Korea’s remarkable economic transformation since the early 1960s has been characterized by fast industrialization and strong economic growth, with the manufacturing sector being a key growth engine.

Rapid industrialization has been supported by export-oriented policies designed to provide performance-based incentives for exporting firms. Exposure to international export markets stimulated efficiency improvements and faster productivity growth in manufacturing industries.

As a result, Korea has been relying more and more on external demand to drive growth. Exports accounted for about 57 percent of the gross national income in 2012, marking a rapid increase from 15 percent in 1970 and 40 percent in 2000.

This recent increased dependence on external demand has been associated with the rise of the Chinese economy, which serves currently as a center of global production networks. China’s share in Korea’s total exports has doubled from 12 percent in 2001 to 24 percent in 2013, indicating a rapid expansion of Korean’s trade with China.

Should Korea change its export-oriented strategy? Overall, the outward-looking, export-oriented growth strategy has worked well, enabling Korea to sustain strong growth and transform into a more technologically advanced economy.

However, the strategy puts the nation in a vulnerable position in global business cycles. As was evident during the 2008 global financial crisis, over-reliance on external demand made Korea susceptible to the ramifications of the sharp drop in industrial countries’ appetite for imported goods.

Global demand may not assure a continued market for Korea’s exports, especially in the current global environment, where the recovery of advanced countries is too fragile to provide stable demand for imports. China’s recent economic slowdown and looming crisis add more worries. Even if China can avoid a financial crisis or steep economic downturn, the gradual slowdown of its growth rates over the coming decades is unavoidable. This slowdown, along with the possibility of long-term stagnation among advanced economies, would have significant consequences for Korean exporters.

Moreover, Korea’s manufactured exports are losing competitiveness due to the narrowing technology gap with China, whose manufacturing industry is gradually shifting to higher value added goods.

In an uncertain global environment, Korea must pursue a policy direction that seeks to improve its manufacturing industries and rebalance sources of growth.

The country needs to improve the competitiveness of its major exporting industries. Korea’s industrial structure now focuses on the semiconductors, motor vehicles, shipbuilding, electronics, petrochemicals and steel industries, and their exports must perform well by overcoming competition with advanced economies and latecomers to the global markets. More investment in new technologies and improvements in efficiency would boost export competitiveness. The OECD’s Economic Survey of Korea 2014 points out the limited return from Korea’s large investment in research and development due to weaknesses in the innovation system. Not only does it call for reforms across the entire innovation system to expand the role of universities, upgrade government research institutes and strengthen international networks, but it also suggests the adoption of policies lowering product market regulations and barriers to foreign direct investment, to boost the innovation of new technologies.

More importantly, Korea should foster a vibrant venture business sector and strengthen small- and medium-sized enterprises (SMEs). The creation of new enterprises is hampered by problems in the venture capital market and SME financing and a lack of innovative skills and entrepreneurship.

Korea also needs economic rebalancing, with more diversified growth sources. Bolstering domestic demand – for example, by encouraging private-sector business investment and household expenditure – is crucial. Additionally, service industries should be promoted. The service sector in a more advanced economy is larger and more important in terms of overall growth. Regarding Korea’s service sector, which employs 70 percent of the country’s workers, the government should take action – should pursue structural reforms, for example – to enhance productivity and develop new high value-added service industries.

For more balanced and sustainable growth, Korea must take steps to promote innovation in start-ups and SMEs, stimulate domestic demand and develop service industries while reducing over-reliance on exports and large enterprises.

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