Korean Economic Development Strategy

Part I: History of Economic Development

Part II: Economic Crisis Management

Part III: Concluding Remarks

Korea Development Institute (KDI)
Part I: History of Economic Development

1. Transformation of the Korean Economy
2. Economic Take-Off with Outward Looking Strategy
3. Pitfalls of Government-led Development
4. Delayed Economic Reform and Financial Crisis
1. Transformation of the Korean Economy (1945~2005)

A. Growth Trend

- Liberation from Japanese Colonial Rule: 1945
- Financial Crisis: 1998
- OECD Member: 1995

Per Capita GNI (US$)

- 1945: 67
- 1953: 87
- 1962: 100
- 1970: 1,000
- 1980: 11,432
- 1990: 7,355
- 1995: 1,000
- 1998: 11,432
- 2005: 16,291

6 Five-Year-Economic-Development Plans

Financial Crisis
B. Changes in Industrial Structure

Changes in Employment Structure

<table>
<thead>
<tr>
<th>Year</th>
<th>Service Sector</th>
<th>Agriculture / Fisheries</th>
<th>Manufacturing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>28.3%</td>
<td>63.0%</td>
<td>7.9%</td>
</tr>
<tr>
<td>2005</td>
<td>73.5%</td>
<td>18.6%</td>
<td>7.9%</td>
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</table>

Changes in GDP Structure

<table>
<thead>
<tr>
<th>Year</th>
<th>Service Sector</th>
<th>Agriculture / Fisheries</th>
<th>Manufacturing</th>
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</thead>
<tbody>
<tr>
<td>1960</td>
<td>47.3%</td>
<td>36.8%</td>
<td>15.9%</td>
</tr>
<tr>
<td>2005</td>
<td>68.4%</td>
<td>28.1%</td>
<td>3.5%</td>
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</tbody>
</table>
2. Economic Take-off with Outward-looking Development Strategy (1960~80)

A. Economic Conditions of the early 1960s

- Weak Technology Base
- Underdeveloped Private Sector
- High Level of Education
- Strong Economic will

5
Note 1: Basic philosophy of the 5-year plan:

five principles!

1. Korean economic development should be achieved through industrialization.
2. Economic development should be achieved under government control and leadership.
3. Although firms should be owned and managed privately, the government could implement private decisions in the case of major investments (“a variant of authoritarian capitalism”, Cho Soon).
4. To finance investments, foreign capital inflows should be induced.
5. Growth should have a higher priority than redressing imbalances in income distribution and unevenness in industrial development across geographical regions.
B. Working Mechanism of Outward-looking Development Strategy

Foreign Capital Inducement (Economic Aids, External Debt)

- Capital Good Imports
- Raw Material Imports
- Foreign Technology Imports

Economic Growth

Reproduction

Manufacturing Processing

Private Enterprises

Government

Technology Development

Financial · Tax Support

Well-educated Labor force
[Reference 1] S&T Policy

Development Stage
- Factor-Driven Stage
  - cheap labor
- Investment-Driven Stage
  - manufacturing capability
- Innovation-Driven Stage
  - innovative capability

Sources of Competition

Major Direction of Industrial Policy
- Expand export-orient light industries
- Expand heavy and chemical industries
- Expand technology-intensive industries
- Promote high-technology innovation
- Transition to knowledge-based economy

S&T Role of Government
- Scientific Institution Building
  - MOST/KIST
  - S&T promotion act
  - 5-year economic plan includes S&T
- Scientific Infrastructure Setting
  - GRI
  - Daeduck sci. town
  - R&D promotion act
  - KAIST: highly qualified personnel
- R&D and Private Research Lab Promotion
  - NRDP
  - Promoting private research labs
  - Promotion of industrial R&D
- Leading Role in Strategic Area
  - Enhancing Univ. research capability
  - Promoting co-op research
  - Policy coordination
  - GRI restructuring

Innovative Capability of Private Sector

New Challenges
[Reference 2] Education & HRD in Korea: Attainments

- Quantitative profile now: impressive; well above the OECD average
  - Education up to college level almost universalized
    * College Advancement > 80%; (College Entry/HS graduate near 100%)
    * Net Enrollment for the aged 18~21 = 41%, (No. 5 in the World)
- Superb academic performances: global leader position (TIMSS, PISA etc.)

### Size and Composition of Educational Investment (2000)

<table>
<thead>
<tr>
<th></th>
<th>OECD AVG</th>
<th>Korea</th>
<th>U.S.</th>
<th>JPN</th>
<th>UK</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP share</td>
<td>5.5</td>
<td>7.7</td>
<td>7.0</td>
<td>4.6</td>
<td>5.3</td>
<td>5.3</td>
</tr>
<tr>
<td>(Public-financed)</td>
<td>4.8</td>
<td>4.9</td>
<td>4.8</td>
<td>3.5</td>
<td>4.5</td>
<td>4.3</td>
</tr>
<tr>
<td>(Private-financed)</td>
<td>0.6</td>
<td>2.8</td>
<td>2.2</td>
<td>1.2</td>
<td>0.7</td>
<td>1.0</td>
</tr>
</tbody>
</table>

OECD, Education at a Glance 2003  (Korean figures are for 2003)
Note 2: Korean economic miracle: OECD Economic Surveys
Three distinctive characteristics

ⓐ an outward-oriented development policy based on the expansion of exports
- to overcome lack of natural resources and small domestic market
- the reform of its exchange rate policies was a key devaluation by 50% in 1964
- the complicated multiple exchange rate system was replaced with a single rate
- tax exemptions and preferential access to credit
- export-promotion policies did not distinguish between industries except during HCI (Heavy & Chemical Industry) Drive

ⓑ macroeconomic stability
- sound fiscal and monetary policies
a high level of government saving to finance public infrastructure and to provide credit to targeted sectors ⇒ made the government a net creditor

© investment in physical and human capital

- well-educated, the literacy rate was 71% in 1960, compared with an average of 29% in other low income countries
- the high level of education in Korea has enabled it to take advantage of technology transfers
- the combination of well-educated labor force and a small stock of physical capital made the return on investment high!
  - this boosted fixed capital formation from less than 10% of GDP in 1961 to 30% in 1980
- the socialization of risk: an implicit guarantee
  - Social capital: trust, stable legal system, ownership, etc
C. Continued High Growth Based on Strong Entrepreneurship and Government Support

- Strong export promotion supports high Growth (Export Growth of 30% per annum)

Efficient Economic Policy making
- Financial Support
- Tax Support
- Marketing Support

E P B
Office of the President
Economic Ministries

Government Think-tank

Economic Policy Design
EPB (Economic Planning Board) was established in 1963 by absorbing the budget bureau from MOF and statistics bureau from the Ministry of Home Affairs
 oval BOK (Bank of Korea) under its control
 Commercial banks were brought under gov’t control by confiscating the stocks of the banks
 Three major administrative instruments to support EOI (export-oriented industrialization):
 ① the government export targeting system
 ② the support of the government-owned Korea Trade Promotion Corporation (KOTRA) for overseas marketing activities
 ③ Monthly Export Promotion Conference presided by the President
 Ignited the people’s “will to economize”
D. Heavy and Chemical Industry Development during 1970s

- Iron and Steel
- Electronics
- Petro-Chemical Products
- Automobile
- Ship-building
- Machinery

Mobilizing Financial Resources
- Selecting National Champions (“Chaebol”)
- Accelerating Competition
Between 1960 and 1979, Employment (60%→36%) and GDP (39%→19%) share of agriculture declined thus for a more balanced growth:

(1) a shift from low grain-price policy to high grain-price policy:
   ① to increase grain production
   ② to alleviate income disparity — a two-tier grain price system

(2) the Saemaul (new community) movement in 1972 (a massive investment in rural infrastructure): a social movement to reform the farmers’ way of thinking and living,
   ① rural enlightenment,
      the spirit of self-help and cooperation, voluntary participation
   ② social development
      environmental improvements, housing improvements, public utility expansion
   ③ economic development
      buildup of the production infrastructure, income augmentation program
E. From Agriculture to Manufacturing/From Light Industry to Heavy Industry

Changes in Export Commodity Profile

- **Wig**
- **Textile**
- **Automobile**
- **Semiconductor**

Semiconductor, Mobile Phone, DTV, Display, Automobile, Ship-building, etc. 79.8% HCI Product

<table>
<thead>
<tr>
<th>Year</th>
<th>Agricultural Product</th>
<th>Light Industry Product</th>
<th>Export Commodity Profile</th>
</tr>
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<tbody>
<tr>
<td>1960</td>
<td>50%</td>
<td>14.1%</td>
<td>Wig</td>
</tr>
<tr>
<td>1970</td>
<td>50%</td>
<td>14.1%</td>
<td>Textile</td>
</tr>
<tr>
<td>1980</td>
<td>50%</td>
<td>14.1%</td>
<td>Automobile</td>
</tr>
<tr>
<td>1990</td>
<td>50%</td>
<td>14.1%</td>
<td>Semiconductor</td>
</tr>
<tr>
<td>1999</td>
<td>6.1%</td>
<td>14.1%</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>6.1%</td>
<td>14.1%</td>
<td></td>
</tr>
</tbody>
</table>
Participation in the Global Economy

1. Globalization provides immense opportunities and significant risks
   - Outward-oriented strategy
   - Integrated approach of multiple tasks
   - Optimal level of Openness (geographic condition, policy factors, institutional factors)

2. Korea is an example of economic dynamism and successful globalization (entrepreneur & GATTs)

3. Institutional preconditions & institutional reforms
   (formal & informal rules of games)
   - Committed and credible government
   - Merit based bureaucratic system without corruption
   - Interaction between the public and private sectors
   - Secure property and contract rights

A. Pitfalls of Government-led Economic Development

- Increased Production Cost
- Efficiency Loss
- Weakened Export Competitiveness

- 1979: Negative Export Growth for the first time since 1960
- 1980: Negative Economic Growth (-3.9%)
B. Recovering Growth Potential with Economic Stability

Stabilization Policy in the early 1980s

- Budget Freeze/Cut Zero-Base-Budgeting
- Phasing-out of Policy Loans and Interest Rate Deregulation
- Investment Adjustment in HCI

Results

- Disinflation Inflation at around 3%
- Strong Exports Current Account Surpluses
- High Economic Growth GDP Growth of 8% per annum
Note 5: Economic Liberalization Policy

① Import Liberalization
- was proceeded on a stop-and-go basis but gained momentum in 1984: import liberalization ratio (=automatic approval items / total tradable items) was raised from 0.80 in 1983 to 0.99 in 1994.
- The average legal tariff rate was lowered from 24% in 1983 to 18% in 1988 and 8% by 1994.
- The nominal rate of protection (=the percentage difference between domestic and world market prices) was lowered from 21% in 1982 to 14% in 1990 for manufactured goods.
- In contrast, the rate for agricultural products rose from 72% in 1982 to 101% (note that this figure is 6 times the legal tariff rate) by 1990.
- Only after 1989, liberalization of agricultural products were made: from 76% in 1989 to 92% by 1994.
Financial Liberalization

The government attempted to reduce the intervention in the allocation of financial resources.

From 1981-83,

1. Commercial banks underwent privatization,
2. Interest gap between policy loans and ordinary bank loans were almost eliminated in 1982,
3. Entry barriers into the financial industry were lowered

Financial interrelation ratio (=total financial assets/GNP) rose from 2.4 in 1980 to 4.0 in 1990 and to 4.7 in 1994. (cf: 7.1 for Japan in 1993, 6.2 for USA in 1993, 5.7 for Taiwan in 1992)
Opening of Capital Account

Korea has always been a net capital importer, relied on foreign borrowing rather than on foreign direct investment as its financing strategy.

Entering 1980s, government restrictions on FDI were relaxed: thus annual average of FDI increased from $130 million in 1980-83 to $920 million in 1988.

Despite the liberalization on the inflow of FDI, its share in total fixed investments was a mere 0.3% on average in 1981-91, much smaller than 1.9% in the 1960s and 2.0% in the 1970s.

The fear of massive capital inflows: relatively high interest rates and anticipated won appreciation.
4. Delayed Economic Reform and Financial Crisis in 1997

- Increased Corporate Failure
- Deteriorated Financial Soundness
- Continued Government Intervention

South East Asian Crisis

- Massive Capital Outflow
- Denied Rollover of Short-term external Debt

IMF Rescue Package
Part II: Economic Crisis Management

1. Government’s Reform Efforts
2. Post-Crisis Economic Management
3. Sectoral Economic Reform Efforts

Part III. Concluding Remarks
I. Government’s Reform Efforts

(1) Korea’s Reform Strategy: Full integration with the Global Economy
   ① Swift and Prudent Reforms
   ② A Coordinated, Multi-Faceted Approach
   ③ Preventing Moral Hazard
   ④ Maintaining Social Stability

(2) Korea’s Financial crisis: key factors
   ① Shortage of foreign reserves
   ② Structural weakness
   ③ Failure to keep up with globalization trend
   ④ Moral Hazard Problems
(3) IMF Programs in Action
- Quarterly Review of Economic Policies, with room of flexibility
  ~ fiscal deficit / interest rate
- IMF-Plus Package
  ~ Elimination of trading band in the foreign exchange market
  ~ Allowance of hostile foreign M&As

(4) Result of Reform Efforts
- Financial and Foreign Exchange Market Stability
- Closure of Ailing Commercial Banks
- Elimination of Cross-Debt Guarantees
- Big Deals to Eliminate Excessive Corporate Capacity
- Abolishing of a Half of Government Regulation
II. Post-Crisis Economic Management


- Focus on securing foreign currency liquidity
  ~ IMF, IBRD, ADB / rolling over / sovereign bonds / current account surplus
- Nation-wide movement of “gather-gold-for-export-and-repayment-of-national-debt”
- Legal foundations for structural reforms
  ~ legislating reform bills / agreement bet. President and five chaebols / legal framework for layoffs
(2) The Second Phase: May - June ‘99
- Full liberalization of foreign hostile M&As
- Abolishing ceiling on foreign acquisition of real estate / limits on foreign stock investment
- Closing 55 non-viable corporations / 5 commercial banks
  * 64 trillion won program for NPL problem and recapitalization
- 8.5 trillion won for unemployment program
(3) The Third Phase: July ‘98 –

- BIS ratio satisfied after injection of 38 trillion for NPL
- Top five chaebols: to improve financial status
- Four mutual funds were established
- Economic stimulus package: fiscal deficit (GDP 5%)
- 10 trillion won program for social safety net
- FIPA: investor-friendly environment
III. Sectoral Economic Reform Efforts

(1) Financial Sector Reform: Bank and non-bank financial institutions

- Of the 25 commercial banks: 13 satisfied BIS ratios
- 12 unsound banks: 5 non-viable to be liquidated, 5 to take corrective actions

★ Two remaining banks to be auctioned off:

♦ Korea First Bank to Newbridge Capital Consortium
♦ Seoul Bank to HSBC group (negotiation failed)

- Same method applied for non-bank financial inst.:
  → licenses revoked for 36, suspended for 55
<Fiscal support for financial restructuring>
- Unsound credit: 136 trillion Won (NPLs: 63.5 Won)
- **KAMCO** purchased banks’ NPL at market value, by paying in kind (KAMCO bonds):
  ※ in ’98, issued bonds (19.9 tril. Won) to purchase banks’ NPLs (44 tril. Won)
- **KDIC**: issued bond (21 tril. Won) for recapitalization and depositor protection
- Additional bond issuance (23.1 tril. Won) by KAMCO and KDIC in ‘99 to make a total of 64 tril. Won
- Fiscal resources through government-guaranteed public bonds
<Capital Market Liberalization and FDI Promotion>
- Eliminating foreign equity ownership ceilings
- Full liberalization of foreign exchange transactions
- Hostile M&As by foreigners were allowed
- Legal basis for FDI: FIPA
- One-stop service at KOTRA
- Industries further liberalized: only 31 out of 1,148 industries partially or fully closed to FDI
- Tax exemptions and reductions
### Changes in the Number of Korea’s Financial Institutions, 1997-2001

<table>
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<tbody>
<tr>
<td>End-1997</td>
<td>33</td>
<td>30</td>
<td>36</td>
<td>31</td>
<td>31</td>
<td>14</td>
<td>231</td>
<td>1,666</td>
<td>2,072</td>
</tr>
<tr>
<td>Exits (-)</td>
<td>5</td>
<td>22</td>
<td>6</td>
<td>6</td>
<td>7</td>
<td>1</td>
<td>95</td>
<td>305</td>
<td>447</td>
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<tr>
<td>Mergers (-)</td>
<td>8</td>
<td>6</td>
<td>1</td>
<td>1</td>
<td>5</td>
<td>0</td>
<td>26</td>
<td>102</td>
<td>149</td>
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<tr>
<td>Entries (+)</td>
<td>0</td>
<td>1</td>
<td>17</td>
<td>6</td>
<td>0</td>
<td>1</td>
<td>12</td>
<td>9</td>
<td>46</td>
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<tr>
<td>End - 2001</td>
<td>20</td>
<td>3</td>
<td>46</td>
<td>30</td>
<td>19</td>
<td>14</td>
<td>122</td>
<td>1,268</td>
<td>1,522</td>
</tr>
<tr>
<td><strong>Net Changes</strong></td>
<td><strong>-13</strong></td>
<td><strong>-27</strong></td>
<td><strong>+10</strong></td>
<td><strong>-1</strong></td>
<td><strong>-12</strong></td>
<td><strong>0</strong></td>
<td><strong>-109</strong></td>
<td><strong>-398</strong></td>
<td><strong>-550</strong></td>
</tr>
</tbody>
</table>

Source: Financial Supervisory Service
(2) Corporate Sector Reform

- **Chaebols**: required to eliminate existing cross-debt guarantees
- Exit of 55 non-viable firms: denying new credit and cross-subsidy bailout for effective exits
- Corporate workout programs: IBRD to provide expertise
- **Big deals**: core competencies, reducing excessive capacity, creating efficient management structures
- **Fair Trade Commission**: concentration of economic power / preventing moral hazard
<Reform Agenda: agreed between top five chaebols and creditors>

- Adoption of combined financial statements
- Compliance with inter’l standards of accounting
- Reinforcing minority shareholders’ voting rights
- Mandatory appointment of outside directors
- Establishment of external auditors committee
- Prohibition of cross-subsidiary debt guarantees
- Resolution of all existing cross-debt guarantees
(3) Labor Sector Reform

- Establishment of **Tripartite Commission**
- Enforcement of **New Labor Standards**
  ~ Layoffs due to managerial difficulties are allowed
    (32% employment cut at 9 banks)
- Introduction of a **Manpower Leasing System**
  ~ Employment outsourcing services for 26 occupations
    (390 companies were established)
Reform Efforts: toward a more flexible labor market

Tripartite Accord

- Labor Reform Restructuring
  (redundancy layoff)
  (manpower leasing service)

- Facilitate Economic Reform

- Social Safety Net Creation
  (expand employment insurance)
  (protect the poor)

Unemployment

- Faster Recovery and Job
Note 6: Tripartite Commission

⇒ Labor leaders, business leaders and public officials
⇒ Corporate governance, unemployment benefits, labor market flexibility
⇒ The Tripartite Accord contains 90 detailed measures for economic restructuring process
⇒ Market-oriented economy with cooperative industrial relations
(4) Public Sector Reform

- **Government reform: smaller but more efficient**
  ~ Central gov’t: emp. reduction by 11%
  ~ Local gov’t: jobs to be cut by 12%

- **Reform of state-owned enterprises**
  ~ 20 out of 109 were privatized in 1998
  ~ 89 subsidiaries subject to privatization and management reform

- **Regulatory reform**: Regulation Reform Committee abolished 4465 out of 11,125 total gov’t regulations
  ~ abolished 23 and revised 248 laws
(5) Summary: Swift Crisis Resolution and Economic Recovery

Crisis Resolution Measures

- Cleaning up Nonperforming Loans
- Reducing Moral Hazard
- Improving Corporate Governance
- Accelerating Liberalization

Results

1. Early Graduation from the IMF Program
   - Foreign Reserves of more than US$100bn

2. Rapid Economic Recovery
   - GDP Growth: 1998 -0.67% → 1999 10.7%

3. Social Stability with Productive Welfare System
III. Concluding Remarks: issues to be resolved

- To overcome xenophobic attitudinal aspect and lack of global perspective of economic agents
  <Public sector reform>
  - reforming quasi-government sector
  - strengthening regulatory reform (OECD guideline)
  - changing administrative practices of public servants
  <Financial sector restructuring>
  - making bank governance and capitalization stronger through foreign competition
  - securing qualified human resources for financial supervision
<Corporate sector reform>
- changing role of gov’t: regulations to be imposed not on the outcome but on the mode of activities
- big deal versus market economic functioning

<Labor market reform>
- layoffs and manpower dispatching to be in practice
- Tripartite Commission to be reactivated
- creating employment opportunities: mismatching to be reduced / downward adjustment of reservation wages

- Korean drive for economic reform will continue.