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Chapter 1

Introduction

The economy of South Korea has grown very rapidly since 1963. The average annual rate of growth of GNP between 1963 and 1972 was about 9.6 percent. Exports have grown even faster, from $87 million in 1963 to $1.6 billion in 1972, and to about $3.2 billion in 1973. The annual rate of growth of exports averaged 38.9 percent between 1963 and 1972 and reached a peak of almost 100 percent in 1973, a very remarkable rate of increase.

This volume examines the relationship between trade and exchange rate policies and the rapid growth of South Korean output and trade. Of particular interest are the attempts to liberalize trade policy and the exchange rate system and the effects of these efforts on resource allocation and growth.

There are a few easy explanations that might be given for the growth of Korean trade. For example, South Korea's economy was devastated by both World War II and the Korean War. Between 1953 (when the Korean War ended) and 1960, exports averaged only 1.1 to 2.4 percent of GNP, although a country of South Korea's population and income might have been expected to reach a much higher level of exports, perhaps one of at least 10 or 15 percent of GNP. Thus one explanation of South Korea's export performance is to say that what appears to be growth is really a case of "catching-up" to some "normal" level. By 1971, however, South Korean exports had surpassed the level that is usual in countries of similar population and income.[1] Exports reached about 26 percent of GNP in 1973 and showed little tendency toward less rapid expansion. While early growth of exports might be attributed in part simply to "catching-up," continued growth remains to be explained. Furthermore, South Korea lacks the readily exportable primary products commonly found in other countries of similar size and income. Almost all her exports are manufactured and as a fraction of GNP they are exceedingly high compared with the proportion of manufactures exported by other less developed countries.

Other easy explanations could be imagined: for example, South Korea's exports may have been boosted by war in Viet Nam. In fact, only a tiny fraction of South Korea's exports have been destined for Viet Nam or were in any way related to the hostilities there. Alternatively, one might attribute South Korea's export growth to government targets. While such targets have played a role, it is unlikely that they are the sole or even the major reason exports grew so rapidly. Unless incentives to export accompany targets, firms will be driven out of business if continuously forced to export, at a loss, an increasing proportion of their output.

Growth in income has also been explained in various ways. The most commonly accepted easy explanation is that South Korean growth is due to very high levels of foreign aid. Foreign aid has been important, especially from 1953 to 1963. Domestic savings averaged only about 3 percent of GNP during those years, while foreign savings (imports of goods and services less exports of goods and services financed mostly by foreign aid grants) averaged 9 percent of GNP. Approximately three-quarters of total investment was financed by foreign aid. Those were the years, however, when economic growth was relatively slow in South Korea. The rate of growth of GNP averaged about 5 percent. After 1964 domestic savings grew very rapidly, rising from about 4 percent of GNP to almost 17 percent in 1970. The fraction of total investment financed domestically rose from less than one-third in 1963 to about 63 percent in 1970. Furthermore, beginning in 1965, foreign capital imports took less the form of foreign aid and more the form of commercial loans. By 1969, well over half of all foreign loan agreements in that year were commercial. The period of decreasing reliance on foreign aid, 1964 to 1970, was also a period of accelerated growth, the annual rate over the period averaging close to 11 percent.

No doubt foreign assistance has been important to South Korea's economic growth. But to attribute rapid growth solely to massive foreign aid would be a mistake, for South Korea's economic policies have played a role too. They have ensured the effective use of foreign resources while increasing the domestic contribution to the process of growth.

In this volume we shall concentrate on the function of trade and exchange rate policies. South Korea has followed a set of policies which are unusual compared with those of most less developed countries. Instead of emphasizing import substitution, most policy initiatives have promoted exports. A wide variety of export incentive schemes has been devised, and the exchange rate has been adjusted frequently and dramatically. During most of the period since 1967, exchange rate policy has been based on the gliding peg.

Chapter 2 of this volume is a brief economic history of South Korea since World War II. It is largely descriptive and intended as general background for the rest of the book.

Chapter 3 deals with phases I and II of the Bhagwati-Krueger scheme.[2] Phase I begins with the end of World War II and ends with the Korean War armistice signed in 1953. The government was directly involved in trade and controlled what little private trade existed. There was a multiplicity of exchange rates and a flourishing black market in foreign exchange and military payment certificates. Phase II lasted from the end of the Korean War until 1960. It was a period of increasingly sophisticated control mechanisms and complicated procedures which were invented to assist barter trade and to facilitate trade payments.

Chapter 4 covers two Phase III attempts at liberalization, the first from 1961 to 1962, the second from 1964 to 1965. A steep devaluation declared in 1961 was followed by an abortive effort to unify exchange rates and to liberalize trade policy. But a bad crop in 1962 combined with the expansionary fiscal policies of the military government, which had ousted the reformist civilian administration in May 1961, led to a return in 1963 to a Phase II regime with multiple rates and stringent controls on trade.

A much more successful attempt to realize a Phase III liberalization began in May 1964 with a devaluation of the won close to 50 percent and continued through September 1965, when domestic interest rates were substantially raised. The multiple exchange rate system was unified, trade restrictions were eased, and tax administration reformed.

Chapter 4 also covers 1966, the first year of a Phase IV regime in which efforts were made to consolidate reforms. Chapter 5 analyzes the continuation of the Phase IV regime from 1967 to early 1973. During this period, tariffs were revised and the trade control program was changed in 1967 from a positive-list to a more liberal negative-list system. The won was allowed to "glide" from early 1968 to mid-1971, i.e., it floated downward at a determined rate which was meant to be consistent with rates of inflation in Korea and in her major trading partners. The won was again devalued in June 1971 and was floated again during the first half of 1972. In August 1972, a new set of reforms involved price stabilization, pegging the exchange rate at about 400 won to the dollar. There was also a tendency during this period to resort to the old price-distorting practices whenever the balance of payments was under pressure. Trade controls were alternately strengthened and relaxed. The number and level of export subsidy measures increased until early 1973.

Chapter 6 is an analysis of Korea's export growth and treats this subject in some detail. Besides discussing the import-intensity of export production, we also analyze the role of exchange rates, export subsidies, and other incentives in stimulating exports. The degree to which exports are responsible for the growth of the South Korean economy, sector by sector, is described by means of various decomposition techniques. South Korea's growth patterns are compared with those of other countries to demonstrate the relatively predominant role of exports in the South Korean economy.

Foreign capital inflows have been very important in South Korea's growth. Immediately after the Korean War, most of the capital inflow consisted of foreign aid grants. By the mid-1960s, private commercial loans became important. Chapter 7 analyzes the part played by foreign capital in South Korea's growth and the efficiency of the foreign capital inflow.

In Chapter 8, we develop an econometric model of the South Korean economy. The estimation of the model involves the testing of a number of hypotheses concerning the role of exchange rates and commercial policy variables on aggregate behavioral relationships in the economy. Chapter 9 uses the econometric model to determine whether alternative sets of commercial policies would have resulted in more or less growth over the decade of the 1960s. The simulations in Chapter 9 examine the optimality of South Korea's exchange rate policy, tariff levels, and levels of export subsidy in a macroeconomic framework.

In Chapter 10, we discuss the efficiency of the South Korean trade and exchange rate regime. The analysis of efficiency involves first the measurement of nominal protection rates by means of a survey of price comparisons of world market and domestic prices. The nominal protection rates are used to estimate the effective protection of some 150 sectors of the economy. We go beyond measures of effective protection to estimates of rates of effective subsidy which include a wide range of taxes and subsidies to industry in addition to tariff rates. In Chapter 10 we also investigate the labor and capital intensity of South Korea's exports and the effect of valuation at domestic prices, or at international prices, on the growth and structure of the economy.

Chapter 11 provides an overview. The first two sections examine the effects of rapid growth on employment and income distribution. Since these topics are not closely related to trade policy, they do not readily lend themselves to treatment in the main text. We felt, however, that a book on Korean development would be sorely inadequate if it omitted discussion of employment and income distribution.

The next six sections of Chapter 11 consider the factors responsible for growth in Korea with particular reference to trade and exchange rate policies. We draw on the results of research presented in the preceding chapters as much as possible. To a certain extent, however, we must take a broader view of the growth process in order to provide a proper context for the analysis of the role of exchange rates and trade policy. Thus we talk about education and literacy, political regimes, the influence of Japanese culture, and other important factors that help to determine economic policies. Furthermore, we cannot hope to be definitive within this volume even with respect to trade and exchange rate policies because of limitations on data, time, and research capacity. Therefore, some of the observations in Chapter 11, even those involving trade and exchange rate policy, are speculative.

The final section of Chapter 11 offers some caveats about generalizing from the South Korean experience and drawing lessons for other countries. The special factors operating in Korea are extremely important to keep in mind.

NOTES

1. See Bhagwati and Cheh (1972). See also the analysis of exports in Chapter 6.
2. For a description of the Bhagwati-Krueger five-phase scheme, see Bhagwati and Krueger (1970) and also the description of the phases in Appendix A.