A BRIEF HISTORY OF KOREA'S ECONOMIC DEVELOPMENT[1]

by Ban-Seok Cheong

Before 1960s: Pre-Development Stage

After being liberated from Japanese rule in 1945, Korea was divided into half, with the southern half being ruled by the U.S. and the northern half being ruled by the U.S.S.R. This division of the Korean peninsula caused a tremendous shock to the South Korean economy because most of the industrial foundation— for example, the electricity production and raw materials—was located in the northern half. The Korean War (1950-3) essentially ruined the small economy that did exist, and as a result, throughout 1950s the South Korean economy was greatly dependent on aid from the U.S. Therefore, the economic system at this time could accurately be called an "aid economy"[2]

1960s: From Agrarian Society to Industrial Economic System

After a coup d'etat in 1961, General Park Chung Hee took power and became the President of the Republic of Korea (South Korea or Korea hereafter). Under his regime, Korea began the first stage of transforming itself into an industrial power. President Park's main strategy can be summarized as followed.

- Since private enterprises had not yet matured, the government had to be involved in every sector of the economy, such as financing, infrastructure, and the building of industry.
- Since domestic demand was minimal and insufficient, an export-oriented industrialization policy was needed.
- Since resources were limited, the government had to control the distribution of resources.
- Since Korea had to escape from absolute poverty, economic growth was the top priority of the overall economic policy (as opposed to income distribution or other policy goals).

From 1962 to 1966, the "First Five-year Plan for Economic Development" was implemented. This plan basically had two goals: building infrastructure and nurturing strategically chosen industries (cement, refined oil, and fertilizer, for example) for import substitution. During this period, the average rate of economic growth was about 8% (See Figure 1 at the end), and the unemployment rate was lowered from 8.2% to 7.1%.

During the Second Five-year Plan (1967-71) light industry goods such as shoes, plywood, bags and cloth started to be exported. Those products were competitive in the international

"Since Korea had to escape from absolute poverty, economic growth was the top priority of the overall economic policy (as opposed to income distribution or other policy goals)."

1) This article refers mainly to
Kihwan Kim, *The Korean Economy*, Korea Development Institute, 1985
Chung-yum Kim, *Policymaking on the Front Lines*, The World Bank, 1994
Keun-Yung Lee, "A Perspective on Structural Adjustment in the Korean Economy", *1998 Korea's Economy*, Korea Economic Institute of America, 1998

2) Some economists insist that this era of an "aid economy" includes not only the 1950s, but also the early 1960s.

market because of the cheap labor force in Korea. Thanks to these industries, the Korean manufacturing industry was able to grow up to 22% a year, and Korea accumulated capital for further investment.

The most remarkable thing about this period was the successful attempt for structural adjustment to reform the overall economic system. The 1960s were a period of successful structural adjustment not just because of the economic statistics, notable as they were. This period marked the beginning of Korea's transition from a traditional agrarian society to a modern industrial society. This real structural adjustment encompassed not only the economic system but the social system as well. One example is the massive migration of the population from rural areas to urban and industrial areas.

"The policy adjustments to all these changes fell into three categories: accelerating the development of heavy and chemical industries, diversifying trade, and increasing domestic production of major food grains."

1970s: Concentrating on Heavy Industries, Diversifying Trade, and Increasing Grain Producttion

Entering into the 1970s, there was a growing worldwide trend toward protectionism in the world economy. At the same time, the Korean Government began to feel the need to assume a greater responsibility for its own national defense. Accordingly, the Government decided to promote the heavy and chemical industries, to improve its export composition structure and also build up its defense-related industrial base.

The worldwide commodity boom of 1972-73 and the quadrupling of oil prices in 1973-74 also affected the Korean economy greatly. Higher prices for imported grains led Korea to try to develop its own agricultural resources and achieve self-sufficiency in major food grains. The oil price increases in 1973-1974 forced Korea to respond to an alarming deterioration in its balance of payments in an unprecedented fashion, and perhaps with insufficient forethought.

The policy adjustments to all these changes fell into three categories: accelerating the development of heavy and chemical industries, diversifying trade, and increasing domestic production of major food grains.

The development of heavy and chemical industries was already an important priority in the Third Five-year Plan (1972-1976), and because of the new political and economic environment noted above, the development of these industries was given added emphasis. The Heavy and Chemical Industry Development Plan, announced in 1973, called for an accelerated schedule to develop technologically sophisticated industries to meet defense needs and also to upgrade the composition of exports.

In order to deal with tariff and non-tariff barriers, Korea developed new exports and diversified export markets geographically. Successful new products were most noticeable in the electronics, steel, and shipbuilding industries. However, efforts to improve the quality of light manufactured exports such as textiles, footwear, and leather goods were inadequate due to a lack of funds.

The efforts to achieve geographic diversification of exports were initially directed to all regions but were most successful in the Middle East and Europe. The share of commodity exports to the Middle East rose from 1.8% in 1973 to 11.7% in 1976, and those of Europe from 11.8% to 17.5%. In the Middle East, Korea sold construction services as well as goods. Gross earnings from construction contracts won in the region by end of 1978 totalled almost 15 billion dollars.

When the Third Five-year Plan was being formulated, the growing gap between rural and urban incomes became a major social concern. This social concern, combined with the prospect of a deteriorating balance of payments due to the international commodity boom, led to the adoption of an agriculture policy aimed at self-sufficiency in major food grains, particularly rice and barley.

To achieve the twin objectives of improving rural income and achieving self-sufficiency in food grains, the government adopted a grain price support program. Initially the program was highly successful, particularly in increasing rice yield per acre and also in reducing the urban-rural income disparity. The program, however, failed to serve the long-term interests of the nation. For one thing, the operation of the program meant a substantial budgetary deficit which added to inflationary pressure. In addition, by encouraging the production of grain at a time when consumer demand was shifting away from grain to non-grain products, the program contributed to an imbalance in the supply and demand of agricultural commodities.

The three major policy thrusts just examined contributed to the high annual average growth of 10.8% between 1972 and 1978. These policy thrusts also contributed to the upgrading of the export structure. The share of heavy and chemical industrial products in total exports rose from 21.3% in 1972 34.7% in 1978.

It should not be overlooked, however, that these changes were achieved at the cost of a high rate of inflation. Between 1972 and 1979 the average annual rate of inflation was nearly 18% as opposed to about 12% between 1962 and 1971. In addition, these changes resulted in serious imbalances in the economy, the most serious being: over-investment in heavy industries and under-investment in light industries; extensive price distortion and lack of competition due to government controls; and a rise in real wages which exceeded productivity increases. These imbalances led to the weakening of export competitiveness and brought about a slowdown in the overall growth of the economy.

1980s: Taming Inflation but a Missed Opportunity

The second oil shock in 1979 was a huge disaster for the Korean economy. Prior to the second oil shock, the excessive investment in heavy industries, the unstable monetary policy and nationwide trend of speculation had been weakening the economy. The second oil shock aggravated the already-bad situation. In 1980, for the first time in more than 20 years the economy experienced negative growth of 3.9%, while inflation soared to 28.8% measured in consumer prices (See Figure 1).

President Chun Doo Hwan, who was inaugurated in September 1980, undertook wide-ranging policy reforms to deal with this critical economic situation. The policy reforms that were implemented had three major objectives: price stability, continued economic growth, and improved income distribution.

In retrospect, his policies on many areas had only a nominal effect on the workings of the economy. With stability, however, he had profound success. That is, he tried to transform the Korean economic system from a high-inflation economy to a low-inflation economy, and it was very successful. The annual inflation rate during the 1980s was lowered to an average of 7%. Since then it has been very unacceptable to both the Korean Government and the Korean public to return to the era of double-digit inflation. One thing remarkable about this adjustment to a low-inflation economy is that the timing of this policy change was rather unusual because the year 1980 marked Korea's worst economic performance since the Korean War.

With comprehensive stabilization efforts during the first half of the 1980s and thereafter,

"The growing gap between rural and urban incomes combined with the prospect of a deteriorating balance of payments due to the international commodity boom, led to the adoption of an agriculture policy aimed at self-sufficiency in major food grains, particularly rice and barley."

"In 1980, for the first time in more than 20 years the economy experienced negative growth of 3.9%, while inflation soared to 28.8% measured in consumer prices (See Figure 1)."

"With comprehensive stabilization efforts during the first half of the 1980s and thereafter, the Korean economy soon returned to its earlier growth path. The growth rate recovered to 5.5% in 1981 and rose higher thereafter."

"The Kim Young Sam government entered the scene in February 1993. By then it was widely recognized that the Korean economy was losing its competitiveness in the world market."

the Korean economy soon returned to its earlier growth path. The growth rate recovered to 5.5% in 1981 and rose higher thereafter. Price stability was quite noticeable, as the inflation rate decreased to 22% in 1981, to only 7% in 1982, and below 5% since 1983. One area which remained unimproved was the balance of payments, as the current account deficits remained large.

Then the Korean economy experienced the best three-year period (1986, 1987 and 1988) in its history. Growth rates were above 11% each of these years, while inflation continued to decline to 3% in 1986 and 1987 (although it rose to 7% in 1988). What was really remarkable was the improved balance of payments situation. The current account balance, a one billion dollar deficit in 1985, suddenly improved in the following years. The current account showed a $5 billion surplus in 1986, a $10 billion surplus in 1987, and a $14 billion surplus in 1988. All of these improvements reflected a rapid growth in exports that was made possible especially because of relatively low Korean wages, low interest rates, low oil prices, and the strong Japanese yen.

Korea should have utilized this golden opportunity to upgrade the economy to produce higher value-added, technology-intensive, refined goods and services which could compete in the world market. Korea felt quite comfortable with her economic system that produced goods and services that were price competitive largely because of cheap labor. Korean policy makers erringly believed that the current account surpluses would remain forever and that the era of balance of payments deficits had disappeared for good. While just spending away the current account surplus, they neglected to implement the policies needed to improve industrial competitiveness.

Early 1990s: Worsening Competitiveness

The Roh Tae Woo presidency began in February 1988. With the surge of the general democratization sentiment and President Roh's relatively lenient attitude, nationwide waves of large and violent labor protests erupted. Such protests had been suppressed during the 30 years of rapid industrialization. During this rather noisy period, the manufacturing sector wage level rose 20% annually, while the consumer price index rose 7%, cutting the competitiveness of Korean exports in world markets.

The Kim Young Sam government entered the scene in February 1993. By then it was widely recognized that the Korean economy was losing its competitiveness in the world market, as the opportunity for transforming it into an efficient high value-added one in the latter half of the 1980s had been squandered, while wage levels had been allowed to rise excessively. Abroad, the newly industrializing economies of Malaysia, Thailand, Indonesia and China started to challenge Korean exports. Something had to be done.

At this critical period, the new economic team tried to boost the economy by stimulating domestic demand. In other words they undertook cyclical measures, not structural measures, and lost the political momentum available for structural adjustments. One meaningful economic measure, though, was the "real name system in financial transactions" introduced in 1993.

One notable development which must be pointed out is that in the late 1980s and early 1990s, Korea began to open wide its goods and capital markets. The current account surpluses enjoyed in the late 1980s along with the global Uruguay Round of trade negotiation led Korea to open its manufactured goods market almost completely. In addition, the Korean Govenrment laid out plans to liberalize the exchange and capital markets and began their implementaion. Such liberalization measures were also needed for Korea's bid to join the OECD. However, this development combined with the high-cost structure of the economy helped contribute to a huge current account deficit and a shortage of foreign currency reserves by the mid-1990s.

New Attempts for Truly Advanced Economic System

Having gone through two years of lower growth, the Korean economy returned to an 8~9% growth path in 1994 and 1995 due to the rapid growth of exports that was made mainly possible by the stronger Japanese yen. Unfortunately this export growth made everyone forget about the long-belated structural adjustments.

But in 1996 export growth again dropped to only 4% as prices for major export goods such as computer chips plummeted and the Japanese yen weakened. The current account deficit rose sharply to 5% of GNP from 2% the previous year. The growth rate fell to 7% and again to 5% in 1997 and the current account deficit reached a recond $23.7 bil. By then it was evident that there were some things fundamentally wrong with the Korean economic structure, political-economic order and economic strategy. Most people agreed that major a overhaul was long overdue. VIP *(e-mail: bsjoung@hri.co.kr)*

"Having gone through two years of lower growth, the Korean economy returned to an 8~9% growth path in 1994 and 1995."

"In 1996 export growth again dropped to only 4% as prices for major export goods such as computer chips plummeted and the Japanese yen weakened."

〈Figure 1〉 Key Indicators of Korean Economy