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Title of paper
The End of Egalitarian Growth in Korea:
Rising Inequality and Stagnant Growth after the 1997 Crisis

Abstract

This paper examines the rise in income inequality after the 1997 financial crisis and neoliberal economic restructuring in Korea. It argues that the egalitarian growth model in the past was over in Korea as inequality in income and assets became serious and economic growth has been in stagnation since then. The labor market reform, corporate and economic restructuring, and more economic opening caused a rise in wage inequality, a growing disparity between household income and corporate profit, and that between industries. The neoliberal growth model in the post-crisis period in Korea is likely to lead to a vicious cycle of rising inequality and stagnant growth through several channels, which is in the opposite direction of the East Asian miracle. This paper calls for more active efforts of the government for income redistribution and re-establishing an egalitarian growth model.

Key words (up to six)

Korea, Income Inequality, Financial Crisis, Egalitarian Growth

Author's name: Kang-Kook Lee
Author's affiliation: Ritsumeikan University
(optional)Author's email and web sites kangkooklee@gmail.com

I. Introduction

Korea was a paragon of the East Asian miracle for rapid economic growth and equal income distribution managed by the developmental state, which is in stark contrast to many other developing countries. It achieved spectacular poverty reduction for three decades since the 1960s in the egalitarian economic growth model. The Korean economy, however, went through a sea change after the 1997 financial crisis. Neoliberal economic restructuring and financial opening in the wake of the crisis transformed the economy to such a great extent that Koreans now suffer from rising inequality and insecurity. Inequality in income and poverty became highly serious along with changes in the labor market, while household income compared with corporate profit fell significantly in the recent period. The disparity in industries and that between big businesses and small and medium enterprises also deepened along with economic growth dependent on exports. Not only did inequality rise but also economic growth became stagnant and volatile in the post-crisis period. This suggests that the structural changes of the economy finally ended the former egalitarian growth model and a new neoliberal growth model has moved the Korean economy in the opposite direction of the East Asian miracle.

This paper aims at examining the recent rise in income inequality in Korea after the 1997 financial crisis from the perspective of institutional changes in the growth model. It first investigates the egalitarian growth model in the past and causes of the financial crisis in 1997. Then, it presents how neoliberal restructuring ended the egalitarian growth model and how the new neoliberal growth model has deteriorated inequality and growth as well. The miraculous success in the Korean economy was thanks to a virtuous cycle of equal distribution and rapid growth, effectively managed by the developmental state. However, careless capital account and financial liberalization in the early 1990s brought about financial vulnerability and caused the 1997 financial crisis. Neoliberal economic restructuring including labor market flexibilization and more financial opening were introduced after the crisis, in an attempt to transform the economy to becoming more open and liberalized. But the neoliberal growth model greatly worsened inequality in income, assets and opportunity. This is highly likely to hinder economic growth through several channels such as stagnant domestic demand, higher social instability and concentration of political power, causing a vicious cycle of high inequality and lower growth. Against this backdrop, there has been a growing political demand for more social welfare and economic democratization in Korea in the recent past. The author calls for more active efforts on the part of the government for income redistribution and establishing a new egalitarian growth model in Korea.

Section I presents key elements for rapid growth and equal distribution in Korea, including historical conditions and government policies. Section II discusses capital account liberalization that led to the 1997 financial crisis and neoliberal economic restructuring following the crisis. It argues that the financial crisis was mainly due to mismanaged financial opening and explains how neoliberal economic restructuring broke up the former development model. Section III examines how inequality and poverty became serious after 1997 and presents the causes for this change. It demonstrates the harmful effects on income distribution of neoliberal economic restructuring such as the labor market reform and the pattern of growth in the neoliberal era. Section IV discusses the limited role of the government for social welfare and emphasizes the need for an alternative growth model in Korea.

II. Egalitarian Growth in the Miracle Period in Korea

The Korean economy is generally known for its rapid economic growth together with relatively equal income distribution. Its growth rate had been higher than 6% for about four decades since the early 1960s. Economic development in Korea was led by successful state intervention such as strong industrial policy, and control of domestic and foreign capital. The government established a state-led financial system by nationalizing banks and setting up special financial institutions that mobilized financial resources. It actively allocated finance to priority industries in line with industrial policy and took the risk of investment through industrial reorganization programs when corporate investment failed (Cho and Kim, 1995). This system succeeded in promoting investment and economic growth miraculously. Its success was possible because of a specific institutional feature, called the 'developmental state'. The Korean government was highly capable, relatively autonomous from interest groups, and was strongly oriented to economic development, different from many other developing governments (Amsden, 1989). In particular, the developmental state was wise enough to support domestic big businesses, called '*chaebol*', very effectively by mixing the market and state mechanism.[1]

In addition to rapid growth, Korea's income inequality had been lower than that of other developing countries. Equal income distribution is helpful to growth, while serious inequality is harmful to growth as recent studies indicate (Aghion et al., 1999). Relatively equal distribution in Korea contributed to growth in several ways. It lowered social instability and strengthened institutional capacity of the government. In fact, the institutional quality in Korea was relatively high and the corruption level was low, compared with other developing countries (Rodrik, 1997). Equal distribution also prevented the Korean government from turning to populism and made it more development-oriented, opposite to Latin America. The Korean economy also succeeded in mobilizing resources thanks to equal income and asset distribution. Low inequality helped households to invest in human capital when the financial market was underdeveloped, and encouraged entrepreneurs to increase industrial investment. This was essential to the economic growth in Korea in mobilizing the various factors of production. It is certain that Korean workers worked hard and long with low wages and their struggle was strongly repressed by the autocratic government in the industrialization process. But their real wages continued to rise together with the growth of GDP and the rapidly growing businesses provided lifetime employment for workers following Japan.[2] Thus, there was a virtuous cycle of equal distribution and high growth in Korea, which can be termed relatively egalitarian economic growth. Table 1 demonstrates Korea and East Asian countries achieved rapid growth and equal distribution simultaneously, and that high inequality is indeed bad for long-run growth.

Table 1.

Initial historical conditions and government policy were crucial to Korea's egalitarian growth story. First of all, the Korean government implemented progressive land reforms

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[1] The Korean government not only supported but also disciplined them by exchanging preferential credit with export performance and investment, providing a kind of 'contingent rent'. This could reduce unproductive rent-seeking and corruption.

[2] It is argued that the low labor share due to repression of workers made profit rates in the corporate sector higher in Korea than other countries, which stimulated investment (Yoo, 1998). But equality in assets and continuous creation of jobs due to high investment and rapid growth made the whole society equal on the whole. While low wages may constrain domestic demand, Korea achieved rapid growth by exports to the world market. The high profit-investment-growth nexus worked well with low wages and export promotion.

successfully, compared with other developing countries, partly affected by a threat of socialism. It distributed land to a large number of tenants from landlords in the way of confiscation with compensation and distribution with compensation between 1946 and 1950. The share of land with tenants fell from 65% in 1945 to 8% in 1951 and more than 1.6 million households came to own the land (Jang, 2004). Land reforms spurred agricultural productivity and reduced power of landlords significantly, changing some of them into manufacturers. The Korean War from 1950 also made the distribution structure much more fluid by shaking the society deeply. These conditions helped the developmental state in the 1960s to be strongly autonomous because landlords' power weakened and interests of businesses were not strong.

It should be noted that active policy efforts contributed to egalitarian growth too. The Korean government guided economic development, by implementing industrial policy and financial control domestically, and trade protection and capital controls externally. It also promoted public education by introducing compulsory education for elementary schooling just after liberation and continuously expanding opportunities for education. As there was cutthroat competition for prestigious schools partly because Korean people had been enthusiastic about education, the Park government introduced a reform to equalize junior schools in 1969, and high schools in 1974 by repealing entrance examinations. The secondary school enrolment ratio in Korea rapidly rose from about 40% in 1971 to 91% in 1985 as a result, and there were also efforts to raise government spending for education. Equal and widespread opportunities for education made an essential contribution to the egalitarian social structure, and high social mobility in Korea (Lee, 1994)[3].

Sound macroeconomic management with low inflation also contributed to both equal distribution and rapid growth. This factor is also presented by the World Bank (2003) as one of the keys to the East Asian miracle. Active development of infrastructure such as highways and roads in rural areas was another factor to help egalitarian growth to work well as cross-country empirical studies indicate (Lopez, 2004). Finally, the role of democratization and struggle of workers in the more recent period should be mentioned. Korean workers demanded and achieved increases in wage by going on general strike in 1987 when the Korean government introduced direct presidential election pressed on, by the people's democratic movement. This led to a significant rise in household income, and domestic demand went up in the late 1980s, which provided further momentum for economic growth until 1997.

A distinctive approach to external policy called the 'strategic integration to the world economy' was crucial to egalitarian growth (Singh, 1995). While promoting export-led industrialization, the Korean government also pursued a strategic integration into the global economy by regulating imports and implementing capital controls. Domestic markets were protected by high tariff rates and various non-tariff barriers, and foreign exchange rates were controlled in order to promote exports and restrain imports. Foreign direct and portfolio investment were strongly regulated by the government until the 1990s. The government allowed foreign direct investment (FDI) after carefully examining its effects on domestic industry, and imposed several regulation measures including the compulsory use of domestic parts. Also, the government only permitted joint ventures to limited foreign ownership and to

[3] Educational policy in Korea was also practical. The government tried to raise labor power that is necessary for export industries and heavy and chemical industries by establishing several technical high schools. Education policy was incorporated into industrial policy organically, and thus contributed to industrialization and economic growth.

maintain the dominance of domestic industry (Lee, 2004).[4] Effective capital controls provided financial stability for the Korean economy, thereby contributing to growth and equality. Import protection also played a role to maintain equality since greater opnness may result in an increase in inequality. Thus, managed openness and strategic globalization contributed to equal distribution and rapid growth as well.

III. The 1997 Financial Crisis and Neoliberal Restructuring

1. From Mismanaged Capital Account Liberalization to the Financial Crisis

The egalitarian growth model in Korea worked superbly, though not without problems. But it came unravelled in the 1990s when its own success weakened the role of the state, which finally led to the 1997 financial crisis and its breakdown, as shown below. There were hot debates about the causes of the 1997 financial crisis. Mainstream economists emphasize the problems of the government-led growth model such as moral hazard and crony capitalism, pointing to low profitability and high debts of Korean big businesses. There is, however, no strong evidence that the Korean economy grew inefficient enough to cause the crisis in the mid-1990s (Crotty and Lee, 2009). The cause of the 1997 financial crisis lay in careless financial opening and liberalization, which had much to do with a broad change of the economy (Singh, 2002).

It was economic development and the change in the financial system and political economy in the late 1980s that weakened the former development regime. In the financial market, non-bank financial institutions and the capital market grew fast throughout the 1980s, weakening government control over financing of the corporate sector. The *chaebol* wanted more freedom in their investment and financing and requested financial liberalization in an attempt to utilize cheaper foreign capital. The government could hardly discipline or regulate the *chaebol* any more because it became financially powerful. Influenced by a dominant free market ideology, the first civil government from 1987 began to retreat from the economy, ending its industrial investment coordination policy in 1990.[5] The most outstanding change in the early 1990s was extensive financial and capital account liberalization. It was demanded by domestic big businesses and also by strong external pressure from the US government and international organizations (Lee et al., 2002). In particular, comprehensive deregulation of short-term foreign borrowing by financial institutions and firms was dangerous when the financial supervision system was weak, while long-term borrowing and portfolio investment were still under regulation (Cho and McCauley, 2003). The Korean government abolished the ceiling on foreign currency loans of financial institutions and lifted regulation of the term structure of foreign loans in 1993. In addition, between 1994 and 1996, 24 finance companies were transformed into merchant banks that dealt in foreign exchanges.

The aftermath of this mismanaged financial opening was a surge in foreign capital inflows and growing financial vulnerability. Foreign debt rose from some $44 billion in 1992 to more

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[4] At the same time, the Korean government actively made use of foreign capital in the form of foreign loans, which was allocated by the state-led financial system (Lee, 2004). When domestic financial resources were deficient, this greatly spurred domestic corporate investment and economic development.

[5] Political democratization in Korea since 1987 also prompted the government to push forward liberalization. Many Koreans were against the despotic government and thought government intervention into the economy was its relic. Thus, they misunderstood liberalization and opening as democratic changes, which occurred again in neoliberal economic restructuring following the 1997 crisis.

than $120 billion at the end of 1997, most of which was due to rising short-term borrowing by financial institutions and firms (Lee, 2010a). This foreign borrowing financed the investment boom driven by somewhat too aggressive investment spending by the *chaebol* in the early 1990s. While operating profitability of the Korean corporate sector was not significantly low, the mode of financing of chaebol companies was indeed problematic since they relied on too much short-term foreign borrowing.[6] Financial institutions, mainly merchant banks, also became fragile owing to the term structure and the currency mismatch problem. In 1996, the external shock of the export market collapse dealt a hard blow to the Korean economy. Several *chaebol* firms started to go bankrupt in early 1997 and many financial institutions were in crisis, as they struggled to pull back their short-term loans and this further aggravated the situation. Finally, the dangerous structure of foreign debt and the contagion effect of the Southeast Asian financial crisis exacerbated foreigners' lack of confidence. When they refused a rollover of short-term foreign loans, the Korean economy plunged into the crisis and the government had no choice but to resort to the IMF in December 1997.

2. Neoliberal Restructuring and Opening of the Economy

The 1997 financial crisis was a historical moment for the implementation of full-blown neoliberalism and financial globalization in Korea. The Korean government accepted the mainstream view and carried out the IMF-suggested restructuring program. Many Koreans even welcomed neoliberal restructuring because they expected it to reform inefficient government-led and *chaebol*-dominated economy. The agenda since 1998 of the Korean government, which saw the crisis as an excuse for economic reform was indeed 'Democracy and Market Economy'. First, the government introduced restrictive macroeconomic policy, raising interest rates very high, a common advice of the Washington Consensus. This was criticized harshly because the Korean economy had sound macroeconomic fundamentals unlike in Latin America. The government finally gave up restrictive monetary policy as of mid-1998, and turned to a Keynesian approach.

Nevertheless, the economic restructuring program to tear down the old growth model completely and establish a more open and liberalized neoliberal model was far-reaching and drastic (Crotty and Lee, 2002; Lee, 2010b). As for the labor market reform, new capital-friendly labor laws were enacted in February 1998 that legalized the layoff system the first time in history to assist restructuring. Temporary help agencies were also made legal after July 1998 and temporary workers, who were dispatched to firms for up to two years, were permitted in all occupations (Ministry of Finance and Economy, 1999). This flexibilization of the labor market to weaken workers' power was long demanded by domestic businesses but was not introduced until after the crisis. The IMF specified this in its bailout finance agreement with the Korean government. It is not surprising that the unemployment rate went up to some 7% in 1998 from less than 3% before the crisis due to deep recession and labor market restructuring. Another result of the sweeping labor market reform was the increase of irregular workers and job insecurity. It was good news for businesses since the labor productivity growth became much higher than the growth of real wages from 1998 onwards.

Financial restructuring measures included shutting down insolvent financial institutions, cleaning up nonperforming loans, and applying strict prudential regulation. Since a large number of institutions went effectively bankrupt in 1998, the government injected a huge amount of public money into the banking system, almost 30% of GDP. About half of the

[6] For example, the share of the foreign debt in overall corporate debt rose from 8.6% in 1992, to 10.0% in 1994 to 16.4% in 1996, due to the rapid growth of short-term foreign borrowing by *chaebol* firms.

financial institutions were shut down through bankruptcy or merger, and the sales of banks to foreign capital were encouraged by the government. In addition, the Bank for International Settlements capital adequacy standard was introduced in the midst of the economic turmoil in 1998. Financial restructuring brought about a severe credit crunch and worsened recession by a vicious cycle of reduction of credit, investment, wage and domestic demand (Crotty and Lee, 2002). Commercial banks had rapidly shifted out of shaky corporate loans into high margin household loans. Thus, financial restructuring enfeebled financial intermediation for the corporate sector as the share of corporate lending out of all loans fell from 65% in 1997 to 43.5% in 2004.

The Korean government announced five principles of corporate restructuring for *chaebol* including an immediate reduction of debts, improvement of transparency, the end of cross-debt guarantees by *chaebol* affiliates, concentration on core businesses and greater managerial accountability to minority shareholders in 1998. Following the guidelines, top 30 *chaebol* reduced their debt ratio from about 500% in late 1997 to less than 200% in 2000. They continued to decrease debts, so that this ratio went down to 118% in 2005. Ordinary profit over sales in the manufacturing sector recovered in 2002 to 4.7%, and then 7.8% in 2004 from negative 1.8% in 1998, thanks to the decrease of the debt ratio and lower interest rates. But a side effect of corporate restructuring was a decline in investment. Corporate investment had been in stagnation, and did not recover to the 1997 level until 2003 because of business conservatism along with corporate and financial restructuring. Investment decline was more serious, especially for small and medium companies, who were financially constrained.

All-out financial opening of the Korean economy was another crucial pillar of the structural transformation of the economy. The government repealed remaining restrictions on capital inflows in the capital market after the crisis. In May 1998 it abolished limits on foreigners' share ownership, and eased regulation on foreign investment in most corporate bonds, in the forward market and in commercial papers. The government permitted hostile mergers and acquisitions by foreign investors after 1998 and tried hard to sell financial institutions to foreigners. The first phase of capital market opening plan in 1999 and the second in 2001 intended to promote full deregulation of foreign exchanges transactions and cross-border capital movements. These opening measures encouraged foreign investment into Korea strongly with inward FDI only $3 billion in 1996 and $8 billion in 1997 up to cumulative $31 billion in 1999 and 2000, though in a decline since then. Foreign portfolio investment also increased in general, especially on large Korean *chaebol* firms, but it was volatile.[7] Foreign borrowing fell dramatically following the crisis but that of financial institutions skyrocketed again in 2006 and 2007, associated with the forward exchange market transactions. The Korean economy almost faced a currency crisis again in late 2008 when foreign financial institutions withdrew their lending in the middle of the US financial crisis. Complete financial opening and globalization resulted in higher financial instability and strong foreign control of the Korean economy (Lee, 2010a).

[7] Because of huge foreign capital inflows, the share of foreigner investors in total capitalization of the Korean stock market tripled between 1997 and 2004 from 14.6% to 42%. Foreigners as a group became the largest shareholders of many major firms such as Samsung electronics and Hyundai automobile and financial institutions, especially commercial banks. See Lee (2010a).

IV. Rising Inequality and Stagnant Growth in the Neoliberal Regime

1. Rising Inequality after the Crisis

(1) Income Inequality and Asset Inequality

The financial crisis and deep recession greatly aggravated income inequality and poverty in 1998, when the GDP growth rate recorded -5.7%. Mass unemployment due to bankruptcies of companies and layoffs led to a serious deterioration of income distribution as Figure 1 demonstrates. According to the National Statistic Office (NSO), the Gini coefficient of market income among urban households with two or more members rose from 0.264 in 1997 to 0.298 in 1999. It fell in the early 2000s along with the rapid economic recovery but kept rising from 2004 up to the peak of 0.320 in 2009 in the recent recession. Inequality since the mid-2000s became even higher than that in 1998, reflecting the structural change of the economy toward a neoliberal model by post-crisis economic restructuring and opening. The current inequality level is the highest in Korea's whole history.[8] Among all families, for which data are available from 2006, the market income Gini coefficient rose from 0.330 in 2006 to 0.342 in 2011. The Gini coefficient of disposable income also demonstrates a similar rise but the increase in social welfare spending made it lower.

Figure 1.

Figure 2.

The ratio of income of the highest quintile over that of the lowest quintile shows a similar change. It rose from 3.97 in 1997 to 4.93 in 1999 and registered a peak of 6.11 in 2009. The relative poverty rate, that is the share of households that earn less than 50% of median income, also jumped from 8.7% in 1997 to 12.2% in 1999, and 15.4% in 2009. The rise in inequality was mainly driven by a relative fall of income of the poorest group in comparison with that of the middle income and top income groups (Choi, 2013). The survey data of NSO in the post-1997 period report the increase in the gap between the bottom 10% and the median income group was much more than that between the top 10% and the median group.[9]

While income inequality has worsened, the concentration of income by the top income group has been in progress in Korea too, similar to what is reported in the United States (Atkinson et al., 2011). According to Kim (2012), using income tax data, the top 1% accounted for 11.9% of total private income and the top 10% accounted for about 44% as of 2010. The share of the top income group remained constant from 1976 to 1997 with the top 1% share being stable at about 7-8%, but it began to rise after the 1997 financial crisis[10].

Figure 3.

[8] An examination of the long historical trend of the Gini coefficient reports that it remained constant throughout the 1980 after a rise in the late 1970s. It gradually fell after 1990 and its level was generally lower than that in the 1980s until 1997. The Gini coefficient in1999 is the highest in the historical data for the 1965-2005 period (Kwack and Lee, 2007).

[9] In the early 1990s, both the bottom and top market income gap (D5/D1 and D9/D5) was about 1.8. But in 2009, the bottom gap is 2.6, while the top gap is 1.9. This is because of a sluggish income growth of the bottom group, while both the median and top income group continued their income growth. The real market income of the bottom 10% decreased by 11% from 1995 to 2010, while that of the top 50% increased by 21% and that of the top 10% increased by 32% over the same period. See Choi (2013).

[10] The rapid increase of the top income share after 1998 is not seen in the survey data from NSO because the top income data using tax data are much more extensive.

The other pillar of unequal distribution is asset inequality. In Korea, real estate is the most important asset for households and its distribution has been much more skewed than income. Many indicate that inequality in real estate holding became even worse after the 1997 crisis. This is mainly associated with the real estate market bubble in the mid-2000s stimulated by the change in the financial system and deregulation measures of the government.[11] The apartment price in Seoul on average rose about 50% from 2004 to 2006, and its rise was especially rapid in several expensive areas known good for education, benefiting rich households owning real estate[12]. According to Samsung Finance Institute, the ratio of assets between the top 20% and the bottom 20% households was much larger than that of income. That was 19.5 for total assets, 12.1 for financial assets, and 23 for real estate in 2006. The top 5% households owned 30.9% of total net assets in Korea in 1999 and this share rose to 39.8% in 2006. Another study using microeconomic data reports that the Gini coefficient for assets rose from 0.61 in 2000 to 0.65 in 2007, much higher than that for income. It is reported that the top 10% households own 53.3% of all real estate assets and 66.5% of all financial assets in 2007 (Pressian, September 3, 2009).

Figure 4. here.

(2) Causes for Rising Inequality

The most important factors to rising inequality were, of course, the financial crisis as such and neoliberal economic restructuring, particularly the neoliberal labor market reform (Lee, 2010b; Bank of Korea, 2004). Korean firms took advantage of new labor laws by firing permanent workers and hiring cheaper, temporary workers. They came to care about short-term profits much more after corporate restructuring. The strong influence of the neoliberal logic of shareholder capitalism and the rapid increase in foreigners' stock ownership played an important role for this change. Labor unions struggled hard against it, only to no avail, given the weakened power during the deep recession. Thus, the tradition of lifetime employment of key employees in Korea was over, which significantly intensifies workers' economic insecurity. The share of irregular workers rose after the crisis along with labor market restructuring. Already prior to the crisis, about 43% of all workers in 1996 were in this insecure status, which includes temporary and daily workers. But the share of these irregular workers rose up to about 52% in 1999 though it has been in decline gradually after 2002 down to about 39% in 2011. But many argue that the share of irregular workers in reality is about 10% point higher than the official statistics.[13]

The fact is that wage and income of irregular workers are much lower than those of regular workers. Average monthly wage for irregular workers is just half of that of regular workers. It constantly fell in the 2000s from about 56% in 2001 to a mere 48% in 2010, though slightly rising afterward. Furthermore, there are large differences in working conditions and social welfare between regular and irregular workers. Low wage groups who

[11] The Korean government attempted to prop up the real estate sector after the crisis by introducing liberalization of the price of real estate for sale and resale, cutting transfer income tax, and so on. There were attempts to raise tax rates for ownership of expensive real estate in response to the bubble but they were not successful faced with strong resistance of the wealthy.

[12] The real estate price in Seoul was already extremely high even before the bubble. The ratio of the average price of a new house to per capita GDP was about 24 in 2003, much higher than 12 in Japan and 8 in the US (Sohn, 2005).

[13] The more realistic statistics presented by unionists counts irregular workers more because irregular workers should include regular workers in the official statistics who have temporary contracts with limited terms with employers.

earn less than 2/3 of median wage are 25.4% of all workers, the highest in the OECD, and 45.7% of irregular workers are included in this category. The poverty rate of irregular workers is more than five times higher than that of regular workers in 2011. Wage inequality is also very serious as the ratio of wage of top 10% relative to bottom 10% is about 5, compared with the average of 3.4 in the OECD as of 2008 (Kim, 2012).[14]

Wage inequality associated with the disparity between regular and irregular workers is the most crucial cause for income inequality since household income consists of mainly labor income. According to Choi (2013), about 80% of market income inequality in 2010 and almost all of the change in inequality from 1995 to 2010 is attributed to inequality in labor income. Another study that uses the Occupational and Employment Statistics for the 2002-2007 period that divide people into wage laborers and the self-employed, also finds that the biggest element to increase overall inequality was within the group of wage laborers (Kim, 2009).[15]. As for the causes of inequality within wage laborers, the status of workers, that is regular or irregular, was the most important in 2007, while factors such as education and gender made larger influences in 2002. This suggests that recently, the structural changes in the labor market and the disparity between regular and irregular workers are the biggest cause for wage and income inequality.

Of course, there could be many other factors in rising inequality in addition to the changes in the labor market. Mainstream economists have emphasized that skill-biased technological change played an essential role in worsening income inequality in developed countries. The skill premium for the highly educated workers rose since the 1980s, along with the technological progress, especially in the US. Some empirical studies report that technological change has increased inequality also in Korea as the growth of unskilled workers' wage was in relative stagnation (Choi and Jeong, 2005; Jeon et al., 2005, Ch. 4). But it is difficult for technological change to explain the abrupt rise in inequality after the financial crisis. It is reported that the polarized structure of the labor market after the 2000s was affected by the higher use of irregular workers and deindustrialization with the increase in the share of the service sector, more than technological change (Jeon et al., 2006). The broad structural, rather than technological, changes in the Korean economy toward a neoliberal model should be understood as an underlying cause of the rising inequality after the 1997 financial crisis.

2. The Neoliberal Growth Model and Inequality

There were structural changes in the pattern of economic growth in the new neoliberal regime. The economic growth rate following the 1997 crisis became systemically lower than that prior to the crisis and more unstable (Crotty and Lee, 2005). The economic booms were short-run and not sustainable, frequently led by bubbles, and the economy went through downturns with the burst of bubbles. In the neoliberal growth model, investment, particularly facility investment, experienced a constant decline due to corporate and financial restructuring and stagnant income growth and domestic demand. The Korean economy quickly recovered after 1999 thanks to a rapid rise in exports and experienced a consumption-led boom in 2002. But it fell into a recession in 2003 because of the burst of the credit-card bubble. Economic growth was led by exports after, while domestic demand was stagnant

[14] Furthermore, Korea's job stability is the worst in the OECD. The average tenure is 5.3 year and its median is 2.2 year, shortest in the OECD. The share of workers with less than one year tenure is 33.8% and that with longer than 10 year is 18.8%, the most and the least individually in the OECD (Kim, 2012).
[15] The increase in inequality within this group explains almost 80% of all changes in overall inequality. This study also finds that the income gap between wage workers and the self-employed widened. Concerning within group inequality, that of the self-employed group was higher than that of workers but their difference became smaller because income inequality within workers rose relatively faster.

except for bubble-led investment in the real estate sector. However, it went through a serious downturn due to the global financial crisis after 2008. As the economy has grown unstable, income inequality and poverty became even more serious in the recent period.

Figure 5.

The Korean economy also grew more vulnerable to external shocks because its dependence on foreign markets and capital rose. As the Korean government adopted a kind of foreign-dependent-growth strategy together with recent depreciation policy, the trade dependency ratio rose from 55% in 1997 to 66.2% in 2004, 92.1% in 2008 and 96.7% in 2011. This made the Korean economy more unstable, as is the case of the recent recession in 2008 due to the global financial crisis. Instability of the economy had much to do with all-out financial opening after the crisis and volatile movements of foreign investment. Foreign capital inflows and outflows increased largely but they were highly pro-cyclical, and thereby intensifying economic instability.

The new neoliberal growth strategy required workers' wages to be repressed, and the labor market reform exactly contributed to this. Since the wage growth was stagnant in comparison with labor productivity growth, the labor share in Korea also fell sharply after the 1997 crisis. The adjusted labor share out of GDP in Korea fell constantly from about 75% in 1996 to about 69% in 1999 and 63% in 2011, which deteriorated overall income distribution.[16] This occurred in other OECD countries since the 1980, while the change in Korea was much later, only after the 1997 financial crisis. An examination of changes in corporate profit and household income also highlights unequal distribution of growth. According to the national accounts data, the growth of household income from 2000 to 2010 was a mere 2.4%, much less than 16.4% of corporate income, while that of Gross National Income (GNI) is 3.4%. Household income grew similarly vis-a-vis corporate income and GNI for two decades before 1997 as Table 2 demonstrates. The decline of the labor share, the increase in foreign exchange rates and the unequal changes in tax rates, all associated with neoliberal changes in the economy, and weakening of workers' power were behind this change (Kang and Kim, 2012). This suggests that economic growth after the 1997 crisis was not shared at all because of structural changes of the economy. As of 2012, largest companies such as Samsung Electronics and Hyundai Auto announced the historically high profits but corporate income did not trickle down. The shared growth principle, a principal feature of egalitarian growth in the past, was long gone in Korea.

Table 2.

Changes in the financial system were essential to the transformation of the growth model and rising inequality. Banks in Korea actively expanded household lending along with financial restructuring, thereby encouraging the real estate market bubble. On the other hand, the liberalized and more open financial system, seeking short-term profitability, cut down corporate lending. Moreover, financial institutions reduced lending to small and medium enterprises (SMEs) more than to large companies, which caused the difficulty of SMEs getting external finance and a decline of their investment. It should be noted that foreign capital played a pivotal role in this change since foreign-controlled banks such as *Korea First*

[16] The adjusted labor share is calculated by (compensation of employee / GDP) * (total employment / total employee) to take the change of the number of employee into consideration. Treating the business income of the self-employed is a tricky issue. Though this is usually included in corporate income, reality may be different. An alternative method is to calculate the labor share by totally excluding income of the self-employed from national income. This calculation also indicates the similar change in the 2000s.

took the lead. The banks owned by foreign capital reduced corporate lending by 33.3% points compared with 24.8% points of domestic banks, while they increased household lending by 35.2% points compared with 26.4% points of domestic banks in the period from 1998 to 2003 (Bank of Korea, 2003). The increase in household lending, interacting with the real estate market bubble, and rising inequality, however, increased household debt rapidly. The ratio of household debt to personal disposable income continuously rose from about 85% in 1996 to 163% in 2011. Its current level is even higher than that in the US and Spain and is making the economy very vulnerable. It is very worrisome that the bubble finally started to burst recently in spite of all-out support of the government for the real estate sector, which would seriously aggravate the household debt problem.

It should be noted that the disparity in industrial growth has been also rising between large businesses in the export sector and SMEs in the service and domestic demand sector. The large *chaebol* companies gained from the export market boom in sectors such as information technology (IT), shipbuilding and automobile in the early 2000s, while the domestic demand sector where SMEs mainly operated was in recession (Mckinsey Global Institute, 2013). Moreover, the link between exports and domestic investment weakened recently, particularly because of the growing IT industry that had high import dependence. The share of imports in equipment investment increased from 30.2% in 1998 to 51.7% in 2005 (Bank of Korea, 2006).[17]

In consonance with this dualized pattern of economic growth, *chaebol* companies have fared well, often at the cost of their subcontractor SMEs, which have weak bargaining power. SMEs in Korea do not have competitiveness due to the lack of technological ability and low productivity. The gap of profitability between large companies and SMEs has widened after 2002, and the growth of equipment investment of SMEs has been relatively low. The difference in wage and working condition also became larger. The number of the employed in large firms fell, while that by SMEs with less than 300 workers rose from 80.6% of all workers in 2000 to 86.8% in 2010. But relative wage of SMEs compared with that of large companies in the manufacturing industry fell continuously from 65% in 2000 to 52.6% in 2011. Moreover, outward FDI from Korea has been rising mainly by the labor-intensive SME sector seeking cheaper labor costs in countries such as China. It skyrocketed from $5.1 billion in 2000 to $10.8 billion in 2006 and $25.6 billion in 2011. It is highly likely that this did harm to unskilled workers in SMEs, and enlarged the income gap among workers.

In sum, structural changes in the growth pattern of the Korean economy under neoliberalism worsened income distribution and poverty after 1997. Wage inequality and insecurity of workers grew serious owing to this structural change as well as the neoliberal labor market reform. As firms and banks became conservative and risk-averse due to the breakup of the former growth model, financial intermediation and corporate investment stagnated. The gap between large companies and SMEs continued to rise. Financial opening and high dependence on export for growth intensified this structural change. The former East Asian egalitarian growth model was finally over by the 1997 financial crisis and consequent neoliberal economic restructuring in Korea.

[17] The share of the IT industry in the manufacturing sector rose from 14.9% in 1995 to 22% in 2005. But this industry highly depends on capital goods imports from foreign countries for investment than others. For example, that in the semiconductor industry and wireless communications equipment industry is about 79% and 67% (Bank of Korea, 2006).

V. The Role of the Government for Egalitarian Growth

In spite of serious inequality, the role played by the government to reduce it so far, is still limited in Korea. It is true that the Korean government increased social welfare spending after the crisis. The ratio of taxes and social welfare transfers rose from about 3% of market income in 1992 to 5% in 2009, which helped to lower the increase in the Gini coefficient for disposable income (Choi, 2013). Nevertheless, reduction of inequality by the government in Korea is only about 7%, much smaller than the average of 25% in the OECD (OECD, 2011a). This is because the level of total government spending and taxes in the economy, and the proportion of social welfare spending in total spending are much smaller than those in other developed countries. According to OECD (2012), public social spending in Korea was 9.4% of GDP as of 2009, less than half of the OECD average, 22.1%. Korea ranked as 29 out of 30 OECD countries in terms of social spending. Although social spending out of GDP in Korea has been increasing rapidly from 3.2% in 1995 to 4.8% in 2000, and 6.5% in 2005 (OECD, 2012), the current level is much lower than that achieved by other developed countries when their GDP per capita was similar to that of Korea. The government plays little role for income redistribution since total taxes and the share of direct taxes are relatively low. The share of tax out of household income of top 20% income group is just 9%, much lower than 37% of the OECD average (OECD, 2011a). Besides, the current level of social welfare is never enough to support the poor. The Korean government enacted the National Basic Livelihood Security Act in the aftermath of the 1997 crisis but its coverage is narrow. The relative poverty rate was about 15% of population but only about 3% of population is covered by this basic social welfare (OECD, 2011b).

Given the reality, it comes as no surprise that many Koreans have demanded more social welfare spending by the government. They also became critical about the concentration of economic power in large *chaebol* groups, which have increased numbers of affiliate firms significantly and have often treated subcontractor SMEs unfairly. In the presidential election in December 2012, both the ruling party and opposition party promised more efforts for so-called 'economic democratization', reflecting the growing criticism. Both candidates presented campaign promises to regulate *chaebol* to establish a fair economic order and other measures to expand social welfare including the wider coverage of national health insurance and pension for the elderly. Since the more conservative Grand National Party won the election, it is not likely for the new government to raise social welfare significantly and to make a progress in the regulation of big businesses. Most of all, it takes a repressive stance toward workers and is not enthusiastic about solving the problems of irregular workers. But more efforts of the government to reduce income inequality are called on because it is likely that the Korean economy will suffer from stagnant growth because of rising inequality.

Serious income inequality and unequal distribution between the corporate and household sector could deter stable economic growth in several ways (Aghion et al., 1999). First of all, they could depress domestic demand and investment. Domestic consumption has been in stagnation recently in Korea, with its growth rate lower than that of GDP, and the difference between consumption growth and economic growth became even larger after the global financial crisis since 2007. A report from the Bank of Korea points out that marginal propensity to consumption in Korea fell significantly in the 2000s because of rising inequality and stagnant income growth (Nah et al., 2013)[18]. Inequality and income stagnation also resulted in a rapid rise in household debt and a fall of the household saving rate at the

[18] They present a result of an empirical analysis that the negative effect of the burden of household debt on consumption is much larger than the positive liquidity effect in the recent period. They also report the empirical findings that income inequality is negative to consumption and lower consumption is related significantly with lower investment in the 2000s.

same time as Figure 6 shows. The financial situation of not only poor households but also middle-income households earning 50% to 150% of median income has deteriorated substantially in the recent period. More than half of the middle-income households are operating in deficit effectively (Mckinsey Global Institute, 2013)[19].

Figure 6.

Second, serious inequality, particularly in assets, could repress investment in human capital and make negative effects on productivity in the whole society when the financial market is imperfect because financially constrained poor families have difficulty in educating their kids. Education is the most important channel for inequality to be inherited and educational inequality became worse recently, which would lower social mobility. While the private cost for education is already high in Korea, recent liberalization in the educational system would make inequality in opportunity more serious.[20] This could create negative effects on incentives for work and innovation. Rising inequality could also lead to social conflicts and instability, and thereby hindering investment as we saw in Latin America. Finally, inequality could generate concentration of political power, which hinders the development of inclusive political and economic institutions. This would be detrimental to long-run growth of the Korean economy as history demonstrates (Acemoglu and Robinson, 2012). Thus, the neoliberal growth model in Korea could cause a vicious cycle of inequality and lower growth by worsening inequality and move the Korean economy in the opposite direction of the egalitarian growth model in the past.

It is about time that Koreans should re-establish the egalitarian growth model and promote a virtuous cycle of equal distribution and growth. The government should play an active role for income redistribution by increasing social welfare spending and implementing a more progressive tax reform. It should make hard efforts to reduce irregular workers, introduce active labor market policy and strongly regulate easy layoffs in the labor market. Regulation of big businesses in an attempt to make the economy fair and encourage the development of SMEs is also necessary. Besides, the government should manage financial openness to restrain volatile foreign capital movements and stabilize the economy, using effective capital controls measures. The financial system needs to be changed so that it can serve the public. The Korean economy should change the current neoliberal growth strategy dependent on exports to an alternative one dependent on domestic demand on the basis of equal income distribution. As for the institutional foundation for this change, Koreans should set up a democratic developmental state that overcomes problems of both neoliberalism and the government-led model through more participation of people. Of course, political mobilization is essential to Koreans in realizing this great transformation of the growth model. But without it, the economic hardship of a majority of Korean people will continue unabated.

[19] The proportion of middle-income households operating in deficit was about 25% in 2010 since their income growth stagnated but they continued to spend a lot on private education. But mortgage payments are counted, nearly 55% of middle-income households could be considered to be in deficit. See Mckinsey Global Institute (2013).

[20] According to the OECD, the total expenditure for educational institutions as a share of GDP in Korea was 8.0%, higher than the OECD average, 6.3% in 2009. The share of private expenditure in GDP is about 3.1% in Korea, the highest in the OECD, much higher than the OECD average, 0.9%. But if we include a large amount of private expenditure on private preparatory schools and institutions in Korea, about 2% of GDP in 2009, it would be much higher in Korea.

VI. Conclusions

The old egalitarian growth model in Korea finally came to an end after the 1997 financial crisis. The Korean economy has entered a neoliberal era since then, in which Koreans have experienced slow growth and high inequality. Irregular workers increased along with labor market flexiblization and inequality in income and assets rose rapidly, dividing the Korean society deeply. Industrial bipolarization also deepened, which enlarged the gap between large *chaebol* companies and SMEs and that between the export sector and the domestic demand sector. The neoliberal growth model after 1997 not only deteriorated inequality but also made economic growth stagnant and unstable. Furthermore, it is highly likely that rising inequality could hinder long-run economic growth and produce a vicious cycle of high inequality and slow growth. What caused this gloomy change is neoliberal economic restructuring following the 1997 financial crisis due to mismanaged capital account and financial liberalization. Thus, the Korean experience clearly demonstrates a failure of neoliberalism.

This post-crisis change was indeed shocking to many Koreans, who suffer from acute job insecurity and economic distress. Koreans passively accepted neoliberal economic restructuring strongly affected by the belief that the former government-led growth model was seriously flawed and liberalization and opening would stimulate economic growth. But what neoliberalism brought to Korea were rising inequality and stagnant growth, contrary to what they expected. This has made Koreans more expressive of their grave concern for inequality and social disparity. Korean people have also been demanding more economic justice and social welfare spending. They have finally realized the need for a fundamental change in the economic system. The global financial crisis of 2008 has only further vindicated the belief of Koreans that neoliberal restructuring is deeply flawed.

In sum, Koreans should learn precious lessons from their own development experience as well as from the global financial crisis. The Korean economy succeeded in both rapid growth and equal distribution, not only because of historical conditions but also active government policy efforts. The East Asian miracle in Korea was achieved by the effective management of the economy by the government, not by working of the market as neoliberalism argued. Although it is impossible to return to the old developmental state model, Koreans need to establish a new egalitarian growth model in which distribution and growth are in a virtuous cycle. The new model should be more equal and stable, based on domestic demand rather than exports, and this calls for more active income redistribution efforts by the government. The more active role of the state to regulate the labor market, to manage financial openness, and to build a fair economy is also called on. This egalitarian growth model requires Koreans to develop a welfare state and a democratic developmental state. This cannot be done without adequate political mobilization.

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Table 1. Economic Growth Rates and Income Distribution in Selected Countries.

	GDP growth rate, 1965-2003 (%)*	Gini coefficient for income, 1960-2000	Gini coefficient for land in 1960
Korea	6.06	0.353	0.339
Taiwan	--	0.301	--
Indonesia	3.92	0.375	0.555
Malaysia	3.98	0.499	0.641
Philippines	1.23	0.485	0.560
Brazil	2.40	0.605	0.841
Mexico	1.75	0.544	0.607
Argentina	0.90	0.418	0.856
South Africa	0.64	0.490	--
Kenya	1.27	0.638	0.750
Turkey	1.93	0.505	0.595
Bangladesh	1.00	0.359	0.418
India	2.54	0.308	0.614

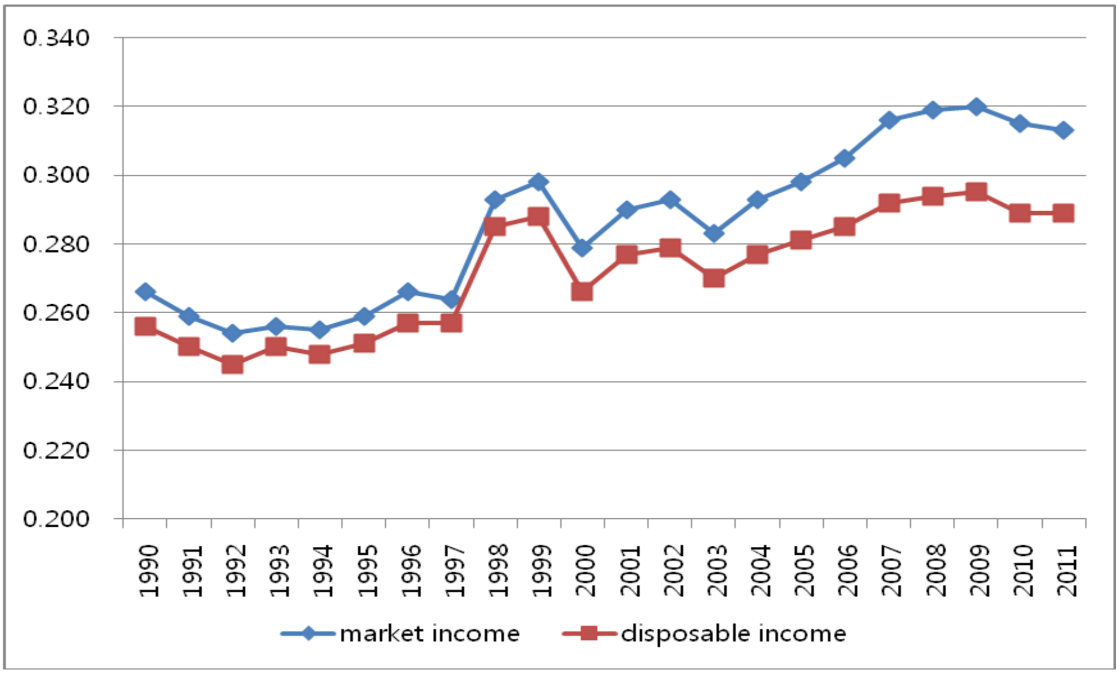
Sources: World Bank Development Indicators, World Income Inequality Database.
Notes:
1) GDP growth rates are growth rates for real per capita GDP.
2) The Gini coefficient for land holding is for 1960. Deininger and Olinto (2000).

Table 2. Growth of Household Income, Corporate Income and GNI (%)

	1975-1997	2000-2010	2000-2006	2006-2010
Household Income	8.1	2.4	2.8	1.7
Corporate Income	8.2	16.4	14.9	18.6
Difference	0.1	14.0	12.1	17.1
GNI	8.9	3.4	3.8	2.8

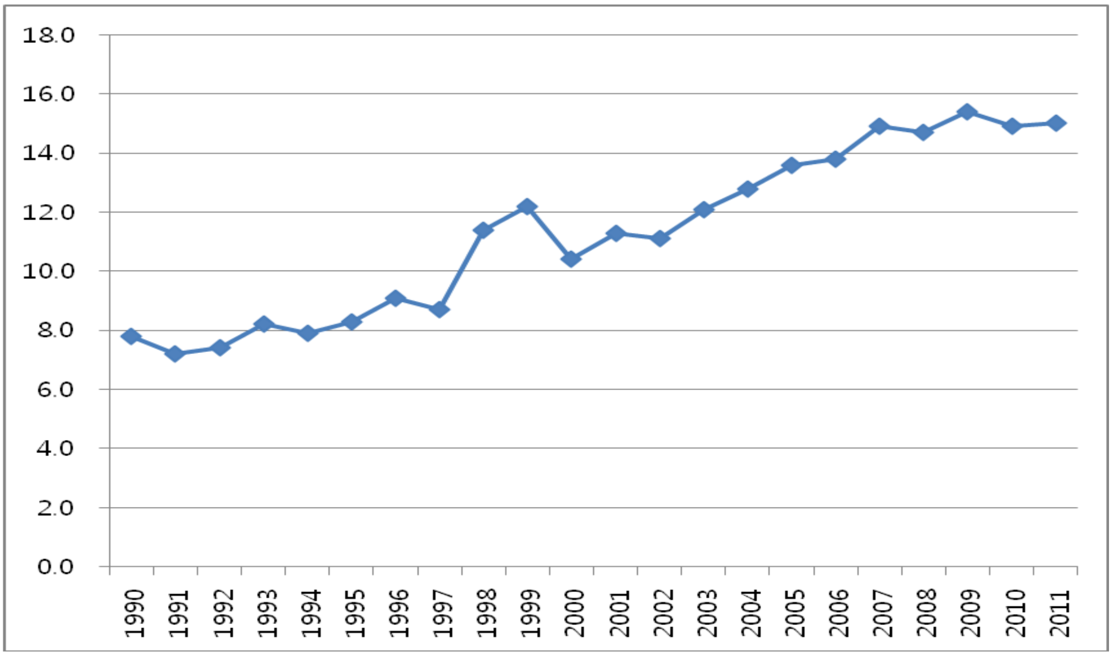
Source: Bank of Korea, Kang and Lee (2012).
Note: Real annual growth rate

Figure 1. The Gini coefficient in Korea



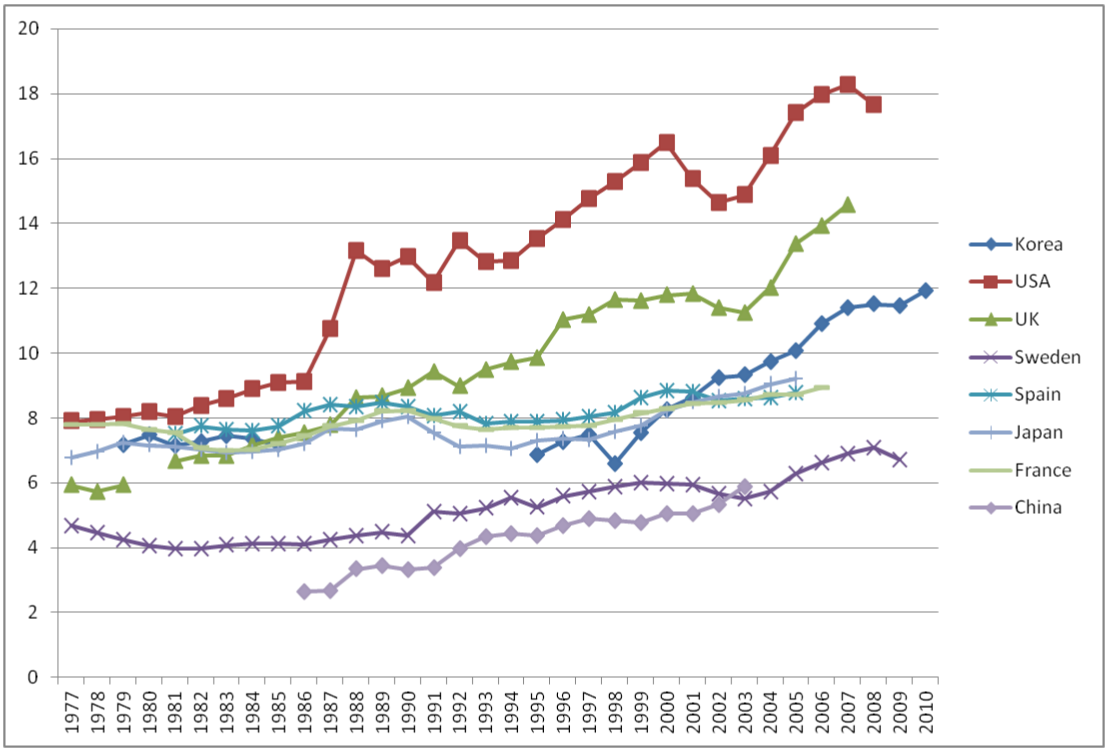
Source: National Statistical Office
Note:
1) For urban households with two or more members
2) The source is different from Table 1 for Korea.

Figure. 2. The Relative Poverty Rate in Korea



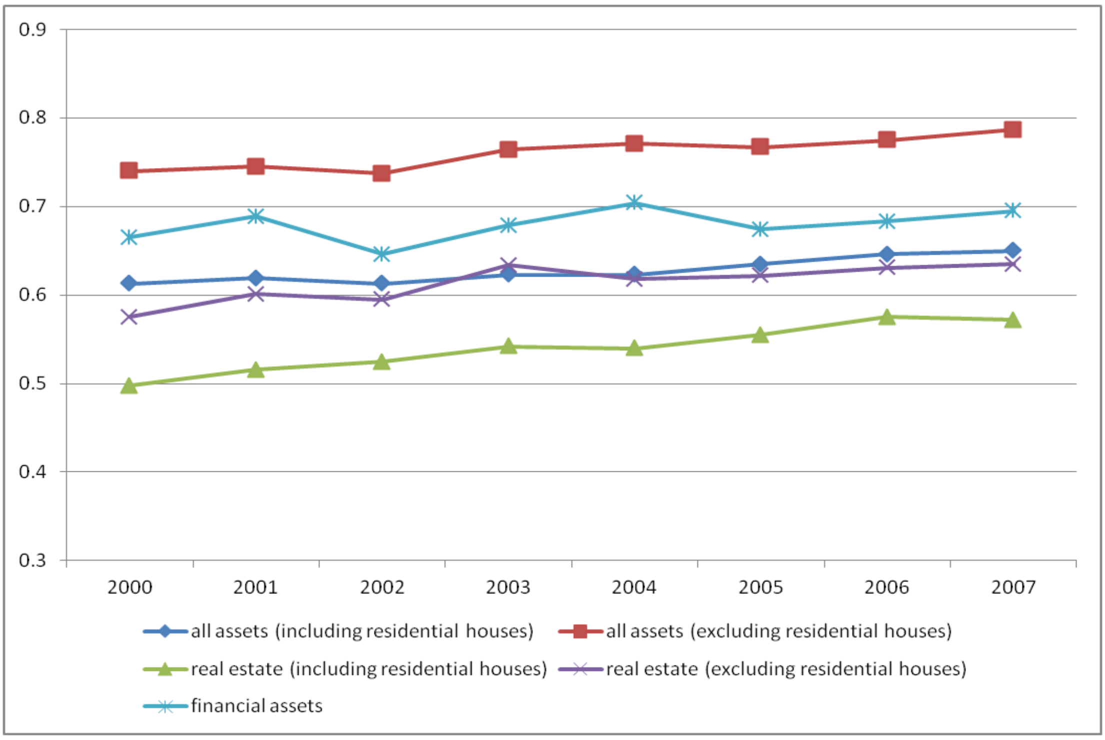
Source: National Statistical Office
Note: For urban households with two or more members

Figure 3. Top 1% Income Share in Selected Countries



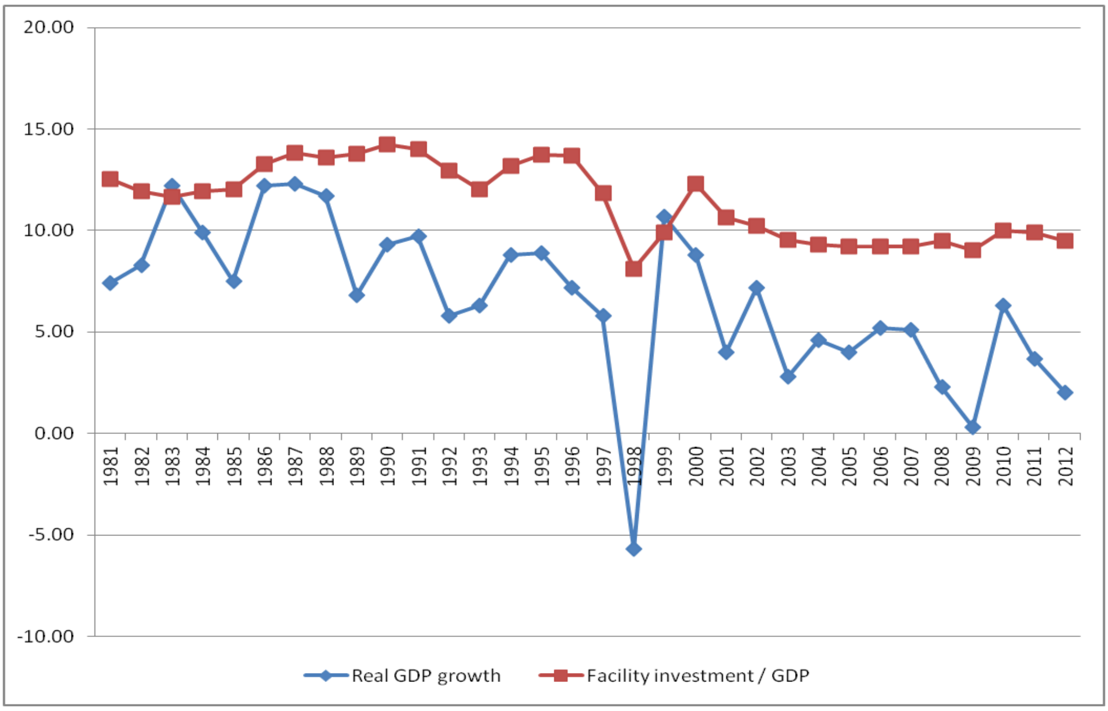
Source: Kim (2012), World Top Income Database (without capital gains)

Figure 4. Gini Coefficients for Assets in Korea



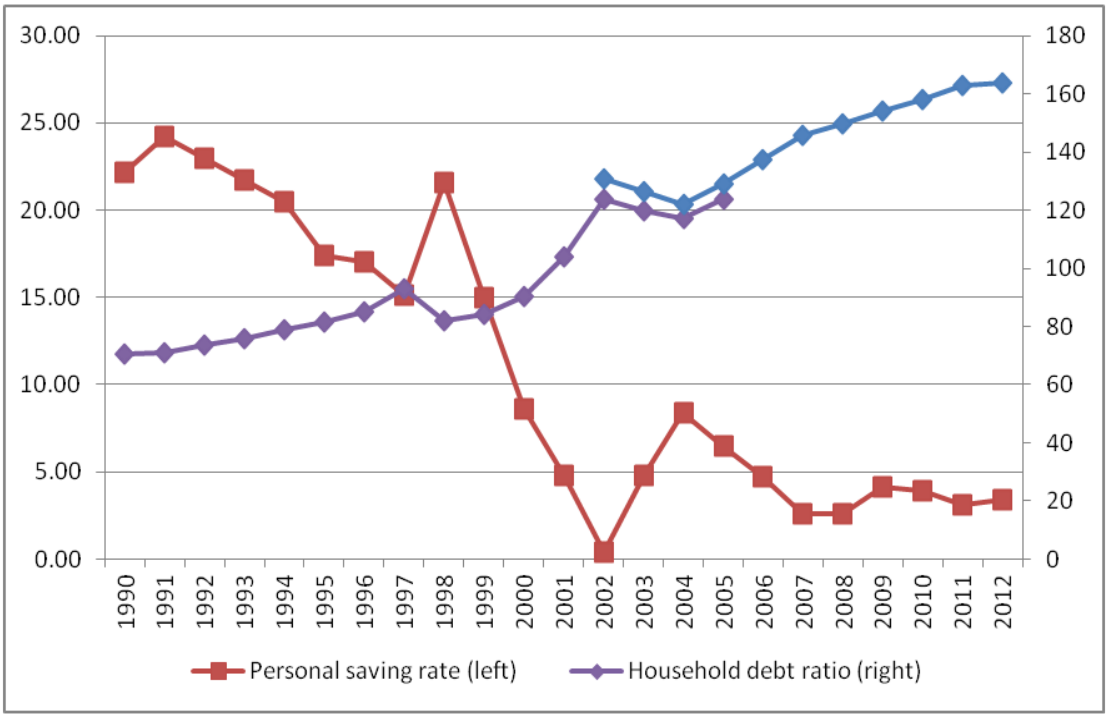
Source: Korea Democratic Labor Party

Figure 5. The Growth Rate and Facility Investment in Korea



Source: Bank of Korea

Figure 6. The Personal Saving Rate and Household Debt in Korea



Source: Bank of Korea
Note: Household debt ratio defined by total househould debt / personal disposable income