The Status of Korea's Restructuring: an Outlook Over the Next 10 Years*

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There are basically three messages that we wanted to leave with you today.

The first is that we actually believe that restructuring has gotten off to a good start from 1997 but there is a very long way to go to complete the job.

Second, if we look out ten years to 2010, we are very bullish on what the economy could look like. We actually believe—assuming that major restructuring is reinvigorated — that the Korean economy could be a UK sized economy by the year 2010. Some people may think that is a pretty outrageous goal to set, but we've actually spent a lot of time doing bottoms-up analysis sector by sector in Korea over the last three years, looking particularly at factor productivity.

I won't go through the economics of that, but when we built up from the bottom and looked forward, we do believe that that is a reasonable target for this country to go for. That is in ten years, and again, that requires some very serious restructuring that is going to have to occur.

If we don't take on the restructuring challenge seriously, we could end up being more like a Latin American country, such as Mexico and Brazil and God hopes not like Argentina, which did not address the restructuring challenge in front of them and have basically been bouncing up and down: growth, negative growth, growth, negative growth. That's the choice that we think the Korean economy faces.

Over the next 12 months, please don't ask. McKinsey is not particularly good at forecasting quarterly macroeconomies. Longer term, I hope we have somewhat better of a perspective on things.

The third point we wanted to raise is that a lot of people, I think, know the "what" to do, in terms of restructuring. We know that we have to downsize some of the corporates, we know we have to increase the productivity, and so forth. We think the fundamental challenge is *how* to get it done. Why is it that we can't get the mechanisms for restructuring to keep the pressure on? And so I wanted to talk a bit, in the end, about what we think are some of the critical mechanisms to ensure we keep the pressure on corporates and on the government and on labour and on everyone in fact to try and to be able to

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achieve that goal.

Restructuring Status

Let me start, first of all, with where does McKinsey think Korea is in the overall restructuring process. In January 1998 we gave a number of speeches on what we thought would have to happen for the Korean economy to go forward. But this restructuring was not a six-month, eighteen-month, or even three-year exercise. This is more a five to fifteen year journey.

This is from work that we've done in other countries, and also looking at about thirty-five other financial and economic crises. No one ever got out of the problem in three years. The view of setting targets for when the crisis is exactly over is ridiculous. You should not do that.

What we do need to do is understand that this is going to take a long period of time to get through. The good news is we are through the liquidity crunch and the financial crunch, but we are right in the early phases of what we believe is the real economy restructuring.

As you know, there has been very good commentary from a number of players about the *early* stages of restructuring. In fact, I think Korea is very much the poster child, particularly in Asia, for countries that immediately seized the challenge. Though again there are some questions about maintaining the pressure and the focus.

For example, if you think about the financial sector pre-1997 and the financial sector now, it is *very* different. Again, there is a lot more that needs to be done, but very significant changes have been made. There has been quite a bit of change in the business sector, and also even on the labour side.

I think the biggest success has really been in the external environment. At the end of October 1997, the ratio of foreign reserves to short-term debt was obviously way beyond the danger zone. That number has gone up significantly, and continues to actually increase, which leads us to say that from an external point of view we are in *much* stronger shape than we were before. However, the problem is that unless the real economy restructures that will not be sustainable over time.

We are, you may say fortunately or unfortunately, not like Japan. Japan has been able to withstand their situation for over ten years because of the wealth of that country. We do not have that luxury, and I think that Japan, over the next five years, is going to be facing a similar challenge, that they are going to have to restructure. But for now in Korea, the external situation is a lot better than it was before 1997.

If you look at the actual recovery of all the Asian economies, obviously you see a big recovery since 1997, though when you start looking out past 2001 it's getting a little shakier. I think that if we really take a close look at what happened, we were very fortunate in terms of some of the external trends that were going on to help us with the recovery: we had an incredible growth rate going on in the United States; we had labour that was willing to share the burden; we had extremely low working capital levels in the country; inflation was low; and oil prices were at a low level. If you look at almost every one of those conditions today, the situation is a lot different.

You know, we looked at the U.S. economy (See Figure 1.) and this is just the GDP growth, actual GDP growth, and you see that we've shifted from an area of between 4 to 5% growth per annum down to around 1 to 0.9. Some people are forecasting that it's going to move into negative territory. Some people are saying it's going to be between 1 and 2%. The fact is, that engine that helped power us out of the crisis in 1997 is not there right now.

Figure 1

I think if you also look at the external commentators, besides ourselves, in terms of what has actually happened in some of the corporate restructuring, there are very big concerns around the pace of the corporate restructuring. And that, I think, is reflected again in terms of our overall credit rating. We seem to be stuck as a country around Triple 'B', which is, you know, the lowest investment grade rating.

Fundamentally again we believe a core part of that is around the corporate sector. What we've tried to do in Figure 2 is measure the economic value added that both corporate sectors in the U.S. economy and the Korean economy have been generating over a ten to twenty year period of time. And if you compare the United States between 1981 and 1995, the corporate sector in the United States, their return on invested capital was significantly higher than their cost of capital throughout that whole period, even though there were dips and bumps all the way through.

For Korea, we've, unfortunately been, except for a few years, in the reverse situation. From an economic value added point of view, our corporate sector has effectively been destroying value over that period. And that's why, you know, the crises come. You have to pay the piper, at some point.

Figure 2

Our view is that, to get restructuring moving forward, it is critical to get the corporate sector back on track. If you look at the industries in Korea, this isn't just concentrated in one or two industries. This value destruction is going on across a wide range of industries in Korea, a significant number of them.

We've talked about this interest coverage ratio, which is a company's ability to just pay the interest on their debt. The worrying factor for us when we look at this is that there is a significant proportion of Korean corporates that are unable to pay the interest on their debt, which obviously is not a sustainable situation. So the pressure needs to be on *these* particular corporates to improve their profitability and their cash generation. It's a big job. There's likely going to be some more non-performing loans coming from that.

The good news is that there's been a shift, not a big shift, but at least a shift in the positive direction over the last year, with the government putting in more stringent criteria on those companies that cannot make their interest payments from cash. So you've actually seen an improvement.

But the big problem is that there is still a large portion of Korean companies that can barely pay the interest on their debt. That's not a sustainable situation. So, again, changes are going to have to occur there.

If we look at the returns on the Korean stock market versus the U.S. stock market from 1990 to 2000, including the big correction that's occurred, you see a vastly different story. If you'd put money in the U.S. market you would have had an average return of roughly 18% versus 4% on the Korean market.

I think that reflects a couple of things. One is the serious difficulty of the corporates. Corporate governance issues have to be dealt with in order to improve the performance of these organizations. Secondly, it actually affects the Korean consumer.

This is a very serious problem for Korean consumers who have savings; where are they going to put their money? Because when you see a stock market like that, it's not going to attract a lot of the important Korean savings into the stock market. So, again, these things are linked.

In terms of the chaebol restructuring, there has been some improvement, but not a lot, frankly, if we really take a hard, close look. For example, look at the number of subsidiaries at the top five chaebol. Have they really focused down in terms of the number of businesses that they are going to hold? Has there been reshuffling? There's a lot more that needs to be done in that group.

I'm going to shift a bit to the financial sector. Figure 3 is a relative ranking of financial systems on a scale of one to ten. We actually did this with a group of central bankers about two years ago from around the world. It was a McKinsey conference that we held where we laid out the countries across the world in terms of their financial system development.

The key criteria we looked at were things like credit skills, the regulatory and supervisory approach, the effectiveness and depth of the capital market, the counties' individual domestic institutions' strengths and capabilities, and the infrastructure efficiency, the payments and clearing systems and so forth.

When we looked at those criteria, Korea was very much like Japan, on the lower end of the scale. It has a pretty under-developed financial system. The good news is that there have been some jumps over the last 3 years. We think that the Korean financial system is better than the Japanese financial system today, which is probably not saying very much, but its better than the Japanese system, and moving in the right direction. But, again, we got a long way to go to get to the stage of a fully developed financial system like the U.K. or U.S. system.

Figure 3

The second theme in this restructuring status overview is that, while we're having to go through this restructuring, the world is unfortunately changing in a more rapid way than it has been before. That is going to increase the requirement on speed for restructuring. We *do* believe that there has been a fundamental shift in how the global economy is working, because of liberalisation, deregulation that has occurred around the world, mobility of capital—there are now truly global capital markets—and obviously the technology side, which is affecting interaction costs.

These forces are going to have big implications for Korean companies. The first is that more markets around the world are going to be globally competitive, from 21% to 60% by 2010. We're seeing the emergence of global standards—and I don't mean that's just for emerging countries moving to developed country standards. There are actually standards that are evolving between the United States, or North America, and Europe, which a lot of people would have thought would be unheard of five to seven years ago on accounting, corporate governance, and legal issues.

Product life cycles are shrinking dramatically. The average product life cycle for a consumer good in the '80s was about 7 years. It had 7 years for it to reach its maturity. That has dropped dramatically, and if you particularly look at areas like PCs it's now in the period of months. That puts a lot of pressure on organizations to re-invent themselves.

There also seems to be a winner takes all economy emerging. There's no middle ground. The best get a lot bigger, faster and the losers disappear from the system. So it is a much more aggressive, Darwinian world that exists out there.

More people are forming alliances. More corporates are outsourcing and doing things with other corporations over time. Having alliances, networks, and so forth, has become much more important.

There is also a war for talent. Korea has a huge amount of talent. Obviously there are a lot of educated people in this country, especially when we look at the number of Ph.D.s per capita and so forth. These highly educated individuals are being targeted by companies and by countries around the world that are trying to attract the talent from this country.

Take a look at Singapore. It made a very specific goal: that they wanted to have the biggest market share of talent in the world, in particular categories, living in their country. There's a lot more pressure that is going to be coming down the system in Korea, in terms of competition for talent.

Figure 4 concerns the capital markets. We've been spending a lot of time at McKinsey looking at how the global capital markets have evolved. There's just one message I'd like you to take away from that figure: that basically there are two financial hubs that seem to have emerged in the world, based in the U.K. and in the United States, in New

York, Wall Street. Frankfurt, by the way, is growing in some significance, but fundamentally the two main financial centers are the U.S. and the U.K.

Well you can say, who cares? Why does that matter? The reason it matters is because that's where a lot of the asset managers are and the investors. They're the ones that are setting the rules, in the sense of accounting standards, legal standards and corporate governance. They have a lot more power than they ever had before.

A lot of people when they draw that map will think that Japan, or Tokyo, given that it's the second largest economy in the world, would be somewhat of a financial centre. Singapore thinks that they are doing something in that particular area. But the fact is it's these two centers, the U.K. and the U.S. It's important to understand that: this is not about politics, it's about money. This is where most of the money and most of the investment decision makers are concentrated. That's what we think is driving a lot of standards.

Figure 4

The point I want to reinforce, is that there's a notion of a winner takes all economy, and there are companies from countries that are becoming global champions. Everyone's heard about Nokia in Finland. Nokia, still right now with their market correction in their stock, and in their telecom stocks in general, is bigger than the entire KOSPI market capital, all put together. Frankly, that spells opportunity for Korea.

If you look at our colleagues in the Netherlands, we see that it's a small country but they have at least five global champions that are based there. If we look at Switzerland, they have six. These are economically smaller countries than Korea.

In Korea we have one global champion right now, which is Samsung Electronics. We believe that as we go forward, Korea should aim to have more in the order of 10 to 15 global champions; corporates that are competing and playing a shaping role around the world. We believe that's doable.

So again, we had a good start to the restructuring, but there's a long way to go. We talked about these four stages, the five to fifteen years, and, again, we believe there is a choice in front of the country. They must seriously tackle these issues or move the way of the Latin American countries where you're just bouncing up and down in terms of growth and leading to a net lower overall growth rate.

Korea 2010

As we look out to 2010, and this is based on primarily this bottoms-up analysis I mentioned before, looking particularly at factor productivity, which we believe fundamentally drives GDP/capita, we believe that the Korean economy on a purchasing power parity basis could and should aspire to becoming a top ten OECD sized country by the year 2010.

That would imply a growth rate of slightly over 6% per annum, which you could say is a pretty serious number to be aiming for, while the OECD is forecasting around a 1% growth rate for that top ten group of countries.

If we then were to compare it to other countries in terms of a per capita income level, that target would put us about seventh in the world. (See Figure 5.) By the way, that's only a little bit behind Ireland, which I think is an interesting story in and of itself in terms of where that country has come from. So that's the goal we think that the country can achieve.

Figure 5

One of the key processes that we did look at was this factor productivity analysis. Basically one of the fundamental problems that we've seen in Korea is that our labour productivity is *half* the productivity of the U.S. today.

Only in one industry, and that's steel with POSCO, we're actually leading the world in terms of productivity. In every other sector and industry, we are far behind. So our labour productivity is the fundamental issue. This is the work we did with Bob Solow, Martin Bailey and a number of others, spending about two years going through in a lot of detail, sector by sector, what are the differences.

What we are assuming, and looking at in terms of going forward is that we'd be able to improve the labour productivity significantly. We would not, in the year 2010, get to

U.S. levels, but we would get close to it. That will require some pretty significant shifts in terms of what this economy focuses on: a shift away from heavy manufacturing to more of a service oriented economy and to those industries with higher growth rates.

Secondly, a much more flexible labour market than we've had before will be required. We think that there's going to be a lot of job creation and job loss as you begin to shift the economy. A huge productivity improvement in the corporates themselves will also be seen. This will, again, force us to ask ourselves how much labour do we need, are we using enough of the capital to help labour in terms of what they're doing?

We have, in the process, also been doing quite a bit of work with Korean companies. What we've found in basically every single Korean corporate we worked with, is that there are *significant* opportunities in terms of productivity and performance improvement in all of them.

Figure 6 are some benchmarks of what we've seen, in purchase cost reduction, operational performance, overhead reduction, etc. These are numbers that we would *expect* to get out of the company in terms of cost savings or performance improvement.

These numbers, by the way, are literally double what we are finding in the rest of our practice around the world, from work that we are doing in Europe or North America. So we found from the trenches, if you will, from the school of hard knocks, that there are significant opportunities in the companies to be able to improve the performance.

Figure 6

If we look at our service sector over time, Korea has a very under developed service sector compared to other countries. We think that is something that needs to significantly shift. If we look at these service sector companies and industries, and look at their growth rates compared to the growth rates of companies that we are traditionally focused on in Korea, there are quite different growth rates.

Look at software, biotech and telecom services. These all see growth rates somewhere in the range of 8% to 15%. There are businesses that do not exist in Korea which need to exist in Korea and come online, particularly in the service sector.

Educational services, which on a private education basis is the single largest private education market in the world in absolute terms (it's about a $30 billion market), has the potential for global champions to emerge from it.

When we compare service industry growth to the other side (manufacturing sector growth), we are looking at things like steel and textiles: they have a very low growth set of opportunities. So again we think that there is a need to shift the focus in the Korean economy from the manufacturing sector more toward the service sector.

We are also going to be looking at a significant ageing of the population in Korea over the next 10 to 15 years, which I think also represents opportunities in terms of the service side. We've seen such trends in many of the other developed economies around the world, in their change over time.

In this process we think, as I mentioned before, there is going to be a lot of job creation, but there will also be a lot of job loss. Our estimate is that as we shift more toward a service-based economy there will be roughly 3 million new jobs that will be created. But in the process there's going to be a large number of people who are going to have to change jobs. So again, labour market flexibility is absolutely critical. If we don't have the labour market flexibility we're not going to get to the goal that we need.

It's also going to require that we see some sectors disappear or significantly drop in importance over time. Agriculture, even though it's a lot less than it was before, is still a significant employer and that, politically, can be difficult, as we know from looking at the Japanese case. But it's going to have to be dealt with.

Ireland is a model that we've always kept in mind, because while we were doing the bottoms-up analysis we were also checking whether this sort of growth has really happened in any other country. It has. Ireland, as I'm going to talk about a little later, is a good example.

Some referred to Ireland as the "basket case of Europe" for a long period of time, ten to fifteen years before 1986. In about 1986 Ireland made a fundamental transition in terms of what they wanted to do. What I've tried to do in Figure 7 is try to show what Ireland looked like in 1981 and what it looked like in 1997. It's *eerily* similar to the Korean situation in terms of the proportion, for example, of the service sector and manufacturing sector. Roughly 50% of their economy was on the service side. They've shifted that to 60%. Ten percentage points may not seem like a lot, but it is. That's been an important part of their recovery.

Figure 7

To emphasize the opportunity in the service sector, we did another analysis. We literally took the Yellow Pages in Seoul versus the Yellow Pages in Manhattan, looked at the services that are there and compared the number and types that are available. You see a large number of gaps.

For example, you see 7'000 categories in Manhattan versus 2'000 categories in Seoul. Again, there are lots of service business opportunities that do not exist in Korea today that *do* need to exist. Hopefully entrepreneurs are going to go after those, because there's a lot of opportunity and jobs to be created from that.

Another element to this service sector growth is driven by what is actually going on in the corporates. We find that there is still a mentality in Korea of corporations wanting to do everything themselves. You want to keep it within the family; your IT, your trading, all sorts of activities.

Well, the rest of the world is moving toward a very different way of doing things. Figure 8 looks at a sample of some European and U.S. companies as to what proportion of their value added is being produced actually *inside* the company versus outside the company.

What you see in companies like Ford, Tyson, ABB, DaimlerChrysler, is that very significant portions of their value added—what they're doing as a company—is not in fact actually done inside the company. It's outsourced to other parties who supply them, and to alliance partners.

We think, again, this is going to be an important element of the long-term transition of the Korean economy to doing *less* inside and outsourcing more. That, again, will be seen all around the service industry: for example, third party logistics and banks combining IT centres, as some bankers are already thinking of doing. All of these are important elements of what has to happen in terms of restructuring.

Figure 8

Another area that's going to be important in our restructuring is dealing with the overcapacity issue in Korea. We've spent some time in the last three years working in industry consolidation, whether it was in the beer industry or the chemicals industry or even sometimes in the steel industry.

We saw that there exists significant profit and productivity improvement potential from, frankly, reducing the excess capacity in the industry. We have in some industries in Korea way too many competitors. Our examples are actually a bit disguised, but not too much. The combinations that have already occurred have improved the performance of the merged company and, in fact, the industry overall.

We've spent a lot of time looking at what's happening in the different sectors and we believe that there is significant overcapacity—there are too many competitors—in these industries overall. So we've tried to be as specific as we can, but these are ones where we think there has to be significant consolidation—fewer players. I think this is something of which the Fair Trade Commission must be more understanding, and the consumer as well. We believe it is in Korea's interest.

The competitive market is not Korea. The competitive market is the global market, as I've tried to say before, so we need to think about that as we move forward.

On the labour side, as I've mentioned, we, in our forecast out over the next ten years, believe that about 5.6 million workers are going to change jobs. That's a pretty significant number for this economy. That's going to require a lot of labour market flexibility. Also, not only will labour have to be more active, but they'll have to be more flexible and understanding, in terms of their role. But it's also going to require the support and safety mechanisms from the state, in terms of being able to allow people to have the chance to find new jobs, and so forth.

As I mentioned in the Ireland case—this is closing up the section on the ten-year prediction—we think it's a very interesting model for Korea to look at. It was the basket case, as I mentioned, of Europe for many years with constant declining growth. In about

1986 they woke up and said, "Enough is enough." They have since achieved a very significant improvement. They actually have had, on average, a 6.2% cumulative average growth rate over the last 14 years, which is quite impressive. The unemployment rate has dropped from around 19% to less than 5%.

A *core* element of that, and this is where I think the politics comes in, is that the two main political parties agreed to an economic consensus. This is something I really hope that Korea can do more of, because it's in *everyone's* interest in Korea to move to where we want to go in 2010.

It shouldn't matter what political party you're involved in. The fact of the matter is that in Ireland *the* two political parties made an economic consensus where they *agreed* on the goal of where they were going to move. These two parties were not friendly parties. They disliked each other fairly considerably. But they were able to agree on an economic consensus and therefore had consistency in economic policy over a long period of time.

They went through several changes in power, in government, and yet were able to maintain the economic consistency. I have no clue how that could be done in Korea, but I just hope people would think about doing so because we need consistency of economic policy to move the country forward.

Spurring Reform Forward

Moving on to the final section, we say, "Well that's all very interesting but how is all this going to get done?" What we've tried to do here is outline what we think are some of the key *mechanisms* to more aggressively drive the restructuring forward.

We think people easily understand what they have to say: improve corporate profitability, cut costs, etc. But it's getting the mechanism in place to drive reform and to make the change happen that is critical.

We've tried to identify five mechanisms: corporate governance, capital markets, labour market reform, aggressive leaders and political reform. If I were forced to pick just one, it would be corporate governance. I think corporate governance can drive a lot of the others, except obviously the political reform. So I'm going to spend a bit of time on that.

Long-term there are also some things that this economy needs to do. I think education reform is one. While Korea spends the most amount of money of any country in the world on education, if you look at the output of the higher education institutes, in terms of research and so forth, it's significantly lower than what we're seeing in other countries. Yet again it could also be potentially, I think, a big strength of this country.

R&D policy is another area where we've seen other countries make significant changes in terms of their focus over time. To have consistency and focus, perhaps having more of the private sector being involved in the process, and frankly leveraging other countries and institutes in other countries, will all be important as Korea moves forward.

On the corporate governance side, I'm not going to spend a lot of time on why it matters. Hopefully people understand that. We've done a survey last year, we've just done it again this year, all across Asia and in fact the world, talking to institutional investors about the importance of corporate governance. What we're finding is that there's a very strong message out there: many investors are saying that they're willing to pay a *premium* for good corporate governance, and, in fact, are saying it's more important than the financial results themselves, in terms of what they are looking at.

Figure 9 is an example of the average premium people are willing to pay for good corporate governance. It ranges, if you look in the middle column—Japan, Taiwan, Korea, Malaysia, etc.—investors say that they are willing to pay about a 23% premium for good corporate governance. That's how important they believe it is, and they are willing to put their money on the table to reinforce that.

Figure 9

There's been a fair bit actually done in Korea, in terms of corporate governance, but there's a long way to go, and I'm just going to point to the right hand side of Figure 9 surveying how well we have done in Korea in this area. If you looked at the criteria of corporate governance, what investors think of, only about 42 of the 73 companies did well. If we look at independence, unfortunately the majority of outside directors are not really independent in Korea. That's got to change to be able to get good corporate governance over time. There are very strict criteria about what investors mean when they say independence.

I think the other factor is that in our estimate, there's a need for 2'000 independent directors in Korea over the next five years. We believe that right now, and this is work we've done actually with the Financial Supervisory Service and with Professor Sang-yong Park at Yonsei University, that presently only about 150 people are qualified. (See Figure 10.) That doesn't mean they're not very smart people; they can do it. But being qualified in terms of trained, in terms of what a director is supposed to do, there are about 150 and we need 2'000. There's a big job to be done here.

Figure 10

Our view is that we think a director's institute needs to be established that would actually certify directors. There's a whole range of different programs that we actually think an institution needs to cover, and this would be *very* beneficial not only to the corporates but also to the image of Korea; also, frankly, to the local stock market and consumers.

The second mechanism we've mentioned are capital markets. This is one that I'm *very* frustrated with. There's a number of people who've been talking about this and trying to get change for several years; talking about its importance and what needs to be done. There've been multiple studies by the World Bank and multiple studies within Korea by various very prestigious research institutes. But frankly, not enough has happened with these.

This building of a capital market is important because it allows us to move to a much better risk adjustment system and pricing system for various instruments over time. It allows us to put pressure on corporates. It's the capital markets and investors that put the pressure on corporates for performance in North America, and are increasingly doing so in Europe.

"Capital markets" is a big fuzzy word. It means a lot of different things to different people. From our point of view, on the McKinsey side, we think *the* most important element is creating a long-term debt market. The debt market today in Korea really goes out to only five years, if you're lucky. We need a debt market that goes out to thirty years because if you have a long-term debt market you can price other instruments, other risks. That will allow other, different capital markets and asset classes—equities, some venture funds, etc.—to be able to come into the market.

It is doable. Singapore had no capital market in 1998. In one year and six-months, they now have a debt market. They didn't need a debt market. They have a government budget surplus. But they have built a debt market, a long-term debt market.

That's because of hard work. It wasn't just the government; it was involving the private sector, not just involving advisors and researchers. It's involving the intermediaries, the financial institutions who actually need the capital market. I think it should be a priority for Korea to get this debt market up and running because it's going to really benefit us down the road. Also, it's not difficult to do.

One thing I'll just mention here is that a lot of people say, "From a supervisory and a regulatory point of view, it's all up to the FSS to ensure the integrity and soundness of the financial system."

In most other developed financial markets, yes, the regulator plays an important role. But actually it's the capital markets themselves that are playing *the* most important role in terms of disciplining institutions and forcing financial institutions to behave properly. It's also corporate governance that's driving it. We need to think about capital markets and corporate governance as key parts of the safety net and reform driving mechanisms.

Concerning labour markets, a lot can be said. There are some interesting numbers, again, which actually show that the amount of unionization in Korea is in fact a lot *less* than you would think. I think 11%, versus in the UK at about 55%.

The problem, we think, revolves around flexibility and mindsets. It's important that we educate labour. You know how many people at various speeches and conferences that are held on global trends and restructuring come from labour? I think it's very important that labour leaders be involved in being educated as to how the world is changing.

The second thing is that if you think about our public expenditure on labour programs, and you compare it to, let's say, Ireland, it is significantly less. That means we have less support for those people who've lost their job in finding another job. This comes in the form of not just unemployment insurance but also job search and job retraining facilities and support. That's been a very important part of many economies that have gone through a transition. It's not about *bashing* labour and waking them up. There's a certain element of that. But it's also about making sure the environment's there for them to shift jobs and so forth.

Fourthly, a key mechanism is aggressive leaders. You know that it is easy to blame a lot of different people for not getting things done. We actually think a lot of the responsibility for change is going to fall on the shoulders of CEOs and leaders in this country.

These times of change haven't all been rosy situations. Many of the situations have been significant turnarounds. I think there are some interesting characteristics about some very successful leaders who have dealt with some very difficult times and corporate situations. I'm not going to go through all of them in detail, but I'd like to point out a couple on them.

The first is how these people, frankly, use their time. It's quite different from what we found about the way in which CEOs in Korea use their time. The second element I'll point out is about intensity. Every one of these successful leaders is extremely intense around performance. They're always asking about how they can make things better, do it faster, improve performance.

There's also an issue, a third issue which we want to talk about, which is these leaders get to stay in their jobs for a little longer than leaders do in Korea. I think one of the big issues I'm going to talk about is that there is much too much turnover in Korea of leaders. Cabinet ministers are changed like you change bed sheets.

The average CEO time period in Korea is much less. It's very difficult to transform an organization if you are changing the leadership on a regular basis. It just won't work. It's that basic.

Figure 11 outlines the tenure comparison, in the year 2000 of the average tenure of CEOs in Korea and the U.S. It's about 2.9 years in Korea. It must have been a good year when we did this analysis. It's significantly less than what you see in other countries. So one of the things we think will be important is that CEOs, assuming they perform well, should stay in their position for a longer period of time in order to get what they need to done.

Figure 11

Another area, to point out, is on compensation. If we compare U.S. CEOs—and this is for equivalent sized companies (we're not looking at small business, we're looking at large businesses)—when you look at their compensation structure, the Korean CEOs are getting most of their compensation in basic salary and fringe benefits. That's quite different than what we're seeing in the U.S. and increasingly different than what we are seeing in Europe, where you see a significant portion of CEOs getting their money from stock options and some sort of performance incentive. We think that's an important element of the changes that need to occur in Korea.

These are just some questions you might ask yourselves. They are questions that we ask a lot of our client leaders when they are thinking about their day to day work in their organization, because, again, change is not going to come from the government mandating things or from the regulator mandating things. It's going to come from corporate executives doing things in a different way. So these are just some questions that we would ask our client leaders as they are thinking about their organization.

Education reform is more in the long term. Korea spends more on a GDP basis than any other country in the world on education. But if we look at our *output*, this is just one element of it, which is faculty research, it is *very* low, and we need to improve it. I think it is easily improvable.

If we were to actually look at the number of Korean Ph.D.s and leaders who live outside of Korea and are playing significant roles, I think we'd all be shocked at the large number. I can tell you from a financial institution point of view there are a significant number of people who are trained, brought up in Korea and then trained in the U.S. They then stay in the U.S. and are now on executive teams of these global champion financial institutions. So the potential is there but our education system is going to have to go through some significant reform.

I'm not going to spend a lot of time on R&D. Figure 12 is taken from MIT where they, on an annual basis, rank the most innovative companies in the world. Not surprisingly the bulk of them are coming from the U.S. and Japan. I'm not going to spend a lot of time on it except to say that Korea is hardly mentioned.

Figure 12

In fact, the issue for us is that we only have *two* on that list, and I think given the technology capability of this country and where we are we should have a lot more on the list. Again there are some examples of what some other countries have done in terms of changing their R&D policy. I think there are some good changes that are going underway in Korea, but we found that much more focus is required.

Interestingly enough Finland in 1987 decided to significantly focus their R&D expenditure in one sector, and interestingly enough that was electronics and telecommunications. In Korea, we can't be broad based investors in R&D—we are too small of a country to be focused on five different areas. So think about focus.

Let me go back to the Singapore case. (See Figure 13.) They are becoming *very* aggressive here. They think their future is going to be dependent on having more than their fair share of research and technology. They set very aggressive, specific goals. They have significantly increased the budget for such R&D.

I think point number four on this Singapore chart is the one that is the most critical; they are recruiting global talent. That is their core objective that they have: to try and attract talented people to move into that country.

Figure 13

Questions & Answers

Q: Let me ask two questions. First, as exogenous variables did you take into consideration the long term one hundred political and cultural cycles by Daniel Bell and Modelski. Also, did you take into consideration the fifty year's techno-managerial cycle by Kontratieff and Schumpeter, namely the fourth cycle, that core technological industry IT is fading these days and the fifth cycle of new technology bio and new ceramic super conductivity paradigm will come out?

Second question. The PRC is emerging, by entering the WTO later this year and the probable Beijing Olympics in 2008, both of which will create a boom until 2008 and probably later into 2009. According to the Korean and Japanese experience, will this make a great depression that will affect the Korean economy?

Did you consider these two exogenous variables?

A: I think in terms of the first question I'd say no. We did not look at the Kontratieff cycle and all these elements to it. We took a factor productivity based approach to what could happen sector by sector and build it bottom up. So that's what we did.

On your second question, on the PRC and Japan, we did, in fact, look at that. In fact, one of our competitors, Booz Allen I think, did some very good work on this. I think they called it the Nutcracker, right? Where you've got Japan what if Japan resurges, and certainly what's going to happen on the China side? And so we did look at that in terms of our forecast by sector. So we looked at textiles, for example. We think that we are not going to be competitively sustainable in textiles versus China, which affects what we think will happen to that particular sector. So on a sector-by-sector basis we tried to look at that.

Q: You properly pointed out that Korean labor productivity is only half of that of the U.S., except in steel. Do you think this is because of Korean workers' mentality problem or is it an institutional or social overhead capital problem?

For example, my productivity as a professor in Korea is just half of that of every U.S. professor. Suppose I move to the USA. Do you think I will be the same? I would appreciate your explanation.

A: I think the labour issue is obviously a complicated one that has many pieces to it. I actually think there is something to both of those points. I do believe there is a labour mentality issue, and I think labour has played a very important part in the development of the economy over time. People could argue that they've been, you know, abused over… if you look at sort of twenty-year period of things. But the world's changed. I think, particularly with labour leaders, there needs to be an understanding of the mind set, that this is a win-win situation, not a win-lose situation.

If I look at what the U.S. went through and what Europe, especially the U.K., went through, and if you look at the some of the companies that weathered through successfully, they spent a lot of time educating labour.

For some U.S. auto makers like Ford and General Motors, when Japan came into the U.S. market and *whacked* the U.S. auto industry, they sent the labour leaders to car plants overseas (e.g., the Nissan plant in the U.K.) to look, to see. "We are not bull crapping you that they're able to make cars better. You look and see for yourself. They are producing these many cars per person, and you can see it." We need to help labour understand. So it wasn't a matter of feeling they were being fooled.

So I think there's an education element. I think also that's where corporate governance can help. I actually think if labour believes there's good corporate governance and it has transparency. They understand what's really happening with the economics of the business.

On the second par of the question, I'm sure you are very productive—what you are doing. But I do think there is an environmental element, in terms of how people spend their time and focus their time, and are they output driven or activity driven and so forth. And I think there are some things that need to change on that front to be able to get the performance.

Q: You gave us the large picture for the next 10 years, with some assumptions. And then you said, first, we can achieve 6% per annum growth once there is additional reform in the service sector. In the second scenario, we can get 4% once we reform the financial sector and manufacturing. And the other, if there is no fundamental reform, there will only be growth of 1 or 2%.

From your experience in Korea and your assessment about the political situation and the labour market situation here, what is the probability of each scenario?

A: I'm maybe an optimist, but I'd say I'd be 70% in the top part and I would say, I frankly think then I'd be 30% on the bottom part. I'd be zero in the middle. I actually don't think we are in the middle. I think we are either in a case of where the economy's going to really restructure and do things or its not. I think there is a certain work ethic and focus here. If people know what they are aiming for, and on the political side—which I'm completely clueless on how to make that part happen—if that part could work then I see no reason why you couldn't get to that level.

Q: You said the size of the Korean economy would become the size of the U.K. by 2010. Does this include the North Korean economy as well? What would be the size of a united Korean economy in 2010, in your view? What about the size of China's economy?

A: I think we did not include North Korea. We assumed that there wouldn't be any integration on that side. But I think… the only comment I would make on *that* one is that I think that what we would have to factor in is the cost of the integration. People have talked about integration costs, and so forth, which are much more significant than what we saw between West Germany and East Germany. We'd have to factor that in. I think that would put a lot of pressure on the system. I hope reunification will happen. But it will put even more pressure in terms of restructuring faster, to be able to afford to do that, given the restructuring that would have to occur up there. So the short answer is: we didn't include that. We just assumed that they'd be developing sort of in parallel beside us. What you do want to think about is the resources required to pump into that place if it does come together.

On the Chinese economy we are actually in the middle of a project that we are actually doing in China, looking at those numbers now. And the early view on the numbers is that China can grow, we think, at about 7 to 8% on a regular basis. The worry we have in China is that there's a *big* debt crisis that's underground and billowing up.

You look at things like the many state owned enterprises (SOE) that are only making monthly payroll based on bank loans. You begin to get concerned about the sustainability of their growth approach. So I would never be one to discount China. I think, as I said, with that nutcracker they are going to have to grow, but they have some serious restructuring themselves they are going to have to work through.

Q: I have two questions. You noted that the Korea did rather well in the early phases of dealing with the crisis and did successfully deal with a liquidity crisis. Then it stopped; the reform effort, more or less, faltered. Why? How can you explain this faltering, the phenomenon of Korea over the past two years or so?

My second question relates to your repeated disclaimer. You said you have no clue whatsoever as to political matters. But I am wondering if you wanted to treat political activities in Korea as a kind of sector. Then compare Korean productivity in the political sector with that in other countries. Wouldn't that be a great service to the country and wouldn't it be a great business for you too?

A: On the first question, I think a number of factors led to the fall off on the reform. I think one was, frankly, the dramatic recovery. When you look at the growth rate that we had and all the right signals were being set and banks were being restructured. It looked very good. Secondly, I got the sense that the pressure and commitment from the government side diminished. I don't know whether it's because there was a focus on elections in that particular period of time, or what. That kind of sense of purpose and pressure dropped off.

You know everyone talked about the IMF crisis. I think it in some ways, it's not a very popular thing to say, but it was *helpful* having these outsiders in here, which is unpleasant, sort of pushing and it became a forcing mechanism. So I think those are three factors.

I think there's also a misunderstanding on the part of government, and I'd also argue with politicians that this is a short-term problem, that this is something *a* government fixes over a short period of time. As I said, this is a 5 to 15 year process. Multiple governments will be involved. You know… those who criticize now better be careful, because they are going to be in there trying to fix this thing, and then those who criticize them are going to have to be careful because they are going to be… this is a *long* term process. So I think those were some of the factors that were there. And I think it's disappointing, because there was such a great start.

On the second one, on the politics side, I think it would be interesting to do, though I think it's a pretty complicated area about what's right or wrong. My sense is a lot of work needs to be done here. I find it very interesting that as the world is changing over time and, you know, the Fortune 75 companies, if you look at them, have had to go through at least two major transformations in the last ten years because of all the changes and things going on around the world. If you look at our basic political process from when it was formed, it's about 200 years old and hasn't changed very much. Something needs to change with it, because I do think it's broken here. But I also think it's broken in some other countries as well. Do we have the longevity to be able to deal with the particular issues? I really wonder about our capability, at McKinsey, to deal with that. I'd probably end up in jail, or something like that.

Q: Thank you very much for providing us with some very valuable frameworks to both diagnose and try and plan more concretely Korea's future.

You were just challenged on the issue of helping direct the political leadership. You've also touched on the challenges facing the academic sector. You've touched on the role of labour—although I always hate to call it "labour" because actually those are human beings, and we also confuse the labour unions and their leadership and their goals with what the ordinary people actually care about and wish to do.

And then you've talked about the corporate sector and the challenges for their leaders. But there's an interesting area that you didn't touch on directly, which I think in Korea is very vital, and is perhaps one of the most difficult parts of Korea to change because of its personal implications for the people involved, and that's Korea's bureaucracy.

Distinguishing the government sector into the political leadership and the bureaucratic functions—the command economy, control centres and systems—and I wonder if you might be able to comment about how you see the challenge for Korea's bureaucratic segment in terms of shifting from a command economy model while still providing leadership that's so vitally needed for Korea's future.

A: I think that's a great point, and it is an important area. You know, my own perspective on that is to me it comes down to corporate governance, again. I think it would be an interesting area of research to look at. What is the most effective corporate governance model for bureaucracy, because I'm not sure that the political process is the most effective way? And I think there are a number of penetrating questions that should be asked to every bureaucracy, if you will, in Korea about what they are focusing on. What is their productivity? Are they focusing on the right thing? And what impact should they be aiming to strive for?

I think there, again, much like I made the comment on the political side, I don't think there's been a lot of reform or change; certainly like that the corporates have had to go through.

This may be a controversial statement. Let me take the Korean post office. If I was a hard assed capitalist and I was able to get access to it, I would love to buy them. I'm telling you, you could crank out some big profitability from that institution. It's happening in other parts of the world: in Netherlands, in Germany. These have become global players.

This may be totally inappropriate, forgive me for asking, but who's putting the pressure on the post office? Is the post office doing everything it should be doing? I'm sure it's run very well, efficiently, and so forth, but I'm just saying in terms of an entity, what could it do is amazing. There are areas in the bureaucracy that need to come under an intense spotlight. The problem is that I don't know who provides that spotlight, or how to make that happen. It would be a very important, interesting area to investigate.

Q: Thank you for talking about the post office, but I would like to probe a little more deeply into the issue of bureaucracy. I'm thinking directly at the ministries and the governmental organizations like the FSC. I've alluded to the personal challenges that people in these organizations face. They have traditionally provided the leadership—the thought leadership, the directional leadership, the executional leadership—for Korea's economy. You alluded to Singapore's economy in the past. You touched on Ireland. Both of those have also, I think, had valuable come from the bureaucratic sector.

As we talk about Korea shifting from a command economy to a free market economy, there's a personal challenge, though. The best and brightest in Korea have migrated into the government sector—the bureaucratic sector—and potentially they see their whole reason for existence being destroyed in a free market economy.

And yet I think it's vital that they shift their paradigm, continue to provide valuable leadership, but in a different form in the future. And my sense is that somebody needs to help them go through that transition just as much as we need to help corporates and other moneymaking organizations go through transition. And, I don't think it's quite the same mine field as trying to guide Korea's political dimension. I think there are pragmatic ways to approach it and there are sort of missions that need to be redefined for some of these organizations, just as much as they might be in a corporate, and also the measures of success.

My sense is many Korean bureaucratic organizations have a measure of success imposed upon them that is not always the one that really aligns with the best interests of the country. It's the threat of the National Assembly coming and asking, "Why did you spend this public money," as opposed to, "Did we come out with a valuable result for Korea?" Perhaps you could just, maybe, comment a little on that.

A: I would agree with all your comments.