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Flying Geese No More

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As Korea challenges Japan across a range of industrial sectors, many in Japan are beginning to view Korea the way some in the US used to see Japan: as a challenger using unfair tactics, like a cheap currency or low wages, to "steal" market share from Japanese industries. This view of Korea is one front in what the Brazilian finance minister called a "currency war" among many countries.

It also reflects an unfortunate transformation in how Japan views itself. Blaming others is a lot easier than undertaking internal reforms. In reality, the key to the Korean challenge to Japan is neither a cheap currency nor cheap wages. It's a surge in productivity that has allowed Korea to export so much more even while raising wages by leaps and bounds. Korea today is competing by doing what Japan used to do so well.

Tokyo blasts Seoul on currency

Speaking in the Diet on Oct. 13, Prime Minister Kan Naoto lumped Seoul with Beijing for alleged irresponsibility on currency issues. Just a month after Tokyo intervened in currency markets to the tune of $25 billion, Kan said, "We'd like South Korea and China to act responsibly within common rules." Japan indicated that it might raise the issue at the Group of 20 meeting held in Seoul last week. That, however, was forestalled after Kim Ik-Joo, director of the Korean finance ministry's international finance bureau, called the Finance Ministry in Tokyo to protest. Apparently in response, Finance Minister Yoshihiko Noda backtracked from the earlier remarks, saying, "We as a nation will do what we have to do first before we say things about other nations' currency policies."

Fear of "hot money"

Korea, like other Asian countries, has been intervening to prevent "hot money" flows from sending its currency skyward. A substantial share of the money being generated by the developed world's central banks to boost sagging economies is ending up in emerging countries' property and financial markets. That raises the value of their currencies and jeopardizes their export-led recoveries. Trying to dampen this is one reason that the foreign exchange reserves of eight Asian countries *other than China and Japan* have risen by more than $400 billion since the global downturn began in 2007. Countries like Brazil and Thailand have instituted capital controls to hinder the flow and reportedly Seoul is considering doing the same.

One consequence of the Greek debt crisis has been to remind leaders in Asia of their own crisis in 1997-98, when the hot money that flooded in during the mid-1990s flowed out even more quickly, whipsawing their economies. The big trade deficit countries were the most vulnerable to capital flight. Korea, which had a current account deficit of 4.2 percent of GDP in 1996, saw its GDP fall 7 percent in the maelstrom of 1998. Fear of a repeat has increased the risk of mercantilist tendencies by making developing countries feel that safety requires a big trade surplus. Even if such mercantilism does not result in outright protectionism, it could make international cooperation more difficult.

It has led quite a few countries to oppose the Federal Reserve's new round of quantitative easing. That reaction – along with criticism for other reasons by Congressional Republicans – has, so far, reduced the impact of the step on long-term interest rates in the financial markets. In short, fear of "collateral damage" on the part of other countries is now becoming a constraint on the Fed's ability to shape market reaction as it pleases.

Is the Korean won cheap?

There are two routes to being competitive. One is to compete on price by running a cheap currency and keeping wages down. That may help exporters sell more, but a country that can only maintain market share by sacrificing wage growth is hardly what we'd call competitive. The other way is to lower costs by increasing output per hour. That's the route to higher living standards. Japan has, unfortunately, shifted from the second method to the first. These days, the Koreans are still primarily competing through the second route: improving efficiency.

One standard measure of the competitive strength of Korean exporters vis-à-vis their Japanese counterparts is the *real*, price-adjusted value of their currencies. According to the Bank for International Settlements (BIS), as of September, the real Korean won is only 10 percent weaker than its 1994-2010 average. It was much weaker just after the Lehman shock of September 2008, when it fell to a level 25 percent below its 1994-2010 average. Meanwhile, the real-price adjusted value of the yen is actually 5 percent *weaker* than its 1994-2010 average. What Tokyo is complaining about is that that the yen is back to normal, rather than being super-cheap.

Wages in Japan vs. Korea

The other standard measure of competitive strength is unit labor costs in manufacturing – i.e., the wage cost of producing a TV or car or ton of steel – *in dollars.* Let's look at the record.

From 1995 through 2008 (latest available), real price-adjusted wages for factory workers in Japan rose a measly 7 percent. By contrast, Korean real wages almost doubled. Korea's firms were able to afford these wage hikes because of soaring productivity, just like Japan used to do. In Japan,

factory output per work-hour has increased 50 percent since 1995 – 3.2 percent per year. By contrast, Korea's productivity has tripled – an 8.2 percent annual increase. All the while, Korea's real per capita GDP has soared from 30 percent of the Japanese level in 1980 to 86 percent in 2009. At this rate, it's only a matter of a few years before Korea's per capita GDP overtakes that of Japan (using the World Bank's Purchasing Power Parity, PPP, measure so that we can truly compare wages and prices.)

Korean productivity not only financed higher real wages, it also bought more leisure time. Back in the early 1980s, the average Korean worker labored a stunning 2,900 hours per year, compared to 2,100 in Japan and 1,900 in the average OECD country. Today, Koreans work 25 percent fewer hours per year, a still-high 2,240, compared to 1,700 in Japan. Yet, despite working 25 percent fewer hours per year, each worker has increased his output from $11,500 in 1980 to $40,300 in 2008 (in 1990 dollars).

Unit labor costs and competitiveness

Mostly as a result of its stellar productivity performance, Korea was able to keep its manufacturing unit labor costs *in dollars* competitive with those of Japan. From 1995 through 2008, Korean and Japanese unit labor costs in dollars have both decreased by about the same amount: 30-35 percent. During that 1995-2008 period, the nominal yen/$ rate cheapened by 9 percent, whereas the nominal Korean won/$ cheapened by 30 percent.

In sum: both Japan and Korea showed a similar decline in dollar-based costs. Japan accomplished this primarily through wage austerity. Korea accomplished this primarily through productivity hikes and somewhat via a cheaper currency. And, as it was doing this, Korea doubled real wages. If current trends continue, Korean real wages will soon surpass those in Japan. The lesson for Japan: productivity growth, not a cheap currency, is the key to genuine, sustainable competitiveness.

The Danger

There is the danger that obsession with currency rates – and a view of imports as the "enemy" – could result in "beggar thy neighbor" policies. So far, however, protectionist moves around the world have been remarkably limited despite the severity of the global recession and the weakness of the recovery.

The bigger danger for Japan is that, by scapegoating the Korean won, Japan will continue to take its eyes off the real source of its problems and fail to implement the domestic reforms needed to restore growth in productivity and living standards. The US has a vital stake in this issue since an economically weak Japan will have neither the political stability nor the sense of confidence needed to act as a political-economic counterweight to a rising China. Prime Minister Kan's difficulty in getting his own party to approve participation in the Trans Pacific Partnership (TPP) is just one example.

The same trade and regulatory policies that would give Japan a bigger role in the Asian economy are part of the package that would enhance domestic reform. History has shown that countries with higher trade-GDP levels tend to grow faster. One reason is that international competition gives domestic sectors a stark choice: become more efficient or die.

It is no accident that Korea's productivity surge occurred during the same period as a surge in trade. From 1995 through 2008, exports surged from 29 percent of GDP to 53 percent, while imports grew in tandem, from 30 percent to 54 percent. While Japan's trade:GDP ratio also increased during the same period, the improvement was much less; exports rose from 9 percent of GDP to 18 percent, while imports rose from 8 percent to 16 percent.

Politicians may be tempted to blame other countries when their domestic economic policies fail to produce results voters rightly demand. But, in Japan these days, parties that produce more excuses than results tend to get tossed out of power. That's what brought down the long-dominant Liberal Democratic Party (LDP). Japan's ruling Democratic Party of Japan (DPJ) would do well to heed that lesson.