

# **The Korean Economy: A Critical Assessment from the Japanese Perspective\***

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It is my great honor to give a talk in front of the real leaders in Korea and I would like to thank Dr. Il SaKong and his staff. Today I will offer a critical assessment of the Korean economy from the Japanese perspective. I have written a lot about Korean economic policies, especially since the financial crisis, but I have never, ever been interested in politics or ideology in Korea. I have no vote here. So, naturally, I am offering a non-political point of view.

Korea has always been a country of dynamism and transition, but the financial crisis was a very painful experience. Today's speech is based on my observations since the financial crisis, based not only on economic analysis but also based on my intuitive observations of Korean society.

My first judgment about the situation now is probably that there have been great social costs for the very intensive reform program after the financial crisis. Society seems to have a very strong feeling of loss of integrity. Many people say their society is bipolarized. The income of the lower classes has decreased while that of the upper classes has remained, or even increased. Not only in income, but disparities and splits have been pointed out in every corner of society.

There can be many reasons for the sense of disintegration. But one of my impressions is that it is the problem of job security. During the crisis, there was a threatened feeling that labor adjustment was the only option for economic survival while recovering market confidence. However, Korean labor relations had never been very mature, as in advanced countries. Labor was not supported by either a full-fledged social safety network or by complementary services, such as professional outplacement or career assessment & development services. These help labor market flexibility. Fear for one's job security has politically empowered the labor unions. This raises costs and reduces the number of potential job opportunities.

Of course, there can also be a psychological factor. The real problem might not have been the inequality itself but social frustration. In fact, the Gini coefficient, which expresses inequalities in society, has been very much worsened in Japan too. It is getting closer to either England or even the US, and is much worse than France or Germany. Some have screamed that the traditional equal society has collapsed. But Japanese society has maintained stability. It does not have that disintegrated feeling, as in Korea.

Where did this frustration come from? There should be two reasons. One should be the asset effect. Actually, if you are a rich person in this country, you benefited so much by the high interest rates after the financial crises. Then you had an equity market boom and even a property market boom. So if you had some good investments, probably thanks to your human network, you never had to work too seriously to maintain your expenses. Your assets have been growing anyway.

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But if you have no such financial assets, you cannot do that. If you are simply working so hard in the office or in the factories, you don't know when you'll be fired. The unstable employment situation has probably set up some very big psychological pressures on laborers and other office workers. The asset effect is an original part of capitalism. There is a psychological feeling, "Why? I've been working so seriously and so earnestly for over decades, and then I have to go? But those guys who have financial assets, they never make any effort, but, still, they are there." So the asset effect has caused some kind of frustration in society. That's my first observation.

The other thing is the debt effect caused by those credit card problems. If you don't have debt, you can still get along. But if you have such a heavy debt after the consumption boom, and you may be further pressured by education costs for children, for instance, you have another problem. The combination of the asset effect and the debt effect might have been a kind of psychological reason for the sense of inequality in this society.

Another issue is the radical introduction of performance systems, especially in business management. When I'm in Japan, businessmen always ask me how Samsung was able to achieve such performance. "How do they manage their people," they ask. I replied that, "If you are not so talented, or if do not have great strength, both mentally and physically, you'll never be able to keep going in the Samsung system. The performance-based assessment in your career path is so severe." Many Japanese companies still try to maintain a traditional Japanese generous system of promotions and management. Some do so strategically, like Toyota, but many others simply do so out of inertia. Samsung has not. This performance system is another factor.

Of course, if you're the winner, you're very happy about this system. But the system cannot guarantee all people will be winners. There are loser problems. Losers should be provided with another round of opportunities. But if the economy does not grow, the chances for another challenge are unfortunately limited. That's why the sense of inequality is not only based on economic status, but is related to the sense of unequal opportunities, which have been seriously discussed over the past years.

Then, it's quite natural to have some kind of background to politicize the economic issues, to politicize people's disappointment at neo-liberal policies. People say, "Oh, the government should definitely do something to stand up for weaker parties," who are a "handicapped" people, in some sense. Therefore, I think there has been an evolution in the debates on economic policies between the neo-liberal and social democrat approach.

Well, markets never function so perfectly in any world. But institutional structures in mature economies and emerging economies are very different. If you are an advanced economy, you have relatively many kinds of investors, institutional investors, for example. They tend to invest for the relatively longer term. That will prevent the market from making some gambling type of move. Corporate law in mature economies reflects an endogenous process of development. Their reform in corporate governance has evolved from their trials and errors. Labor relations tend to be the most endogenous, even among the G-7 economies, by its nature in dealing with human capital. So, just copying the "best practices" should have limited effect, and Korea has to build up its own institutions for a mature economy based on her own sequence and experiences.

Since the expectations about the market and the market-led economies were the principle ideas that you're supposed to believe in when the financial crisis came, people tried so desperately and so hard to copy the "real" market system, that of an Anglo-US type of system. Then, probably, Koreans seem to have gotten very tired of it. As the

growth structure before the crisis had been so deeply rooted and entangled with the socio-political one, implementation of reform, seeking an endogenous sequence, was expected to be a difficult task. Indeed, the social and political costs have now been imposed, and have disrupted policy consistency.

My major observations here are that there have been kinds of very structural and mutually deeply related socio-political factors affecting the Korean economy. Actually, first, if you simply just look at the macro performance over recent years, it's not necessarily so bad, once you experienced such negative growth right after the crisis. Still the growth rate is almost nearly to the levels of the potential growth rate, because the potential growth rate has already dropped. But the way people feel is totally different. One of the reasons might probably be because the recovery is jobless, especially since 2002 when the consumption boom busted and prospects for a job recovery remained gloomy. Chances for recent graduates entering the labor market have not picked up substantially since immediately after the crisis.

There should be a certain structure to this jobless recovery. First would be the weakened linkage between exports and investment. The traditional pattern of Korean economic growth is very strong export-led growth. If your exports are growing at 20% or 30% per year, it usually stimulates facility investment, and jobs and improved wage increase private consumption, as linked to exports and domestic demand. This type of high growth was unanimous until the crisis. But in recent years, even though exports are going so well, it does not stimulate investment, especially in the manufacturing sector. Outsourcing has become so popular, including active FDI into China, and rising labor costs together with the risk of policy inconsistency have deprived Korean firms of investment incentives.

Second, there is also another lack of linkages between global firms and SMEs. Samsung, LG, POSCO and some other global firms are doing just fine. But so-called "middle class" firms, in terms of both scale and value added, have decreased both in number as well as in employment. On the other hand, interestingly, small firms have been increasing very rapidly in Korea. This is not necessarily a really bad situation for Korea, but their contribution to job creation is limited.

Since the global firms are performing in a very severe global competition, they are trying to survive with relatively laborsaving technologies and with competitive intermediary goods allocation. Without healthy middle-sized firms, they might find small firms too unreliable for their business counterparts, both in the quality of goods and in transaction terms. Some small firms may be fine for exports, independently from any transactions with global firms. But other small firms concentrate on the domestic market in services. Those firms have not been affected by shrinking consumption. In any case, bipolarization in industrial organizations may have weakened industrial linkages in Korea.

The service sector, which consists of SMEs, is also divided. While there are new ventures with high productivity, there are still a large number of very traditional restaurants or small hotels of many kinds with such low productivity. They have to be re-shaped and become more sophisticated to create more jobs. Once the labor unions have acquired a bigger voice as a vested interest group, and as labor costs become so high, it will be very difficult for globally competing firms to increase employment at home. Rather, employment is expected more in the service sector, which has a better chance to improve productivity while remaining relatively protected by linguistic and even cultural barriers.

Many people feel that they have been damaged by the radical changes that took place after the financial crisis. Actually, the participation rate in labor unions is already very low in Korea. But the number of people who have some sympathy with the labor unions' demands is not small, including various NGOs. They demand more and more about welfare and rights. They try to demand it from the government politically, probably partly because of the structures of labor unions. If the labor unions were all company unions, there might have been other types of negotiations. But the Korean labor union structure is very complicated. So the easiest solution, after all, is just to claim their demands from politicians. There exists even a vicious cycle whereby big firms tend to promote more professional managers from finance, rather than from labor management. This has deprived managers of incentives to tackle labor issues.

Unfortunately, the situation can be even worse. Korea has, I believe, very strong entrepreneurship, especially since people experienced the radical structural reform after the crisis. People have learned that you have to find your own way to survive. Entrepreneurship is definitely here. But there should also be another round of structural problems to empower this entrepreneurship.

First, probably, the industrial capital allocation system still needs an overhaul. Korea has tried to shift toward an industrial capital allocation system based on corporate bonds. But after the Daewoo shock and the venture boom collapse, which revealed a premature market structure, the bond market is still in the developing process. Many traditional SMEs and new ventures have found it difficult to issue bonds. Banks have begun to play a complementary role. Banks probably need further structural adjustment after having concentrated on retail services, to supply industrial capital flexibly to SMEs, ventures, and local firms with more sophisticated risk management and market segmentation.

In fact, Japan did suffer a financial shrinkage during its "lost decade". But the situation of the capital supply has recently changed. First, Japan used to be either famous or notorious for its so-called "main bank" system, with its relational banking structures. But after a series of reforms, banks have actually started to function as a kind of investor in the market. Banks have emerged as sources for a lot of private funds. The economy has been very much restructured by these funds, not by government policies or directions. Interestingly, these funds are all equipped with the information accumulated by the relational banking system of the past. This evolutionary change, rather than a revolutionary change, has contributed to reducing the social costs of radical change.

Another evolution has been the transformation of trading houses into investment bankers. Japan used to have a lot of trading houses, or *sogo shoshas*. After restructuring, though, they have strengthened their financial services and supply risk money for those who have long had transactions with them. Based on this experience, they have good business and information networks to assess the real value of the their counterparts' business. They know quite well which companies have good assets, technology assets, marketing networks or brands, often far better than traditional bankers. They try to mobilize this information in restructuring the businesses. This change in the role of trading houses is another evolutionary process in Japan.

The second issue is labor market flexibility, as has been touched upon very often by Koreans. In my observation, the labor market in Korea needs both better institutions and market-enhancing services. I've asked a lot of my Korean friends about having a very strong sense of "career path". If you do some kind of professional things, you will be promoted to this or that position. In the end, you'll end at a certain level. This is true for some professional people, like lawyers, medical people or maybe professors in Korea.

But in general business, people do not have a strong sense of career path. Careers in Korea seem to be evaluated, first, by diploma and then only by physical compensation. This excludes any sense of mission for the individual, as well as the value of experience beyond knowledge or skills. For many people, a career ends in a short life without a consistent pattern of developing expertise.

In fact, at one time I used to work for a Japanese bank, which has now gone bankrupt. However, they had a certain career path system. One day, just before it went into difficulties, I was called to go visit the president. He said the bank would no longer be able to guarantee my future. So he said they wanted to ask me what I wanted to do. The president suggested to me to go to graduate school. That's why I was able to go to the US with the company's support. This kind of complimentary relation system, as well as communication between management and labor, does not seem to function properly in Korea.

On this issue, institutions also matter. Japanese institutions used to be very firmly addicted to providing more incentives for lifetime employment. That was quite a famous system. Then we brought in new systems. For instance, if you had just quit and went to a different company or a different business, you could carry all you pension funds and these kinds of things with you. Note, though, our company pension fund system is under crisis. We are so desperate to reform it. This has prepared another incentive for Japanese people to move around, based on their own prospects.

A third issue is the lack of collaboration within business society. Sometimes, foreigners, especially from the US and other Westerners, seem to be very surprised to see a stagnant Japanese economy have such a stable society. One of the structures for this stability seems to be a sort of collaborative culture. After the so-called "lost decade", there have emerged a lot of collaborations among different business types, which try to produce different business models for different domestic Japanese markets.

The typical one is the success of convenient store franchises that operate 24 hours per day. Now, Japanese convenient stores, like Seven-Eleven, not only sell goods under a unique marketing system with just-in-time logistics, but they also serve as a bank, laundry, business and logistics center. Some even include a support center for senior citizens. They provide all sorts of personal and business services through collaborations with many other firms. After all, companies have had to survive in a stagnant market in Japan. So in sectors where competition has been fierce, there have been a lot of collaborations between companies. Fortunately, the Japanese market was still large enough to allow many trial and error cases of such collaboration efforts.

Since the export-dependency of the Korean economy has been so high, and also since many big firms have been going through a structural adjustment phase, there have probably been only a very few cases of collaboration. However, if there were a stronger culture of collaboration between global firms and local firms, between manufacturing and service ventures, new business could be easily created in the domestic market. This would increase investment opportunities.

Despite the size constraint, the domestic market is important in creating higher value-added goods and services. If Korea does not succeed in this effort, China is always catching up. China has huge potential to attract any experimental business, even by foreign firms. Korea will be caught. To be honest, some sectors, like the textile industry or some light labor-intensive industries, have already been completely caught. If Korea does not find any other sector to absorb labor, the so-called "hollow-ization"

will go on. If Korea does not want to be threatened by this fear of “hollow-ization”, there is only thing that can set it free. It must shift into different businesses. But if all of the above-mentioned structures do not allow you to challenge and enter new businesses, the entrepreneurship is still there but will never be properly tapped.

Finally, I would like to mention policy issues, which is also related to the structural issues already mentioned. First is the policy-making infrastructure. I honestly believe that Korea might even have a better policy-making infrastructure than Japan. Japan is suffering from all kinds of amateurism in economic talks. Usually, bureaucrats have led Japanese economic policy. But sometimes, the elite bureaucrats tend to come from law school rather than the economics department. Even economic policy tends to lack a sense of economics and tends to ignore market dynamism by sticking to a legal paradigm. Accountability tends to be very poor, especially in English, reflecting the resources of international economists.

But Korea has a large number of great economists who have trained in a very systematic way. Korea has potentially some very good resources for policy-making, including a number of think tanks and research institutes. But sometimes the structure itself is so controlled by pure politics, ignoring market logic. If you belong to a certain government related think tank, it should be difficult to maintain a certain intellectual independency. Japan really lacks independent think tanks. The management of think tanks is very difficult there in Japan. So Korea has an advantage, though politics frequently destroys this otherwise advantage.

Second concerns the platform for policy debates. Korean media and Korean internet sites are always debating something. Korea is so rich in that it has every possible topic for debate. However, one thing that is typical about Korea, which is also something different from a mature economy, is that internet discussions sometimes create and amplify emotional arguments without strict grounds. Internet discussions never require your personal name. So sometimes you can be super critical, simply in terms of emotion or sensationalism. I think there should be a certain high-level, intellectually free but established platform for this decision-making process, based on professionalism; something that goes beyond populism.

Lacking in well-functioning infrastructure and platforms very often leads to blurred priorities and policy sequences. This ends up with inconsistency. This tendency has been accelerated since the intensive administrative reform started, to reduce policy inconsistency and bureaucratic procedures. Korea seems to have a blueprint, but sometimes we never realize which one is most important and what kind of specific strategies are to be taken, and who are to drive the goals.

Of course you want to make a Northeast Asian Hub. Of course you want to establish many FTAs. But of course you need agricultural reform. Of course SMEs need to become more competitive. Of course excessive concentration around Seoul should be corrected, while local economies be activated. Of course you want a very good participatory welfare society. Of course you have to stay at the technology frontiers of global powers. But you cannot attain all of these in such a short period of time during which the present regime can take responsibility for it all. There definitely should be certain priorities and very specific strategies to realize each one of these.

If you are so interested in creating a welfare society, that’s one of the good things that you should desperately try to do. However, since the market is there, and since Korean capital markets are totally open to any investor in the world, you cannot ignore the market’s responses. If there is no accountability for the goal, including trade-offs that

must be paid, the market won't respond positively. You would not be able to mobilize market functions to realize your policy goals. As a small and open economy, accountability and dialogue with the market is a crucial principle for economic stability.

In fact, what impressed me so much just after the crisis in Korea were the great government and other institutional efforts to achieve accountability to the market, as well as to the people in general. That's a very great effort by a Korean government. That's why I've always asked Japanese bureaucrats to copy this system. If you go to a Japanese government homepage, there is such a lack of information. The slow pace of information opening will disappoint you. The information there is not really good enough. So Korea has started very well in this regard.

But as time has gone by, the enormous pressure has faded. Complacency and political ambiguity has been allowed to shadow these great efforts. The precious lesson that Korea learned during the crisis should be that, if you don't prove you are desperate about transparency and if you're not honest with the market, you'll never be able to survive.

However, in recent years, some parts of the Korean accountability system seem to have gone back to traditional ways. Some people got so idealistic without any practical strategy. Often a very Confucian kind of formalism is there. People simply don't care about the contents, but care all about how it looks.

Another tendency is a kind of Korean chauvinism. In other cases, sometimes people tend to be too moralistic. Sometimes, morals are even regarded as being more important than potential or capability. That's a kind of confusing structure for policy consistency in Korea. Policy makers are changed, one after another, within a structure that has made it impossible to maintain consistency.

Now, let me leave the structural argument and go on to policy discussion. The most impressive debate in recent years has been the one about growth: whether growth is complimentary with distribution or whether distribution should be prioritized. In fact, all the studies about income disparity in Korean society have proved that relatively speaking, Korea is doing much better than most other countries in the world.

Koreans themselves never think that way, or that that is the problem. Probably, as I mentioned earlier, the right question may not be between growth and distribution, but may be how to achieve growth and distribution at the same time, which is quite a classic one.

In fact, if you do not deny everything about the past, Korea herself has provided a very excellent case of achieving both. Unlike many other developing countries, Korea chose the right technology, which at that time were labor-intensive ones. Then you had a comparative advantage and your exports grew to improve productivity constantly. Then investment followed. Then new jobs were created.

This is in sharp contrast with countries that tried to maintain a continuous import-substitution type of industrialization or which chose capital-intensive technologies. This discussion may also be related to the basic question about whether equality is the goal or the result. This proves again that sequence should be more significant.

Empirically, high growth does not guarantee better distribution if the structure is not sustainable both in economic and socio-political terms. However, on the other hand,

distribution policy may have a danger of endless, unproductive politics as were shown already in many countries. By nature, politicians are tempted to regard distribution as the goal for the politics, rather than the result of growth.

Korea should value the very successful experience of its own and recall that only good growth with the right strategies will bring better distribution as a result. Empirical studies show that, generally, economies with higher, sustainable growth tend to achieve better distribution than stagnant economies, including former socialist countries.

In fact, some people claim that equality is a precondition to sustain growth. I agree partly with them; if people are frustrated about the equality of chances, the situation is not socially sustainable. So definitely you need some distribution policy to try to make sure weaker parties are provided equal opportunities. That's good.

But if you're stuck to this as a goal, and only rely on government expenditures, there will be a risk of not getting anything at all: no growth and no distribution. Worse, the weaker people may start to suffer from the stagnant economy much earlier than others, which may create more demands for support all the time.

Japan is a typical case in this failure. After a high growth period, being fascinated by distribution policies, politicians often tended to give up discipline over the national budget in what is called *baramaki* politics. *Baramaki* is a Japanese word indicating to give money to everybody. There is no frustration and at least somebody can get something. *Baramaki* exposes politicians to the temptation of populism. As a result of *baramaki*, infrastructure building has continued to completely ignore the market. The Japanese budget is in crisis. Such pressure might be here in Korea already. Korea really needs to avoid this at any cost, for there are potential burdens from a North Korea risk

In fact, from a slightly different angle, the discussion of growth and distribution is quite familiar to Japanese during the "lost decade". Many people had serious concerns that aggressive reform would plague equality and might increase social costs. Many politicians made good use of this fear to postpone reform. The discussions continued until Prime Minister Koizumi emerged with his campaign of, "No growth without reform." This represented consensus.

So, let me just quite briefly touch upon what's good about the Japanese economy after this consensus. We have mounting problems and we still have to go on fixing them. But there is something in the Japanese example that might have certain implications for the Korean economy. The Korean economy can get back in really good shape and depart from this psychological pressure and its endless ideology debates.

One thing in particular is that Japan has been desperate to reform the framework and the consensus for it. This approach, at least in some parts, has turned out to be a market oriented one, after many trials and errors. Compared to the situation about ten years ago, market functions have been somewhat improved by deregulation and by having new ideas brought in by foreign financial service firms.

Moreover, complementary frameworks have mitigated the psychological resistance toward reform consistency. For example, the financial system has gone through fierce restructuring, with new prudential regulations and a new financial supervisory system. However, at the same time banks and corporations have been encouraged to take and challenge any opportunities that may emerge after each series of deregulations. Restructuring itself has emerged as the fastest growing business in Japan, including property related services. Professionals have been in great demand and have moved



around to different companies while training their juniors at each new office.

Secondly, the manufacturing sector has found a new strategy for its survival, especially since it faces competition from China. Manufacturers have sought advantage in knowledge-intensive technology, especially tacit ones rather than digital ones. They have become much more convinced about the importance of intellectual asset protection as a result. That's why, in Japan's case, it has been the business sector not the financial sector, and it is facility investment not consumption, that has been a kind of engine for the slow but steady recovery we've seen.

That's why, in some sense, business society has recovered a certain confidence about the division of labor with China. The debates of "hollow-ization" are gone in Japan. Manufacturers are leading the introduction of foreign human resources. Following Nissan's success, Sony has decided to welcome US managers. Mobility in the labor market is beginning, from engineers and businessman to top leaders. This has served as an engine for reform.

In retrospect, Japan opted to take a long-term approach to make consensus first and then to begin reform. This was simply the result of postponing reform until the opportunity cost became intolerable. But on the other hand, it was based on the intuitive judgment that the social cost of the reforms, without proper sequencing, would also be intolerable.

Therefore, after a long, long debate to initiate reform, Japanese change has been very evolutionary. It's not just like an instant, overnight change like *haru acchime*. In the financial sector, there have emerged a variety of funds that have started to work on corporate restructuring. Other new financial products, like REITs, which must also be common in Korea, have been rapidly promoted.

Unique products have been invented, like a "social investment fund". This fund is a kind of evolutionary financing system. A government's state financial organization would find some public character to work with on certain projects. Then the private sector cooperates with the state financial sector to assess the market value and to manage the operations. That creates certain investment opportunities, especially in local areas. The private sector has been the *ex-ante* and *ex-post* management for the project, and is supported by a sense of community in the local areas.

Another evolutionary change in the market is the decreasing presence of cross-shareholding structures. These had become quite famous in Japan. Those structures are now substantially gone. Thanks to that, some of the venture companies have been to rise. A number of establishment firms have been increasing strongly. We also have some withdrawal. But we've started to have certain M&As and strategic alliances after the revisions of corporate law. The law tried to promote the whole restructuring processes. Mobility in the labor market has been quite rapid, as I touched upon, between government, private, global firms, SMEs, manufacturing, services, etc.

Also, many people, even in the government, are trying to learn from successful manufacturers, like Toyota with its collaborative culture. Even Toyota is trying to help some local business societies in the Nagoya area. Interestingly enough, Toyota people say they are gaining more than losing. So they are happy to continue.

The situation is in some ways very different in Korea. Korea went in rather the opposite direction: reform first and social costs later. But if the social costs in Japan had been relatively small, there seems to have been several implications. First, Japan's evolutionary process based on an endogenous institutional setting mitigated social costs.

For instance, the change of a main bank or trading houses into an investment bank maintains the historical interface between the capital provider and the firms. This prevented panic among the management.

Second, it was not *baramaki* by political intervention, trying to create jobs by investing in infrastructure that contained social disintegration. Rather, it was a consistent and complementary reform package and set of deregulations. This helped to prepare for reform and maintain social integration. The revision of bank and corporate law, pension reform, deregulations in placement services and even education, all worked far better than *baramaki* toward reducing the social costs.

Third, this growth strategy brought relief from the psychological fear of losing one's job. In Japan's case, it was manufacturing which found a way to compete with China and to bring back facility investment. This stimulated the service sector, allowed collaboration with others and created jobs for new graduates. It was not the government but the private sector and the market that has contributed to the betterment of society, including to the local communities.

Based on the temporary conclusions above, I believe Korea should start again by reassessing its own advantages, beyond chauvinism, to find a proper role for the government. It should then empower the private sector to the best of its ability with the right and specific growth strategy. In my observation, Korea's original advantages are as follows.

First is its speed and dynamism. That's why Samsung has won all the games with the Japanese semiconductor manufacturers. Second is drive and energy for certain specific goals. Concentration is an asset for the Korean people. Korea had to go global because the home market is not necessarily that big. Naturally, with its crazy investment in English education, younger people probably have broader, global views.

Third, the response to change and crisis management is also a valuable asset. I think the Korean people are far better at risk management than risk prevention. That's why there have been successes in petrochemicals, steel, semiconductors, LCDs and even the drama-making & entertainment content businesses. There are certain characteristics that are quite common in the management of these types of businesses: they all require flexibility and driving energy.

So if you're serious about maximizing these endogenous advantages, I actually think the timing is quite good for Korea. The emergence of Russia, India and China are great chances for Korean companies, especially SMEs. Thanks to Japan's aging population, Japan has started to retire from serious competition in emerging markets.

As time goes by, Japan will tend to simply concentrate on protecting its home market. That will provide a great chance for Korea. Actually, Korea is ageing, too. But Korea has one or two decades before it completely catches up with the Japanese demographic structure. These may be the last two decades for Korea to catch up. Globalization should be centered on a growth strategy with some concentration on emerging markets.

For this purpose, FTAs definitely need to be promoted aggressively and speedily. Such treaties must create a better business environment for Korean firms. The cost of protecting unproductive sectors is far larger for Korea than in Japan or China, with huge domestic markets.

If you try to have more vigorous facility investment, you need mature labor relations.

For this purpose, you need a rational law and realistic law enforcement, cooperating with the business society. You need, of course, a small but effective government.

For this purpose, Korea's potentially good existing policy infrastructure should be maximized, while creating a high-quality debate platform dependent on strong evidence. This will prevent populism and the politicization of economic issues. Since non-Koreans own a major part of Korean equity, you have to invent certain good corporate governance systems, including for foreigners. If you do that, globalization is basically a big opportunity for Korea.

Secondly, I still think the significance of medium-sized firms, though not the really small ones, is quite important. In this aspect, Japan is somewhat gifted because of the size of the market. Japan is quite rich in middle-sized firms. These middle-sized firms can be a kind of link between the super global firms and the very small firms. This kind of linkage should be somewhat restructured in Korea, too.

For this issue, the service industry is quite important. Unfortunately, as some of the venture booms in IT have just ended, the Korean home market in IT services is unfortunately limited. You have to find global markets, even in the export of services. SMEs are always complaining about money in Korea. But SMEs also need good management and good supporting systems, in addition to the market itself.

Government, I think, should get away from the traditional behavior of simply protecting small companies. Get away from the mentality where it should help. If you are a loser, even the small companies have to get out. There should be a certain rational exit policy, however, even for small firms. Instead of raw protection, policy measures are needed to encourage collaboration between firms. This will increase human resource mobility from larger firms to SMEs and will mitigate the pains of exiting the market by good legal and financial services.

Finally, I will touch upon investment potential as a method of reform. Actually, Korea seems to have a certain number of good potential investment opportunities, especially compared to Japan which is a pretty mature economy. Hard infrastructure in local areas is still poor in Korea, with its intensive concentration around Seoul. That means there is potential demand in local areas if you successfully make a plan, especially in relation to globalization programs.

If Korea had super powerful NGOs and citizen movements, it could probably use this asset to mobilize private sector financing initiatives or social investment funds. This would create certain owners and controllers within the community. Considering this industry-services balance, Korea needs to find potential investment opportunities before it gets too late.

Local industries have gotten so weaker since the crisis. Another round of international industrial accumulation is quite necessary to revitalize local economies. The business environment requires standards that can compete well with China and Japan in specific aspects. Special economic zones of gradual deregulation may not have enough impact to attract investment. Since Korea's advantage lies in its speed and its driving forces, the government should learn from the private sector in such policy implementations.

So my message is that market function enhancement should be a priority, rather than simply trying to realize a simple welfare society. For that purpose, politicization will probably not help at all. Also, Korea is actually running out of time. These two decades are the last chance for Korea to have a big success. We don't have a lot of time. So

politicizing things and descending into quite unproductive arguments is quite a loss.

Another issue is that, as the Japanese budget crisis clearly suggests, there's always a danger of bigger government in a politician-led policy making system. Well, politicians have to win the elections. To win the elections they need popularity. They need votes. There's always a political cycle. We have to prevent the kind of big government that uses irrational expectations plagued by populism, or which, worse, uses chauvinism without grounds.

My final point is that Korea has its own advantages. Why not maximize on those? Just copying certain successful cases from the global society probably does not mean anything to Koreans. Ireland has been successful, and certain IT-led small economies have been successful. But Korea is not such a small economy like Ireland or like some other city-states. It's time for Korea to go back to its original advantages that have certain deep historical roots. Those will provide a good, very healthy growing structure for the Korean economy, which could not be copied by others.

Thank you very much.

### Questions & Answers

**Q** Do you still think you and Professor Watanabe's famous writing in *Korea After Five Years* is still correct, where you said the, "Japan/ Korea one market era is coming"? Do you think this idea is still believed, despite the recent textbook and *Dokto* problems?

**A** Thank you very much for reading my oldest book, with Professor Watanabe. Yes, I'm quite happy to see the recent market integration, which has already started between Japan and Korea. Even without a free trade agreement, actually we may still have some kinds of non-tariff barriers, but the markets have been quite integrated strongly. This is a fact in a globalized market.

For instance, Korea is going to host an exhibit from a British museum next week. For those kinds of events, the two markets are totally integrated. The third party, whether it be a British touring museum exhibit or a concert or show on the road, will come from Japan. Then, since the market is large enough, they can have several exhibitions in Tokyo, Osaka or Kyushu. Then they can go to Korea, too.

Korea has very much benefited from such market integration. If Korean intellectuals are desperate to try to bring first-rate operas and other cultural events solely to Korea, the market would be somewhat limited. But if you're integrated with the Japanese consumption market, you can enjoy all the first-rate performances and arts. *Yon sama* is also a typical case of market integration. His fan base is quite dominated by Japanese *ajuma*. They've been repeatedly coming to Seoul to see *Yon sama*. So Korea is becoming a second home for them, quite probably. The market is quite integrated

Thanks to global market logic, fortunately there is no *Dokto* in the financial markets. The markets have already begun to integrate. In fact, among Asian currencies it is only the Korean won that moves closely with the yen, even after adopting a floating exchange rate system. This is a natural movement, considering the macro and industrial structure between Japan and Korea. The market has been already integrated in some parts, while it is following in other parts.

**Q** What are the similarities and differences between Japanese *zaibatsu* and Korean

*chaebol*? In general, how should they each contribute to their national economies and, in particular, to the development of small and medium enterprises?

▣ The differences between the *zaibatsu* and the Korean *chaebol* are numerous. Actually, even though I'm from the development studies department, my final thesis was on the development process of business organizations. It was a comparison between Japan and Korea.

There are a number of very interesting differences between Japanese *zaibatsu* and the *chaebol*. One thing is probably that the notion of the Japanese family is not really that strict. In Korea, if someone does not have the blood of the family you are not regarded as a member. But in the Japanese *zaibatsu*, outsiders are sometimes quite generously accepted. So the notion of the outsider is sometimes quite different between Japanese *zaibatsu* and the *chaebol*.

SMEs are always family businesses, in every country. In Japan, especially, SMEs are family businesses. The relationships between the *zaibatsu* and the small firms are family versus different families. But since the *zaibatsu* already have certain professional managers, as well as many kinds of outsiders, already in management through an evolutionary process, the interface with different families is a kind of natural interface.

Of course, the market structure is a very important environment which decides the behavior of the companies. But sometimes the relationship with the outsiders of the families means a lot. That's why Japanese *zaibatsu* have a lot of collaboration and many cases of joint ventures, like Mitsubishi, Mitsui or Sumitomo. They've never tried to internalize every business solely within the family. That's the difference with the Korean *chaebol*.

In every big business in every country there are certain histories of family businesses. Korea is in the exact transition period between family businesses and modern more mature corporations. I'm not really so pessimistic about the transaction relations between the *chaebol* and the SMEs.

But my point is that since the gap between the big super global firms and the small firms in Korea is too large now, it should be difficult from a global companies' point of view to start intensive transactions with such a very small company. So my very foreigner's point of view about Korea's industrial structure is that if there are certain independent firms, it might work. Korean *chaebol* have gone through a very severe restructuring process. There are a lot of companies that have been spun off or de-merged. So there should be certain independent companies recently spun from the core companies. Those might be sources for middle-class firms. This is also quite related to the SME issues.

I think the Korean government has been doing a lot, especially for SMEs in the manufacturing sectors. But there should be something more for the service sector. The service sector firms are quite different from each other. There should be a more specific approach to the characteristics of the businesses in different service sectors. Since there is a lack of middle-class firms, business organizations might be quite divided.

In manufacturing especially, my idea is to promote those middle-class firms to concentrate on exports to recently emerged economies. The price range in emerging markets is quite suitable for those firms. Samsung or LG are probably trying to sell their products there, but do not really dominate all demand in the market. They have certain marketing capabilities, though. They have certain good information networks. If they

tried to share those with the middle-class companies, it would work.

For the real small companies, it would be too hard to catch up with those emerging markets. After all, we should let them compete effectively, but should support them with better consideration in the Korean-language markets. But those middle-class firms that are trying to go with the super global firms form quite a strategic sector on which Koreans might be able to focus their SME policies.

**Q** You did mention an exit system. To make the market function properly, you have to have a very flexible entry and exit system. You also talked about the growth of SMEs into big firms. But those firms are already in the market. Have you done any comparative studies of this, the ease of entry between Japan and Korea? Since we still have all kinds of red tape and regulations, it's very difficult to establish a new firm. I really don't know how difficult it is for Japan. For example, we all know Hewlett-Packard started in his father's garage. If any college graduate in the US decides to establish a firm, they can do it. But in the case of Korea it is very difficult, even today. Have you ever seen a study on this aspect between Japan and Korea?

**A** I don't know exactly of any studies which deal with the exact topic of comparative studies on firm establishment. But as far as I know, the Japanese firm establishment system has quite improved over recent years. You can establish a company with very little capital. The requirements to establish a firm have been substantially deregulated.

Also, there are probably some differences between Japan and Korea. Usually, smaller firms are always complaining about big firms, complaining about the banks or complaining about the big trading houses. They say they are discriminated against under relatively worse business transaction conditions, etc. Actually, the Japanese supporting system to help establish companies seems to be working fine.

That's why it is quite easy to establish an SME. Also at the same time, they are allowed to go out of business. Bankruptcies among SMEs have never been politicized. It's only the personal favors, or just simply a business subsidy. Japan seems to have a different framework to deal with the bankruptcy of small firms. Not big firms, though. The environment is getting close here in Korea, too.

**Q** According to recent studies, companies are not free to exit the market. They have not performed well, though. The government in Korea has been over-protective of small companies over the past 20 years. At the moment, it's in an almost hopeless state. Almost two thirds of small and medium companies have no way to survive. As you rightly pointed out earlier, the lack of a link between global firms and the small firms is quite severe. This comes partly from the protection of the government, particularly in the financial area. I'd like to hear your comments about the comparative status between Japan and Korea.

**A** That's a very good but very difficult question to answer. Probably in Japan, big firms have always been somewhat protected, perhaps because of industrial policies or because of the familiar "too big to fail" policies. If compared to those big firms, it is true that Japanese SMEs have always been under very severe competition. No one expects that, since we are weaker, we should be protected, and we are discriminated against when compared to the big firms. If you fail, that's it. You have to get out.

But before just getting out, you have several chances to talk to your banking people, to talk to your business counterparts, etc. The situation never changes rapidly, as in Korea.

If the SMEs are doing reasonably fine, the crisis always continues bit by bit. But in Korea, crises happen immediately. This panicky atmosphere and herd behavior has hurt even healthy SMEs here.

Also, in my observations, probably the mobility of both the human capital and information is quite different between Japan and Korea. Now, many people who quit the big firms have already moved to a smaller firm. Since small firms are mostly family businesses, sometimes they find it very difficult to settle in with the new management system, but some people are doing just fine. I don't know if Korean SMEs are able to accept staff—total outsiders—who come from a very serious management system. That's one thing.

Even the banks are involved. Recently, the Japanese Ministry of Finance changed its rules. Of course, if you are too strict about a bank's prudential regulations, the bank cannot continue to lend to small firms. The easiest thing, then, for the banks to do is to simply cut all finance for small firms. They try to solely concentrate on big firms. That's what happened during the Japanese financial shrinkages.

Japan has learned a lot. Recently, the ministry announced a unique project to make a new round of relationship banking, especially between local banks and local industries. We don't know how far they'll be able to go. But at least small companies have recently gotten away from the really threatening psychological feeling that they had no way to survive.

The M&A market has also been growing quite fast. There is a famous battle going on concerning a venture business guy named Takafumi Horie. He's trying to make a hostile M&A of the Fuji TV corporation, a large company in the Japanese entertainment business. So M&As are not regarded as exceptional cases any more in Japan. M&As are starting to be quite active, not really among small firms, but among the mid-sized and larger firms. That is another incentive for big firms to separate and spin off certain businesses so they can be independent relatively middle-class firms recently spun from the really large firms.

System- and environment-making is quite a crucial issue for the government. That's a role no other body can do. The popular view of Korean SME policy is that they are the socially weak party, so they should be protected. But in the Japanese experience, it's only competition that will improve SMEs.

**Q** Since you participated in writing the Korea-Japan free trade agreement (FTA), let me ask you this question. I'd like to know the general Japanese perception of China. Do Japanese see China as more of an opportunity or a challenge? Related to that, Japan, Korea and China have a study group to explore the feasibility of a three country FTA. Japan and Korea are even in the early stages of negotiations, too. After these two countries conclude an FTA, do you think a third country, like China, could be included in the near future? Can we conclude a three country FTA in the near future? You did touch on some of the advantages of having an FTA between Korea and Japan. Could you just make comments about China, too?

**A** The view of the general Japanese population on China has two aspects at the same time. China is an emerging rival country in terms of economic power. But at the same time, the Japanese economy is quite dependent on Chinese growth. We need China and China needs Japanese technologies and know-how. In this political sense, sometimes for Japan, China is an even easier counterpart than Korea.

China has very clear priorities for economic development. Of course, the political situation is much, much more serious with China. But definitely they need Japanese cooperation so that's why they remain calm about economic relations.

Even though the political situation is so bad, economic business ties between China and Japan are quite vigorous and quite dynamic. Most people who are so disappointed with the slow Japanese pace of reform just abandon Japan and try to realize their personal dreams in China. China is quite willing to accept those people. There are some kinds of very strategic relations between Japan and China. How long we'll continue to be this way, we don't know, maybe one decade or so.

As one who has studied Korea for such a long time and who has some very strong respect for what this country has done and for what your people have done, of course I have to think about the Korean position. I think a Japan-Korea FTA before a Japan-Korea-China FTA is more advantageous for Korea. That's why I've been working on this issue.

If China enters the FTA, unfortunately market logic will kick in. The trading volume between Japan and China is so large. What's more important for Korea is that such trade is pretty much dominated by Japanese FDI going into China. Therefore, Japan has more of a tendency to accept Chinese demands and conditions. But if we do that, where will be Korea's position? We don't know.

On the other hand, Korea is a very strategically important country for Japan. Unfortunately, many Japanese politicians have never understood this significance well enough yet. China is not yet a capitalist regime under WTO rules. It has to first be admitted as a capitalist regime. That's the first sequence.

On the other hand, Korea, actually, except for some very complicated emotional/historical kinds of things, does share a common economic system with Japan. What we can get from a Japan-Korea FTA is very deep integration with a very established framework, admitted by the WTO and other major economies. This explicitness is a very precious asset for Asia, where people may try to escape enhancing rights.

I think Asia has to get away from the kind of "no action, talk only" (NATO) kind of behavior. They are always talking about cooperation, but in the end they just end up without doing anything. Japan and Korea are in a position to have the first Asian very established FTA at the OECD level. Korea will be able to use this establishment as a kind of leverage toward China. Japan is trying to do the same thing toward China, too. The US is going to welcome such an explicit transparent FTA in East Asia. That's why, for Japan, Korea is a very strategically important country. It has a shared regime, shared ideas and that's why the exchange of people is important, too.

Finally, I would like to add one more thing about the role of Korea. Many economists in Japan wish to invite more market pressure coming from Korea. We've been in many disputes. But I think some of the people have already used the Kimpo-Haneda airline link. That sort of deregulation would never, ever have been realized in Japan without any external pressure. But thanks to President Kim Daejoong's suggestions—it took almost seven years to realize it—but finally Haneda has started to function as an international airport and consumers have quite benefited from that.

One of the advantages of Korea is that it has a sense of business and has a strong incentive to demand something from Japan, which is also intellectually supported by



well-trained economists. That's different from the position of the other Asian countries. I hope Korea will continue to keep this role, separating the political logic from the market logic. After all we are living under capitalism, but not under one certain political ideology.