policy actions, can we take to vitalise or revitalise the SME sector? Basically, economists and management experts say we have to withdraw protection from the SMEs and expose them to competition. Can there be any other policy prescription?

Third, the last time I was in Pudong I was amazed. The contrast that popped into my mind was the Incheon free economic zone (FEZ). The FEZ in Incheon is just a barren field where a lot of construction is beginning. In Pudong I saw modern buildings ready to be launched on the global stage. Korea is so far behind Pudong in terms of trying to become one of the business hubs in Northeast Asia. I would like to have your view on this comparison between the Pudong project and the Incheon project.

A I will take the first two questions as one about investment. It is important that the government encourage and not prohibit or stop investment. As for the *chaebol* and for new businesses going forward, they have to set up a governance structure outside of the old system of control. Rather than controlling the amount of equity they put in, they could control the governance by which those new businesses are run. The equity restrictions are a blunt instrument, and they probably are restricting investment.

One particular industry for investment would be health care. Health care is a huge opportunity for Korea. The natural players would be the *chaebol*. I'm not sure if they will participate in that market, though. Someone would need to talk to them about it.

As for the SMEs and smaller companies, there is a lot more that could be done. Figures #9 through #12 showed companies that were growing rapidly, at about 50% per year. Five years ago many of those companies were SMEs. Ranbaxy was an SME. Huawei was an SME. They did not exist 20 years ago. They were small only about five to ten years ago, in or around the early 1990s. Now they are big.

Korean SMEs do not need competition. They need support and more awareness of opportunities. Many countries provide support for their SMEs and let them learn about opportunities in other parts of the world. For example, auto parts manufacturers in Korea are world-class. There's no question about that. I do not know how that developed, but they are world-class. However, are they playing as big a role as they could in the auto world? I am not sure. We should think about what type of support, perhaps advisory support, the government could provide. Perhaps they need money to look for opportunities. There should be more Korean SMEs with growth rates of 50%.

I do not know if this is done in Korea, but other governments have organised road trips for their companies, like "Team Australia" or "Team Canada". The prime minister takes a group of about 100 SMEs to different parts of the world. This opens up connections. The managers get to meet people in the other governments. We should help Korean SMEs see what opportunities are out there.

Your last question was about the hub. With all due respect to Shanghai—and the city has a lot going for it—I actually think Korea has more substance, particularly if you're talking about a high technology hub. Korea has more companies that can actually do high technology business.

Korea, however, is far behind in terms of government mindset. In comparison, the Shanghai government runs itself like a business. It is a conglomerate. They have a dairy company, an auto company, and some others. I don't want to pretend I know him that well, but the mayor of Shanghai runs that place like a business. The city of Shanghai is one of McKinsey's most important clients. They pay fees. I was shocked when I heard that.

As an anecdote, once during a progress review we talked about where the Shanghai government should place its retail sites and how the subway station group should coordinate for the next ten years. It was a classic issue in an organisation. We had to make sure the engineers and the retailing people were coordinated. There was nothing more to it than that.

I remember the vice-mayor vividly. He was wearing one of those red bandanas from the Communist Party. At the end, he gave the final speech. It was in Mandarin but there were translators. He said, "Comrades," pointing to the city of Shanghai employees. "Listen, Comrades," he said, still pointing to the staff, "your job is to make sure the market works. I do not care if people want to sell underwear, socks, jet engines, groceries or anything else. Whatever they want to sell, they will sell. You have nothing to do with that. If I hear any of you try to say what we should or should not sell, I will fire you. Your job is just to make the market work."

I was shocked. I was checking my earpiece to make sure the translation was correct. If Friedrich von Hayek were there, he would have stood up and clapped. The vice-mayor of Shanghai was saying this in a supposedly Communist country. That is the difference with Korea. I am not trying to make a blanket statement about Korean politicians. But the growth/business mindset of Shanghai government people is very high.

Q You mentioned the area within a two hour flight time of Korea. You said it could become an economic zone for Korean business and that those companies should look to that region across China and Japan as their domestic market. What type of industries or countries would do best? How do you expand a domestic market? What type of services would work? What type of support is needed?

A There are quite a number. First of all, outsourcing is one broad theme. People talk a lot about India as being the outsourcing centre. I actually think Dalian could be the outsourcing centre for Northeast Asia. We're seeing more of that. NTT, for example, already has a call centre in Dalian. NTT has been able to teach Chinese people to speak Japanese in six months, well enough to handle phone enquiries. I found that surprising.

In financial services, too, you could do things. The company would not have to be owned by Chinese. It could be run by Koreans and still provide those services. Credit card services is another example, or mortgage servicing. These are factory processes that could be done in a place like Dalian. It is very much within flight distance and you could manage such a firm closely.

Obviously, light manufacturing could be moved there. Parts suppliers to the electronics industry, or to ship builders, or to the auto industry, could all move there. Those industries will consolidate. Food services also have potential, as do retail services. There is no reason why you cannot have Korean, Japanese or Chinese companies doing more and more across this area, and this really has to include Japan. Japan's the biggest.

One of the issues is that the four mayors—of Tokyo, Seoul, Shanghai and Beijing—should encourage more flights. That would help this area become more of a domestic market. Haneda (HND) to Gimpo (GMP) should be the regular flight route, and Hongqiao (SHA), instead of Pu Dong (PVG), to Haneda should be its counterpart. There's a lot more that can be done on the transportation side.

The computer manufacturer, Lenovo, is beginning to break its business into different pieces. They have actually moved some design work to Japan. They feel that a lot of the leading design work should be done there. In terms of research and design on the engines of the computer, they are actually doing it through a joint venture in Korea. Lenovo is beginning to break up its business across the region, and it needs such transportation links. In almost every sector, from design to outsourcing, you could position things.

Q There are a lot of factors in the Korean economy. Just to keep up with other Asian countries, there is a lot Korea has to do. In many areas, Korean products are fighting head to head with Chinese products. What can we sell in the next era? What is the exit for the Korea economy?

A There are a number of areas. Higher value added is the broad theme. For example, rather than the manufacturing cars, Korea should design cars. If you look at Hyundai or Kia—it is amazing that that organisation is able to sell cars in a market like the US and in markets like China and India. Those two markets have very different consumer needs. Korea should move away from manufacturing and toward design. What kind of needs does the customer require? That's the sort of question Korean businesses should be asking themselves.

Look at California. Twenty years ago, it had many, many manufacturing companies. Those have all more or less been taken apart, not only within the US but internationally, too. There's been a shift within the US and overseas, toward India. In California now you see much more design, financial services and advisory work. Those areas have higher margins. In the car industry, for example, it's in telematics that you make a lot of money, not in metal bending.

In electronics, as well, rather than the manufacturing of semiconductors, Korea's strength is in product design. Where's our i-Pod? Korea has the opportunity to do such things. Korea is doing that in other industries, like film and pop music, from what you can gather in Asia. A real push on more of that would be good.

Financial services is another area. Domestically, Korea has some very good banks. They could play a broader role in the system as a whole. There's a lot of changes that need to be made, of course. But Korean firms have more familiarity with some of the growing pains through which other countries are going. There's no reason to think those banks cannot play a role there.

Health care is another industry. I don't know why Korea could not be a hub for healthcare. If you want to get, say, open heart surgery, why can't we make this the place to which you want to come? To get hernias, you go to Canada. Why don't we pick an area for Korea, like heart surgery. With our technology, care, services and so forth, there are many areas where we could attract business and do things. It's a big field.

Q You didn't mention currencies? Is that intentional? Are exchange rates less important than these other issues?

A On the currency side, obviously, there is a new equilibrium toward which the world is moving. I don't claim to be an expert on that. That's why I didn't mention it. Whether the renminbi is going to appreciate or not—I actually think it will appreciate—will not have such a big effect on US-China trade. So much of US companies' supply chain is already hooked into China. Wal-Mart now buys some USD 13 billion worth of products there. Whatever you do is going to get shifted across.

Q Figure #47 shows the way in which Korea climbed down to fifth place over two years. This coincides with the advent of the Roh Moo-hyun government. Does this say something? Perhaps the Roh government discourages foreign investment?

Second, while staying in Shanghai, you may have spoken with Chinese friends. I heard the Chinese are gloating over the ideological divisions going on internally in South Korea. They think Koreans should do more to revive their country. Did you hear such things?

A On your first point, I learned in Economics 101 that correlation does not imply causation. I'll leave it at that.

The issue is not that Korea's rank has fallen. The issue is the speed with which other countries are moving up. We have to realize that the rest of Asia is moving at a very fast pace. Vietnam is now emerging on the scene. This is a call to action that we must speed up. Everyone—the government and the private sector—has to get a lot more open that way in terms of moving things forward.

Second, in China I have not heard any gloating about how fast they are doing. People are very optimistic and confident. People are excited because they see what is happening. That is so different from any other part of the world. The average Chinese person is so excited. Even if you take a cleaning lady who is being paid the equivalent of USD 200 per month, she is excited about the future. She knows her children will be much better off than she is. She is willing to make the sacrifice. That is the mindset you see. We have a great future in front of us. Let's sacrifice and invest and move forward. That's different from what you feel in other parts of Asia, including Korea.

I did not hear any comments directly about Korea. There's a lot of respect for Korea, for the technology, and, believe it or not, in film and music. I am amazed at the number of Korean shows and movies on my television in Shanghai. There's quite a lot of interest on that side. Korea does have a role to play. With Japan, there are still feelings about World War II, even in this generation. That is different from what I felt about Korea. That is something that is different.

Q You lived in Korea. You closely observed Korea and Korean society. Now you live in Shanghai. You can see Korea from that perspective. What are the major problems for direct foreign investors in Korea? Is it labour relations? Labour costs? Koreans is seen by the outside world as having very radical labour relations. You already noted that labour costs here are the highest in Asia. Is it because of government intervention and regulations? How are the social amenities for ex-pat managers in Korea? How is the living environment? If you were asked to rank all of these factors, which are the real obstacles to foreign investors?

A There are three issues that come to mind. The first issue is labour flexibility. If you want to build a business, you are obviously going to go through ups and downs. You will need to "right size" and change your business. People worry that if you put money into Korea, it will be very painful to make changes when you need to. Some companies have been able to do that successfully in Korea and have worked through it. But the image out there is that Korea is a tough place to do business. That's the overriding image. That sets people back.

I remember having conversations with Temasek three years ago in Singapore. I was talking to the chairman of the Temasek board of directors. Some CEO from one of his holding companies wanted me to talk about Korea. I said, "This is a wonderful place. You really should be putting money in here. It's a great place."

He took my document and literally pushed it to the side of the table. "I don't want to read your numbers," he said. "It's a tough place to do business." I said, "Well, it's changed. You have a pre-1997 view." But it didn't matter. It is very difficult to get any business done in Korea. You have labour unions, costs, mindset, regulations, etc. This has of course gotten better, as Temasek is now here. I am sure they would like to do more.

In a place like China, on the other hand, the red carpet is rolled out so fast it's not even funny. If you're an investor, you get police escorts when you come in from the airport. The mayor of Shanghai from 1987 to 1991, Zhu Rongji, set up a forum of CEOs to provide advice to the mayor's office. In the business culture there, there is very much a feeling toward flexibility and a desire to have foreigners.

The second issue is that there is still a feeling that Korea does not like foreign investors and does not really like foreigners. Even a foreigner's local identity card says "Certificate of Alien Registration". Do I come from Mars? Am I an alien? These are subtle things but they mean a lot. That's why I included figure #46. It may be that *The Financial Times* exaggerated the issue or perhaps does not understand the context of why the government is thinking about this. But the image that goes out is that Korea does not really want foreign investors.

The third issue is the living environment. Now that I live in Shanghai, I can say that even I made too much of this issue while I lived here. From a family's point of view, Seoul is a nicer place to live than Shanghai. You have mountains and hiking here. There are amenities. Sure it's sure not as cosmopolitan. But Shanghai is a business city and a nightclub city. If you like nightclubs and you're in your twenties, it's a great place. Beijing is very government driven. Seoul has a lot going for it. But, again, it doesn't match the image. If people were to rank their top five places where they'd want to live in Asia, Seoul wouldn't even be on the list.

Recently, one leading global company tried to recruit staff to be stationed in Korea. The firm interviewed 30 top people. None of them wanted to go to Korea. One of the main reasons they gave—and this was younger staff—was the educational system here. Korea does not have proper schools for their kids. Medical services, too.

If Korea wants to become a hub, you have to pay attention to all these things. It's very important for Koreans, particularly policy makers, to realize what it takes to make the nation a hub.

Q What about corporate governance. You mentioned the Korea discount. One of the factors often mentioned by foreign observers and analysts is Korean corporate governance. Corporate governance is not transparent or accountable. Korean standards are too low, even though Korean corporate governance changed dramatically after the currency crisis. In your view, is that observation accurate? Do you think major Korean corporations, in terms of corporate governance, are still behind their global competitors?

A Corporate governance is a big issue. A lot of the hardware was put in place after 1997: independent directors, smaller boards, committees, etc. The scaffolding of the building was built. But inside, things had not changed. Did many independent directors ask tough questions? Not very many did. The software side—the tough questioning, challenging management about what they should be doing, and really training the board members—needs to be improved. That is a concern.

The ownership structure, which is more hardware than software, worries people. People worry about buying a particular company that may be somehow linked to another. There is a probability that someone might take money out of the one company and put it in the other. It has happened. It has happened recently. People worry. That leads to a discount.

The other element about the stock market is that we don't have enough long-term money in the market to provide stability. The Indonesian market has at times had lower valuations. For example, Indonesia has more corruption and software problems than Korea. But for some strange reason they have a more stable market.