
Korea's Economy: the Recent Past and the Road Ahead

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It is a well-known fact that during the three decades before it was hit by the Asian financial crisis in 1997 and 1998, South Korea experienced extremely rapid economic growth on the basis of export-oriented industrialization. Because of this growth and despite the setback created by the recent financial crisis, the Korean economy now ranks 13th in the world. Three decades ago, South Korea's per capita GDP (gross domestic product) was comparable to the poorer countries of Africa and Asia. Today, its per capita industrial output level is almost the same as some economies of the European Union.

South Korea (hereafter, Korea), a "late-late industrializer," has been remarkably successful in imitating and copying from the existing technologies of more advanced countries. The "late-late industrializers" in the 20th century differ in an important way from the nations that began their industrialization process in the 18th or 19th century. While Great Britain's industrialization was based primarily on inventions, and the later industrialization processes in the United States and Germany on innovations, Japan's (and Korea's) industrialization process was founded on learning processes, *i.e.*, on applying (or copying) already existing technical knowledge. As Japan did, Korea has achieved "industrialization by learning." That is, the industrialization process was not propelled by independent innovations in the areas of products or production processes but rather by the acquisition of technological and technical skills from abroad.

In the second half of the 20th century only a small number of newly industrialized nations man-

aged the process of mastering technological processes. The level of Korea's industrialization is indicated by the following data:

- As of January 2001, Korea's "internet penetration rate" (the number of internet users per 100 inhabitants) was 23.2% is the highest among the OECD (Organization for Economic Cooperation and Development) countries. This rate is compared to 20.2% for Canada, 18.2% for the United States, 12.4% for the U.K., 11% for Germany, 8.4% for Japan, and 5.1% for France, respectively.¹ Korea also enjoys the highest penetration rate of high-speed broadband (digital-subscriber-line and cable-modem) connections in the world.²
- Korea ranks fifth in terms of the overall "technology development index³," after Finland, USA, Sweden and Japan.

In 1988, when Korea sponsored the 16-day, \$3 billion festivity – the 24th Summer Olympic Games – Fortune magazine called Korea "tomorrow's power house."⁴ Korea's industrialization was so swift and remarkably successful that it was proclaimed as "Asia's Next Giant" by Alice H. Amsden, a noted American economist.⁵

The following three factors well illustrate Korea's economic dynamism:

- The first factor concerns the country's unparalleled increase in merchandise exports as a percentage of GDP. This percentage went from less than 1% in 1960 to 35% in the late 1980's and 1990's. As in the case of Taiwan, Korea's major competitor in the export market, the pattern of export-led growth is an extreme one.

- The second factor has to do with the rapid increase in manufactures as a proportion of total merchandise exports. The percentage of manufactures went from approximately 15 percent in the 1960's to over 90 percent by the mid-1980s and in the 1990s. With the exception of Taiwan, the history of industrialization gives no other example of structural transformation so rapid and so radical, where economies have changed from agrarian to industrial in just two decades.
- The third factor is related to the additional major characteristic of Korea's economic growth: its investment-led character. The gross fixed investment as a percentage of GDP rapidly increased from about 10% to over 35%.

This rapid climb in exports and investment and the generation of "virtuous-circle" feedback accelerated growth, creating the so-called "take-off" process.⁶

In the 1980s and into the early 1990s, economists focused on the role of the state in economic development. They argued that Korea's "race to the swift"⁷ industrialization was orchestrated by a highly interventionist state. What did the "interventionist" (and often "authoritarian") Korean state do to develop the economy?

Before the early 1990s, the private and public in Korea were rolled into what one might term "Korea Incorporated." The state of Korea raised industrial capital at home and abroad, refracting it in ways commensurate with its purpose. In the process, the state created and then rewarded a new class of entrepreneurs collectively called the *chaebol*. A *chaebol* is a large, family-owned and managed group of companies that exercises oligopolistic control in product lines and industries. As the *chaebol* groups – the spearhead of the export industry – flourished, so did the state and so did the economy.

In the first two decades of industrialization until the mid-1980s, Korea's economic strategy

was to take advantage of lower labor costs to capture international markets, selling relatively low quality goods at low prices. In order to keep industrial wages at a low level, the government resorted to certain repressive tactics: before 1987, strikes were illegal, and when a strike would break out, the government intervened and suppressed it. In 1987, a massive people's movement for democratization succeeded in establishing a democratic rule. Unfortunately, the democratization was a double-edged sword for the economy. It opened the floodgate for management-labor disputes, resulting in double-digit wage increases far exceeding productivity gains and thus hampering the international competitiveness of Korean exports.

Moreover, the pendulum of Korea's labor laws showed an extreme swing, from the pre-1987 prohibition of strikes to current rules under which it is very difficult for corporations to lay off workers and corporations are required to pay full wages and benefits to full-time labor union officials and staff, thus making Korea's labor market very inflexible. "Democratization" touches all aspects of Korea's society and economy. As the economy matures, slower economic growth will add to unemployment. At the same time, growth of the economically active population will begin to slow and Korean workers will continue to demand job security, shorter working hours, higher wages and more benefits. A corollary to this trend will be greater demand for social welfare as the population ages.

In late 1997, the financial crisis that was started in Thailand spread to Korea. Overnight the star economic miracle maker of Asia was changed to an economic miscreant. The causes that helped precipitate the Asian financial crisis have been varied. The common element was the massive capital flows from industrial countries into Korea and other Asian "miracle" economies that eventually precipitated the

Asian financial crisis. These capital flows, in turn, were pushed by:

1. the relatively low returns available in mature industrial economies because of their maturity
2. below potential economic performance and record low interest rates (as in Japan)
3. surges in the dollar/yen exchange rate (the value of the yen in terms of the dollar) driven by the fear of targeted protectionist pressures from the U.S.

The capital flows were also pulled in by the widely-shared perceptions of relatively high, risk-adjusted expected returns on capital in Korean and other Asian economies that have long enjoyed demonstrable economic success. The massive inflows of capital in various forms that eventually set the stage for the eventual eruption of the Asian financial crisis occurred because of the perceived soundness of macroeconomic fundamentals of Asian economies, as measured by such conventional indicators as government budget balances, inflation and domestic savings rates.

In increasingly globalized financial markets supported by the greater liberalization of domestic financial markets and external capital account transactions, increasingly mobile capital tends to get allocated across borders and across instruments, seeking to maximize the risk-adjusted total returns of capital. In view of the prevailing euphoria about the coming Asian Century, it was not surprising that a lion's share of savings from the mature industrial economies flowed into Korea and other miracle economies in Asia in the post-Cold War years.

The (proximate) roots of the financial crisis in Korea and other Asian countries may be understood in terms of over-borrowing (over-lending), over-investment and, more importantly, the hasty liberalization of international capital

account transactions and financial/banking markets under the pressure of the accelerated globalization of financial markets, which, in turn, was spurred by the euphoria celebrating the widely declared triumph of capitalism over socialism. All these culminated in a massive financial crisis. Perhaps the single most irresponsible action in the whole crisis was capital account liberalization without a framework of regulation. The blame should be shared by the governments of Korea and other Asian countries as well as the IMF that pushed hard for capital account opening for several years before the crisis hit these countries. As James Tobin, the Nobel laureate in economics, pointed out, Korea and other Asian countries were "victims of a flawed international exchange rate system that, under U.S. leadership, gives the mobility of capital priority over all other considerations."⁸

The financial crisis exposed certain long-standing weaknesses in Korea's development model, including state-directed banking systems and lending decisions, inadequate financial regulation and bank supervision, massive over-investment by corporations in projects without careful assessment of risk and return, the maturity mismatch and currency mismatch in the balance sheets of financial firms and their client firms, and the lack of transparency.

The crisis also precipitated and accelerated economic reforms that hopefully ought to lead to more stability in the future. Koreans have learned the perils of fixed (but adjustable) exchange rates; they have discovered the dangers that come from excessive reliance on short-term debt denominated in foreign currency; and they have seen the consequences of lax financial supervision.

In Korea, financial and corporate restructuring that has been underway since the 1997/1998 crisis should improve the financial system, corporate governance and the efficiency with which capital is

used. Will these structural reforms in Korea prevent future financial crises? I think not. They may help to reduce somewhat the chances of another crisis but may not prevent another one as long as something is not done institutionally regarding short-term capital flows. Economic historian Charles Kindleberger of MIT has characterized short-term capital flows as “manias and panics.”⁹ And such volatile capital flows were the major culprit in the recent financial crisis.

What has happened in recent days to the impassioned oratory we heard in Washington, DC and New York until a few years ago about the need for remaking the “global financial architecture”? The oratory now seems to be dead. While no one can disagree that transparency and reform of banking systems in the emerging economies will help, they will not prevent the crises that unregulated short-term capital flows inherently generate.

In this connection, I wish to quote Jagdish Bhagwati of Columbia University, who served as Economic Policy Advisor to the Director-General of the GATT (General Agreement on Tariffs and Trade), the predecessor of the WTO (World Trade Organization):

This powerful network, which may aptly, if loosely, be called the Wall Street-Treasury complex, is unable to look much beyond the interests of Wall Street, which it equates with the good of the world...

And despite the evidence of the inherent risks of short-term free capital flows, the Wall Street-Treasury complex is currently proceeding on the self-serving assumption that the ideal world is indeed one of free capital flows, with the IMF and its bailouts at the apex in a role that guarantees its survival and enhances its status. But the weight of evidence and the force of logic point in the opposite direction, toward restraint on capital flows.¹⁰

It seems prudent for Korea (and other emerging countries in Asia) severely impacted by the recent financial crisis to attempt to limit inflows of hot money, especially very short-term loans from international banks. Money that pours into a country can just as easily pour out. Highly volatile short-run capital, often moved by self-fulfilling waves of euphoria or panic, can disrupt economies and cause massive swings in exchange rates. Some speed bumps, or “sand in the market's gears,” should be imposed on inflows of short-term capital through appropriate regulation of the banking system or taxes. It is an “ideological humbug” to argue that without free mobility of volatile short-term capital Korea and other Asian economies cannot function and their growth rates will collapse.

I would like to end this very secular article with a quotation from a non-secular source, the Old Testament. In Chapter 9, Verse 11 of Ecclesiastes, I find a very interesting, perceptive passage, which is as follows:

I came and saw under the sun that the race is not to the swift, and the battle is not to the warriors, and neither is bread to the wise, nor wealth to the discerning, nor favor to men of ability; for time and chance happeneth to them all.

Though I am not trained in biblical interpretation, I would venture to say that the above passage from the Bible articulates the basic truth that essentially there is no divine justice – the race is not given to the swift. In an allegorical sense, this passage is certainly relevant to the situation of Korea that achieved a swift industrialization during the past three decades. Contrary to what many would like to believe, the much vaunted ideology of free capital mobility exacted a heavy price – the wise, the swift, the discerning and the men of ability in this emerging country did not necessarily benefit, but were secondary to the purpose of global financial capital-

ism. As chance would have it, economic and political conditions worked to the advantage of Wall Street. And as time and chance change, I hope, so too will the fortunes of the people living in this re-emerging country.

NOTES

- 1 *OECD Report on the New Economy*, May 16, 2001.
- 2 *The Economist*, June 23, 2001, p. 62.
- 3 Computed based on eight criteria including the number of patents per 100 inhabitants, the amount of technology license fee receipts per 1000 inhabitants, and the number of internet hosts. See *JoongAng Ilbo* (Korea Central Daily), July 20, 2001, B-6.
- 4 Louis Kraar, "Korea: Tomorrow's Powerhouse," *Fortune*, August 15, 1988.
- 5 Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization*, Oxford University Press, New York, 1989.
- 6 Miyohei Shinohara and Fu-chen Lo, *Global Adjustment and the Future of Asian-Pacific Economy*, Tokyo: Asian Pacific Development Center and Institute of Development Economies, 1989.
- 7 Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization*, Columbia University Press, New York, 1991.
- 8 James Tobin, "Why we need sand in the market's gears," *Washington Post*, December 21, 1997.
- 9 Charles P. Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises*, 3rd edition, New York: John Wiley & Sons, 1996.
- 10 Jagdish Bhagwati, "the Capital Myth," *Foreign Affairs*, 1998, 77(3): 7-12.

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