Small Firms Will Determine South Korea’s Economic Future

The chaebol spearheaded the country’s rapid industrialization, but it’s SMEs that will keep South Korea’s economy driving forward in the digital era.

By Yong Kwon
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The Organization for Economic Cooperation and Development (OECD) anticipates a 0.5 percent decline in South Korea's potential growth rate between the periods 2017-20 and 2021-23. This is not a slowdown that can be simply explained away as a natural part of the country's broader convergence with other advanced economies. Rather, it signals structural handicaps in the market. And while South Korea faces a number of internal headwinds, one in particular carries implications for many other economies in the digital era: the productivity gap between large corporations and their smaller counterparts.

Casual international observers do not often hear about small and medium-sized enterprises (SMEs) in discussions about the South Korean economy. The actors that receive the most attention are large conglomerates – the chaebol – that carry the mantle of having spearheaded the country's rapid industrialization that began in the 1960s.

But whether these conglomerates are still playing a positive role in the economy has been up for debate in recent years. During early stages of South Korea's economic development, policymakers felt that scarce resources had to be concentrated in the hands of a few market actors to make possible capital-intensive investments in productive industries. However, as the economy matured, the dominant market share of these state-sanctioned behemoths prevented more entrepreneurial start-ups from competing in the market.

Affirming the deleterious role of conglomerates in promoting competition and innovation, a recent paper in Economic Policy asserted that...
the collapse of several debt-laden goliaths during the 1997 Asian Financial Crisis had an unexpectedly positive impact on firm-level performance. The research found that, since the crisis, non-conglomerate companies in sectors that had previously been dominated by conglomerates have enjoyed both increased patenting activity and labor productivity. These estimates bolster the views of many anti-trust advocates in South Korea today who believe that the government must more actively prevent the concentration of market share in the hands of few actors. And with conglomerates still controlling significant shares of industrial sectors like autos (Hyundai-Kia controls over 75 percent of South Korea's domestic automotive industry) and plastics (Hanwha Group produces nearly half of all PVCs in the country), the economy may be ripe for more regulatory intervention.

However, the transition to the digital economy adds a further wrinkle to South Korea’s effort to rebalance the market. Here, the problem is no longer conglomerates constraining competition, but rather the slow adoption of new technologies by SMEs. This presents a sizable challenge to South Korea’s ability to enjoy long-term growth because these small firms not only employ a majority of the labor force (over 80 percent) but also are concentrated in sectors that promise the most growth potential in the digital era.

OECD economist Mathilde Pak and co-authors of a recent report found that South Korea’s SMEs utilize digital tools at much lower rates than larger companies. Although the country’s flagship firms are robust adopters of services like cloud storage on par with or above other countries in the OECD, South Korea overall lags
far behind global peers because smaller domestic players have been slow to adopt these tools. For instance, only 23 percent of Korean companies use cloud computing, compared to over 50 percent of enterprises in Nordic countries. It also goes without saying that South Korea’s SMEs also lag behind the productivity of counterparts in other industrialized economies.

In addition to the lower productivity, the slow adoption of digital tools by SMEs might mean that South Korea concedes a major marketspace that is created by the emerging digital landscape. The services sector is anticipated to see the most demand growth in the coming years. This makes perfect sense when one considers that a smartphone, for instance, is valuable mostly as a tool to access other offerings. From this perspective, the lagging productivity of Korean SMEs is a major liability because they are predominantly concentrated in the services sector. This means that even in the information and communications technology (ICT) sector where the conglomerate Samsung has built a successful global brand through its manufacturing prowess, South Korea’s long-term competitiveness is far from guaranteed.

Pak and her co-authors recommend that the public sector more aggressively support both the cultivation of a technology-sawy workforce and the adoption of digital tools by SMEs. In addition, Seoul could more consciously avoid public policies that stymie new entrants into the market and actively crack down on business practices that have anti-competitive outcomes. For instance, large e-commerce firms employ gig workers (instead of full-time workers) to cut down on labor costs. This makes it harder for start-ups to compete against established actors.
in the delivery space on the basis of having developed a better digital platform.

The broader takeaway is that ensuring a competitive market space requires the government to be more proactive in its response. This applies to adopting necessary regulations when times are “good” and not passively waiting on recessionary environments like the 1997 financial crisis to spur change. Simultaneously, the public sector may be critical to ensuring that the labor market and “the rules of the game” facilitate efforts by entrepreneurs to build new SMEs that can deliver competitive goods and services.

As agencies in other countries also strive to build a fairer digital economy alongside tech giants like Meta and Amazon, South Korea’s headwinds offer a reflective case study that regulators can consider when adopting their own appropriate responses.

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