KOREA’S ECONOMIC MIRACLE: FADING OR REVIVING?

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Chapter 1

Introduction

1.1 Background

After the devastation of the Korean War and the partitioning of the country, South Korea was one of the very poorest countries in the world. Economic recovery during the period 1953 to 1961 was characterised as being very slow, heavily dependent upon US financial assistance, and was focused upon an import substitution development policy. By the early 1960s the import substitution policy was recognised as having failed, and, by 1962, a “switching point” was reached whereby emphasis instead was to be placed on the development of export oriented industries. The country’s substantial investment in both private and public education during the period after the war provided a well-educated labour force that formed the backbone of the country’s export oriented labour intensive industries. The country’s starting point for its export led industrialisation was, however, inauspicious, with a per capita GDP at only US$87 in current prices in 1962, much lower than that of most of its regional neighbours.

The introduction of the country’s First Five-Year Plan (1962-66) proved to be a catalyst for the remarkable transformation of the economy, enabling it to achieve by 1970 the status of a Newly Industrialising Country (NIC). Korea continued its rapid growth during the 1970s despite the two oil crises, and by the late 1970s had even overtaken Malaysia, on a per capita income basis, which was then the second most advanced ASEAN nation. By the mid 1980s Korea overtook countries such as Mexico, Argentina, Brazil, Portugal, Poland, Yugoslavia and Hungary. By 1989 Korea joined the highest income developing countries group, consisting of Israel, Hong Kong, Singapore and Taiwan. Over the period 1962-89, characterised by rapid and sustained economic and trade growth, per capita income increased from US$87 in 1962 to US$5,199 by 1989, the economy’s GDP expanded from US$2.3 billion in 1962 to US$220.7 billion in 1989, and exports increased from US$55 million in 1962 to US$61.4 billion in 1989.

From the mid 1980s the economy entered a new phase with the onset of the so-called “three lows” – low oil prices, a lower US dollar, and low interest rates. For the first time in the economic history of Korea domestic savings began to consistently exceed investment, with the saving rate rising to over 30 percent of GDP, and the international balance of payments turning from a chronic deficit position to a surplus. As a result Korea was able to rapidly reduce its foreign debt, which had peaked at US$46.7 billion in 1985. It was no longer necessary for Korea to worry about foreign debt and rely on advanced countries for economic assistance. By the late 1980s Korea appeared to have achieved its earliest goal of realising economic independence. An economic ‘miracle on the River Han’ appeared to have been achieved.

Few countries in history have attained so rapidly such a high level of development. In a single generation this poor nation, consisting primarily of subsistence farmers in the 1950s and early 1960s, had become by the mid 1990s the world’s largest producer of home appliances, the second largest producer of semi-conductor chips, the second
largest ship builder, the fifth largest car maker, the 11th largest economy, and the 12th largest trading nation. Rapid economic growth and development with low unemployment, driven by high savings and investment and export growth became the norm for the country. By 1996, per capita income surpassed US$10,000 and remained relatively equally distributed, while living standards for ordinary Koreans increased dramatically. The country’s attainment of OECD membership in December 1996, signified the culmination of 35 years of extraordinary growth and the economy’s coming of age. For many developing countries Korea’s economic development model, state directed capitalism, appeared to offer a viable framework with which to replicate such rapid development.

Despite these remarkable achievements, structural weaknesses and an inability of the country’s political and economic organisations to keep pace with the country’s material achievements began to undermine the economy from the early 1990s. Reform and liberalisation was urgently required in a number of key areas: the corporate sector; financial markets and the banking sector; the labour market; the small and medium sized enterprise sector; and also in trade and investment. At the core of these problems was the close relationship between the government, banks and the so-called chaebols (business conglomerates) which lay at the heart of the state led capitalism development framework. In particular, the state guided banks’ habit of lending on the basis of political whim rather than proper risk assessment resulted in a severe misallocation of resources, and a substantial accumulation by the banks of non-performing loans. Government backed industrial policy resulted in an overly close relationship between the government and the business conglomerates, which resulted in corruption, a sapping of entrepreneurial creativity and growth, and an unwillingness to open up the economy to foreign trade and investment due to the chaebols wishing to protect their own interests and dominance over domestic markets.

This system resulted in excessive and ill utilised loans to the chaebol, with little concern for adequacy of return and risk, and resulted in: over-capacity in many sectors of the economy; dangerously over-leveraged chaebol; a crowding out of small firms; less innovation and flexibility in the economy; and the accumulation of non-performing loans by the banking system. This was exacerbated by capital market opening from 1993 that led to a rapid increase in capital inflows, over-borrowing, particularly in the form of short-term debt, and an overvalued domestic currency. During 1997 the country’s financial and corporate fragility was exposed. An unprecedented eight conglomerates were declared insolvent or sought protection from their creditors, leading to increasing bad debts for the banking system which then tightened credit and caused more difficulties and corporate failures. The situation was exacerbated by the dramatic decline in the value of the won, the domestic currency, against the US dollar towards the end of October 1997, as investor confidence in the currency and economy waned. The banking and corporate sectors’ need to service foreign loans primarily denominated in US dollars in exchange for domestic currency, as well as currency dealers questioning the ability of the country to pay back its US$153 billion in foreign loans of which two-thirds was shortly maturing debt, put downward pressure on the currency. By the end of 1997 it was clear that re-establishing confidence in the currency and financial markets was a top priority, and that major restructuring of the economy was required. The old model of economic development appeared to have run its course, and the need to move towards the development of a market oriented new economy was required.
Structural weaknesses in the corporate and banking sectors, in particular, left the country in a particularly fragile financial situation by the second half of 1997. The danger signs became apparent during the early part of 1997 with the Hanbo Steel debacle, which was to prove to be the precursor for an unprecedented number of business insolvencies, including 8 of the 30 largest chaebols. On 2 July 1997 the devaluation of the Thai baht, and its subsequent contagion effect to other regional currencies including that of the Malaysian ringgit, the Filipino peso and the Indonesian rupiah, provided the trigger for the financial crisis in Korea. The regional financial crisis resulted in an unprecedented withdrawal of capital, some US$100 billion net private capital within the space of six months mainly in the form of short-term capital and led by foreign commercial banks, which contributed to the further downward spiral of regional currencies and stock markets. Korea managed to avoid the brunt of this financial turbulence until October, when countries such as Taiwan and Hong Kong succumbed to the regional crisis. Finally, however, the country turned to the IMF on 21 November 1997 as the rollover ratio of short-term external borrowings by domestic financial institutions kept decreasing and the country’s usable foreign currency reserves plummeted to US$ 7.3 billion, down sharply from US$ 22.3 billion only a month before. On 3 December 1997 Korea and the IMF signed an agreement for a financial aid package totalling US$58.3 billion, subject to a broad range of conditions including macroeconomic stabilisation and structural reform. The IMF committed emergency funds amounting to US$21 billion. An additional US$14 billion was committed by the World Bank and the Asian Development Bank. As a second line of defence an additional US$23.3 billion was pledged by the United States, Japan, Australia and other interested countries.

The causes and consequences of the crisis have invoked a plethora of literature and discussion, from which no apparent consensus can be discerned. However, two major viewpoints are apparent. The first emphasises weaknesses in economic fundamentals as being at the core of the crisis. This position emphasises structural weaknesses and policy distortions as the major causes of the crisis, although this position also acknowledges that the panic reaction of investors played an important role. A variant on this argument emphasises the role of moral hazard and its contribution to imprudent banking and corporate failure, arising from over-investment due to a widespread belief among debtors and creditors that they would be bailed out if their investments went bad. The second emphasises the role of a sudden shift in market expectations and confidence. While this latter view also recognises that structural and policy weaknesses were at work, they are incapable of explaining the depth of the ensuing financial, economic and social crisis. Blaming the crisis on only one factor, however, is likely to give an unsatisfactory and too simplistic an explanation. In the case of Korea blaming it solely on an economic system once praised as a successful model for development is not satisfactory, particularly given that the economy had operated without a financial crisis for many years under the same circumstances. Similarly, attributing it exclusively to irrational (or rational) speculative attacks and contagion is insufficient, since the contagion varied widely across the East Asian countries. The truth is likely to contain elements of both of these explanations. The interpretation of the crisis is important, however, since this will have a major bearing upon the framing of an appropriate policy response. An incorrect interpretation of the
forces driving the crisis could lead to an inappropriate policy response that simply intensifies the extent and impact of the crisis.

In attempting to isolate the key factors in the context of Korea the authors draw an analogy between an economy’s financial system and the human circulatory system. In particular the notion of a ‘stroke’ is used, which occurs when there is a sudden blockage of an artery in the brain by a blood clot or by other debris carried in the bloodstream. This approach may be considered as a kind of general systems theory. The ‘stroke’ hypothesis synthesises and presents most of the appealing explanations and theories of the financial crisis, and shows how the numerous factors were coherently intertwined in causing the financial crisis in Korea. The hypothesis also allows a systematic evaluation of the consequences and the performance of the IMF’s structural reform program.

The onset of the crisis in late November 1997 focused the attention of the authorities on re-establishing stability in the foreign exchange market and financial markets more generally. Initially this involved turning to the IMF, and other international financial organisations and countries, for emergency support funds. The limited success of this in calming financial markets resulted in the government negotiating an extension of the maturities of financial institutions' short-term external debts in January 1998, and the issuing of foreign-currency-denominated government bonds in April that year. The authorities supplemented these measures with economic stabilisation policies, in particular a high interest rate policy, and mounted a wide-ranging drive for structural reform of the financial, corporate, labour and public sectors. The policy framework and structural reforms ultimately had a positive effect on confidence that boosted capital inflows, bolstered by a huge current account surplus, and stabilised the exchange rate from early 1998.

With stability in the foreign exchange market achieved, the stance of monetary policy then turned to lowering interest rates with the objective of reversing the decline in domestic consumption and investment demand. This was further supported by a mildly expansionary fiscal policy. As a result, a remarkable recovery of the economy began in the second half of 1998 that gathered momentum in 1999. This quick and strong V-shaped economic recovery facilitated further restructuring in the corporate and financial sectors, which lay at the heart of the structural reforms. However, by mid 2000 it was clear that the pace of reform had slowed, partly reflecting complacency in the context of double digit output growth achieved in 1999 as well as the politicisation of economic issues in the run up to national elections in April 2000. Since the second half of 2000 the Korean economy again began to show some instability due to a slowdown of GDP growth and a bearish movement of the stock market, attributable to a too rapid V-shaped economic recovery without sufficient restructuring of the financial and corporate sectors. The slowdown in growth in the latter part of 2000 exacerbated existing underlying weaknesses in the corporate and financial sectors. As a consequence the government initiated a second round of reforms to try and restore, once again, confidence in the Korean economy. These policies and structural reforms were promulgated on the basis of reviving the “old” macro-economy. However, it is clear that if Korea is to achieve a return to high and sustainable rates of economic growth it will be essential to place greater emphasis on the development of the “new economy”.
The world is experiencing a knowledge revolution that is contributing to a major transition from an industrial society into a new economic paradigm where information and knowledge are the principal drivers of competitiveness. While this new economic paradigm is variously referred to as the “new economy,” “digital economy”, or “knowledge-driven economy,” it has a common feature in that the driving force behind it is rapid advances in information and communications technology (ICT). Bringing with it fundamental changes to the economic transaction modes of business and government, and lifestyles. The Internet and electronic commerce (e-commerce) are growing at breathtaking speed, altering fundamentally the way people work, consume, communicate, and play. Access to ICT-related tools and skills are becoming crucial components in economic development worldwide, and in disparities relating to this.

With limited natural resources Korea developed mainly through an outward-oriented, industry-led strategy based on large firms. Although this strategy produced remarkable results for the economy while it remained rather small and simple, until the end of the 1980s, this was challenged in 1997 with the onset of the financial and economic crisis. The old economic paradigm came under close scrutiny. Recognising that for Korea to become more competitive in world markets, and to make its growth sustainable, it now needs to move away from the old paradigms toward new modes of development and to make the transition to a knowledge-based economy. Hence in order to answer the question as to whether the Korean economic miracle will fade or revive depends largely on whether the economy is able to embrace the new economic paradigms underlying the “new economy”. This will also require the movement away from state direction in the operation of the economy to one where the market plays the major role in allocating resources.

While changing the economic paradigms under which the economy is to operate will have important implications for the future development of the economy, another potentially important development relates to enhanced economic cooperation or integration between North and South Korea. During 2000 President Kim Dae Jung of South Korea and Chairman Kim Jong Il of North Korea held an inter-Korean Summit, marking a historic turning point in inter-Korean relations. The summit produced the South-North Joint Declaration, an agreement that aims to promote peace, reconciliation and co-operation between the two Koreas. The Joint Statement states, “the South and the North have agreed to consolidate mutual trust by promoting balanced development of the national economy through economic co-operation and by stimulating co-operation and exchanges in civic, cultural, sports, public health, environmental and all other fields.”

North Korea, consisting of 22 million people, is the other half of the divided Korean peninsula, and has been effectively isolated from South Korea and the rest of the western world since the end of the Korean War. Depending upon how the South copes with the newly shaping North Korea, South Korea - and North Korea - may find a new way to revive their own economies. South Korea may find a new economic territory, in the new climate of détente.

1.2 Structure of the book

The book consists of four key parts. Firstly, in Part A, focus is placed upon providing
background information relating to the rapid growth and development of the South Korean economic miracle covering the period from 1962-89, and the fading of the miracle with the onset of economic weaknesses during the period 1990-97. This is contained in Chapters 2 and 3. The second part, Part B, focuses upon the financial and economic crisis of 1997-98, both immediately before and after the crisis. This is contained in Chapter 4. The third part, Part C, emphasises three key areas that need to be tackled if the country is to return to high and sustained growth of the economy over the long term, focusing upon ways of reviving the old economy through macroeconomic measures and structural reform, developing the new economy, and expanding economic cooperation between the North and the South. This is discussed in Chapters 5, 6 and 7. Finally, the fourth part, Part D, deals with what else needs to be done to maintain sustainable growth, and increase the quality of life and welfare of the Korean people in the 21st century. This is discussed in Chapter 8. This chapter also provides some discussion on the prospects for the Korean economy in the 21st century.

The book proceeds as follows. Chapter 2 examines the major factors behind the remarkable transformation of the Korean economy over the period from 1962-89. Described as the period of the Korean economic miracle. Developments in key macroeconomic variables are presented, giving particular focus to that of economic growth and the growth of exports. In addition the key features of Korea’s rapid growth, growth pattern, and sources of growth, business cycles, and related issues are also discussed. The contribution of trade to structural transformation is also highlighted as well as the changing industrial structure and policies during this period. The role and conduct of Korean economic planning and policy formulation during this period is also given emphasis.

It is argued that Korea’s economic performance over the period 1962-89 can rightly be described as an economic miracle. The catalyst for this remarkable transformation being the adoption of an outward oriented industrialisation growth strategy, based upon export expansion, in conjunction with a strong government, and policy-makers with considerable foresight. By the end of the 1980s, however, the need to attain a more globally competitive and liberalised economy was becoming paramount. At this point in time the future for the Korean economy appeared to depend upon how the country managed its transition to a mature developed economy. In particular, how best to conduct the further transition of the economy from being government led to market oriented; and how to cope with capital market opening.

Chapter 3 reviews the achievements of the Korean economy during the pre-crisis period 1990-97, and compares this with other regional economies. The chapter highlights the early warning signs for the region in terms of slowing export and GDP growth in the period prior to the crisis. For Korea, the apparently benign macroeconomic environment of the 1990s is shown to have hidden growing financial weaknesses in both the corporate and financial sectors and an unprecedented accumulation of short-term debt. The latter arising as a direct result of a liberalisation of short-term capital movements. These developments increasingly exposed the country to financial turbulence in global and regional financial markets. Such fragilities were of little concern in an environment of rapid growth of exports and output, but with the deterioration of the country’s terms of trade and resulting growth slowdown in export values in 1996 and 1997 the highly over-leveraged corporate sector came under intense profitability and cash flow pressures. An already shaky
financial sector, arising from imprudent and excessive lending to the chaebols, experienced a further sharp deterioration in their non-performing loans. Government action to tackle this problem head on was lacking. The country’s economic miracle appeared to be fading. By October 1997 further pressure began to be strongly applied by international investors on the currency as concerns over the third major fragility, excessive short term foreign debt, came in to play. The financial crisis was triggered and the period of the economic miracle seemed far distant.

Chapter 4 conducts a review of developments immediately preceding the crisis and in the immediate aftermath of the crisis, and in doing so identifies the key triggers for its occurrence. A brief review of competing explanations for the crisis is also presented. A systematic and comprehensive framework, in the form of a “stroke hypothesis”, for analysing the financial crisis encapsulating the key features of the Korean financial crisis is discussed and developed. The IMF’s structural reform program in the context of the Korean financial crisis is also conducted. It is argued that the financial crisis was initially badly handled by the IMF, whose policy response in the form of tight monetary and fiscal policy with a severe interest rate hike turned the financial crisis into an economic and social crisis. While the structural reforms required by the IMF are of considerable importance for the long term economic growth of the economy, their emphasis in the context of an economy suffering from a temporary liquidity shortage, specifically that of foreign exchange reserves, detracted from the immediate problems and merely served to compound the country’s difficulties. It is also argued that if the contagion effects within the region had been tackled more effectively early on in the process, through an appropriate IMF response, this could have spared Korea its subsequent economic trauma. In 1998 the country suffered its worse recession in the post war era. However, from the middle of this year the country staged a remarkable recovery that continued most impressively into 1999 and then into 2000.

A review and assessment of the macroeconomic management and restructuring process in the wake of the financial crisis in Korea is conducted in Chapter 5. The macroeconomic policy framework adopted by the Korean monetary authority in an effort to stabilise the currency, and to recover and maintain macroeconomic stability, is initially discussed. This is followed by a discussion of the structural reform process pursued by the Korean government in an effort to address more fundamental weaknesses in the economy. Focus is then placed upon the key structural reforms that have been conducted as well as progress made to date. In particular focus is given to reform in five key areas: the financial sector, the corporate sector; the labour market; the public sector; and further liberalisation of the capital and foreign exchange markets. While considerable progress can be identified in each of these areas much still requires to be done, and it will remain essential for the authorities to maintain the reform momentum. Outstanding challenges that still remain to be overcome in the process of returning to high and sustainable rates of economic growth are also identified. While Korea’s recovery from the depths of the economic crisis in 1998 was truly remarkable, exemplified by a rapid V shaped recovery in economic growth, there is no room for complacency. Since the second half of 2000 the growth of the economy has slowed once again, and confidence in the economy has retreated. Internal and external factors indicate that the economy faces a bumpy ride in the imminent future. However, maintaining macroeconomic stability and the reform momentum must remain the centrepiece of government policy, if sustainable
economic growth is to be achieved over the medium to long term of the so-called “old economy”.

While the recovery of the old economy can play an import role in the further development of the economy in the short to medium term, it will be the new information and knowledge intensive industries that will provide for longer-term economic growth and development. Chapter 6, consequently, provides an overview of the current state of play of Korea’s information and communications technology (ICT) industries and their impact on the overall economy, and discusses the challenges and prospects from the emergence of the new economy in Korea. Since the 1960s the economic growth of Korea has been driven by several industries, which varied from period to period. Growth in the 1960s was driven by labour-intensive light industries such as textiles and clothing, while the period of the 1970s witnessed the significance of capital-intensive heavy and chemical industries. During the 1980s a more balanced approach to economic growth was apparent. High-tech assembly industries such as the electronics and automobile industries took turns in driving growth during the period of the 1990s. The ICT sector and the Internet provide a new potential for innovation in the Korean economy. It is argued that Korea is likely to benefit more from ICTs and the Internet than any other country in the world. Given its rapid progress in developing the ICT sector, it seems now that ICT-related industries are about to, if they have not already done so, take the lead in the Korean economy during the 21st century. They can allow Korea to leapfrog old technologies and help it catch up with developed countries like Japan. This chapter also examines the development and role of ICT industries as a driving force behind the nation’s recent record of fast growth and low inflation. It also discusses the challenges and prospects that the emergence of the new economy may pose to Korea. Nonetheless it is expected that much of its impacts are still to come, and the ICT industries may lay a new momentum of vitality for the Korean economy that will provide the main engine of growth over the next couple of decades.

Chapter 7 reviews the current state of the North Korean economy, focusing upon the prospects for major economic reform and increased openness for this economy. A review of the current state of inter-Korean relations is also conducted. The chapter identifies how a gradual process of economic integration between the two Koreas could ultimately lead to the peaceful re-unification of the peninsula, and enhance the efficiency of resource allocation in both economies. However this will depend upon the willingness of the North Korean elite to countenance major economic reform and openness. It is argued that even though the long-term objective for North and South Korean economic development is to make the two economic structures mutually co-operative and organically connected, so that they could develop into a single national economy, a fixed timetable is neither necessary nor desirable. What is needed is to establish reconciliation and co-operation first in economic fields, and then gradually to move on to the goal of political unification. Once goods and factors of production (labour and capital) are allowed to move across the borders, the two Koreas will have achieved a de facto stage of unification. The final stage of political unification of the peninsula could take decades, perhaps as long as another half century.

Finally, chapter 8 discusses outstanding issues in the attainment of sustainable growth, and increasing the quality of life and welfare of the Korean people in the 21st century. Three of these are given particular focus. The first of these relates to the Korean
education system. The country’s education system needs to be innovated to embrace the new economy, which will require its businesses, individuals and government to create, acquire, transmit and use knowledge and information effectively for greater economic and social development. This will require an educated population that can create and efficiently use knowledge and information. Therefore developing an appropriate education system to produce creative and knowledgeable people will be fundamental for Korea’s transition to the new economy. Second, Korea needs to adopt systemic reforms of its welfare system and to develop a social safety net and public pension system that will promote an efficient labour market as well as equitable support for marginal workers, the poor, and the elderly. In order to promote labour market flexibility, credible insurance against the risk of loss of employment and income for workers needs to be provided by the government. Thus an adequate social safety net is in need not only for reasons of equity but also for the efficient operation of the labour market. Third, Korea needs to open up the economy further to trade and foreign investment. Opening up to trade and foreign investment provides more competition and thereby improves the productivity of the overall economy. This will also result in a faster accumulation of capital in the Korean economy.

The chapter concludes with some discussion on the prospects for the Korean economy in the 21st century, suggesting that reviving Korea’s economic miracle over the long term will depend on how Korea tackles the problems behind its diminishing source of economic growth. First of all, successful restructuring of the old economy is important not only for the short to medium term prospects, but also for Korea’s growth potential over the long-term. Implementing the principles of the market and competition will increase the efficiency of the overall economy, particularly of the “old” economy. This will also help bring more investment from both internal and external sources, and result in greater capital accumulation. Secondly, implementing, successfully utilising, and developing ICT and Internet innovations, and thereby transforming the Korean economy into the new economy, will be crucial in reviving the economic miracle. Finally, expanding Korea’s new economic territory, by successfully pursuing economic integration with the North, is another key to the revival of the Korean economic miracle. The gradual development of economic integration between the two Koreas will make North Korea become a new market for South Korean exports, a new investment opportunity for South Korean firms, and a new source for labour.