



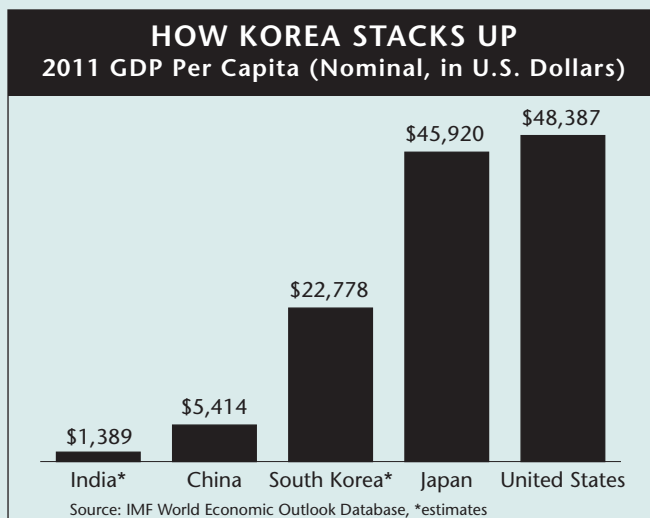
The Ascent of South Korea

One country in Asia that seems to attract less attention than it might deserve, considering its modern-day achievements, is South Korea.

While index provider MSCI this year (once again) left South Korea classified as an “emerging market,” both FTSE and Standard & Poor’s have placed Korea in the “developed market” camp for several years now. In June, South Korea became the seventh nation in the world to become a member of the so-called “20-50 club”—a moniker referring to countries each having a population size over 50 million and national incomes exceeding US\$20,000. Other nations in the club are the U.S., Japan, France, Italy, Germany and the United Kingdom, with the U.K. having joined most recently. But what makes Korea even more impressive is just how far it has risen in a relatively short span of time. In 1960, the year following the end of the Korean War, the nation was among the poorest in the world, and its GDP per capita was comparable to some of the most impoverished areas of Africa. This economic progress has come in combination with Korea’s democratic trajectory. Now among Asia’s most democratic countries—on par with Japan—Korea’s political system includes leftists and progressives within a broad ideological spectrum. What has propelled Korea to this status? Let us examine the forces we believe to be shaping its future as well as the challenges that lie ahead.

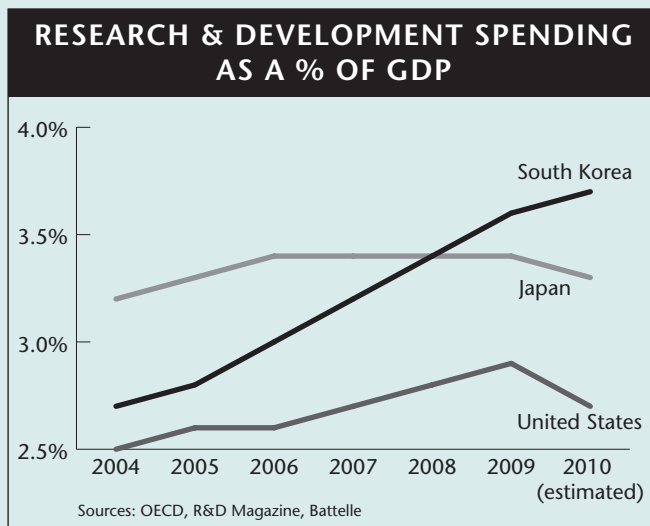
Emphasis on Education and R&D

Among Korea’s chief attributes is its strong emphasis on education. Korean parents are known for the importance they stress on education. In fact, Korea’s private sector spending on education is the highest among Organization for Economic Co-Operation and Development (OECD) member countries. Even today, small town communities hold celebrations for local students who are admitted into prestigious universities. The achievement is considered an honor for the entire town, and educational pedigree is generally considered a greater status symbol in Korea than monetary wealth. There are more than 75,000 foreign students from Korea currently studying in U.S. universities—a high ratio considering



Korea’s university age population. Many of the students also tend to rejoin Korea’s workforce, benefiting Korea’s transformation from an industrial nation to a more research and development-focused economy.

In 2010, Korea showed the third-highest ratio of research and development (R&D) spending to GDP among OECD countries, and outpaced both the U.S. and Japan in this area. In fact, Korea has been one of the few nations to consistently increase R&D spending in recent years while many other countries have cut back. Even amid the recent global financial crisis, Korea increased its R&D spending. Accordingly, product quality among Korean auto and electronics makers has noticeably been on the rise.



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Globally Competitive Companies

In many product categories—from semiconductors to shipbuilding—Korea now boasts a dominant market share. Its auto industry has also been making impressive and steady gains that have resulted not only from competitive pricing but also from improved brand image and product quality. This year, despite offering fewer incentives than the industry average in the U.S., Korean auto companies still continued to gain market share. One Korean automaker was also ranked highest among all automakers in the U.S., according to a recent consumer survey and has been honored with several automotive accolades in the past few years. Not bad for a company that didn't start making its own branded cars until 1975—about seven decades after Ford introduced the Model-T and about 40 years after Toyota's first car. Considering Korea's recent free trade agreement with the U.S., Korean companies should be able to increasingly tap into the large U.S. consumer market.

The Road Ahead

Korea's strides in branding and R&D, coupled with a well-educated and Internet-savvy workforce (it now has one of the highest penetration rates of broadband and smartphone users), no doubt have helped to maintain its low unemployment rate, which was 3.2% in May. After Korea was hit, like many other countries, by the recent global financial crisis, it demonstrated notable resilience with its quick recovery.

Still, Korea's growth is not without hurdles. Concerns include its quickly aging population and a birth rate that has been on the decline since the 1970s. Government officials have been trying to reverse this trend with measures to create easier access to childcare, better work and social benefits and more affordable education. Another measure taken to address labor shortage issues was the reform of its foreign worker policy. The government introduced an Employment Permit System (EPS) in 2004 to manage foreign workers in a more systematic way while also improving the basic rights of foreign workers. Between 2006 and 2010, Korea had a net influx of 283,000 foreign workers. Fortunately, Korea's growth in labor productivity has been one of the fastest among OECD members, allowing it to produce more goods and services with the same levels of labor.

It is difficult to explore Korea's economic ascent without a discussion over its system of chaebols—large, often family-controlled conglomerates. Korean chaebol companies represent both the economy's successes and challenges. On one hand, concentrating domestic economic power within a few chaebols has enabled Korea to compete internationally, driving growth as most chaebols have done exceptionally well in overseas markets. However, this concentration of power can also leave Korea vulnerable. The fall of one chaebol company could have significant and wide-reaching social, political and economic consequences. For example, the infamous collapse of one conglomerate in 1999, in the aftermath of the Asian Financial Crisis, forced a wave of closures and impacted jobs in several countries.

Many argue that Korea needs to cultivate a stronger small and medium-enterprise (SME) sector to better weather economic downturns. Fortunately, there are encouraging signs as we see an increasing number of smaller firms making inroads in areas such as consumer-related industries, particularly in China. In addition, Korea has seen its so-called “soft goods”—Internet services, pop music and television dramas—enjoy new popularity. These industries are primarily led by entrepreneurs, rather than chaebol-related firms.

Relationship with North Korea

Another long-term challenge continues to be South Korea's relationship with its Stalinist neighbor to the North. Since the Korean War ended in an armistice in 1953, North Korea has continued to threaten South Korea with periodic military provocations that have included artillery fire attacks. Each incident has led to short-term market volatility and we expect this to continue to be the case for the foreseeable future. North Korea is still undergoing a leadership transition since long-time leader Kim Jong Il died in 2011. His son, Kim Jong Un, is expected to lead the country; for the time being, little is known about him and North Korea remains a closed economy.

Should North Korea change its stance, however, there are great potential benefits to the Korean peninsula. On a basic level, North Korea could become a good source of the labor and natural resources that South Korea lacks. In turn, South Korea—could provide the technology and capital to help North Korea develop.

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More to Come

Korea tends to be viewed with the same lens that investors use to consider Asia’s two largest economies—China and India. But that may be the wrong comparison. China and India are still considered emerging countries while Korea has already gained developed country status. When compared to other developed nations, Korea’s growth profile stands out. Among developed nations, Korea had the third-highest GDP growth rate in 2011, trailing Israel and Sweden. In 2012, based on the OECD’s forecast, Korea is expected to be the fastest-growing developed country. Despite its growth over the past few decades, however, Korea’s GDP per capita is still just about half that of Japan, indicating room for further expansion.

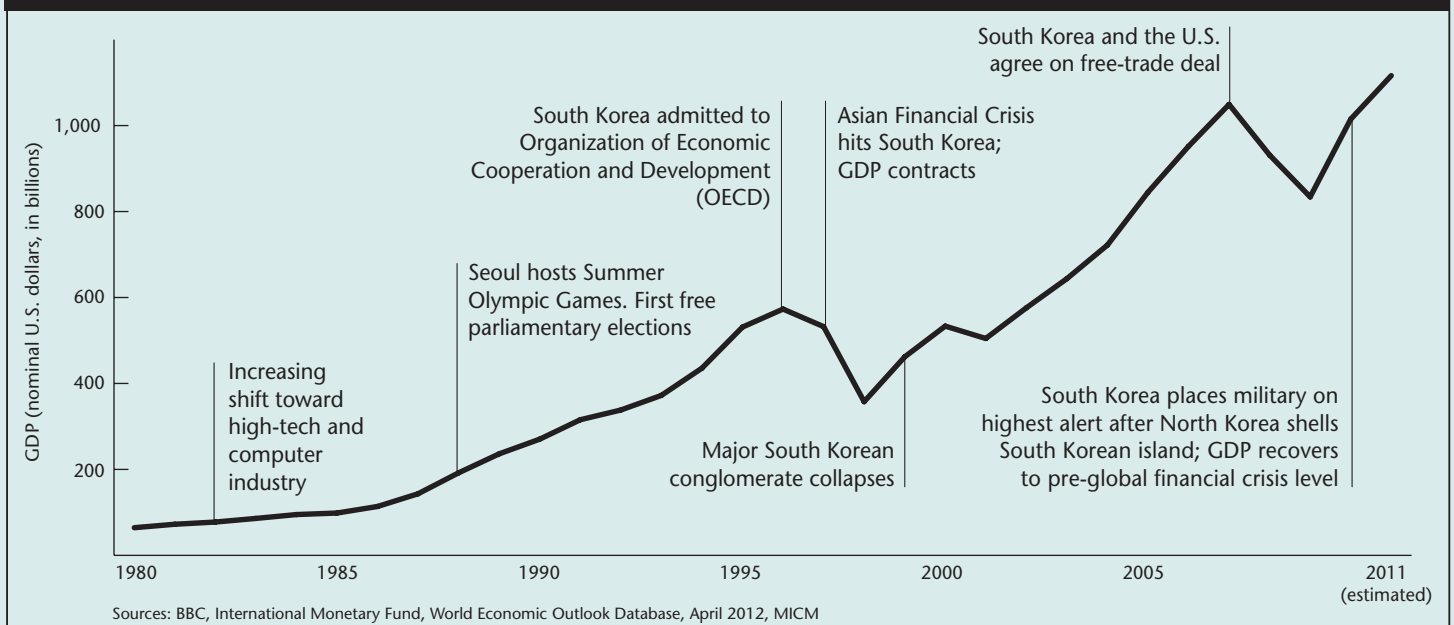
Not only is Korea’s growth rate positive, it is also now more transparent. Last year, Korea became one of the first countries in the region to adopt International Financial Reporting Standards, which require companies with assets of more than 2 trillion won (US\$1.7 billion) to make financial statements easier and more transparent for foreign investors to access. SMEs are expected to be required to

adopt these standards by next year. Since the 1997-98 Asian Financial Crisis, Korea has also undergone significant corporate governance reforms. The introduction of outside directors is a major feature of the changes to board regulations, and enhances a board’s monitoring functions. Holding companies have simplified their shareholding structures and other measures have increased management accountability, protecting minority shareholder rights and information disclosure.

What I find most encouraging about Korea is its legacy of resiliency. If Korea can continue on a path of innovation and transparency, it should be able reach the next GDP milestone of US\$30,000 GDP per capita. It took Japan five years to reach that target after joining the “20-50 club” and nine years for the U.S. Only time will tell when Korea will surpass such targets, and we will continue to keep a close watch.

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KEY EVENTS FOR SOUTH KOREA’S ECONOMY





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