

## **Competitiveness: Korea's Latest Economic Challenge**

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Korea is a tough economic competitor. Its meteoric rise over just 30 years from one of the poorest in the world to the ranks of the OECD helped earn Korea the moniker of "Asian tiger," and its recovery from the 1997 financial crisis reinforced this image.

Economic performance in 2007 underscores Korea's strengths. The economy expanded by 5.2 percent on an annualized basis in the third quarter. Industrial production and consumer sentiment are healthy. In spite of a strong won, exports remained robust in 2006, expanding to \$332 billion, and export growth has continued apace in 2007, at 13.9 percent on an annual basis from January through October, off only slightly from 14.2 percent over the same period in the previous year. This is partly due to the increasing role of high value-added products, facilitated by a high level of investment in product development and design. Indeed, Korea ranks very highly on competitiveness indicators for technology and scientific infrastructure.

Yet, competition within northeast Asia and globally is increasingly stiff, posing challenges for Korea as it seeks to maintain its economic challenging position going forward, as noted in recent Article IV review by the IMF in October. The continued strength of the won will increasingly weigh on the economy, particularly for small and medium-sized enterprises, which are less able to hedge against currency risks and absorb the squeeze on profits imposed by the strong currency, according to the IMF. Since this sector accounts for 50 percent of manufacturing output, one third of exports, and 90 percent of total employment, its trials reverberate loudly. The Ministry of Finance and Economy announced on November 27 that industry forecasts predict export growth will slow in 2008, due to a softening U.S. economy and oil prices.

Appreciation against the Japanese yen is a particular problem. Measures of export similarity and trade competition indicate that Japan is Korea's most intense competitor. The won has appreciated 60% against the yen over the last four years, though there has been some easing more recently. Korea's trade deficit with Japan has continued to widen as a result, as both consumers and manufacturing look to Japan for high tech products.

The evolving economic relationship with China also poses important challenges. China is now the largest market for Korea's exports. Yet it is also increasingly competing with Korea for markets, as its products are starting to replace Korea's low-tech and medium-low tech goods internationally. Korea has been a major investor in China, helping develop China's manufacturing potential and its role in processing exports for the region, thus also creating demand for intermediate inputs for production and creating synergies in the economies. Yet, China is quickly outgrowing the role of simple processor, as it moves toward producing goods with higher value-added.

China's burgeoning shipbuilding industry is a clear example of the rising competition between the two neighbors. A report in the November 10 Economist suggests that the Chinese shipbuilding industry could surpass Korea's by volume in 2012. However, it appears that while China is increasing the volume of production, the focus is in low-tech oil tankers and dry-bulk vessels while Korea is increasingly in the higher end segment of the market. Further, Korean manufacturers are looking for ways to reduce costs by moving some manufacturing to North Korea.

In sum, Korea has maintained competitiveness, expanding exports and maintaining strong GDP growth in the face of very strong competition from its neighbors and beyond. To continue this record, Korea must find a way to stay ahead technologically, deal with a declining labor force, and enliven the service sector, where productivity is very low.

Can Korea hold its own? This is a country with a strong track record for rising to such challenges. The drive to innovate and move up the value chain must continue. Korea's focus on research and development in the high-tech sectors has helped it stay ahead of China, but Korea still relies heavily on Japan and other more advanced economies for high-tech inputs for manufactured goods. News this month in the Korea Times, for instance, that Hyundai has succeeded in sourcing core parts of its power steering system locally suggests that Korea may be beginning to break out of this pattern.

The ambitious pursuit of Free Trade Agreements with the United States, European Union and other key trading partners demonstrates Korea's determination to continue to thrive. As the first country in northeast Asia to negotiate

an FTA with the United States, Korea has set itself apart in making its access to the U.S. market more secure and become a focal point for trade in the region. The FTAs are also a mechanism for locking in domestic reforms and helping spur further modernization - notably in the service sector.

As Korea moves up the value-chain in exports, the economy also needs to shift to greater reliance on services. While the service sector has grown, contributing 56 percent of the value added in the economy and providing 65 percent of employment in 2005, according to the Bank of Korea, productivity is still very low. Investment in the services sector is also very weak, with Korea attracting a smaller share of FDI to this sector than any other country in the OECD.

Improving the business environment to attract foreign investment in the services sector and beyond is critical. While foreign investment has made a limited comeback from lows in 2003, Korea is still underperforming in attracting funds from abroad. The OECD ranks Korea 14th in its potential for foreign direct investment while its performance comes in at 24<sup>th</sup>. Improving this record means, among other things, increasing the transparency and reducing complexities in the regulatory framework. Commitments under the KORUS FTA indicate Korea intends to take action in these areas, and indeed reforms may move ahead with or without implementation of the FTA.