
Development of Korean Economy I

Ch.2: The Growth of Korean Economy and the Role of Government



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I . Introduction



Korea

- Great changes in economic growth and social development over six decades
- Per capita income: \$67 (1953), \$1,342 (1960), \$10,548 (1996), \$20,757 (2010)
- Nominal GDP: \$2.3 billion(1962) , \$480.4 billion(1996), \$986.3 billion (2010)
- Life expectancy : from 52.4 (1960) years to 79.6 (2010) years
- The political structure: an authoritarian one to a fully functioning democracy



The market-
friendly view

The development-
state view

Q) Role of Government?

Four Stages of Development

Liberation & state-building Export promotion & industrialization Stabilization & liberalization Recovery & globalization

The first stage
(1945-48,
1948-
1960)

The second stage
(1961-
1979)

The third stage
(1980-
1997)

The fourth stage
(1998-
today)

1.2 DEVELOPMENT: 1963-1996

1.2.1 Extensive State Intervention

1960'S	Export-led industrialization Labor-intensive industry
1970'S	Heavy & chemical industry
1980'S	Economic liberalization
late 1980'S	Political democratization Free market approach

II . Liberation and state-building (1948-1959)

Establishing a market economy

- Hyperinflation and Right–left wing conflict(1945-1948)
- Establishing a market economy based on private property ownership
 - From 1945 to 1948, the **American military government** tried to introduce a modern market economy system based on private property ownership
 - Selling confiscated Japanese-owned property despite calls for nationalization
- Agricultural land reform
 - Enacting the Farmland Reform Act of 1949
 - With the principle of compensated forfeiture and non-free distribution
 - The reform contributed to state-building, redistributing wealth and reducing income inequalities.
 - The reform hampered the growth of large-scale farming and productivity growth of the agriculture

II . Liberation and state-building (1948-1959)

Establishing a market economy

- **President Rhee, Syngman** desired a self-sufficient Korean economy
 - Economic reconstruction plans and foreign aid
 - Expanding the economic infrastructure, building key industries, increasing the productive capacity of manufacturing
 - Foreign aid from the UN and the US (1950s & 1960s)
-
- Exchange rates and trade policies
 - In 1950s, An overvalued Korean won discouraged imports
 - The tariff system was geared to protect domestic industry
 - In 1950, the Tariff Act was enacted
 - In the late 1950s, Tariff rates were still high (27.4% ~ 66.5%)

II. Liberation and state-building (1948-1959)

Establishing a market economy

- Financial market policies
 - A strong financial repression (interest rate set, dual markets)
 - In January 1954, the **Korea Development Bank** was launched as a solely government-owned bank to provide long-term credits to key industries
 - The excessive reliance on the central bank generated high inflation (demand > supply of credit)
 - Emergence of *Chaebols* (why?)

Price inflation

Unit: %

	1946	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959
Producer price	385.4	73.9	62.9	36.7	-	-	-	25.3	28.2	81.1	31.6	16.2	-6.2	2.6
Consumer price	280.4	78.9	58.4	24.9	167.5	390.5	86.6	52.5	37.1	68.3	23.0	23.1	-3.5	3.2

- Annual inflation fluctuated between 20 and 400 percent between 1946 and 1957

Market interventions during 1950s

1.2 DEVELOPMENT: 1963-1996

1.2.3 Factors Contributing to Korea's Economics Success

- State intervention
 - extensive state intervention in all sectors
 - the initial states of economic development
 - the Economic Planning Board
- Export-led industrialization
 - lack of natural resources and small domestic market
 - export promotion: Export Promotion Council, KOTRA, and Korea Traders' Association

	1962	1996
Export-GDP ratio	3.9%	30.3%
Share of world export	0.04%	2.5%
Share of manufactured export	27%	93%
Share of H&C industry	10.4%	71.7%

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Ⅲ. Export promotion and government-led industrialization (1960-1979)

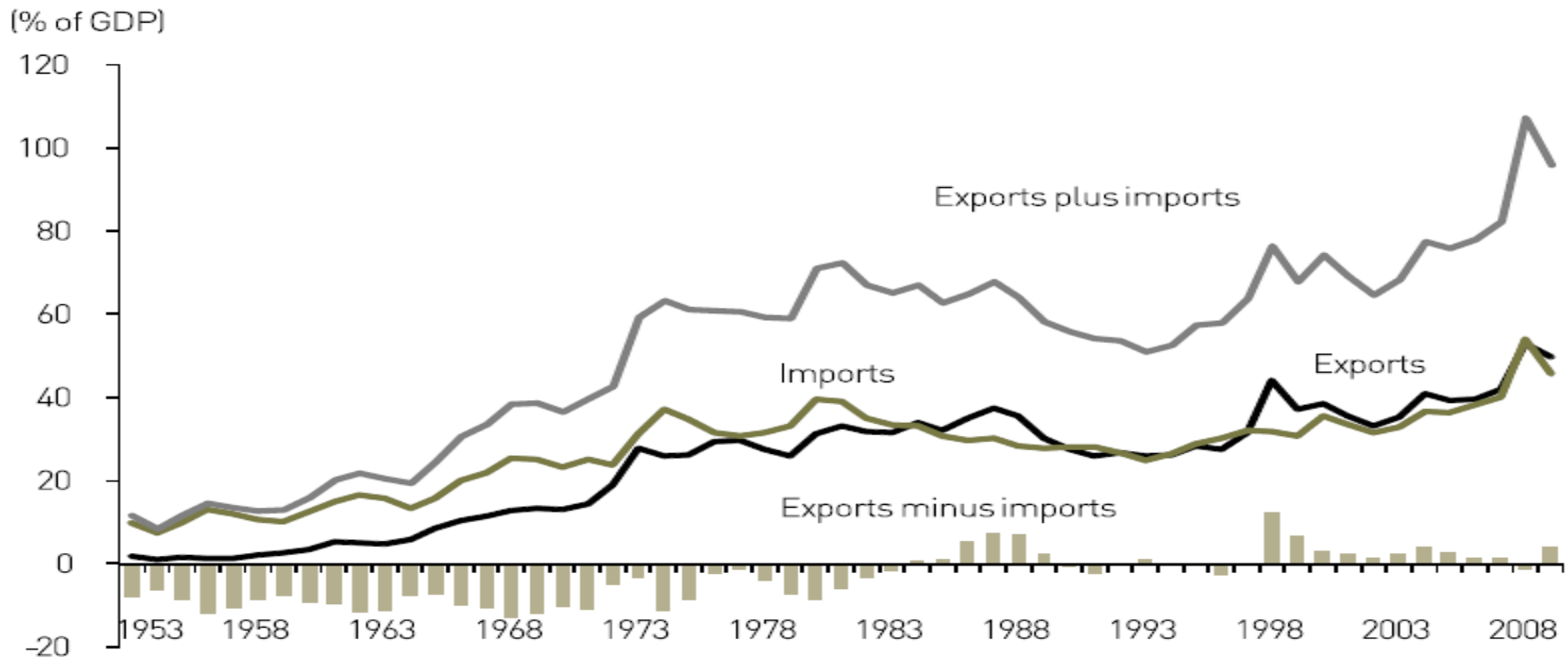
Growth Strategy

- Export promotion by **President Park, Chunghee**
- Why export promotion policy?
- Korean won devalued from 130won/\$ to 255won/\$ (1964)
- A comprehensive export incentive mechanism
 - automatic export credit to L/C recipients
 - tariff exemptions on imports of intermediate goods
- Administrative measures
 - A target (each year's total exports by adding up the export forecasts of individual firms.)
 - Monthly Export Promotion Meetings
 - The Korea Traders Association and The Korea Trade Promotion Agency

Ⅲ. Export promotion and government-led industrialization (1960-1979)

Growth Strategy

Exports and Imports (1953-2009)



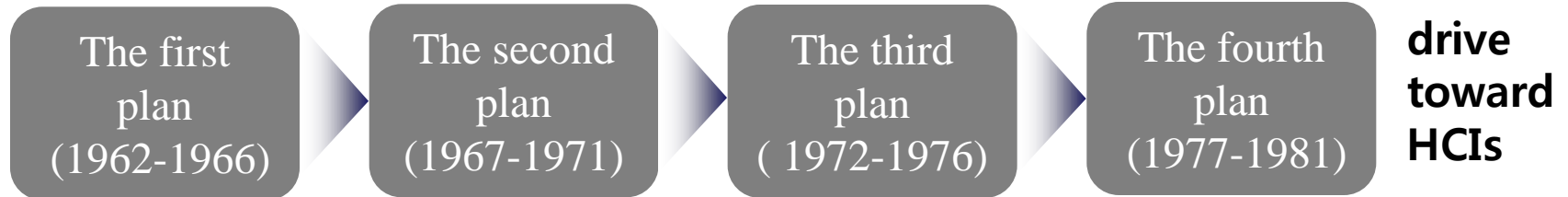
Source: Bank of Korea (<http://ecos.bok.or.kr>).

- Exports as a proportion of GDP , 5% in 1963 → 28% in 1973

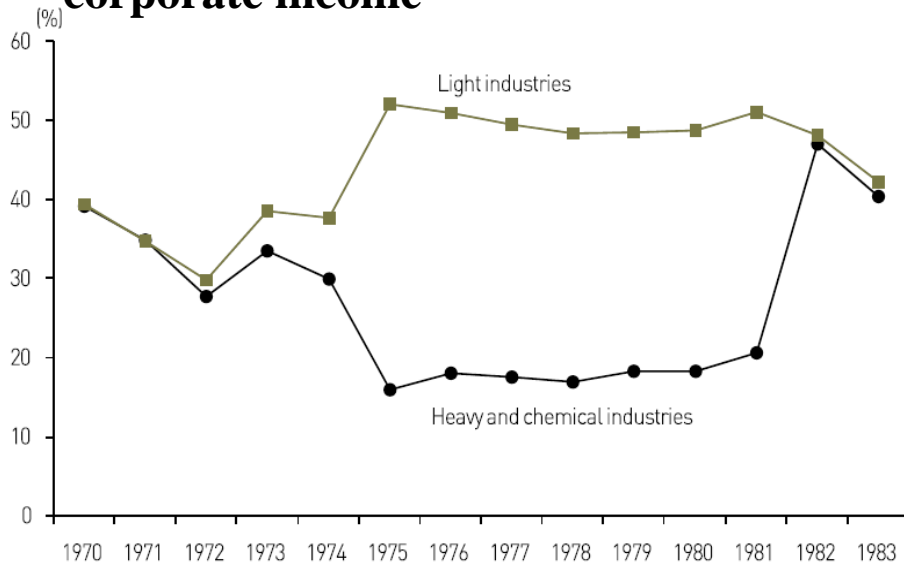
III. Export promotion and government-led industrialization (1960-1979)

Growth Strategy

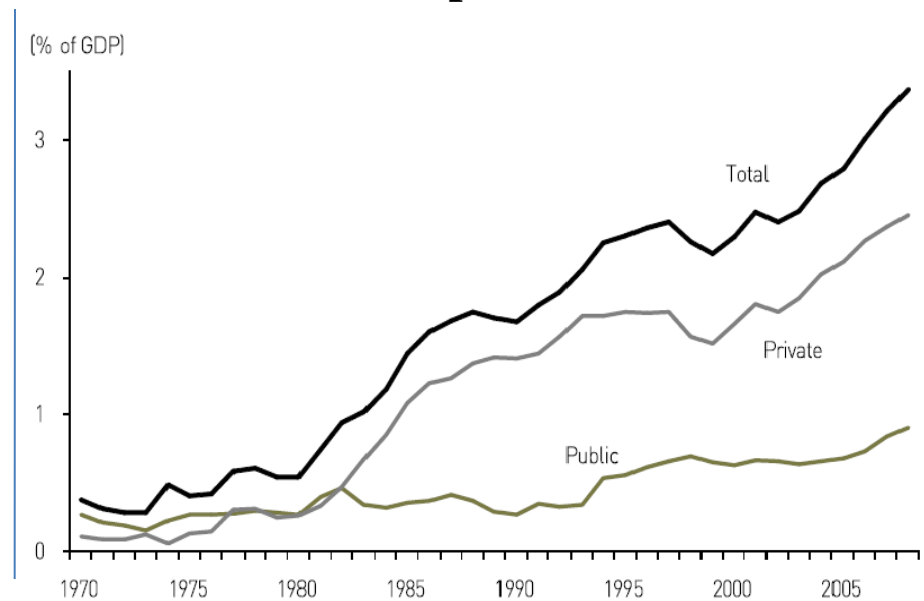
■ Government-led industrialization – Five year economic plan



Marginal effective tax rates on corporate income



Trend in R&D expenditure



Source: Tae-won Kwack (1985). Recited from Jung-ho Yoo (1991).

Source: National Statistical Office (<http://www.kosis.kr>).

III. Export promotion and government-led industrialization (1960-1979)

Industrialization

- The central theme of the Five-Year Economic Plans (1962)
 - The initial version of the **first plan** (1962-1966)
 - mining and manufacturing
 - The revised version (1964)
 - cement , fertilizer, industrial machinery, oil refinery, and others
 - The **second plan** (1967-1971)
 - HCIs (steel, machinery, and petrochemical)

A full-scale drive toward HCIs (1973)

Six strategic industries:

steel, nonferrous metal, machinery, shipbuilding, electronics, and chemical engineering

1. to strengthen its self-defense industry
2. to upgrade the industrial structure and find new export industries

III. Export promotion and government-led industrialization (1960-1979)

Characteristics of the HCI

- A clear export orientation
- The government led the drive but left actual implementation to the private sector.
- Finished goods production then diversification to upstream

Negative impact of the HCI

- Determined through bargains between politicians, bureaucrats and businessmen
- Produced excess capacity
- Retarded overall output growth
- Unhealthy accumulation of debts by enterprise
- Increased the power of *chaebol*
- Chronic inflation
- Obstructed the development of a competitive financial sector

POSCO in 1971-1973



포항 1기 설비 착공



역사적인 첫 출선 (1973.6.9)



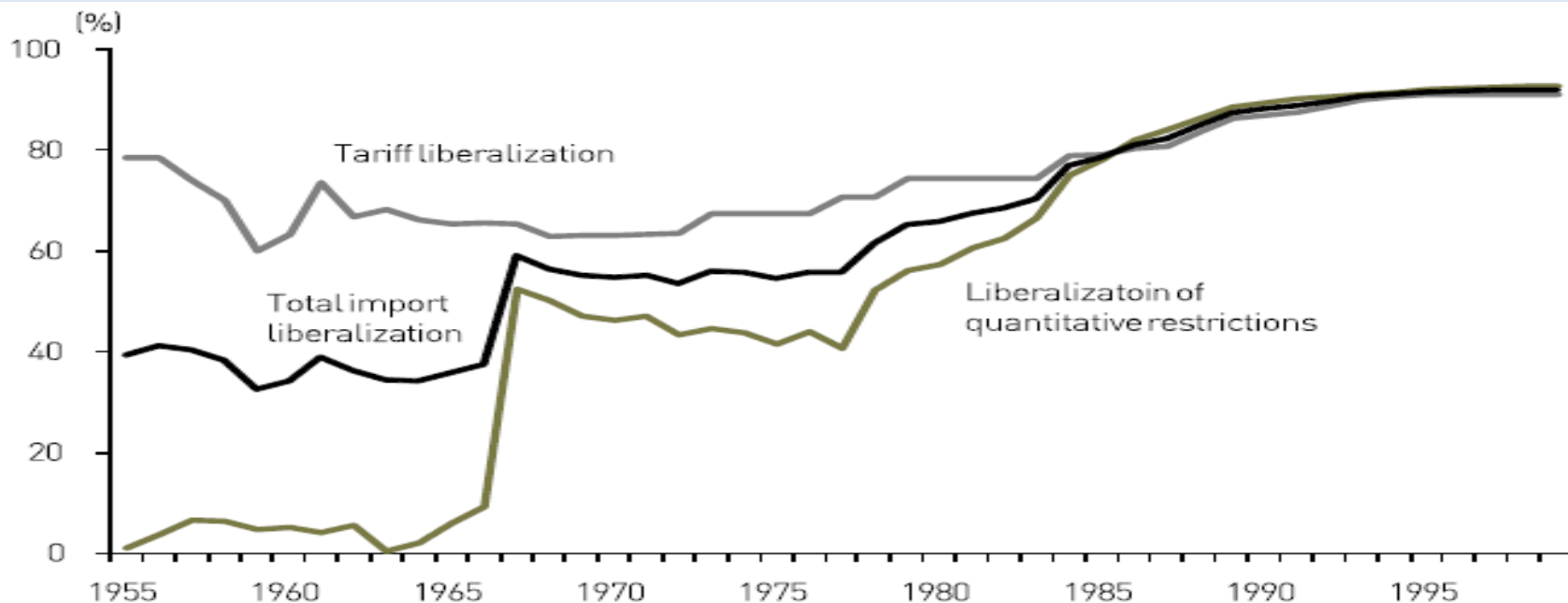
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III. Export promotion and government-led industrialization (1960-1979)

Growth Strategy

- Import liberalization

Trend in import liberalization (1955-1999)



- Positive list system → Negative list system (July 1967)
- Liberalization of quantitative restrictions (9.3% in 1966 → 52.4% in 1967)

III. Export promotion and government-led industrialization (1960-1979)

Growth Strategy

- Large increase in foreign borrowing

The Foreign Capital Inflow Inducement Act (1960)

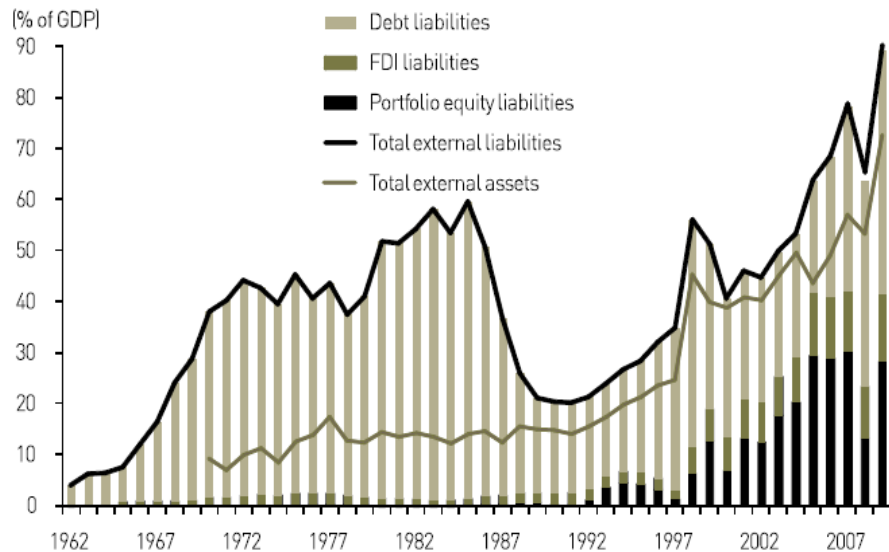


The Foreign Borrowing Repayment Guarantee Act (1962)

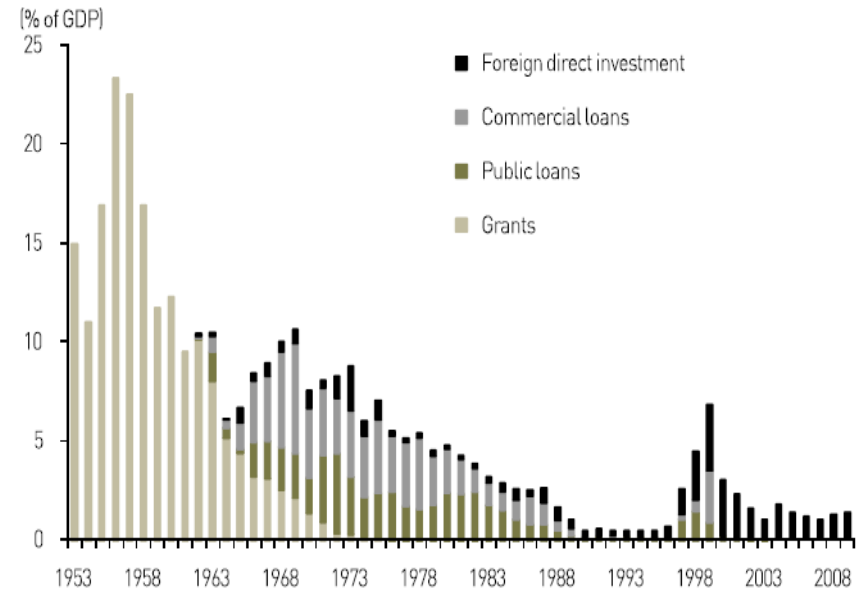


The Foreign Capital Inflow Act (1966)

Outstanding stock of external assets and liabilities (1962-2009)



Inflows of Grants, loans, and FDI



Ⅲ. Export promotion and government-led industrialization (1960-1979)

Large increase in foreign borrowing

- The Foreign capital Inflow Inducement Act (1960)
- The Foreign Borrowing Repayment Guarantee Act (1962)
- Normalizing the diplomatic relationship with Japan into full consideration.

heady growth of foreign borrowing

- Access to state guarantee (a privilege), all private enterprises wanted to get a share

The outstanding stock of external liabilities

1962	1970s	the early 1980s	the late 1980s
4%	40%	50-60%	20%

III. Export promotion and government-led industrialization (1960-1979)

Growth Strategy

- Financial repression
 - Commercial banks were renationalized, Specialized banks were established
 - The Bank of Korea Act was revised twice (1962, 1969): More influence (monetary policy) by government
 - The interest rate reform (from 15% to 30% on Sept. 30, 1965). Results?

- **August 3rd Measure (1972)**
 - Relieving enterprises from the burden of curb market loans
 - Report all the curb market loans and convert long-term loans with 3 year grace period with 16.2% interest rate
 - Providing special financial support

IV. Stabilization and liberalization (from the 1980s to the Crisis of 1997)

Presidents Chun, Duwhan (1980-88), Rho, Taewoo (1988-93), Kim, Youngsam(1993-98)

Consolidating growth on the basis of stability

■ Macroeconomic stabilization


■ Major macroeconomic indicators (1975-1990)

unit :%

	M2 (end of year)		Consolidated central government							Unemployment rate	Consumer price inflation
			Fiscal balance	Expenditure and net lending			Revenue				
	Nominal growth	Real growth		% of GDP	Nominal growth	Real growth	% of GDP	Nominal growth	Real growth		
1975	25.2	0.6	-4.4	52.2	22.3	20.6	51.4	21.7	16.2	4.1	25.2
1976	35.1	11.5	-2.8	34.8	11.2	20.2	48.4	22.4	17.4	3.9	15.3
1977	40.1	22	-2.6	25.8	9.6	19.8	26.8	10.4	17.2	3.8	10.1
1978	35.4	10.8	-2.5	36.6	11.8	20	37.7	12.6	17.6	3.2	14.5
1979	29.7	9.5	-1.4	24.2	4.8	19.4	31.6	11	18	3.8	18.3
1980	44.5	16.2	-3	36.1	9.5	21.6	26.2	1.5	18.6	5.2	28.7
1981	36.1	16	-4.3	34.3	14.4	23	27	8.2	18.8	4.5	21.4
1982	37	29.1	-3.9	8.3	2	21.7	9	2.6	17.8	4.4	7.2
1983	22.9	17.2	-1.4	2	-2.7	18.8	15.1	9.7	17.4	4.1	3.4
1984	19	13.9	-1.2	11.3	6.5	18.2	12.5	7.7	17	3.8	2.3
1985	18.1	13.3	-0.8	9	4.6	17.8	11.2	6.7	16.9	4	2.5
1986	29.5	24.3	-0.1	4.6	0.4	15.9	9.3	4.9	15.8	3.8	2.8
1987	30.3	24.3	0.2	17	11.6	15.8	19.1	13.6	16	3.1	3
1988	29.8	21.7	1.2	15.2	8	15.3	22.3	14.7	16.4	2.5	7.2
1989	25.8	19	0	22.1	15.5	16.5	13.4	7.2	16.5	2.6	5.7
1990	25.3	13.5	-0.8	29.9	17.6	17.8	23.9	12.3	17	2.4	8.5

IV. Stabilization and liberalization (from the 1980s to the Crisis of 1997)

Macroeconomic stabilization

- excess demand created by the HCI
 - the Middle East construction boom
 - fiscal deficits
 - the first and second oil shocks
- 
- a rapid escalation in inflation
 - the overvaluation of won
 - the loss of price competitiveness of Korean exports
-
- Comprehensive Economic Stabilization Program (1979)
 - reducing export subsidies
 - moderating HCI investments
 - scaling back the rural housing improvement program
 - Zero-based budgeting (1982), ZBB (Fiscal consolidation)
 - fiscal balance:
a deficit of -4.3% of GDP in 1981 → a surplus of 0.2% of GDP in 1987
 - consumer price inflation: over 20% in 1981 → under 5% in 1983
 - inflation: below 10%

IV. Stabilization and liberalization (from the 1980s to the Crisis of 1997)

Consolidating growth on the basis of stability

- HCI investment coordination and industrial rationalization

- Investment coordination

- 1979: The comprehensive Economic Stabilization Program

- 1980: Restructuring with three more industries (heavy electrical instruments, electronic switchboard and copper smelting)

- 1983: Rescue packages including loans from state-controlled banks.



- Industrial rationalization

- 1985: The Tax Reduction and Exemption Regulation Act (TRERA) was revised, The Manufacturing Development Act (MDA) was introduced

IV. Stabilization and liberalization (from the 1980s to the Crisis of 1997)

Table 2-10. Investment coordination and industrial rationalization in automobile manufacturing

Date	Events	Note
August 20, 1980	Production of passenger cars was to be unified as Hyundai Motor took over Daewoo Motor. Kia would become the monopoly producer of 1-5 ton trucks.	Coordination
February 28, 1981	Duopoly production of passenger cars by Hyundai and Daewoo Motors was allowed. For other types of cars, Kia Industry and Dong-a Motor would be merged.	Coordination
July 1986 - June 1989	New market entries were banned and the existing market structure comprising of four producers was maintained.	Rationalization

Source: Economic Planning Board, 1994, Table 2.3.2 and 2.3.6.

IV. Stabilization and liberalization (from the 1980s to the Crisis of 1997)

Consolidating growth on the basis of stability

- Financial liberalization
 - Financial market became increasingly liberalized in the 1980s and early 1990s
 - especially as many *chaebol*, as owners of NBFIs, demanded deregulation
 - Privatization of commercial banks in early 1980s
 - Liberalized interest rate on commercial papers
 - Lack of a clear orientation , concurrent strengthening of prudential regulation

Problem

1

The amount of loans that were not subject to prudential regulation grew as the CP market and the bank trust accounts expanded.

2

Regulatory standards remained outdated.

3

Various authorities were involved in prudential regulation, creating overlaps and gaps in supervision.

4

The authorities did not pay sufficient attention to the strengthening of the financial market infrastructure necessary for the sound operation of a market-based financial system.

IV. Stabilization and liberalization (from the 1980s to the Crisis of 1997)

Consolidating growth on the basis of stability

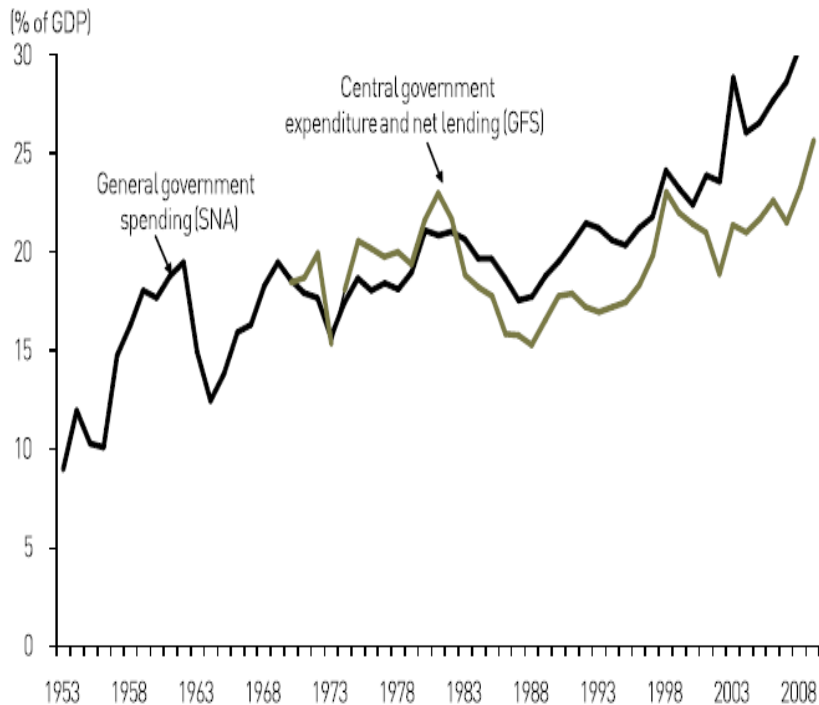
- Market opening
 - In January 1990, Korea moved into the status of a GATT Article XI nation
 - Tariff rate 34.4% in 1981 → 9.8% in 1995
 - Import liberalization 60.7% → 92.0%
- Competition policy and *chaebol* policy
 - Deregulation and Privatization
 - Introduced various ad hoc regulations to tame the *chaebol* but failed

IV. Stabilization and liberalization (from the 1980s to the Crisis of 1997)

Consolidating growth on the basis of stability

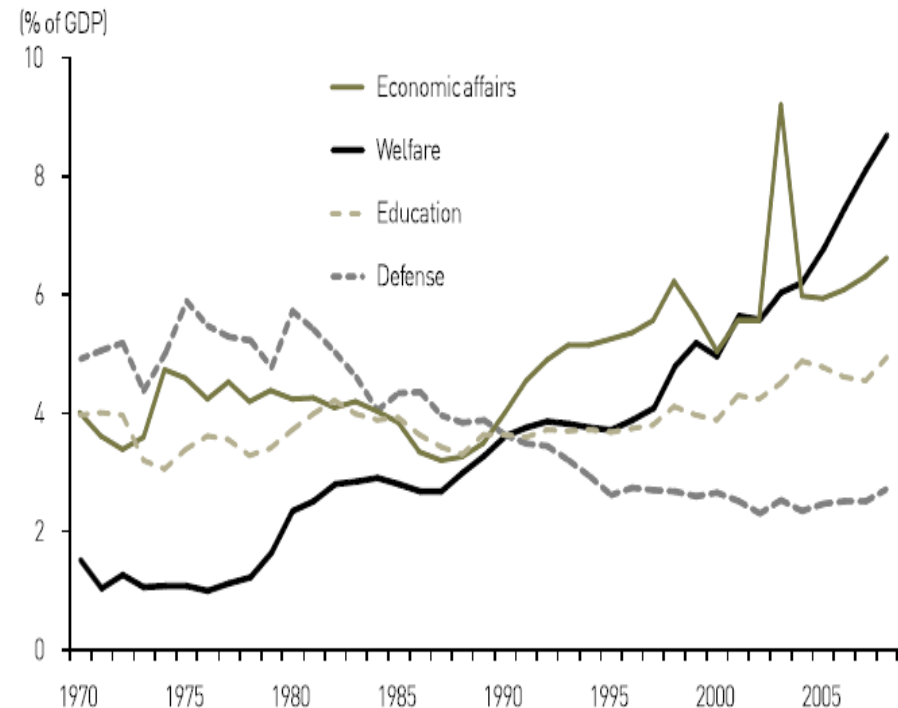
- Spending increasingly in response to the growing demand for public services

General and central government spending (1953-2009)



- 18% in 1987 → 30% in 2009

General government spending by function (1970-2008)



- Welfare spending increases greatly

V . From the economic crisis to the present (1997-2009)

President Kim, Daejung (1998-2003)

The crisis and its causes

- Economic crisis began in November 1997

Weak economic fundamentals



A high degree of intrinsic instability of international financial markets

- Major macroeconomic indicators (1991-2000)

	Output growth	Money supply (Lf) growth	Real yield on corporate bond	Consumer price inflation	Real effective exchange rate	Operational fiscal balance	Current account balance	Default Rate of commercial bills	Unemploy ment rate
Unit	%	%	%	%	2005=100	% of GDP	% of GDP	%	%
1991	9.7	12.1	7.9	9.3	98	-2.2	-2.7	0.06	2.4
1992	5.8	13	7.7	6.2	104.2	-1.1	-1.2	0.12	2.5
1993	6.3	11.8	5.8	4.8	107.3	-0.6	0.2	0.13	2.9
1994	8.8	15.8	4.9	6.3	106.1	-0.4	-0.9	0.17	2.5
1995	8.9	10.8	5.9	4.5	104.9	-0.5	-1.6	0.2	2.1
1996	7.2	11.2	6.6	4.9	101.2	-0.9	-4	0.17	2
1997	5.8	9.7	9.2	4.4	107.9	-2.5	-1.6	0.52	2.6
1998	-5.7	7.2	9.7	7.5	142.1	-5	11.3	0.52	7
1999	10.7	9.2	10	0.8	124.6	-3.7	5.3	0.43	6.3
2000	8.8	6.1	8.3	2.3	115.6	-1	2.3	0.39	4.1

- The only signs of instability came from the external sector

V . From the economic crisis to the present (1997-2009)

Causes of IMF

- increasing short-term external liabilities (280% of the foreign exchange reserve in 1996)
- poor risk management, financial institutions
- excessive expansion and diversification of chaebols
- instability increased in international financial markets

■ Average return on assets of the largest 30 *chaebol*

[Unit: %]

The <i>Chaebol</i> by asset size	1993	1994	1995	1996	1997
Largest 5	1.86	3.54	4.86	1.41	0.43
Next largest 5	0.87	1.17	1.10	-0.49	-2.15
Next largest 20	-0.40	-0.06	-0.08	0.08	-3.00
Largest 30	1.11	2.19	3.15	0.23	-2.13

Source: Fair Trade Commission, recited from Youngsun Kot et al. (2007)

V . From the economic crisis to the present (1997-2009)

Policy responses to the crisis

- Monetary and fiscal policies
 - The austerity policies followed by loose monetary and fiscal policy (an expansionary mode)
 - Strong export push
- Corporate sector reform
 - Restructuring insolvent firms
 - Swapping of business lines between the *chaebols*
 - Out-of-court debt settlements (workout program)
 - Strengthening market discipline to prevent future crises
 - Transparency in management (corporate governance)
 - Specialization over diversification
 - Intensifying competitive pressures

V . From the economic crisis to the present (1997-2009)

Policy responses to the crisis

- Financial sector reform
 - Planning a speedy state-led restructuring of financial institutions
 - A consolidated regulatory agency with oversight on the banking, securities
- Labor market reform
 - In January 1988, the Tripartite Commission was established
 - Legalizing layoffs for managerial reasons
- Public sector reform
 - A large-scale privatization program
 - The regulatory Reform Committee was installed in the Prime Minister's Office
- Welfare policies
 - The coverage of Employment Insurance System was extended
 - Additional public assistance program

Improvements of several sectors with advanced market economy

V . From the economic crisis to the present (1997-2009)

Outcomes of policy responses

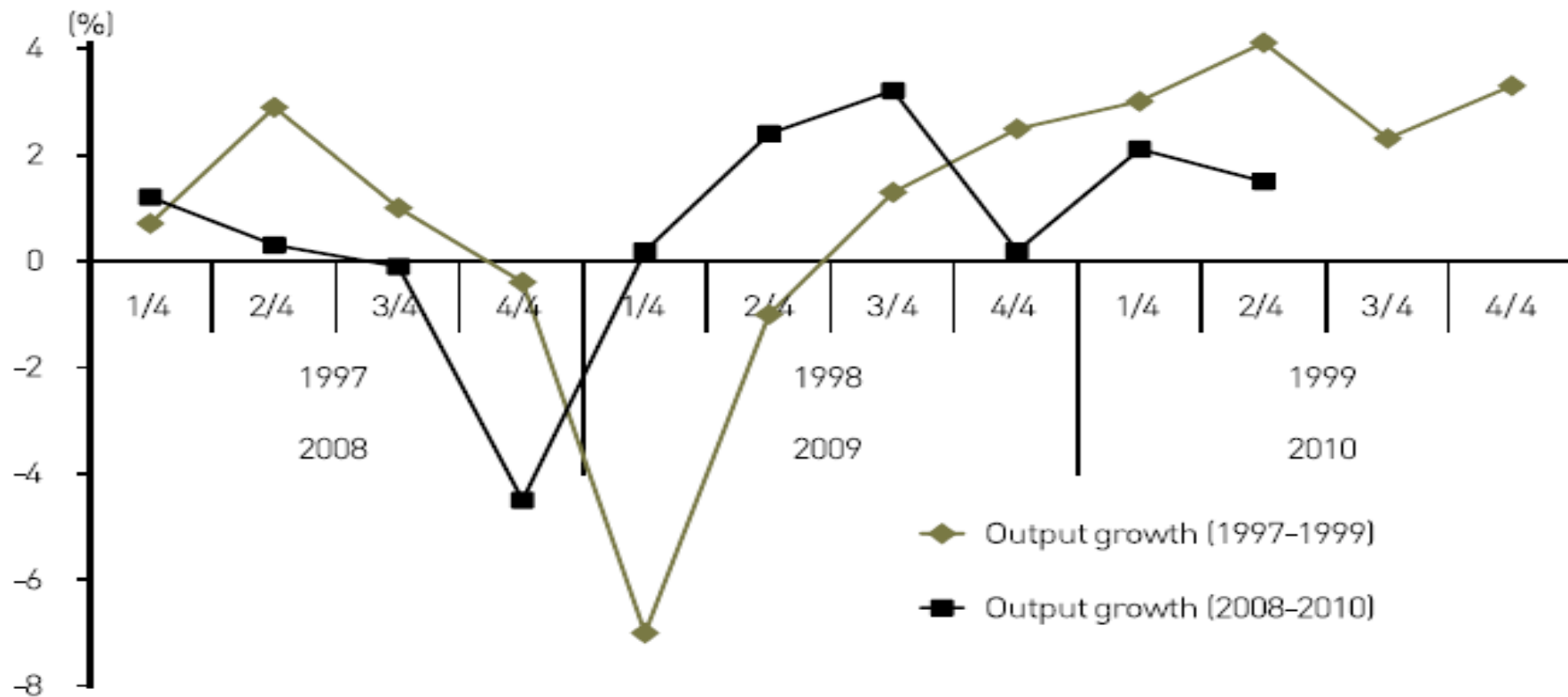
- Rehabilitating the financial health of the corporate and financial sectors
 - change of latent non-performing assets in the corporate sector
 - the disappearance of implicit state guarantees to business
 - the sweeping in the financial sector
 - all weak financial institutions were closed down or merged
 - the number of banks decreased by half
 - public sector reform
 - privatization of SOEs
 - the decrease of the number of SOEs, their subsidiaries, and employment

- Establishing an advanced market economy
 - became much more open to international capital flows
 - the enhancement of the transparency of corporate management
 - the improvement of the working of the financial market

V . From the economic crisis to the present (1997-2009)

The 2008 global financial crisis and the Korean economy

Output growth: Comparison of 1997-1999 and 2008-2010




- In the last quarter of 2008, output contracted by 17%, but returned to positive growth in the first quarter of 2009
- The pain was milder than during the 1997 crisis.

VI. Conclusion

Conclusion

- In the 1960s and 1970s, Korea concentrated its efforts on fostering economic growth
- The government employed financial repression to support exporting companies and HCIs
- In the 1980s, the risk partnership system was not dismantled but strengthened and played a part in triggering the financial crisis in 1997.
- The Korean government strived to restructure the corporate and financial sector and to install an advanced market system with institutional reforms.



The Korean economy still faces many challenges

1.4 PROSPECTS FOR THE KOREAN ECONOMY

1.4.1 Policy Framework

- further interrelated, integrated, and competitive world economy
- moving toward a knowledge- and information based economy
- the rise of China
- declining growth and ageing of the population



- market principle and global standards toward globalization
- ameliorating demographic growth and an ageing population
- R&D and an advanced education system

KOREA



Q&A