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Autores (as)	Moon-Soo Kang
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KOREA'S ECONOMIC DEVELOPMENT AND ROLE OF GOVERNMENT

Moon-Soo Kang

1 INTRODUCTION

The Korean economy has achieved unprecedented growth in the last four decades. From 1962 to 2002, the Korean economy grew at an average annual rate of nearly 8 percent in real terms. As a result, between 1962 and 2002 Korea's per capita GDP increased from US$87 to US$ 10,013, and Korea's GDP grew from US$ 2.3 billion to US$ 476.6 billion, all at current prices.

In addition, Korea's industrial structure has been significantly transformed. The manufacturing sector expanded its share of GDP from 14.4% in 1962 to 29.6% in 2002. Korea's trade volume increased from US$ 500 million to US$ 319.6 billion, making Korea the 13th largest trading country in the world.

Many factors have contributed to Korea's rapid economic growth. The first is a literate population capable of quickly learning skills, which played a key role in the export-oriented and labor-intensive industrialization of Korea during the earlier phases of development. The labor force has been hard-working and disciplined in their drive to improve their socio-economic status.

Secondly, a strong leadership committed to economic development combined with capable bureaucrats have also been critical. The military government led by General Park, which came into power by means of a coup in 1961, promised to liberate the Korean people from poverty. With the success of the economic development initiated by the government, public confidence in the government has increased in Korea.

Thirdly, with credit being made available to entrepreneurs, Korean entrepreneurs have proved themselves to be very dynamic and forward-looking. More recently, they have aggressively explored markets overseas for trading, local construction and investment. Despite the highly concentrated domestic market, competition among business groups has been strong without passing on much of the costs to consumers. Finally, Korea's economic performance can be credited to government led policies. The takeoff of the Korean economy began with the implementation of an export-oriented industrialization strategy in the early 1960s. This strategy enabled Korea to maximize its available resources to its fullest potential which was mainly labor, and overcome the limitations of a small domestic market.

TABLE 1
The Korean economy

	1965	1975	1985	1995	2000	2002
GDP ($ Billion)	3	21.1	93.4	489.4	461 7	476.6
Per capita GNI (US $)	105	592	2,229	10,823	9,770	10,013
GDP growth (Real %)	8 5	6.7	7.7	4	9.3	6.3
Employment growth (%)	3.7	2.5	3.1	0.6	4.3	2 8
Industrial (employment) structure (%)						
Agri , forestry & fishery	38 0 (59.0)	27 5 (45.9)	14 1 (25.2)	6 8 (12.4)	4 7 (10 9)	4.0 (9.4)
Manufacturing	18.0 (9 5)	28.4 (18.7)	32.6 (23 7)	32 2 (23.5)	31.6 (20.3)	29.6 (19 1)
Construction & services	41.9 (31.5)	44.1 (35.4)	53.4 (51.2)	61 0 (64 1)	63.7 (69.0)	66.4 (71.5)
Commodity exports ($, Billion)	0.2	5	26.6	124.6	175.8	162 5
Total exports/GDP (%)	9.5	28.5	35 5	31	46 4	41.4
National savings rate (%)	13 2	19.5	31.1	35 5	32.4	29.2
Foreign savings rate (%)	0.2	9.6	-0.6	1 8	-4.1	-3.1
Tax burden/GDP (%)	8.6	15.3	17.1	19.1	21.8	21 8
Consumer price inflation (%)	14	12	5.8	2	2 3	2.7
Won/US$ (year-end)	273	484	890	775	1,260	1,197

Since the mid-1980s, a favorable external environment, particularly a strong Japanese yen, resulted in rapid growth of exports and a sizable surplus in the current account. The surplus, however, brought strong foreign pressure to further open the domestic market and appreciated the Korean won. Furthermore, the June 29 Declaration of Democratic Reform in 1987 resulted in greater demand by workers for wage increases and better working conditions. Substantial wage hikes coupled with strong domestic demand and progress in liberalization of imports worked together to deteriorate Korea's current balance.

Korea's international competitiveness began to deteriorate in the early 1990s due to the amassed structural deficiencies within the Korean economy. In 1996, the Korean economy took a major hit as a result of a shock in the terms of trade.

The unanticipated intensity and fast spreading financial crisis which first took place in Thailand and then moved on to Indonesia, came to bear its effects on Korea, as the country was going through a period of restructuring as well as a cyclical economic downturn.

In November 1997, less than a year after its accession to the OECD, Korea experienced a severe financial crisis. The Korean government formally

requested assistance from the International Monetary Fund to mitigate the external liquidity shortage and regain the confidence of international investors.

Since December 1997, Korea has embarked on a comprehensive program for economic reform and recovery, which has already proved to be successful in rectifying the causes of the crisis.

2 EXPORT-LED TAKEOFF IN THE 1960s

2.1 Establishment of economic development plans

Korea initiated national efforts to launch an economic takeoff by implementing a series of economic measures called the Five-Year Economic Development Plans. Korea deployed its First Five-Year Economic Development Plan in the early 1960s. At that time, Korea's economic conditions were similar to those of resource-poor, low-income developing country existing today. With an annual population growth of nearly 3%, unemployment was widespread, especially in the agricultural sector, which constituted nearly two-thirds of the population. The domestic savings rate was negligible and per capita income was a meager $ 80. In 1961, Korea's exports totaled only $ 43 million, less than one quarter of its imports. Preoccupied by the issue of reunification, President Rhee Syngman showed little interest in developing Korea as an independent economic entity during his presidency from 1948 to 1960.

In contrast, the political leadership that came into power in 1961 was strongly committed to economic development and adopted an outward-looking growth strategy. This export-oriented development strategy was appropriate for a small economy lacking in natural resources but abounding in labor which could be easily mobilized to produce simple, labor-intensive manufactured goods for overseas markets.

To implement this strategy, a strong central planning agency – the Economic Planning Board – was organized, and institutional arrangements were established to mobilize what resources were available.

2.2 Increased tax revenues

The nation's tax administration was strengthened with the establishment of the Office of National Tax Administration in 1966. The following changes were made to the tax system in the 1960s. Taxation on consumption of luxury items, business income, high personal income, inheritance and gifts were raised in an effort to increase revenues. Tax exemptions and reductions on public enterprises were abolished. Moreover, a tax revenue target was set for each locality and tax category. As a result, tax revenues rose from 9.7% of GNP in 1961 to 14.8% in 1970.

2.3 Changes in the financial sector

A financial system can influence the allocation of real resources by intermediating financial resources between surplus and deficit units. In addition, a financial system can be used to channel financial resources to certain favored deficit units that are expected to use the resources for specific purposes, or the terms on which the financial resources are provided can be manipulated to influence the decisions of the potential users.

Few governments in developing countries seem to believe in the allocational efficiency of the financial system. As studied by Shaw[1] and McKinnon,[2] the financial sector is perhaps one of the most heavily regulated industries in developing countries. The governments in these countries intervene extensively, allocating credit and setting interest rates on both deposits and loans. The Korean government was no exception.

The government relied heavily on financial policy tools to induce private investment in strategic sectors. Consequently, the financial policies strongly influenced Korea's investment allocation, more so than fiscal policy measures. The fiscal tools were limited due to low income levels and their corresponding inability to raise significant tax revenues at the time the economic growth plan was deployed. Consequently, monetary policy tools became more important, as monetary authorities exerted a strong influence on the allocation of financial resources into strategic sectors.

The government enacted the Illicit Asset Disposition Act on June 20, 1961. Commercial banks that were privatized in the late 1950s were 'nationalized' by being converted into public corporations on October 29, 1961, as the government seized control of the bank's stocks.

Specialized banks were established by the individual ad hoc acts rather than the Banking Act. In the 1960s, the government created a group of specialized banks. They included the Small and Medium Industry Bank (1961), the Citizens National Bank (1962), the National Agricultural Cooperatives Federation (1962), the National Federation of Fisheries Cooperatives (1962), the Korea Exchange Bank (1967), the Korea Housing Bank (1969), the Export-Import Bank of Korea (1976) and the Korea Trust Bank (1968). Specialized banks were owned, directed, regulated and supervised by the government.

Governmental controls over credit allocation in Korea were initially exercised through a system of guidelines that established loan priorities for

1. Shaw, Edward S., Financial Deepening in Economic Development.

2. Mckinnon, Ronald I., Money and Capital in Economic Development

different sectors and within each sector. Beginning in the early 1960s, the government assumed a more active role in guiding the allocation of resources through the formulation of both five-year economic development plans and annual overall resource allocation programs. As part of this leadership role, the government increasingly interfered with the allocation of credit.

Medium and long-term facility investment financing has mainly been provided by specialized financial institutions. The KDB has extended credit primarily to key manufacturing industries, with government funds and resources borrowed from the National Investment Fund (NIF) and foreign sources.

The Export-Import Bank of Korea finances medium and long-term trade, overseas investments and major overseas natural resource development projects. The necessary funds are mobilized by borrowing from the NIF and foreign or domestic banks, as well as through the issuance of debt.

Since 1974, deposit money banks have contributed to the National Investment Fund. The NIF makes funds available to specific projects by pooling financial resources contributed by financial institutions and deposits from public organizations and funds. Funds from NIF have been mainly utilized in the heavy and chemical industries, and the electricity generating industry.

Other preferential loans for small and medium-sized firms, housing, agriculture and fisheries are supplied both by the government and banking funds, primarily through specialized banks. All commercial banks are required to maintain their outstanding loans to small and medium-sized firms above 35% of their total loans outstanding.

A new local banking system was introduced as the Bank of Taegu began its operation in 1967. During the period from 1967 to 1971, ten local banks were established, one in each province. These local banks were privately owned with no restrictions on voting power of major shareholders.

The entry barrier was lifted for foreign banks in 1967. In doing so, the government anticipated foreign banks to facilitate foreign capital inflows and to stimulate domestic banks to improve their banking practices and managerial skills. In July 1967, Chase Manhattan Bank became the first foreign bank to open a branch office in Seoul.

2.4 Inducement of foreign loans

The government amended the Foreign Capital Inducement Law in 1960 and streamlined relevant programs and institutions to promote and to allocate borrowings from international sources more efficiently. Furthermore, the Bank of Korea began to provide repayment guarantees for foreign loans in order to

attract and secure these necessary loans. The repayment guarantee for foreign loans was subject to the approval of the Economic Planning Board and the National Assembly.

2.5 Interest rate reform for savings mobilization

In September 1965, the Korean government implemented a major financial reform, which drastically increased interest rates on time deposits in commercial banks. The interest rate on one-year time deposits increased considerably from 15% to 26.4%. The government aimed to increase private savings at banking institutions that had been deposited in the informal money market or used for accumulating inventories and other real assets to guard against inflation.

Combined with the sharp drop in the inflation rate, this readjustment increased real interest rates on those deposits by a positive of 20% in 1965 from a negative of 15% in the preceding years. The interest rates were maintained between 17% and 20% in the following four years. These changes were accompanied by some increases in the lending rates; however, they had little impact on the volume of loans, since the new interest rates were still not high enough to affect the demand for bank loans when compared to the curb market interest rates and rates of return on capital. In addition, the increase n loan rates applied only to certain loans and did not affect the low rates for export producers, farmers, and many categories of investment loans by the special banks.

The financial reform in 1965 seemed to be the beginning of a new era, moving the economy from financial repression toward financial liberalization, while supporting the rapid growth of the financial sector. Over the next five years, total bank deposits rose nearly seven-fold. As a result, commercial and special banks were recognized as important mobilizers of savings. The interest rate differential between domestic and foreign capital markets, together with government repayment guarantees, induced a massive inflow of foreign capital in the form of trade credits and direct investments.

The interest rate reform and accompanying policy measures contributed significantly to Korea's economic growth. Domestic savings relative to GNP more than doubled, from 7.5% in 1964 to 18.8% in 1969. The increase in domestic savings, together with the massive inflows of foreign capital, stimulated investment and financed a large part of corporate capital investments during this period.

In the case of Korea, where informal financial markets were competitive and efficient, it would be reasonable to conclude that the interest rate reforms in 1965 promoted the transfer of funds from the informal financial market to

the formal financial market. Furthermore, the high domestic real interest rate induced an inflow of foreign capital, which expanded the amount of funds available.

The major financial reform of this period was the substantial increase in interest rates. This, however, did not lead to full financial liberalization. Rather, the adoption of the high interest rate schedule was a government measure designed to mobilize funds needed to finance capital investment. The government channeled the higher domestic savings and the inflow of foreign capital to exporters. Led by the high rate of investment, the average growth rate exceeded 10% during this period. This was due primarily to the expansion of exports, which recorded more than a five-fold increase over this brief period.

2.6 Export-oriented industrialization policy

In the early stage of economic development, Korea adopted and has since pursued an export-led industrialization strategy. Korea during the early 1960s was heavily dependent on aid from the U.S. However, foreign aid gradually declined.

Korea faced a set of difficult choices, in that the country could either continue to be dependent on U.S. aid and remain economically dependent on the U.S. or it could find its own alternative sources of foreign exchange. The only alternative sources of foreign exchange were Korea's exports. Given that Korea had negligible mineral resources, all that was left was the export of manufactured goods. Further import-substitution was limited (selectively in the shipbuilding, steel, machinery and petrochemical industries) due to the small size of the domestic market and large capital requirement.

Therefore, export-led industrialization that focused on the development of labor intensive light industries proved to be successful. Light industries included textiles, garments, footwear, plywood and wigs.

2.7 Export incentives

In line with this strategy, the government backed a variety of export incentives, including tax benefits and financial support. Tax benefits given to exporters included the reduction or exemption of income taxes and indirect taxes as well as depreciation allowances on invested capital. Financial support was extended in the form of direct subsidies for export and automatic export loans at preferential rates. Exporters were also given preferential access to import licenses.

The official exchange rate was devalued from 130 won to 255 won per dollar in May of 1964 and made more flexible within a certain range upon

the adoption of a unitary and floating exchange rate system in 1965. In addition, short-term export credit was made available at a preferential rate and tax rebates were allowed on raw materials imported for the production of exports. A number of free trade zones were also established and customs procedures were simplified. All of these measures enabled Korean exporters to operate, in effect, under a free trade regime.

The Korea Trade Promotion Corporation (KOTRA) supported overseas marketing activities of Korean exporters by continuing to expand its overseas network. The Monthly Export Promotion Conference (later renamed Monthly Trade Promotion Conference) essentially served to disseminate the government's emphasis on export promotion and also to quickly resolve problems encountered by exporters with a final decision coming from the president.

The international environment during the 1960s was also highly favorable to the growth of Korean manufactured exports. World trade was expanding at an unprecedented rate as the major industrial nations were still adhering to the original GATT rules.

The results of the outward-looking development strategy surpassed all expectations. Exports at current prices rose at an annual rate of 40% between 1962 and 1971. Propelled by the rapid growth in exports, the gross national product grew at an annual rate of over 9%.

3 HCI PROMOTION AND MACROECONOMIC IMBALANCES IN THE 1970s

3.1 Heavy and chemical industry policy and policy loans

By the end of 1970s, the Korean economy was suffering from serious internal and external macroeconomic imbalances. Inflation had accelerated, and the second oil price shock dealt a heavy blow to the balance of payments, which had already been deteriorating due to weak exports.

Under these circumstances, the government believed promoting the heavy and chemical industries (HCIs) would help develop a domestic defense industry, while simultaneously upgrading the export structure. The main objective of the tax, credit, interest rate, and trade policies of the 1970s was to promote HCIs, including the iron and steel, non-ferrous metal, shipbuilding, general machinery, chemical and electronics industries.

While tax incentives for exports were actually reduced in the early 1970s, the tax incentive policy played an increasing role in affecting resource allocation among industries. Korea's trade policy was also geared towards protecting preferred industries by limiting the import of competing goods. The government utilized credit allocation measures through the banking system as its most

powerful means of supporting preferred industries. In order to finance large-scale HCI investment projects, a National Investment Fund was set up in 1974 by mobilizing public employee pension funds and a substantial share of banking funds. Because these funds proved insufficient, the banks, which were basically owned by the government, were directed to provide loans to "strategic" industries on a preferential basis. During the latter half of the 1970s, the share of policy loans in domestic credit extended by deposit money banks rose steadily, from a level of 40% to 50%.

As a result of the strong and concerted support given by the tax, trade and credit policies, manufacturing investment during the late 1970s was predominantly directed to HCIs. Such disproportionate incentives, together with over-optimistic assumptions regarding world trade prospects led to excessive investment in some areas. In order to correct this situation, the government intervened in 1980 and coordinated negotiations among firms to relinquish projects or reduce capacity. In addition to creating inefficiencies in investment, policies promoting HCIs gave rise to serious sectoral imbalances and complications in macroeconomic management.

With the promotion of heavy and chemical industries (HCIs) in the 1970s, policymakers had to tighten their control over financing in order to allocate resources to the heavy industries, since private firms were reluctant to make investments with a long development period and uncertain rates of return. To induce private investment in these industries, the government had to provide further incentives in the form of preferential loans. To facilitate such a resource allocation, monetary authorities had to keep nominal bank lending rates below the market level and intensify credit rationing, which led to a negative real interest rate and rapid expansion of the curb market.

During the 1970s, the share of policy loans[3] in domestic credit rose steadily reaching 60% from less than 50%. During the latter half of the 1970s, bank rates for export-related loans and equipment investment loans in key industries averaged 8% and 13%, respectively, compared to 17% for general bank loans and PPI inflation rate of 16%.

3.2 Exchange rate policy

The value of the domestic currency (won) against the U.S. dollar remained stable during the 1970s, except for three periods of devaluation: 14% in June 1971, 7% in the first half of 1972, and 21% in December 1974.

3. Policy loans include those extended to earmarked sectors at preferential or non-preferential rates and non-earmarked loans extended at preferential rates with policy considerations

The devaluation of the domestic currency and appreciation of the Japanese yen caused the won to depreciate by about 33% between 1970 and 1973 in real effective terms. In spite of a large won devaluation in 1974, its real effective exchange rate has appreciated since 1973 due to an acceleration in domestic inflation. The exchange rate was fixed during the second half of the 1970s primarily to stabilize import costs and the burden of servicing foreign debt.

3.3 Growing macroeconomic imbalance

In the 1970s, the macroeconomic imbalance began to worsen. An increased fiscal spending policy for alleviating the recessionary impact of the first world oil crunch created a large budget deficit. The Defense tax and value added tax were introduced in 1975 and 1977, respectively.

Rapid monetary expansion was caused by increased policy loans and foreign capital inflows that were needed to finance large-scale investment projects, as well as by large foreign exchange earnings from the boom in overseas construction. Current account deficits reached 10% of GNP during the oil shock (1974-1975) and 7.5% during 1979-1981.

4 ECONOMIC STABILIZATION AND LIBERALIZATION IN THE EARLY 1980s

4.1 Price stabilization efforts

The second oil price shock in 1979 exposed Korea's striking macroeconomic imbalances. In the early 1980s, to alleviate the economic cost associated with disinflation, inflation control was pursued not only by curtailing aggregate demand through monetary and fiscal tightening but also by stabilizing factor costs such as wages and interest rates.

4.2 Comprehensive Stabilization Program

In the spring of 1979, the government adopted a comprehensive stabilization package consisting of restrictive fiscal and monetary policies and investment adjustments in the heavy industries. The comprehensive stabilization program can be described as follows. High inflation and the rise in real estate prices distorted income and wealth distribution. Chronic inflation also threatened to undermine the economy's growth potential and export competitiveness by discouraging innovation and financial savings while promoting speculative behavior in the real estate market. In the early 1980s, fighting inflation was given top priority among Korea's economic policy issues.

4.3 Monetary policy

Annual M2 growth was rapidly lowered to 27% during the period between 1979 to 1981, and further down to 17% during the period between 1982 to 1985, down from more than 34% during the period of 1976 to 1978. Real interest rates rose and financial deepening accelerated as indicated by the rise in the ratio of financial assets to GNP.

4.4 Foreign pxchange policy

With the overvalued exchange rate, fixed to the U.S. dollar from 1975-1979 despite a large disparity between the two countries' inflation rates, exports in 1979 recorded negative growth in real terms. Faced with both high inflation and a widening deficit in the balance of payments, Korea chose to tackle the problem of external imbalance by substantially depreciating the exchange rate and by adopting a flexible exchange rate system in the early part of 1980.

The won-dollar exchange rate, which had been fixed since 1974, was devalued by 20% in January 1980. At the same time, the fixed exchange rate system was replaced by a multi-currency basket system. The won-dollar rate was determined by taking into account the inflation differential between home and abroad, variations in exchange rates among major trading partners, and other domestic policy factors. The realistic exchange rate management had a favorable effect: the current account deficit dropped substantially as from 1982.

4.5 Interest rate policy

After an upward trend in early 1980 as a part of the economic stabilization package, interest rates were adjusted downward on eight different occasions before June 1982. During this period, the interest rate on time deposits with a maturity of one-year dropped from 24% to 8%. At the same time, the government abolished the complex interest rate schedule that had been applied to policy loans with preferential terms. The downward adjustment in interest rates in the early 1980s reduced the financial burden of firms during the recession. However, the downward adjustment of interest rates, which was taken alongside decelerating inflation, was accompanied by signs of disintermediation in the financial markets.

4.6 Incomes policy

Believing that restrictive demand management alone would be overly depressive, the government relied on an income policy as well. Since 1982, a schedule of wage increases for public employees has been applied as an informal wage guideline for private sector employees. The government has made great efforts to create wage stability by adopting a more forward-looking scheme for setting wages based on expected future inflation.

4.7 Fiscal policy

Since 1983, when economic recovery was becoming apparent, fiscal policy was further tightened. The total government budget as a percentage of GNP decreased from 28% between 1980 and 1982 to 23% during the period between 1987 and 1988. The consolidated budget balance, as a percentage of GNP, also improved from a deficit of 4% to a surplus of 0.8% over the same periods.

4.8 Results

Consumer price inflation decreased considerably from an annual rate of 25% during 1980-1981 to 7% in 1982. The domestic inflation rate subsided to less than 3% during the period between 1983 and 1987. Firm price stability and substantial positive interest rates contributed to a steady financial deepening. On the other hand, the tight fiscal policy during the period led to inadequate infrastructure investments.

5 MACROECONOMIC IMBALANCE SINCE THE LATE 1980s

5.1 1986-88: economic impact of the "three lows" and large current account surplus

During the latter half of the 1980s, Korea was able to achieve strong economic growth with a significant increase in exports due to the so-called "three lows". The real effective exchange rate depreciated by about 35% between 1982 and 1987. The won-dollar rate depreciated by more than 20% during the same period, and the Japanese yen appreciated from an average of 238 yen per dollar, between 1982 and 1985, to 128 yen in 1988. As a result, exports increased by 31% per annum in dollar terms between 1986 and 1988. The rapid expansion of exports, in conjunction with low international rates and petroleum prices, resulted in a current account surplus of US$28.6 billion for the 1986 to 1988 period.

5.2 1986-1988: monetary policy

The current account surplus added about 15 trillion won to the domestic money supply during the period of 1986 to 1988, accounting for 73% of the net increase in money supply (M2) during the period. The Bank of Korea issued Monetary Stabilization Bonds (MSBs) to absorb excess liquidity injected by the monetary expansion in the foreign sector. Non-bank financial institutions were in fact forced to purchase MSBs, hence distorting their asset management.

5.3 1989-91: external pressure for currency appreciation and rapid wage increases

In the period of 1989-1991, there was external pressure for currency appreciation and rapid wage increases. The won-dollar exchange rate appreciated by around 24% between 1987 and 1989. The appreciation of the won was due to a large current account surplus as from 1986 and partly due to increased pressure from the United States. Meanwhile, an outbreak of labor disputes in the wake of the 1987 Declaration of Democratization spurred a rapid rise in wages, which created inflationary pressures. Unit labor costs rose by 18% per annum during the period between 1988 and 1989.

Domestic demand overheated with the expansion of private consumption and construction. Real wages increased by 11% per annum between 1989 and 1991. Residential investments were made on an extremely large scale as two million housing units were built in just three years.

Economic growth propelled by the expansion in consumption and service production, however, resulted in serious macroeconomic imbalances with rising inflation and a large trade deficit.

5.4 1992-96: recession, recovery and unfavorable external environment

Faced with growing external and internal imbalances, the government pursued comprehensive stabilization policy measures in 1991. The government introduced a new set of regulations designed to manage construction activities and to tighten restrictions on the construction of commercial buildings.

Given these stabilization efforts, inflationary pressures were eased at the expense of slower economic growth (slightly above 5% in 1992 and 1993). The economy soon regained its growth momentum to achieve more than an 8.5% growth per annum over the period of 1994 to 1995, largely due to strong facility investments and rapid expansion of exports along with the appreciation of the Japanese yen.

However, the current account deficit recorded $24 billion (5% of GNP) in 1996 as the Korean economy was severely impacted by unfavorable external shocks in 1996. The terms of trade deteriorated approximately 20% in 1996. It was the largest external shock in Korea since the first oil shock of 1974. International prices of major export goods such as semiconductor chips, steel and chemical products dropped considerably in 1996. For example, the unit price of semiconductor chips fell by more than 70% in 1996.

6 THE 1997 CRISIS AND IMF BAILOUT PROGRAM

6.1 1997 financial crisis

Korea's international competitiveness began to deteriorate in the early 1990s due to the amassed structural deficiencies within the Korean economy. In 1996 the Korean economy took a major hit as a result of a shock in the terms of trade in the same year. The terms of trade deteriorated by approximately 20% in the period of 1996-1997, the largest drop since the first oil shock of 1974-1975. The terms of trade shock placed extremely heavy pressure on the thin profit margins of firms.

Another big shock to the Korean economy occurred with the bankruptcy of the Hanbo Group in January 1997 which was followed by bankruptcies of four other of the thirty largest chaebols in 1997: Sammi, Jinro, Haitai and New-Core Groups. The failure of these chaebols revealed problems with low profitability and excessive leverage ratios in the corporate sector, as well as inadequate corporate governance in Korea.

Foreign investors had already become increasingly skeptical of the government's willingness and ability to implement economic reforms and undertake serious structural adjustment. In addition, the unanticipated intensity and fast spreading financial crisis which took place in Thailand and then moved to Indonesia, came to bear its effects on Korea, as the country was going through a period of structural adjustments as well as a cyclical economic downturn.

In November 1997, less than a year after its accession to the OECD, Korea experienced a severe financial crisis. With its useable foreign exchange reserves nearly exhausted, the Korean government formally requested assistance from the International Monetary Fund to mitigate the external liquidity shortage and regain the confidence of international investors.

A complicated and often unclear combination of macroeconomic distortions and financial weaknesses were at the core of the economic crisis in Korea. Korea's problems stemmed from an inefficient and distorted financial sector, weak supervision and prudential regulation, as well as from a corporate sector burdened with high levels of short-term debt.

In the financial sector, structural problems were deeply rooted and endemic due to the extensive use of credit restrictions as a primary tool of economic development in the past. Protracted periods of interest rate control and selective credit allocations gave rise to an inefficient distribution of funds. Short-term foreign debt utilized to finance the strong investment demand of the corporate sector began to mount significantly as the economy entered a period of rapid economic growth in 1994.

Since December 1997, the nation has embarked on a comprehensive program for economic reform and recovery, which has already proved successful in rectifying the causes of the crisis.

6.2 Dealing with liquidity crisis

In resolving the financial crisis, external financing was one of the most pressing issues for Korea. Therefore, one of the primary goals of the government was to encourage the flow of foreign capital into Korea. The Korean government and the IMF agreed on a financial aid package on December 3, 1997. The IMF, the World Bank and ADB promised to provide US$ 21 billion, US$ 10 billion and US$4 billion, respectively. The combined total of financial assistance received by Korea was US$ 16.1 billion and US$ 12.6 billion in 1997 and 1998, respectively, from the IMF, IBRD, and ADB. Improvements in the roll-over of credit and the opening of new lines of credit by some commercial bank creditors were also effective in halting outflows of foreign capital, thus helping to stabilize the won's currency value.

Korea's short-term debt difficulties were further ameliorated by the New York agreement in January 1998, whereby a total of US$ 21.74 billion in short-term debt of Korean banks was refinanced and converted into medium-term debt with a maturity of one to three years. In the first week of April 1998, the Korean government successfully reentered the international capital market by issuing sovereign global bonds worth US$ 4 billion.

TABLE 2
Korea's total external liabilities
(US$100 Million)

	End 1999	End 2000	End 2001	End 2002	End-Mar. 2003
Total external liabilities	1,371	1,317	1,188	1,310	1,370
I. Public sector	295	283	208	197	171
II. Financial sector					
A Domestic financial institutions	473	378	333	367	384
B Branches of foreign banks	137	130	117	169	207
III Private sector	466	526	530	577	608
Long-term liabilities	978	838	778	812	813
Short-term liabilities	392	479	410	498	557
I. Financial sector					
A Domestic financial institutions	127	153	131	173	188
B Branches of foreign banks	98	104	91	139	171
II. Private sector	167	222	188	186	197
Total external credit	1,454	1,647	1,654	1,853	1,880
I. Public sector	749	970	1,035	1,221	1,244
II. Financial sector					
A Domestic financial institutions	536	494	405	390	387
B Branches of foreign banks	37	58	64	46	48
III Private sector	132	125	149	196	200
Net credit	83	331	466	543	510

Korea's current account balance improved substantially. The current account surplus was recorded at US$ 40.6 billion and US$ 24.9 billion in 1998 and 1999, respectively. The current account surplus, coupled with portfolio capital inflows and the improved rollover of current bank credit, has significantly expanded the usable foreign exchange reserves as shown in Table 4.

TABLE 3
Balance of payments
(Unit: US$ billion)

	1997	1998	1999	2000	2001	2002
1. Current account	-8.17	40.56	24.48	12.24	8.24	6.09
Goods account	-3.18	41.63	28.37	16.87	13.49	14.18
Services account	-3.20	0.63	-0.65	-2.89	-3.83	-7.46
Income account	-2.45	-5.05	-5.16	-2.42	-1.20	0.45
Current transfers	0.67	3.35	1.92	0.68	-0.23	-1.08
2. Capital account	1.31	-3.25	2.04	12.11	-3.28	1.52
3. Increase in reserves	(-11.92)	(30.98)	(22.98)	(23.77)	(7.58)	(11.80)
4. Error & omissions	(5.07)	(6.19)	(3.53)	(0.58)	(-2.61)	(-4.19)

Source: Bank of Korea.

As of the end of July 2003, Korea's foreign currency reserves reached US$ 132.9 billion. The Korean government has repaid all US$ 19.5 billion borrowed from the IMF in the wake of 1997 financial crisis. The total of US$ 19.5 billion that Korea received from the IMF is composed of US$ 13.5 billion in the form of supplementary reserve facility (SRF) and US$6 billion in a long-term stand-by arrangement (SBA).

TABLE 4
Foreign currency reserve balance
(Unit: US$100 mil.)

	End-Dec. 1997	End-Dec. 1998	End-Dec. 1999	End Dec. 2000	End Dec. 2001	End-Dec. 2002	End-July 2003
Foreign currency reserve balance (A)	204.1	520.4	-	-	-	-	-
Holdings of Korean banks' overseas branches (B)	113.3	33.3	-	-	-	-	-
Others (C)	2.0	2.0	-	-	-	-	-
Usable foreign currency reserve A (B+C)	88.7	485.1	740.5	962.0	1,028.2	1,028.2	1,329.0

Source: Bank of Korea.

7 THE ROLE OF GOVERNMENT

In this chapter, we examine the government's role in Korea's economic development during the past four decades and how that role has been changed in the structural adjustment process. Although there were several attempts to identify the policies that led to Korea's high-performing economy, none seem to fully capture the complexity of the policies and Korea's rapid economic growth.

7.1 The neoclassical view

Supporters of the neoclassical view emphasize Korea's success in getting the basics right. They argue that Korea's move toward international trade and the absence of price controls and other distorting policies have led to relatively low price distortions. They stress the importance of investment in people, education, and human capital in the success of the Korean economy.

7.2 The revisionist view

In Korea, the government made a series of five-year economic development plans and extensively intervened in the market by providing subsidies, tax incentives, and protection. This experience appears to support the revisionist view that the rapid expansion in export was made possible primarily because of the government's intervention. The industrial policy and the interventionist approach in the financial markets are not easily reconciled within the neoclassical framework.

While maintaining that promotion of specific industries generally did not work, the World Bank (1993) credits the careful policy interventions of the governments to the rapid growth of Asian NICs. According to the World Bank, governments could improve on market-based competition by creating contests that combine competition with the benefits of cooperation between the government and the private sector. Japan and Korea, which were equipped with high-quality civil services, could bring about the contests through council deliberations whereby the government distributes rewards such as access to credit or foreign exchange.[4]

7.3 Korean experiences

One significant feature of the Korean government's policies is that they were significantly different from decade to decade. Korea's growth experience cast doubt on the revisionist view that the rapid economic growth and industrialization of the Asian NICs' is due to the government's industrial

4. World Bank (1993), p. 11 and p. 24

policy. However, it is true that the Korean government has extensively intervened in the allocation of resources in the market.[5] Throughout Korea's rapid growth, exports as well as imports increased at a rapid pace. Interaction with the world market proved indispensable. If the government's policy interfered with the interaction, then it was detrimental to economic growth. On the other hand, if it facilitated the interaction, then it was beneficial to growth. The government provided political stability most of the time. Although not always successful, the government made great efforts to maintain the macroeconomic stability. The real exchange rate was not left to get out of line too long. The government made tremendous progress in the 1980s in the liberalization of imports despite widespread opposition.

It is worth noting that the Korean government's role in economic development has felt few ideological constraints. The "pragmatism" that prevailed in the policy-making process made available to the government a broad range of policy instruments and tools in achieving the defined goals and solving policy problems. The government endeavors to prescribe a solution, constantly monitors its implementation progress, and adjusts the policies as necessary. This approach may work only when the bureaucracy is under the control of highly motivated and competent administrators.[6]

7.4 National budget

Through the national budgeting process, the Korean government has played an important role in the mobilization and allocation of resources since the early 1960s. The Korean government has maintained strong fiscal discipline. The increase in government spending was gradual and consistent with the increase in revenue, thus preventing serious inflationary pressure.

TABLE 5
Government expenditures (as % of GDP)
(1960-2001)

Period	Non-defense	Defense	Total
1960 – 1964	12.2	5.0	17.2
1965 – 1969	10.7	3.9	14.6
1970 – 1974	11.0	3.8	14.8
1975 – 1979	10.4	5.0	15.5
1980 – 1984	10.9	5.5	16.4
1985 – 1989	10.1	4.4	14.5
1990 – 1997	10.7	3.3	14.0
1998 – 2001	13.9	3.0	16.9

5. Yoo, Jungho (1999) p. 13.
6. Hyun Oh-Seok (2003).

The government became a net saver after 1964 as a result of reduced government spending and increased government revenues. Fixed investments in the public sector increased from about 4% of GDP during 1960-1964 to about 6% on average from the late 1960s until the 1990s.

TABLE 6
Government consumption, savings, and fixed investment (as % of GDP)
(1960-2001)

Period	Consumption	Savings	Fixed investment
1960 – 1964	12.3	-1.0	3.7
1965 – 1969	10.0	4.2	5.6
1970 – 1974	9.5	4.6	5.3
1975 – 1979	10.0	5.7	5.7
1980 – 1984	11.6	4.8	6.3
1985 – 1989	12.9	5.9	6.8
1990 – 1997	13.1	7.3	6.7
1998 – 2001	17.0	5.6	6.5

The government's relatively efficient use of the national budget for mobilizing resources is partially due to the improvements in tax administration. The tax system was reformed to support economic development at the end of 1967 with the establishment of the National Tax Administration in 1966. In addition to procedures for strengthening tax enforcement – such as tax audits, tight supervision, and public campaigns – the National Tax Administration adopted a system of targets or quotas for tax collection, by regions and tax items.

One important principle in fiscal management was established in the early 1980s. It was the principle of "Expenditure within Revenue," or the balanced budget principle. It acted as a way of imposing self-discipline on the budget authorities against imprudent management of the budget.

The balanced budget principle kept public debt to a minimal level. In 1996, the year before the economic crisis, the gross debt of the central government was less than 10% of GDP, and the net debt was negative; that is, the central government was a net creditor to the other sectors of the economy. The local governments were generally in good shape as well.

Strict application of the balanced budget principle enabled the Korean government to keep the size of the government's debt at a manageable level, and allowed it to implement appropriate fiscal policies when the economic crisis hit Korea in 1997. The Korean government provided huge fiscal support for financial restructuring initiatives. It also significantly expanded the social safety net for the poor and the unemployed.

8 CONCLUDING REMARKS

The development strategies and resulting characteristics of development patterns that led to the sustained growth and structural transformation in the early 1960s can be summarized.

Korea has adopted an export-oriented industrialization (EOI) strategy for economic growth. Import-substitution industries were promoted on a selective basis in the 1960s and on a more expanded scale through the development of heavy and chemical industries in the 1970s. The strategy of government-led economic development was further demonstrated by the government's intervention in the market economy. Some instances of such intervention consisted of economic planning, industrial policy or government-guided industrialization and intervention in the market price system.

The government's economic policy during the first two decades of rapid growth in the 1960s and 1970s was skewed towards an interventionist approach. In spite of that, Korea was able to make this approach work. The export promotion policy in the 1960s proved successful not because the export incentives distorted the prices in favor of exportation, but rather, the incentives worked to offset the bias against exports inherent to the protectionist policy.

The targeted interventions of the HCI drive were successful in helping to create the foundations for the current competitive heavy industry sector. In the 1970s, the Korean government placed major policy emphasis on promoting heavy and chemical industries. Although this effort produced some unintended consequences, it significantly contributed to upgrading Korea's industrial and export structure.

Throughout Korea's rapid growth, exports as well as imports expanded at a rapid pace. Imports, which consisted mostly of natural resource products, industrial raw materials and capital goods, served a very useful purpose. Despite the poor endowment of natural resources, Korea was able to produce competitive goods and services for the world market due to the imports.

The "growth first and distribution later" strategy was followed until around the mid-1980s, when the focus on policy gradually shifted towards the issue of distributive equity. The growth strategy emphasizing the efficient use of available human resources has been pursued in the implementation of the EOI strategy.

Korea's high growth was accompanied by an increased concentration of economic power in the hands of a small number of business groups due to the preference given to large firms by the government in the course of promoting industrialization.

Korea's economic development paved the way for political democratization beginning in the late 1980s. The Korean experience displays the case of political democratization led by economic development.

Under certain circumstances, the government's control of credit allocation may lead to better economic performance rather than a market-based financial system. The chances of success should be high when the economy is in its early stage of development, backed by capable bureaucracies and a political leadership strongly committed to economic development. Nevertheless, the incentive structure imposed by the government should deviate as little as possible from the market-based system, in that it should supplement the market system by redressing its shortcomings.

Policy emphasis since the 1980s has shifted towards enhancing the role of the market in resource allocation by reducing direct government intervention and fostering competition. As Korea's economic structure evolved more like that of other industrialized economies in the 1980s and 1990s, the Korean government moved toward indirect macro management of the economy. The trade of goods was significantly liberalized. But, political pressures and nationalistic sentiments played a role in slowing full liberalization, particularly by placing restrictions on foreign direct investments and financial services. Political sentiment and democratization made specific intervention in support of individual business groups unacceptable.

One significant feature of the Korean government's policies is that they were very different from decade to decade. Korea's growth experience cast doubt on the revisionist view that the rapid economic growth and industrialization of the Asian NICs' is due to government's industrial policy. Even though, it is true that the Korean government has extensively intervened in the allocation of resources in the market.

The Korean government provided political stability most of the time. Although not always successful, the government made great efforts to maintain macroeconomic stability. The real exchange rate was not left to get out of line too long. The government made tremendous progress in the 1980s in import liberalization despite the widespread opposition.

The "pragmatism" prevailing in the policy-making process has allowed the Korean government to select among available to the government a broad range of policy instruments and tools in achieving the defined goals and in solving policy problems. The government endeavors to prescribe a solution, constantly monitors its implementation progress, and adjusts the policy direction as necessary. This approach may work only when the bureaucracy is under the control of highly motivated and competent administrators.

FIGURE 1
GNP per capita and growth

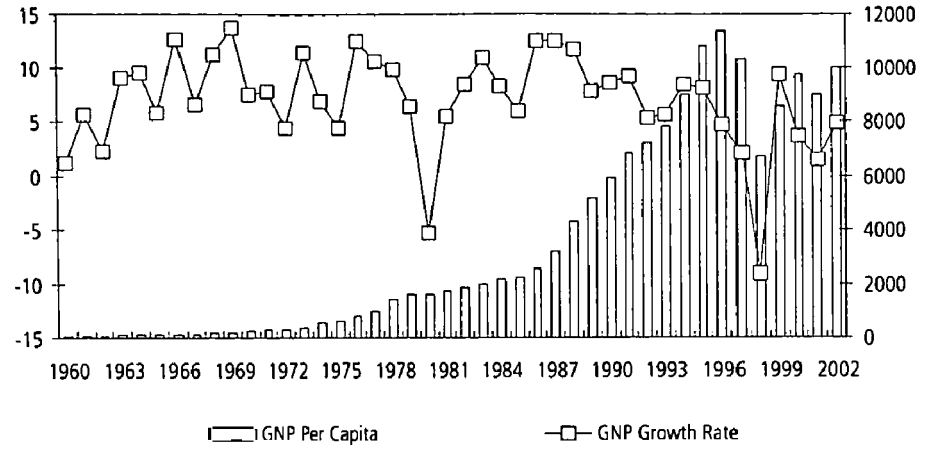
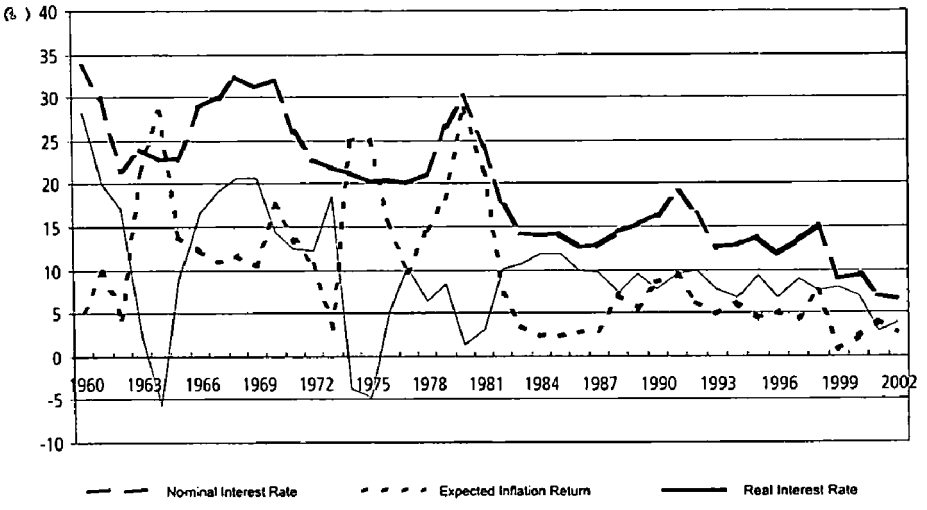


FIGURE 2
Interest rate trend



Note: 1. Corporate bond rate with 3-year maturity.

FIGURE 3
Inflation rate (CPI)

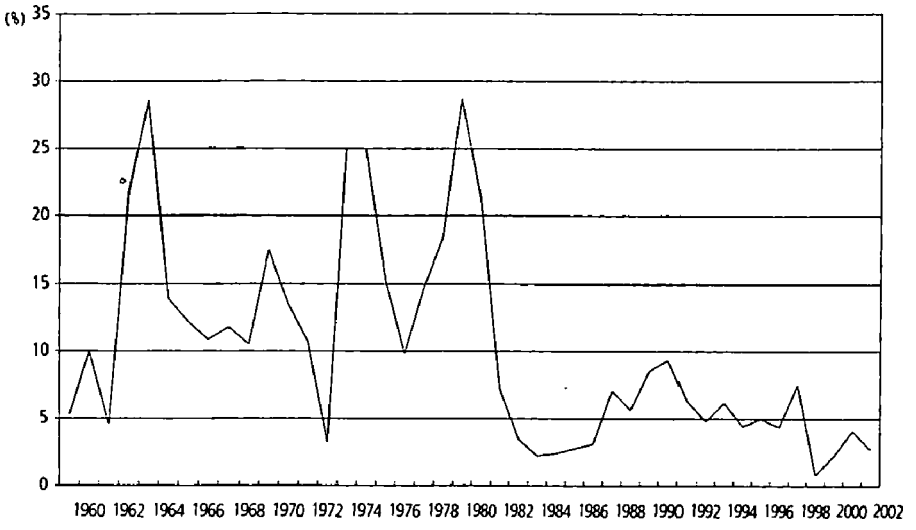
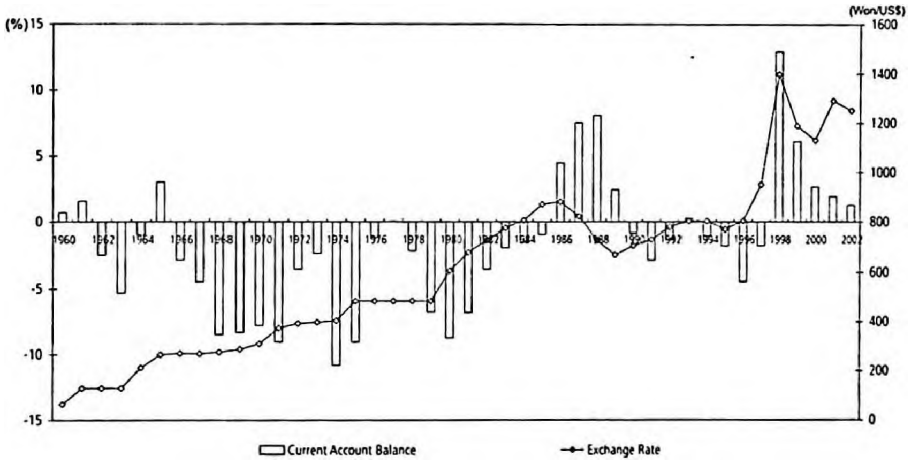


FIGURE 4
Exchange rate and current account balance



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