

The Role of Government in Korea's Economic Development

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Korea's Leading Think Tank





C O N T E N T S

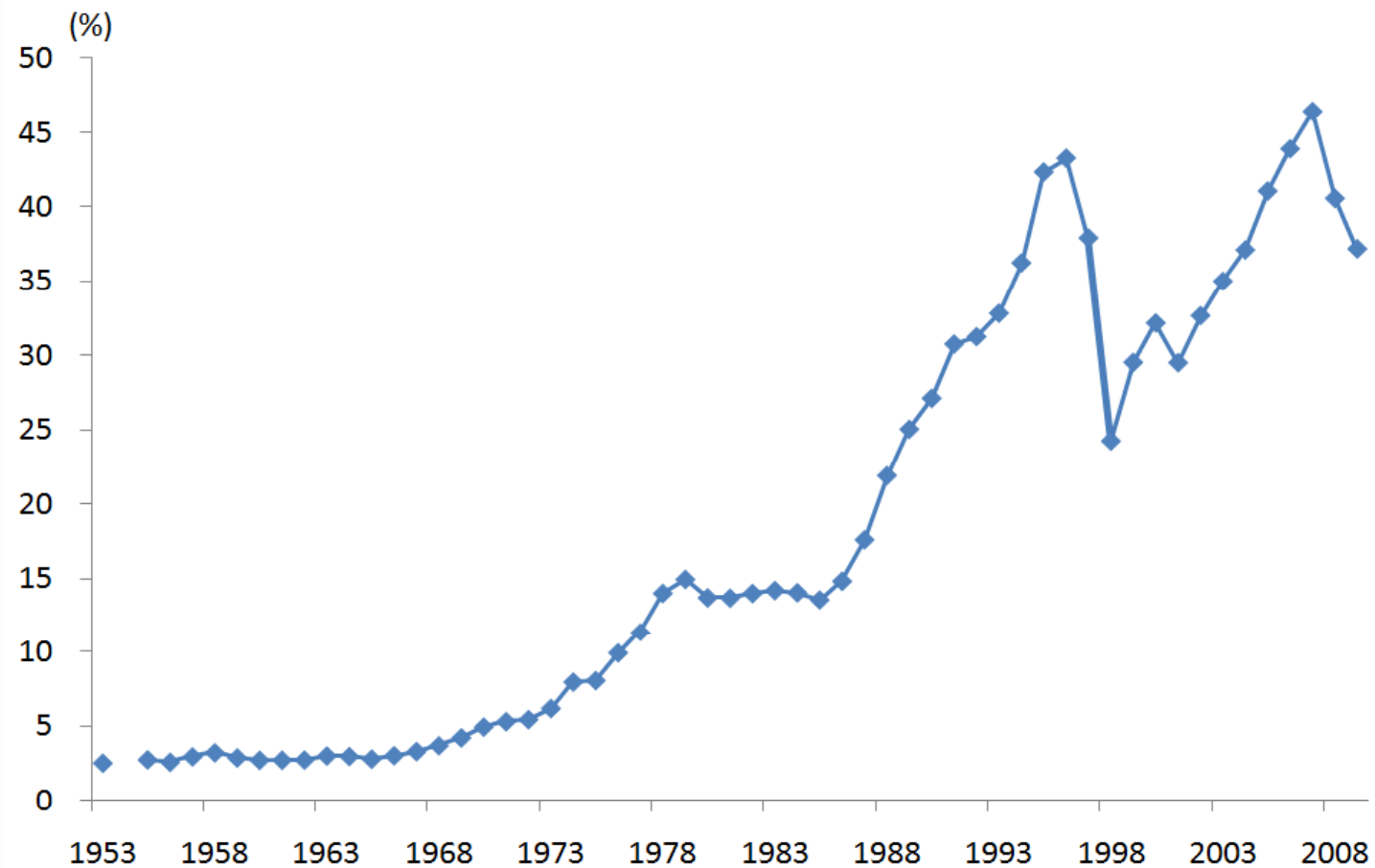
1. Performance: 1950s-2000s
2. Proximate causes: Investment in physical and human capital and technology
3. Deeper-level causes: What motivated such investment?
4. Problems with the government-led growth strategy
5. Challenges facing the Korean economy
6. The role of government



Performance: 1950s-2000s

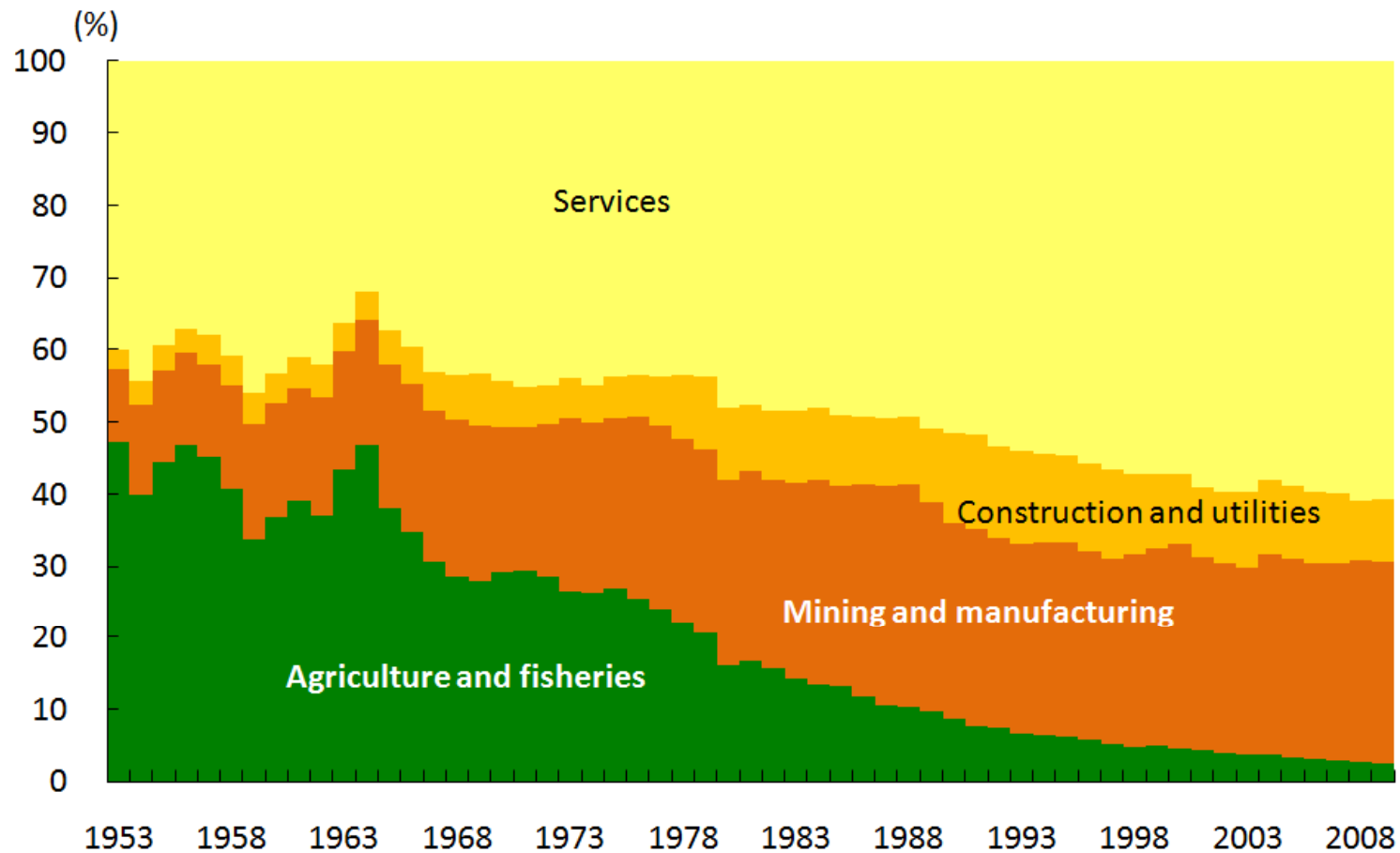
Phenomenal growth

■ Korean per capita GDP (US = 100%)

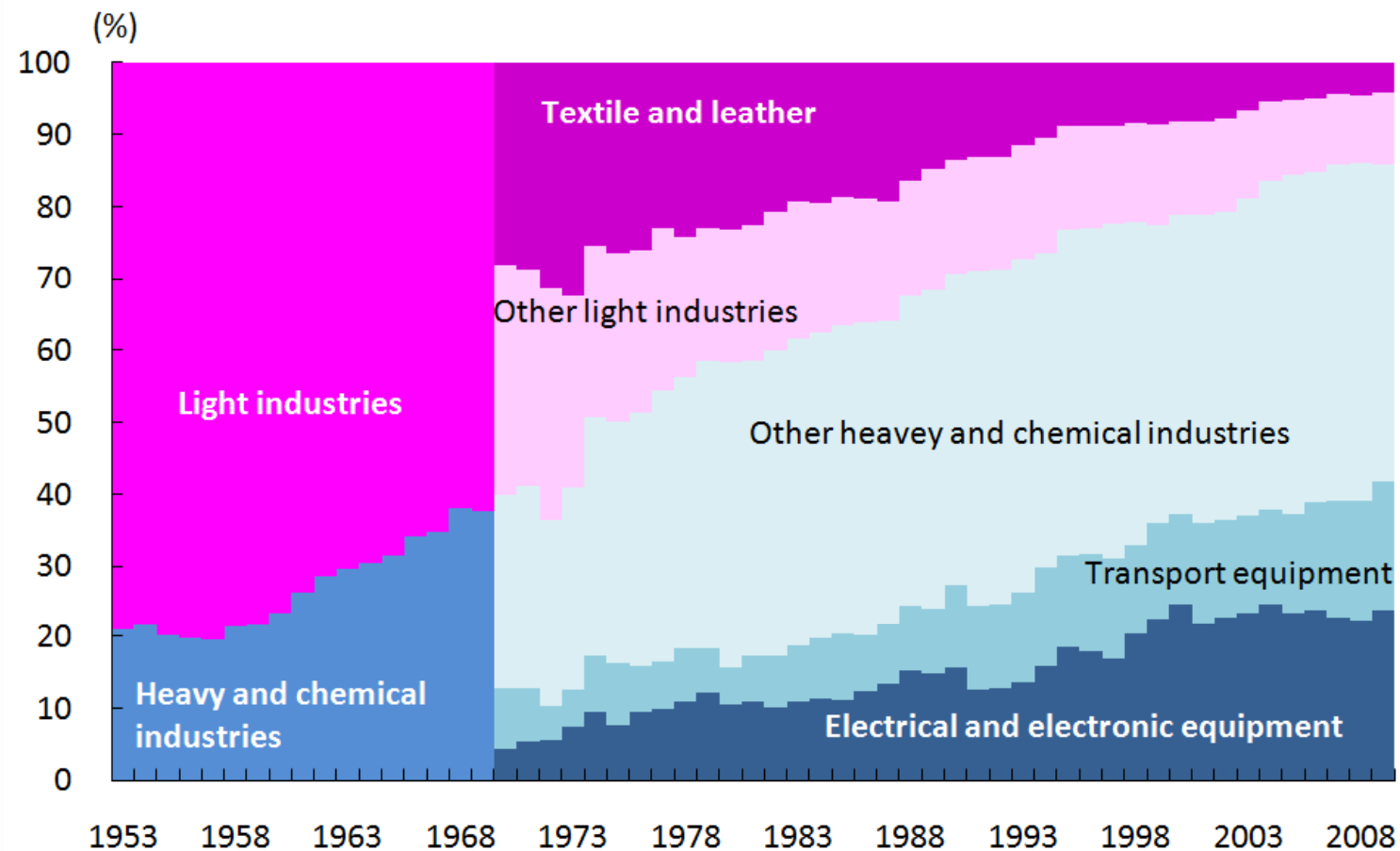


Rapid changes in industrial structure

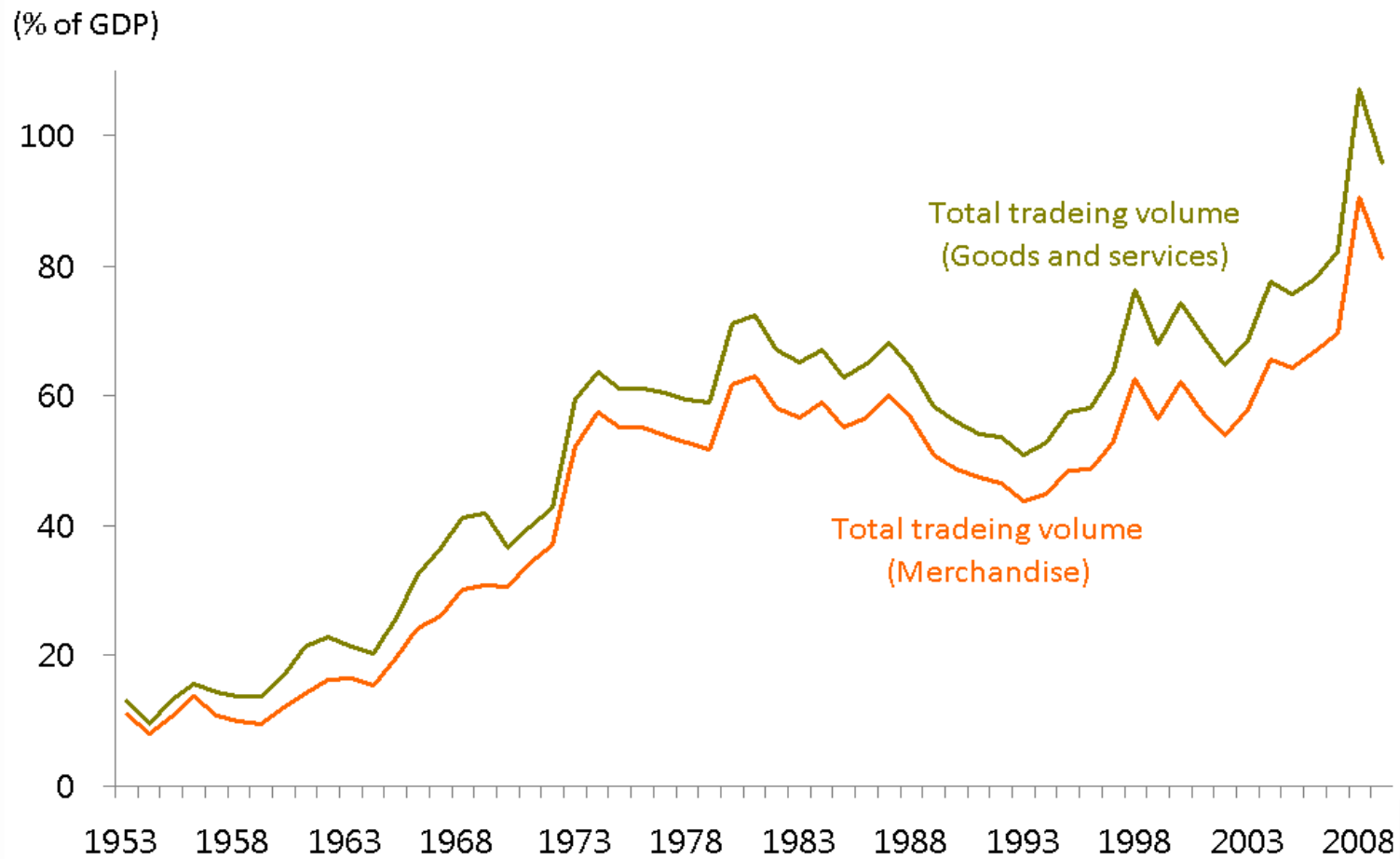
Value-added by sector



■ Manufacturing value-added

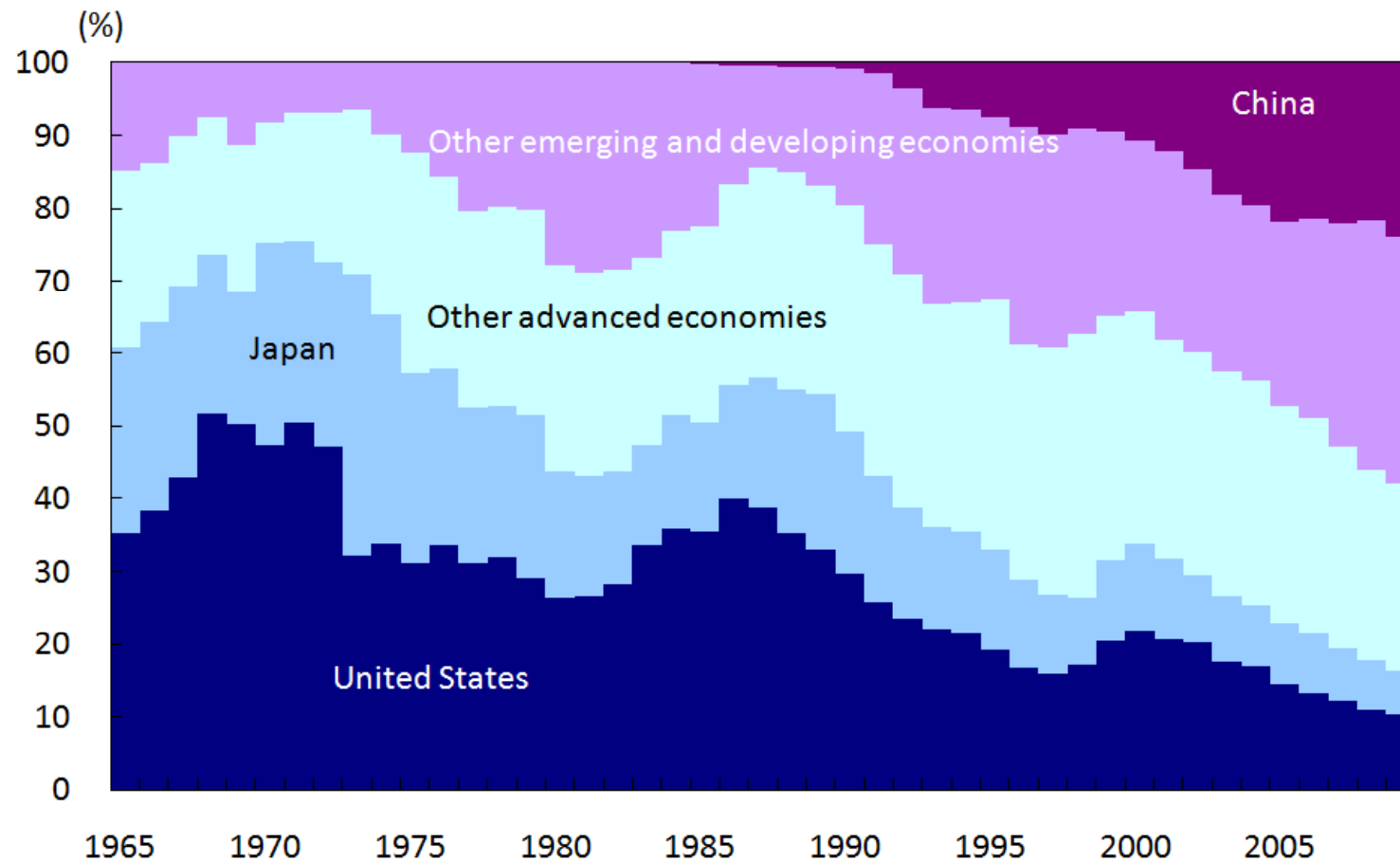


■ Trading volume



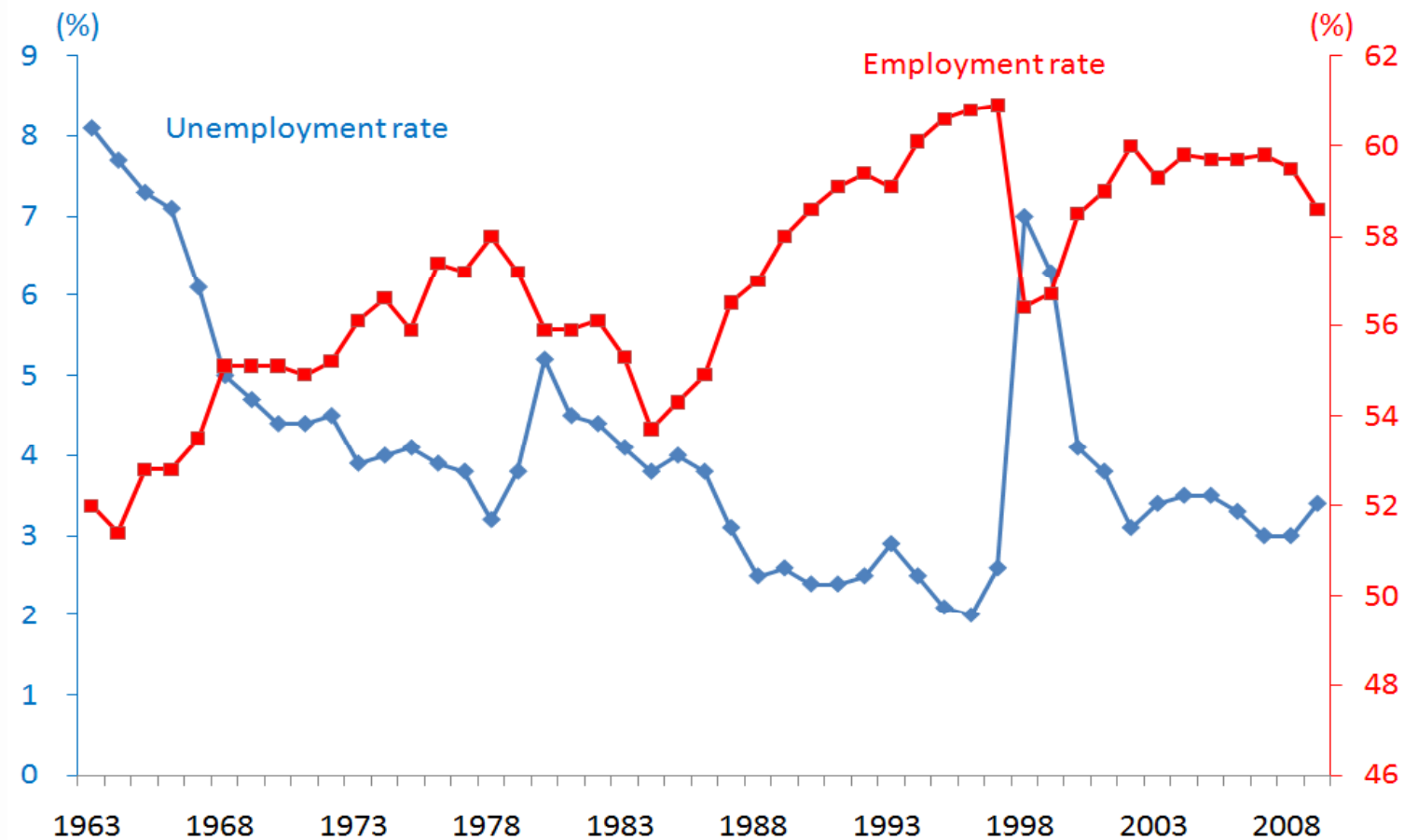
Diversification of trading partners

■ Korea's export market



Expanding job opportunities

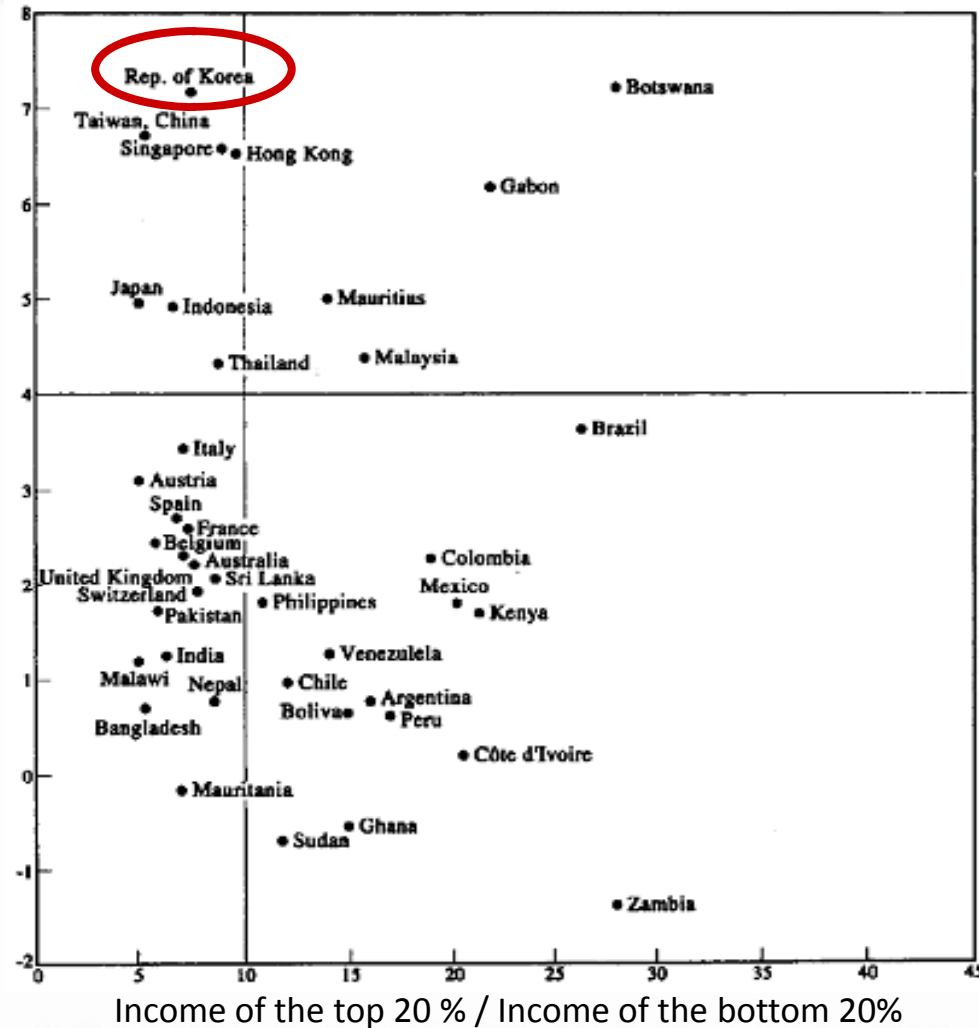
■ Labor market indicators



Relatively equal distribution of income

- Growth and distribution of income (average over 1965-1989)

Per capita GDP growth (%)



Source: World Bank (1993).

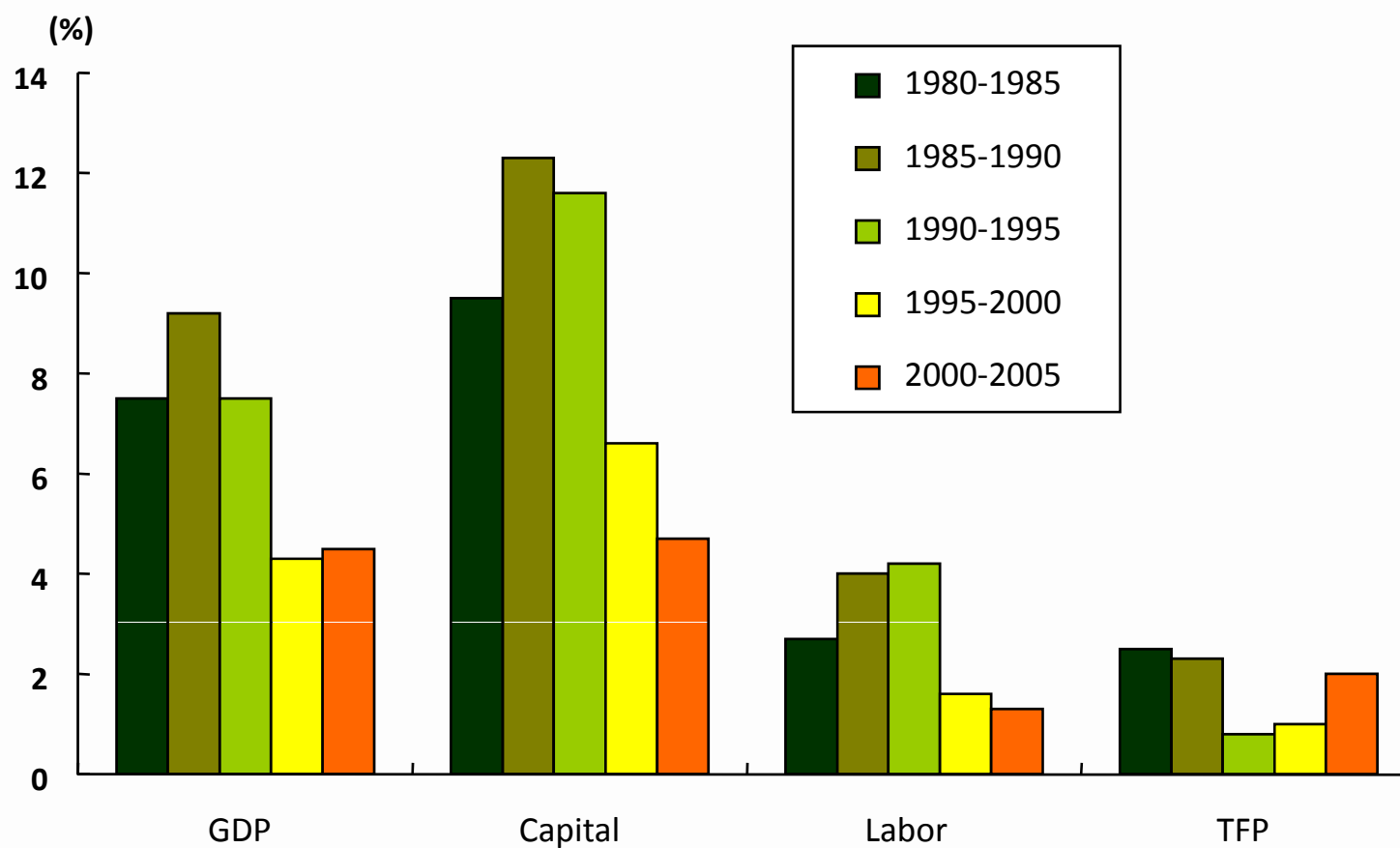


Proximate causes

Investment in physical and human capital
and technology

Rapid growth of inputs and productivity

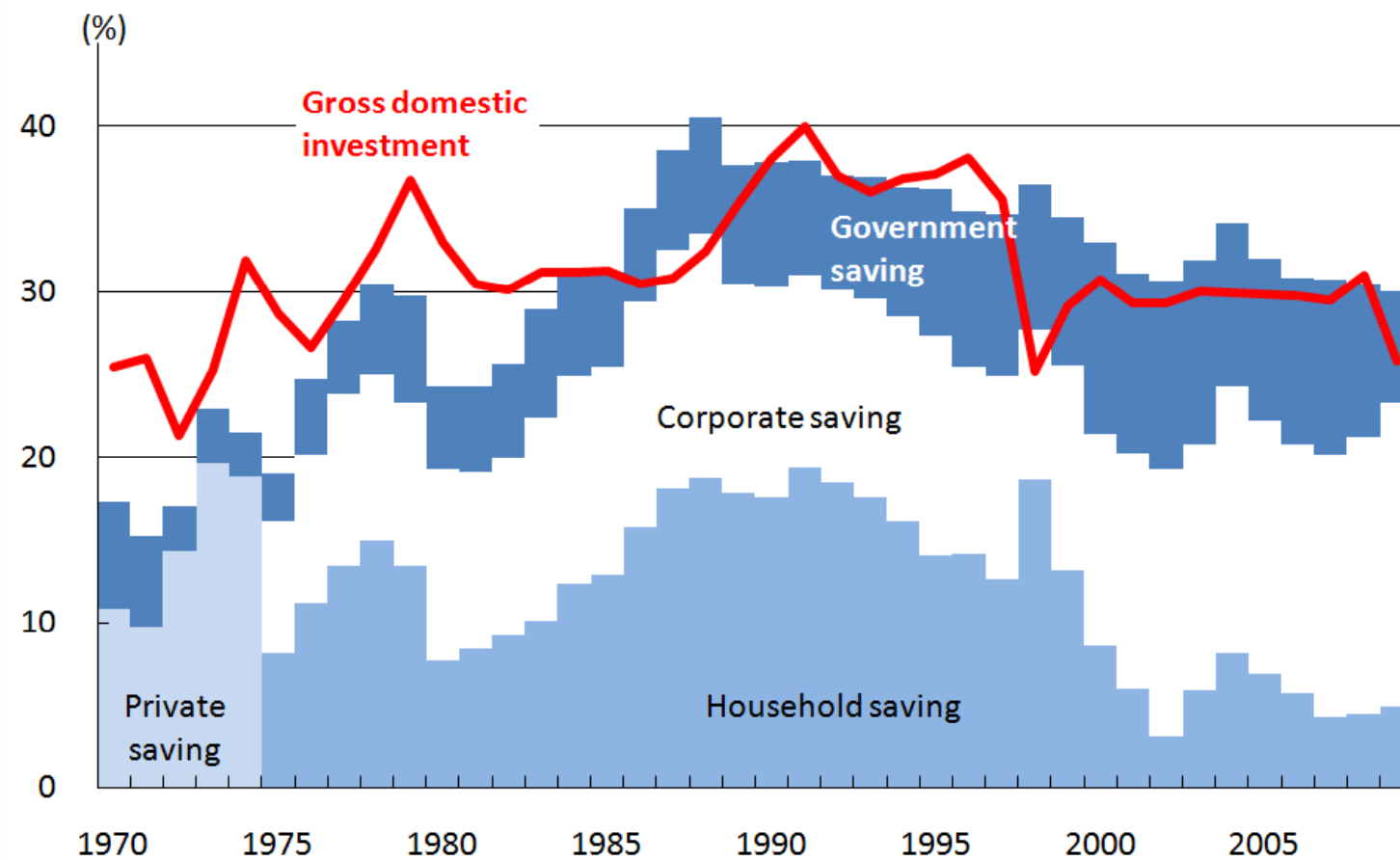
Growth accounting: 1980-2005



Source: Hahn and Shin (2007).

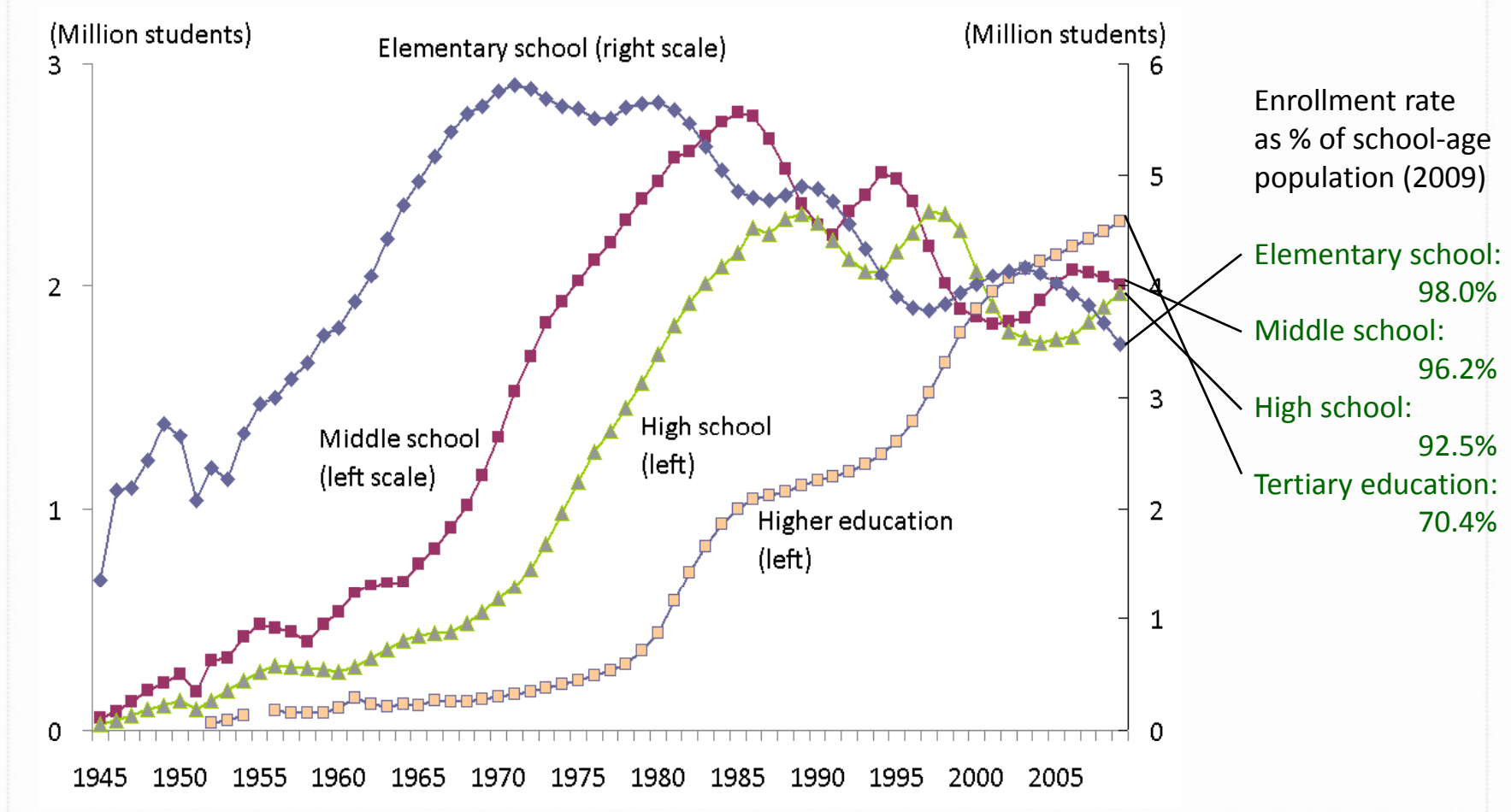
High savings and high physical investment

Savings rate and investment rate



Investment in human capital

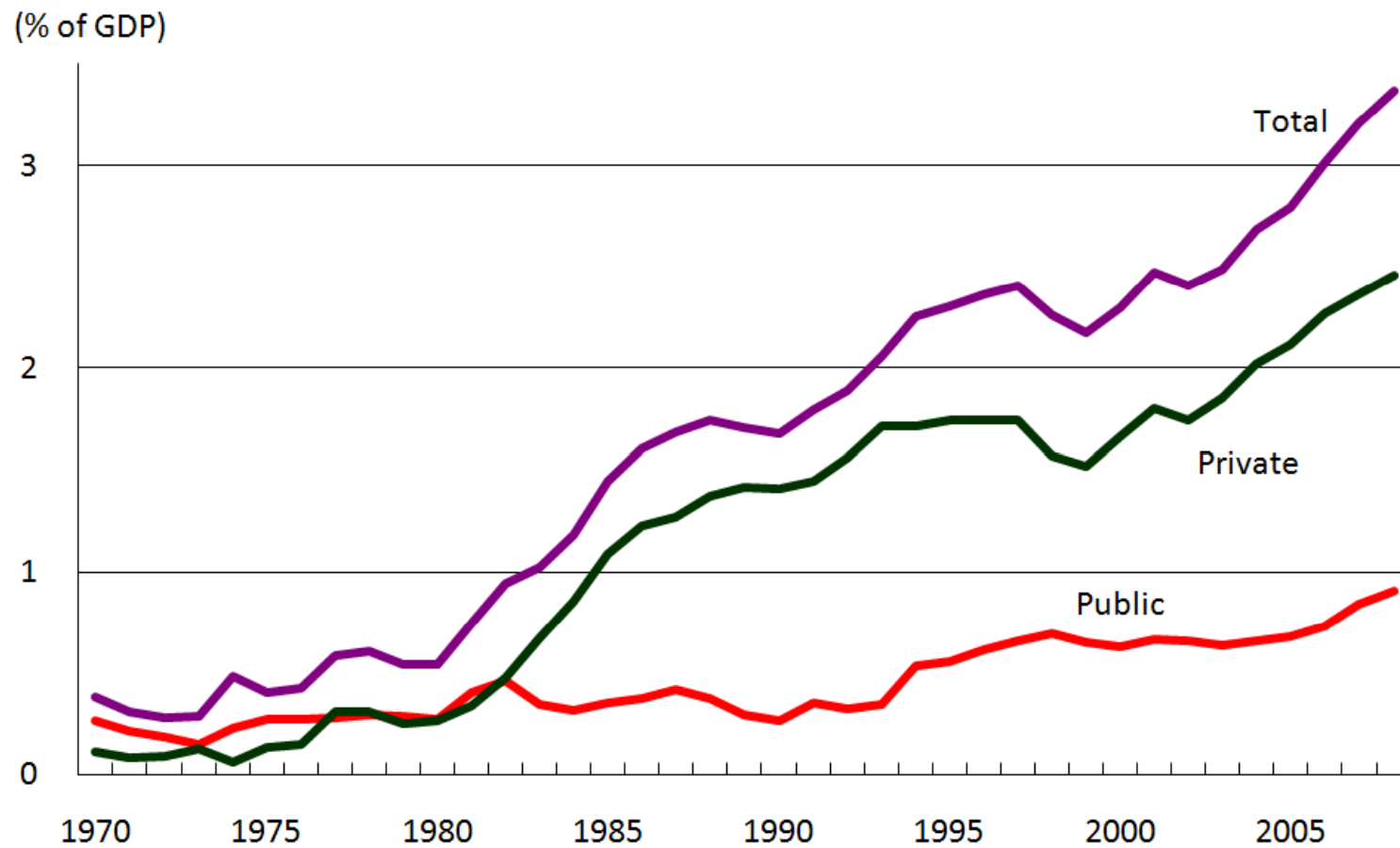
Number of enrolled students



Note: Higher education includes 4-year colleges and graduate schools.

Investment in technology

R&D spending





Deeper-level causes

What motivated such investment?

- Traditionally, very homogeneous society
- Korean war (1950-1953)
 - Devastated existing capital stocks, contributing to the equalization of wealth.
- Agricultural land reform in the 1950s
 - The government bought farmland from landlords at forced prices and sold it to farmers at below-market rates, leading to big losses to landlords.
- Perception of equal opportunity
 - Everyone was now placed on a more or less equal footing, and individual effort and ability rather than family wealth became the most important determinant for individual success.

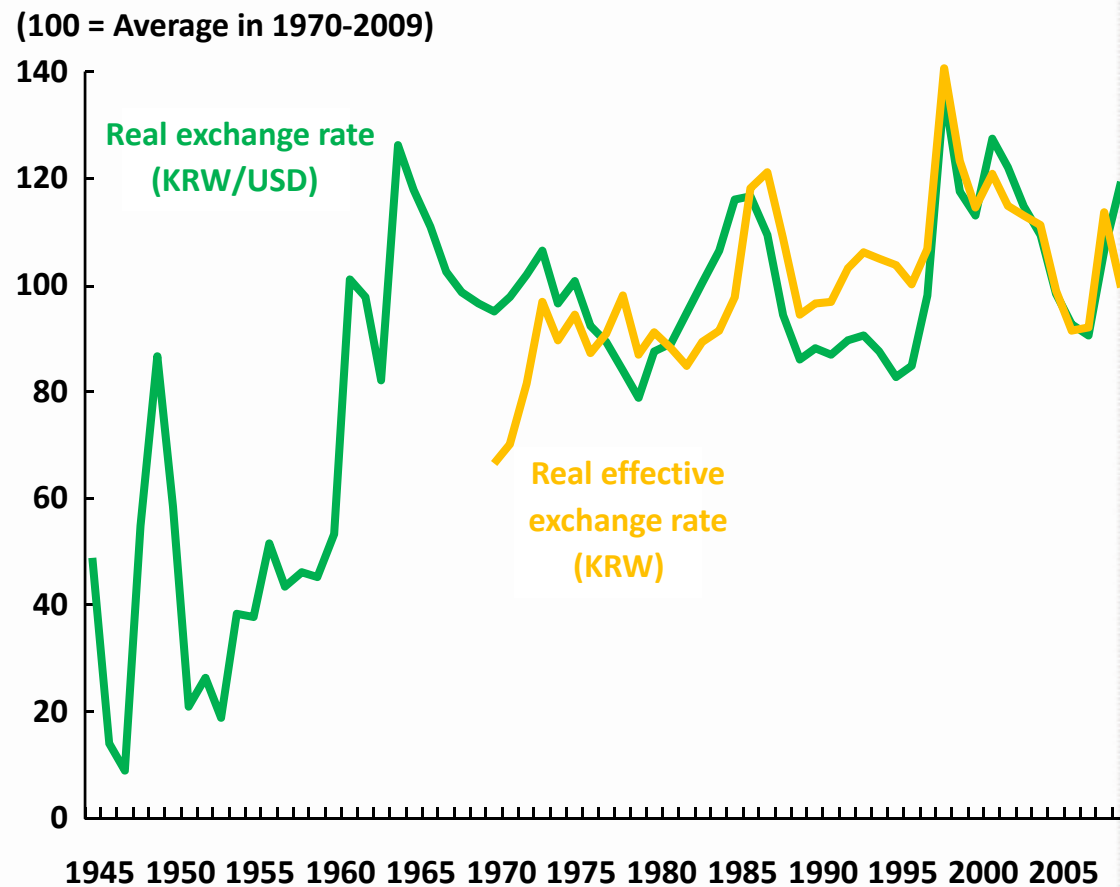
- In the 1960s and 1970s, Park Chung Hee enshrined growth near the top of the regime's value hierarchy (Jones and SaKong, 1980).
 - The authoritarian government fully understood the importance of economic success in legitimizing its power.

- The government deployed virtually all policy tools available--- financial, fiscal, administrative and regulatory tools---to promote growth.

- The successive Five-year Economic Plans set out clear goals to be attained in each year.
 - They had a major “announcement effect” in articulating leadership commitment.

Eliminating opportunities for rent-seeking

- The strong political leadership guided the private sector
 - away from zero-sum rent-seeking activities
 - toward positive-sum productive activities (Jones and SaKong, 1980).
- Example: the exchange rate reform in 1964



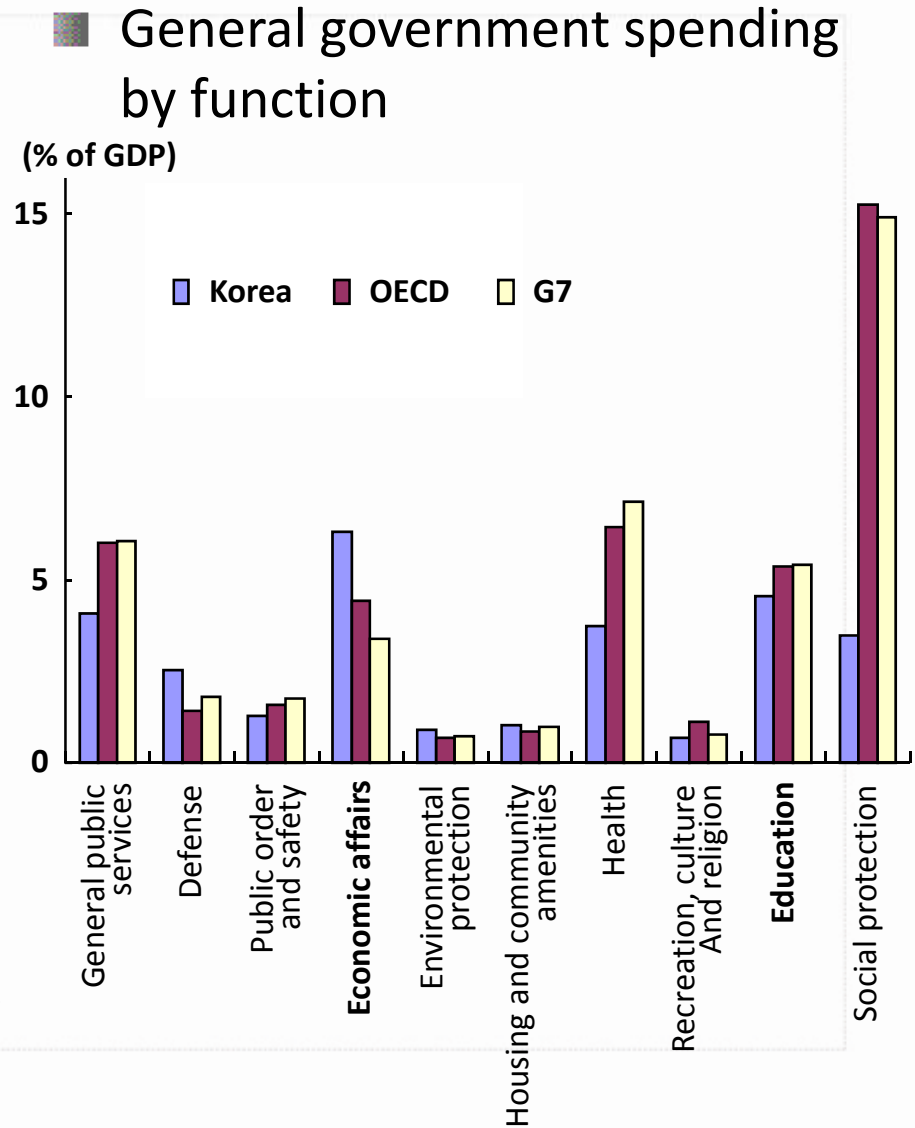
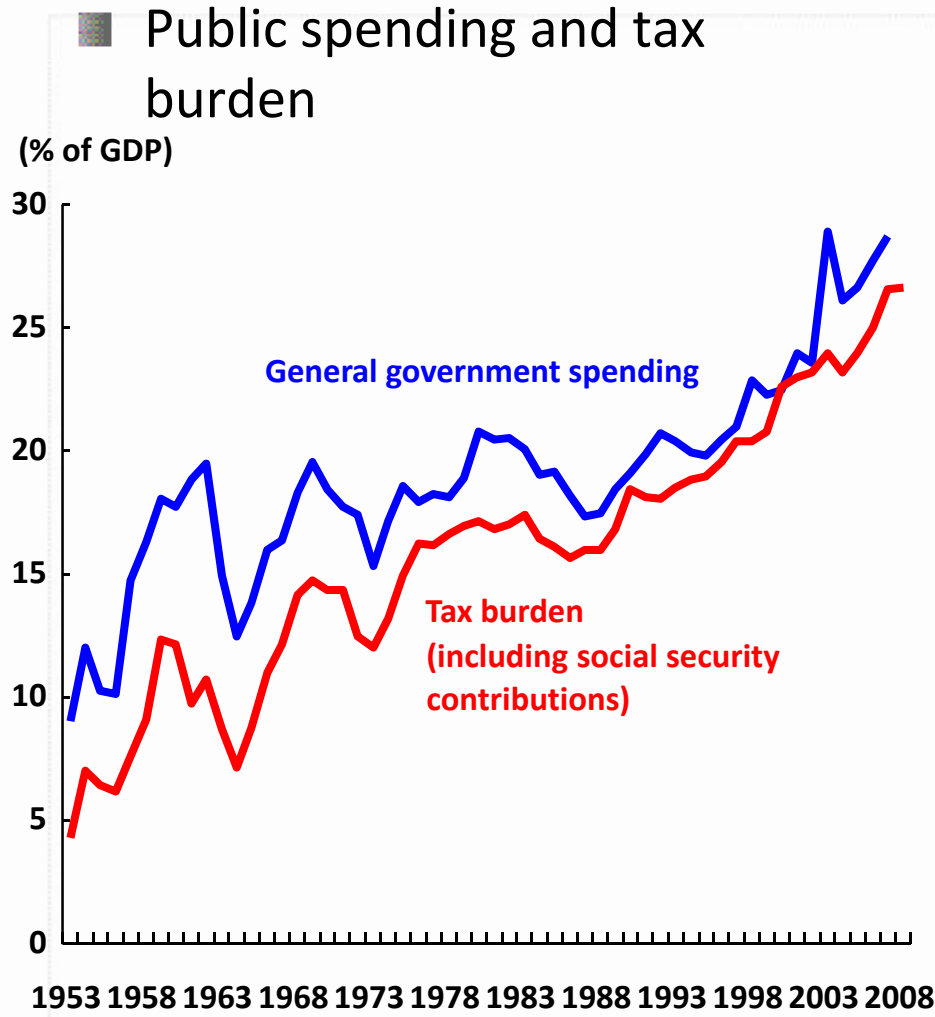
Note: The rise in exchange rate indicates the depreciation of KRW.

- Consistent emphasis on exports since the 1960s
 - Financial supports, tax advantages, administrative arrangement

- Multiple benefits of international trade
 - Enhancing the division of labor
 - Realizing economies of scale
 - Stronger competitive pressure on producers to reduce inefficiencies and invest in productivity-enhancing capital goods and innovation

- *[T]he common denominator [that accounts for the rapid growth across East and Southeast Asia] was manufactured exports, supported by a regime best characterized as free trade for exporters (Radelet, Sachs and Lee, 1997).*

Small government, focused on growth



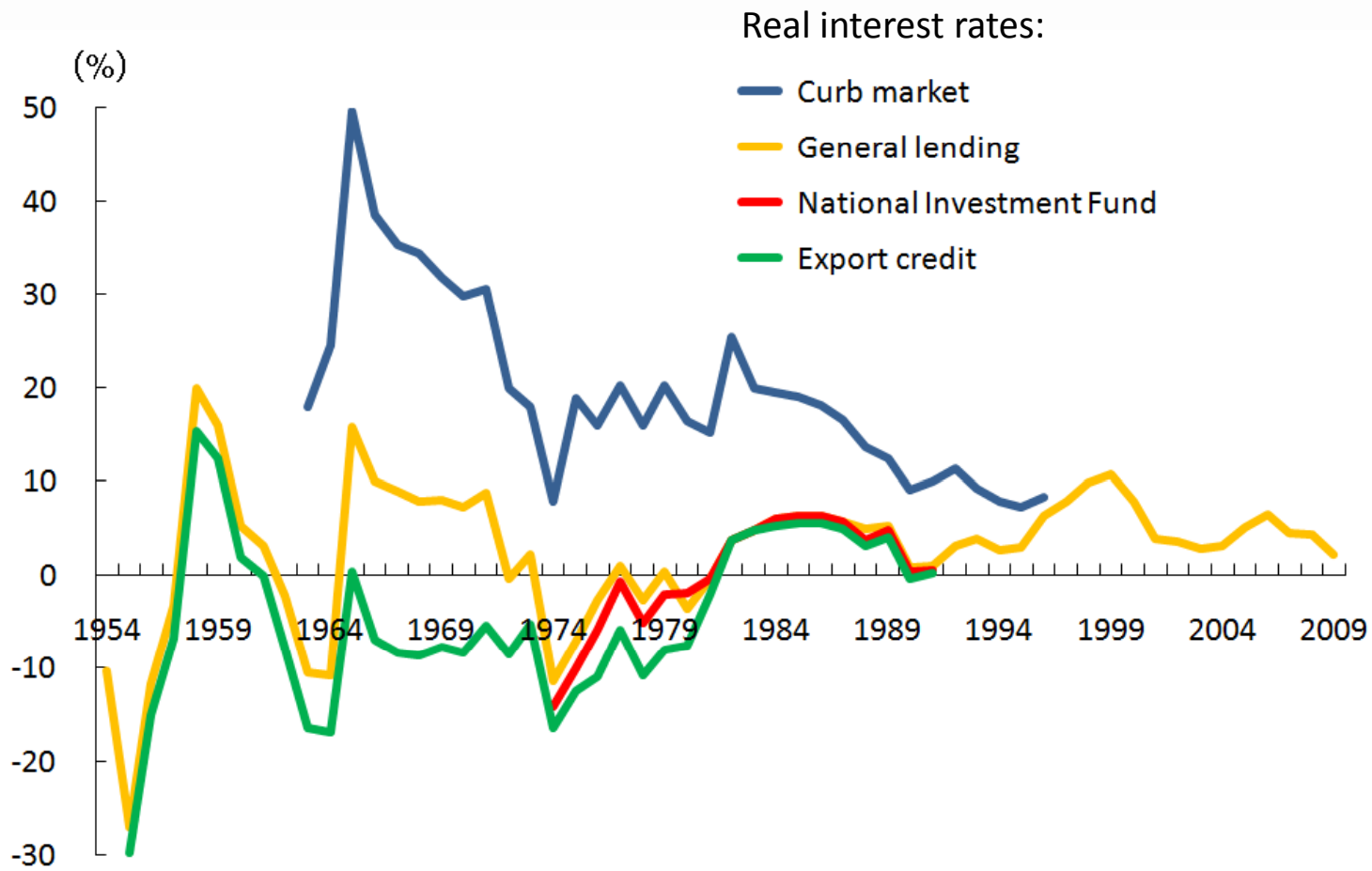


Problems with the government-led growth strategy

- To promote exports and HCIs, the Korean government
 - Revised the BOK Act and severely limited the independence of BOK.
 - Nationalized commercial banks and established various state-owned banks.
 - Korea Development Bank, Korea Eximbank, Korea Exchange Bank, Industrial Bank of Korea, etc.
 - Provided large-scale policy-loans amounting to 40-60% of domestic credits.
 - Exporters and HCI firms were entitled to loans from commercial and state-owned banks at low interest rates.
 - The losses incurred by banks were covered by BOK that subsidized banks through its discount window.

Financial repression (2)

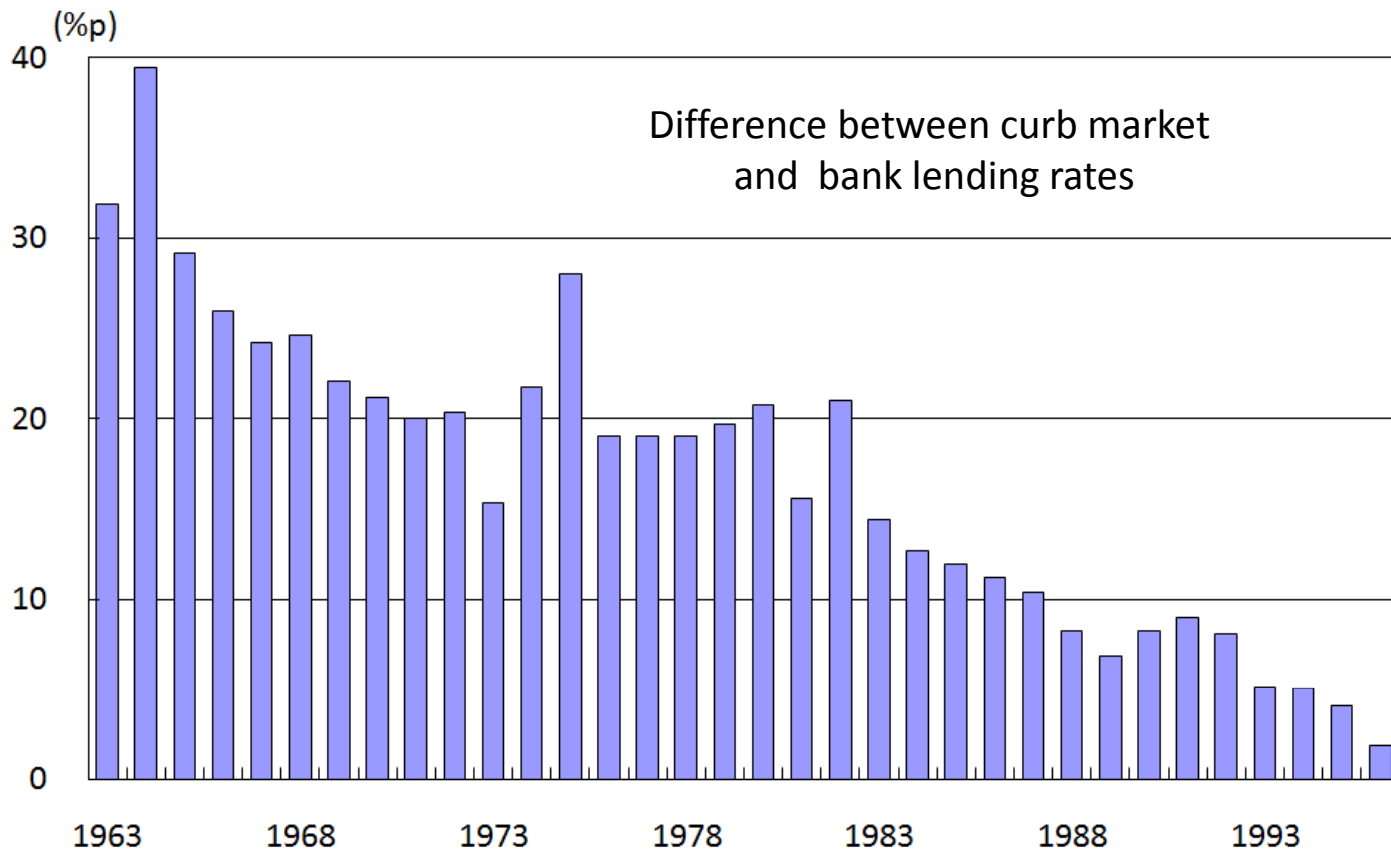
- Kept the interest rates at low levels.



Note: Real interest rates were obtained using the GDP deflator.

Financial repression (3)

- Tried to control unorganized as well as organized markets.
 - August 3rd Measure of 1972: Reported curb market loans were to be repaid over 3 years after a 5-year grace period.
 - “The government will come to the rescue in times of trouble.”



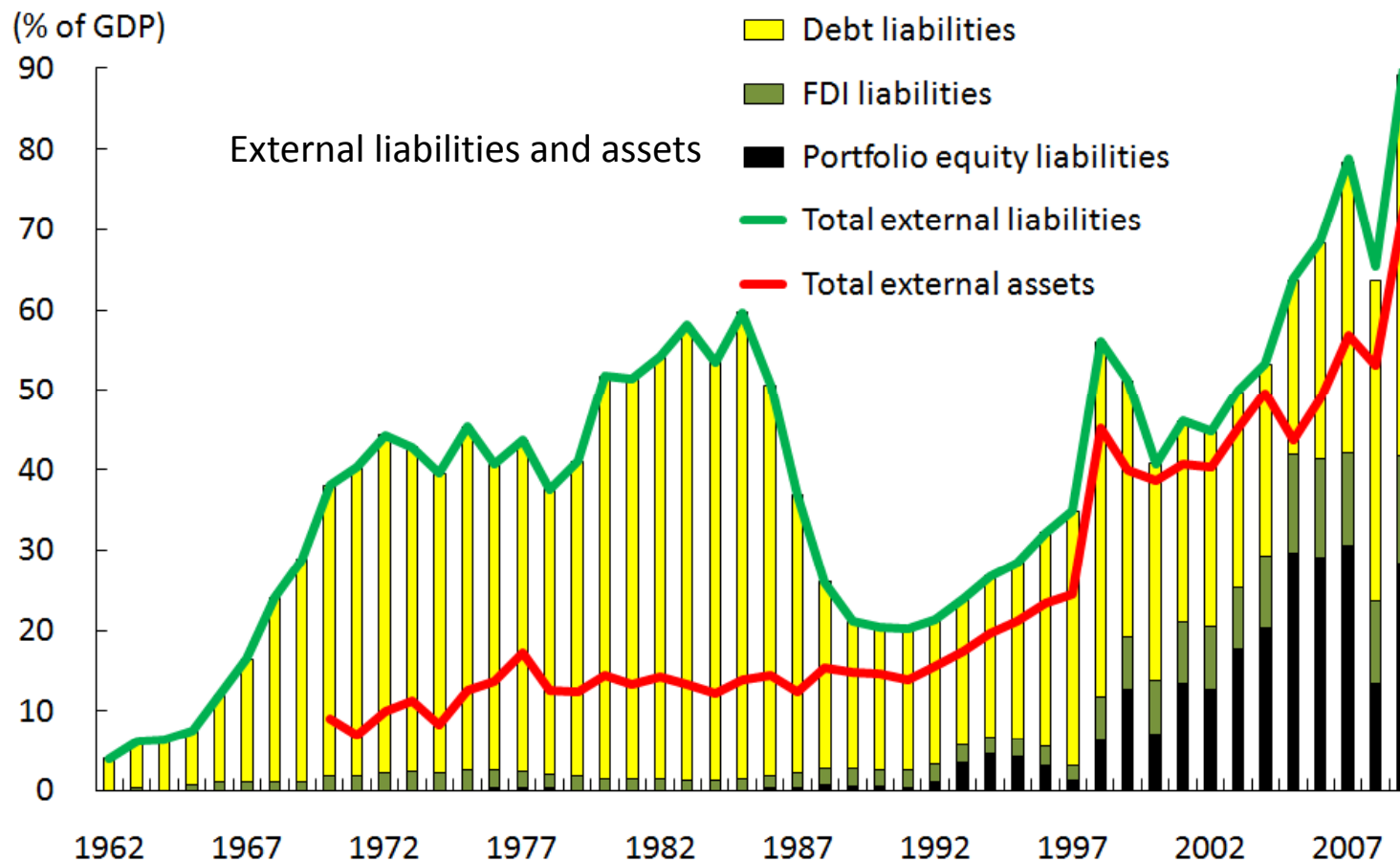
■ Repeated bail-outs of private borrowers

- August 3rd Measure (1972)
- HCI capital restructuring (1979-83), industrial rationalization (mid-1980s)
 - Relied on anti-competitive measures to guarantee monopolies.
- Restructuring of insolvent firms (1986, 1988)
 - Redeemed all debts in excess of assets.
 - Special BOK loans of 1.7 trillion won (about half of the growth of reserve money between 1984 and 1987) provided to commercial banks.

- Succeeded in short-term stabilization but had a long-term destabilizing effect by aggravating the moral hazard.

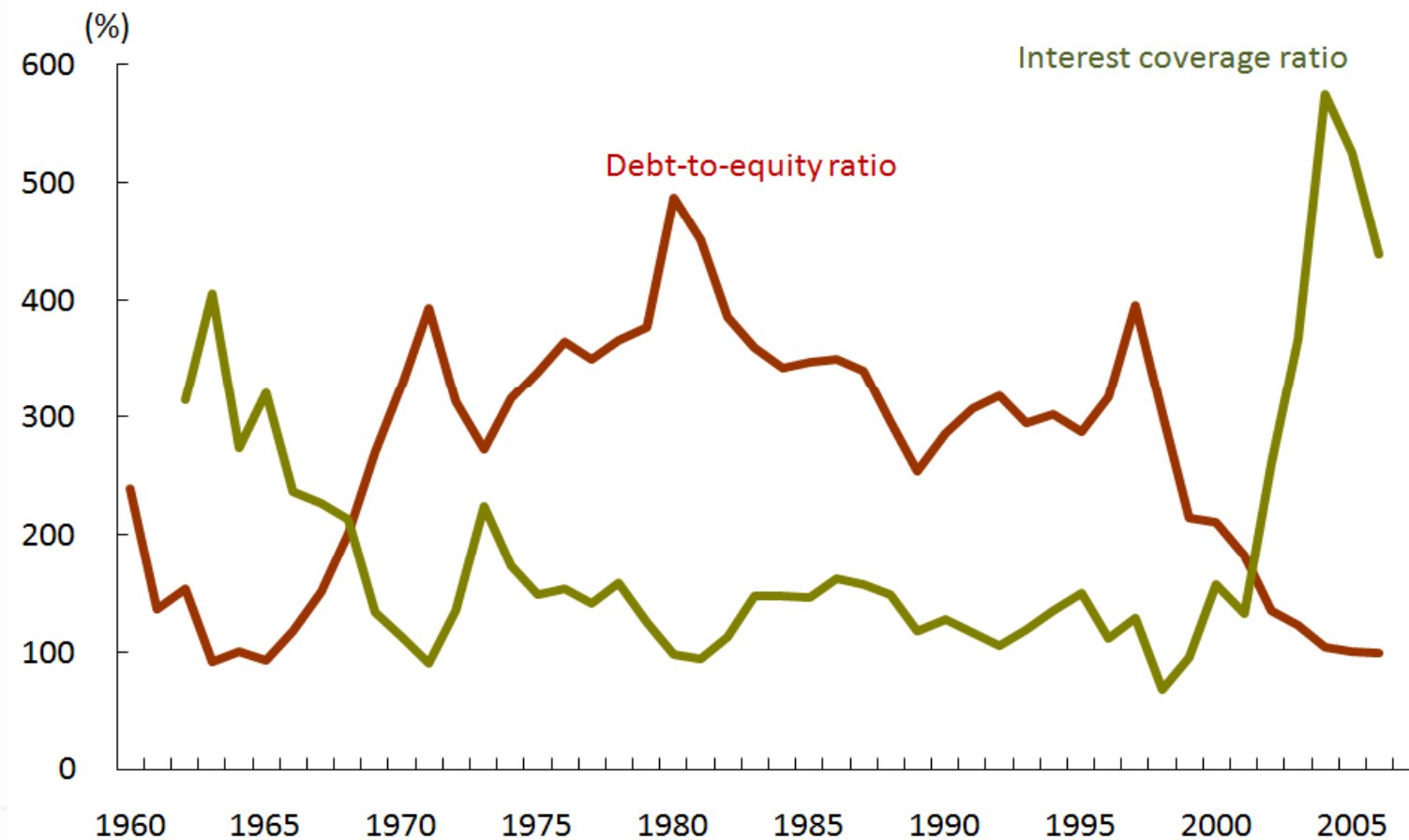
Increasing corporate indebtedness (1)

- In the 1960s, the government began to provide guarantees to borrowings from abroad.



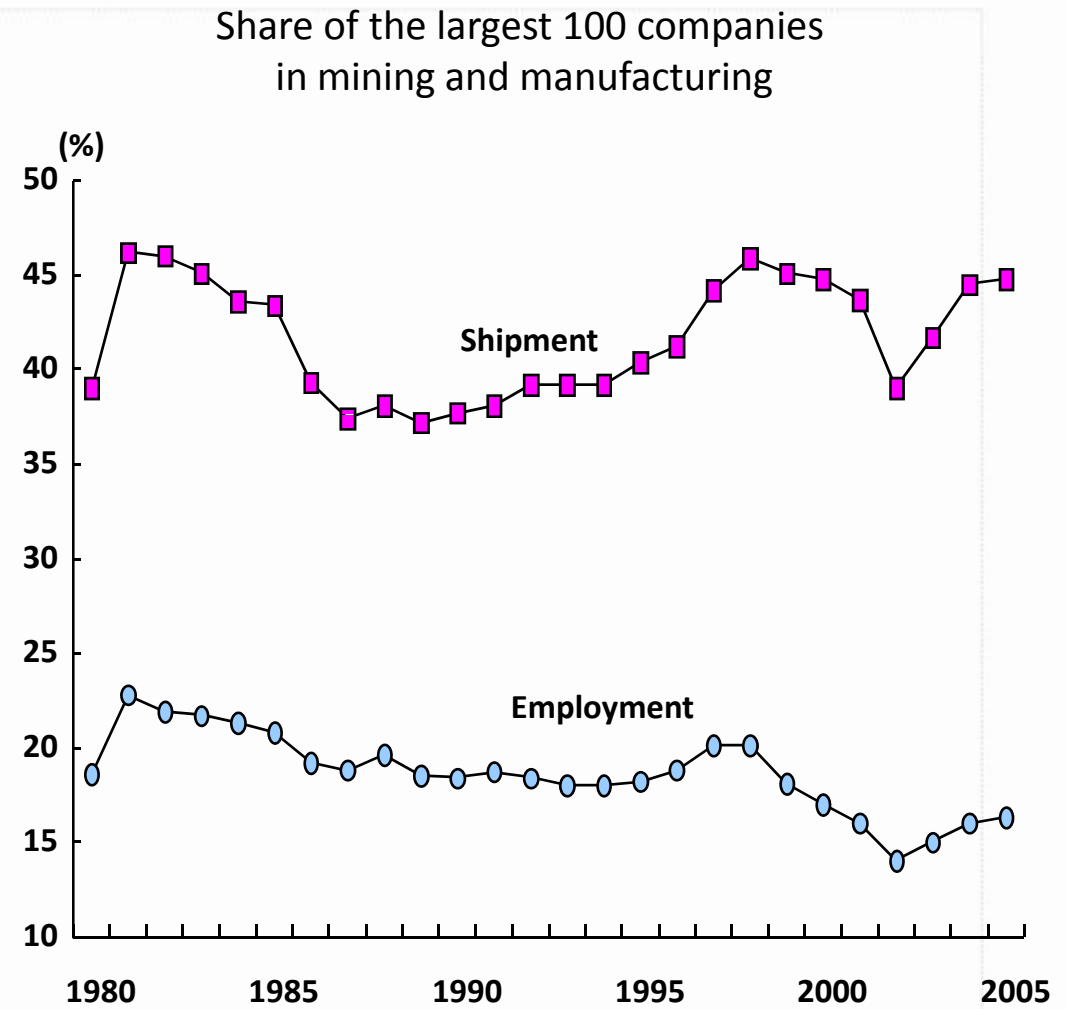
Increasing corporate indebtedness (2)

- The corporate financial health deteriorated significantly.
 - The banking sector came to be plagued by the NPL problem.



The *chaebol* problem

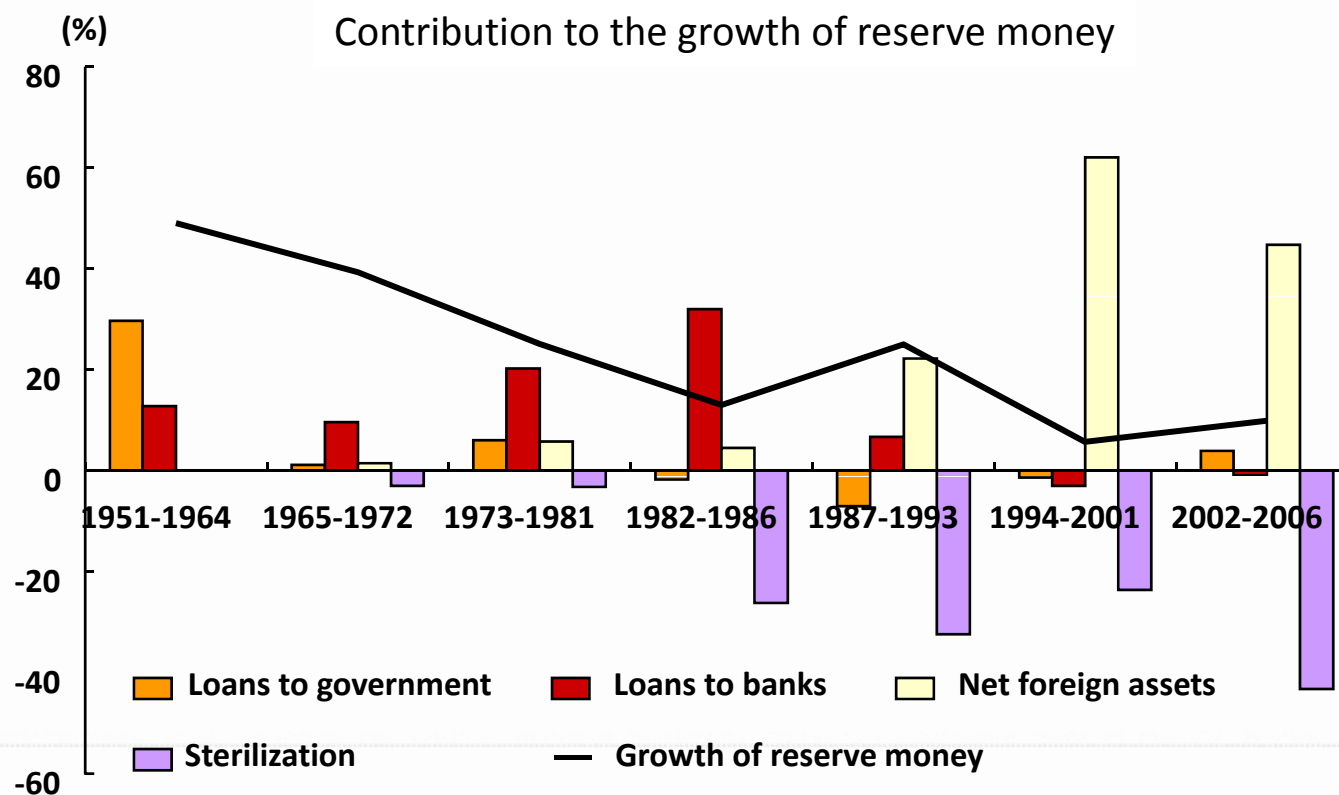
- Increasing concentration of economic power in the *chaebol*
 - In the process of allocating foreign loans (1960s), the HCI drive (1970s), and industrial rationalizations (1980s).
- Various *chaebol* regulations addressed the symptoms rather than the root cause of the *chaebol* problem (“too big to fail”).



Source: Lee (2007).

Price instability and direct control of prices

- The primary responsibility of the central bank lay in providing 'growth money.'
 - Higher inflation than in Taiwan and other EA countries.
 - Tried to stabilize consumption goods prices through direct controls.



- Long history of militant labor movement from the colonial period
- In the 1960s-1980s, the government oppressed labor movements while promoting exports and HCIs.
- Labor movements became increasingly charged with politics and aimed at overthrowing the ruling power.
- Entailed long-term costs in terms of social cohesion and political stability.

■ Financial liberalization in the 1980s and 1990s

- Liberalized interest rates
- Reduced policy loans
- Privatized banks
- Let the number of NBFIs increase rapidly
 - The *chaebol* kept demanding more liberalization while expanding their control over NBFIs.

■ Weak prudential regulation

- Poor or non-existent standards of prudential regulation
- Increasing share of credits exempted from regulation (CPs, bank trust accounts, etc.)
- Divided regulatory authorities

■ Weak market infrastructure

- Backwardness in accounting and disclosure standards
- Low credibility of rating agencies

■ Capital market opening in the 1990s

- Liberalized the overseas operations of banks and NBFIs in the mid-1990s.
- Short-term foreign borrowings increased rapidly since 1994 to meet the increasing investment demand.
- The maturity mismatch between foreign assets and liabilities became serious.

■ Weak prudential regulation

- The authorities believed that their control of the banking sector would guarantee the stability of the financial market as it did in the past.

■ Thorough liberalization

- Capital market liberalization

■ Dismantling the risk partnership

- Letting Daewoo, one of the top 5 *chaebol*, go bankrupt
 - “Too big to fail” became no longer relevant.

■ Strengthening market discipline

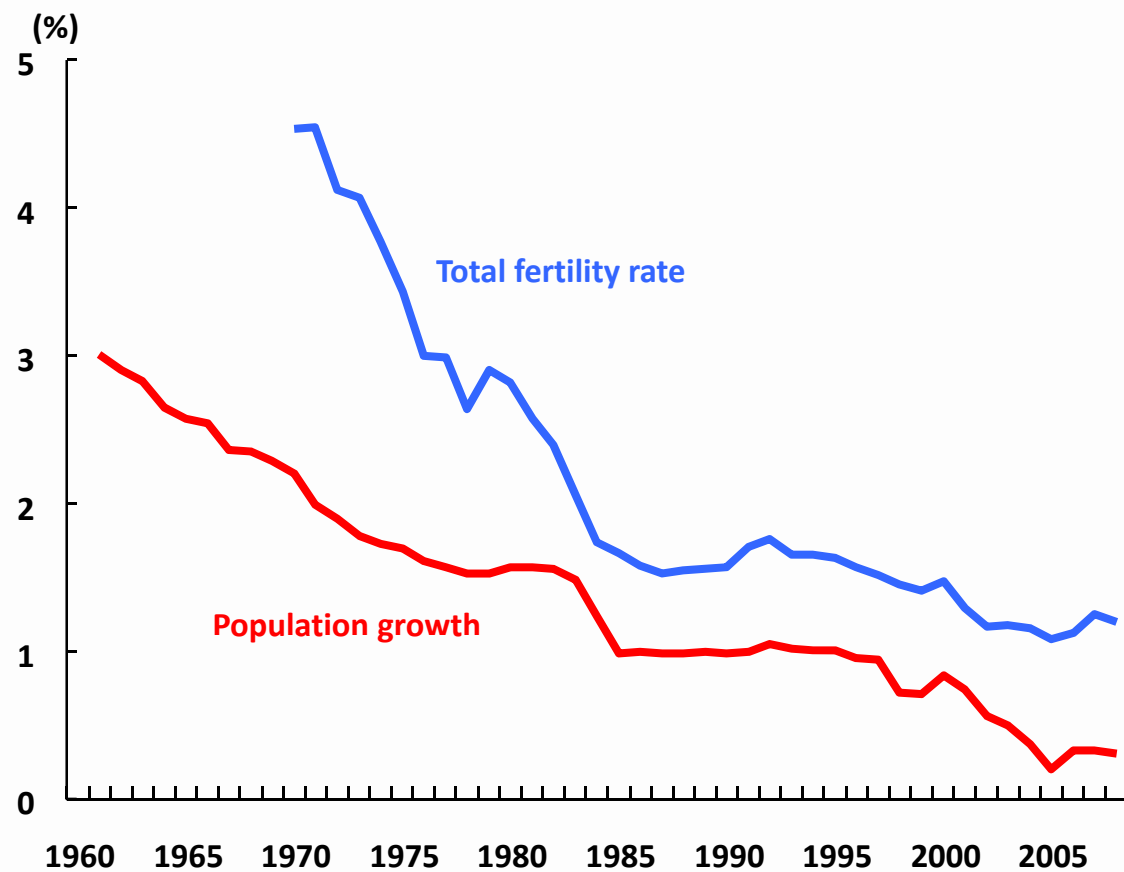
- Penalizing corporate crimes
 - Imposing penalties of KRW 26 trillion on Daewoo management
- Introducing a modern prudential regulation
- Reforming the corporate governance
- Reinforcing competition policy



Challenges facing the Korean economy

Slower growth

- The potential growth rate is falling with the slowdown in population growth.



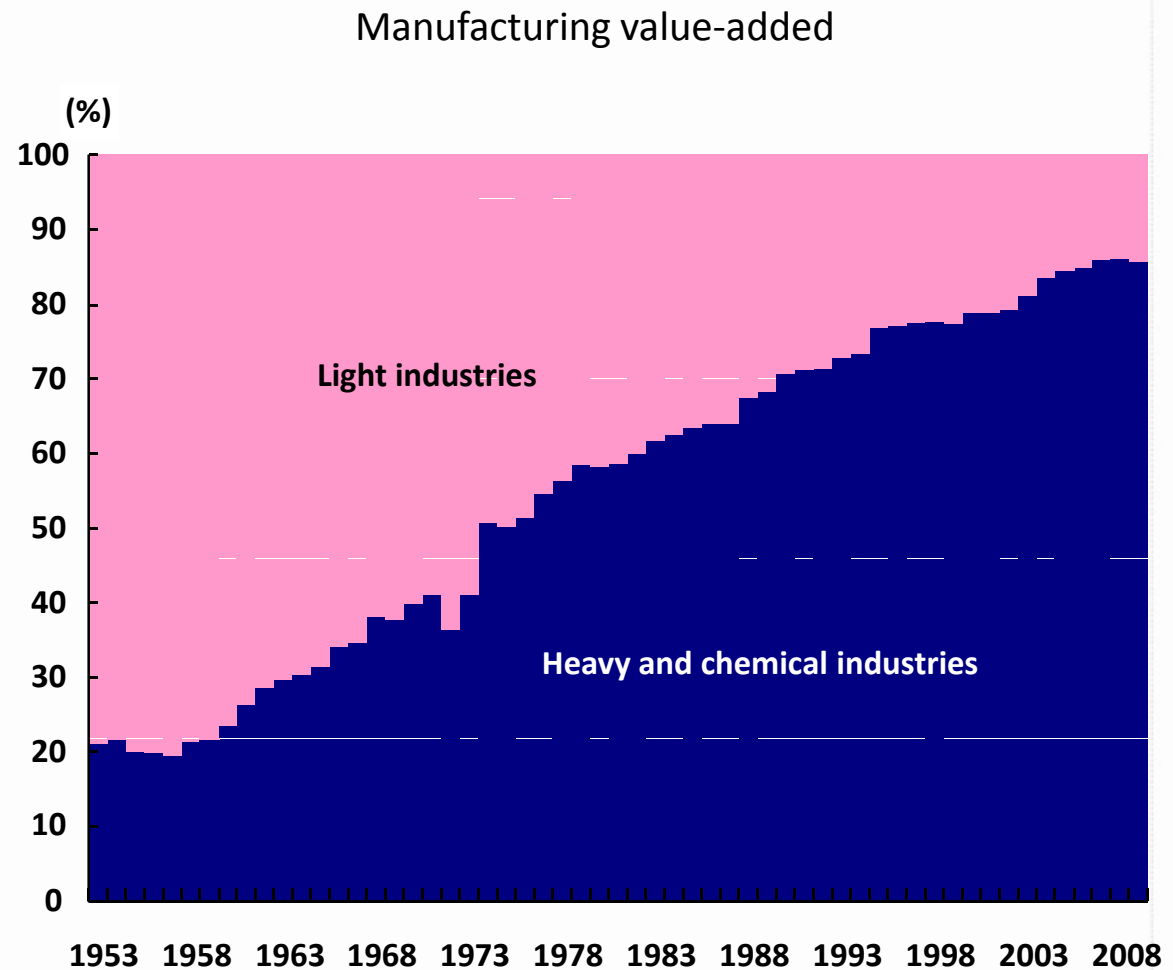
Increasing gaps in productivity (1)

■ Between manufacturing and services



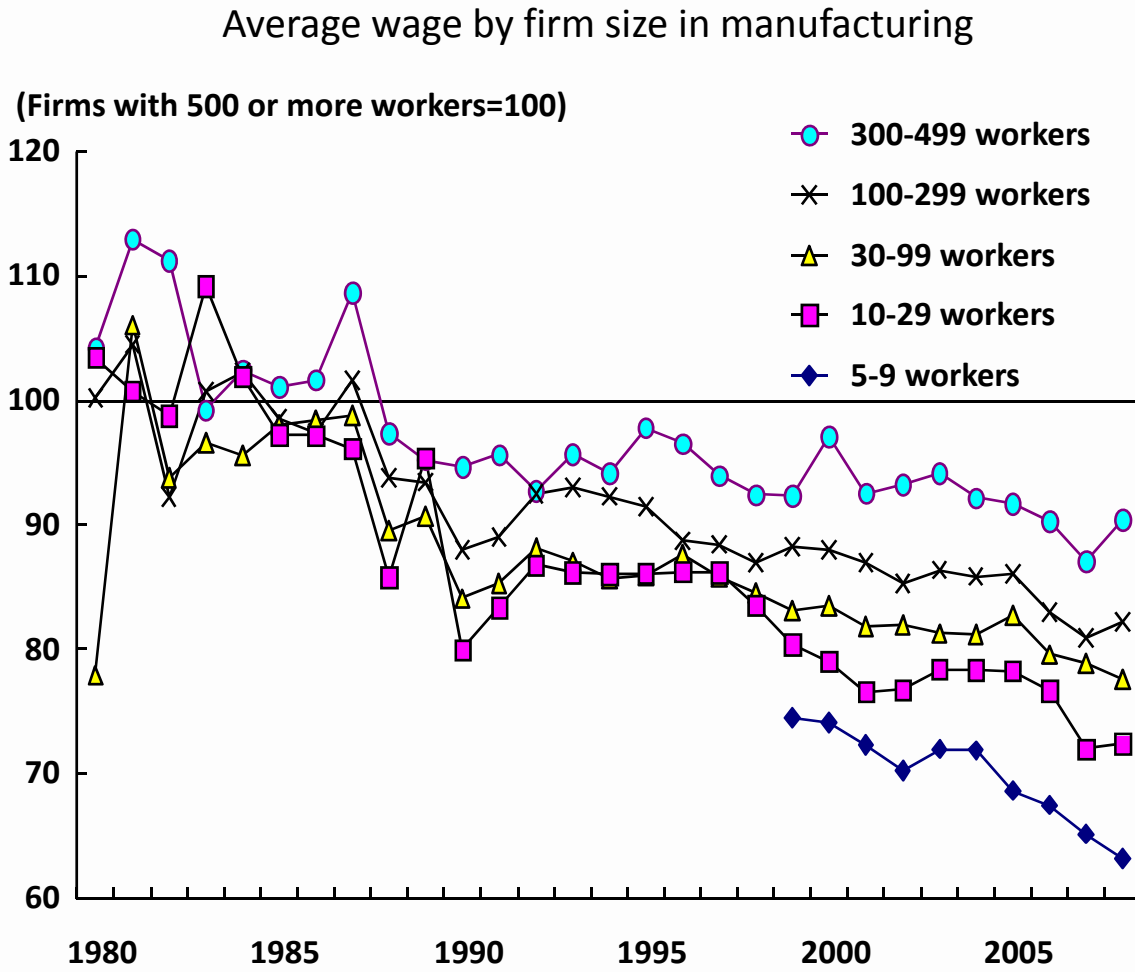
Increasing gaps in productivity (2)

- Between light industries and HCIs



Increasing gaps in productivity (3)

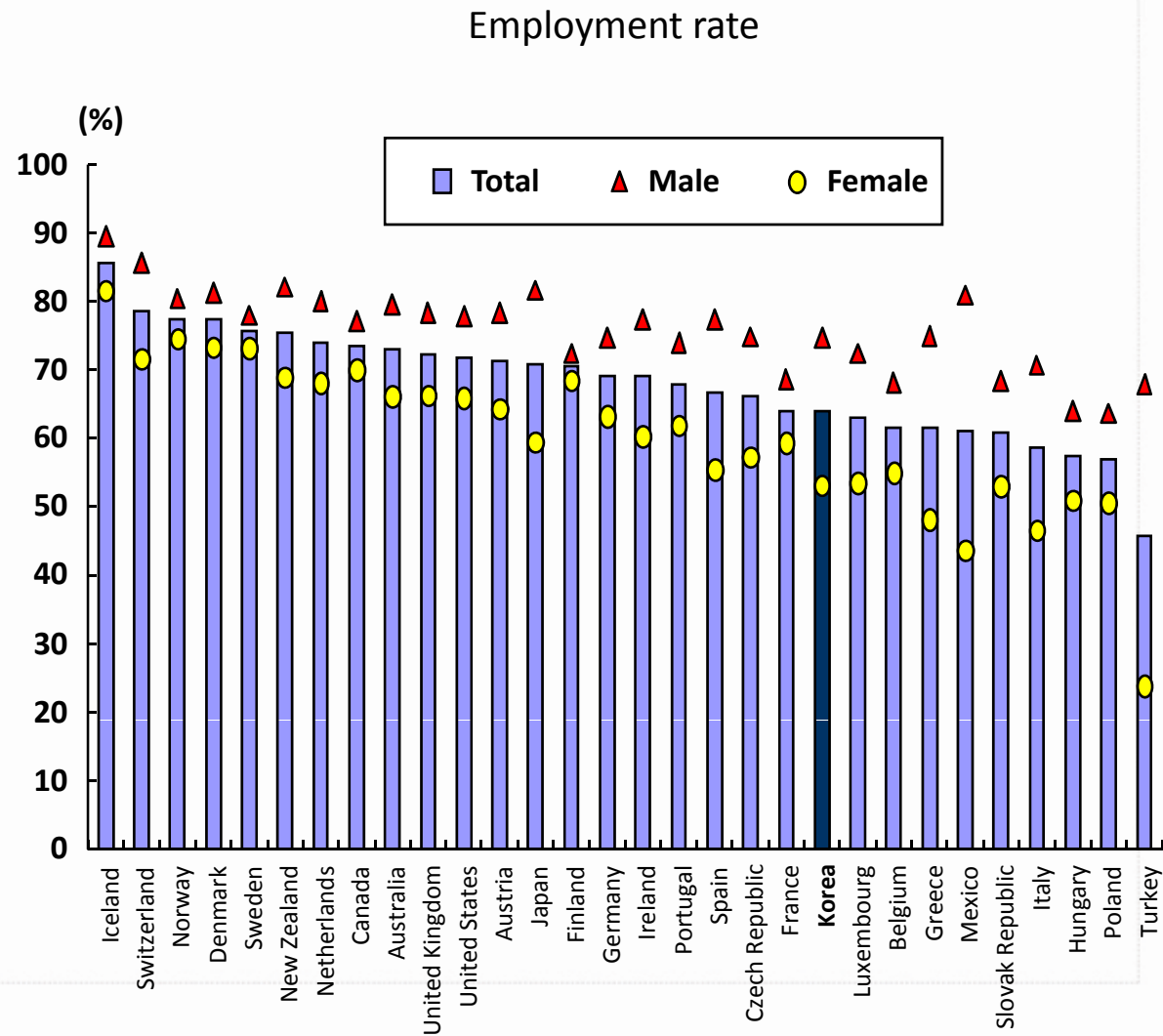
Between large corporations and SMEs



Stagnant employment growth

■ Male and female employment rates remain low.

- Capital-incentive growth
- School-to-work transition difficult
- Inflexible labor market



Unsatisfactory quality of education

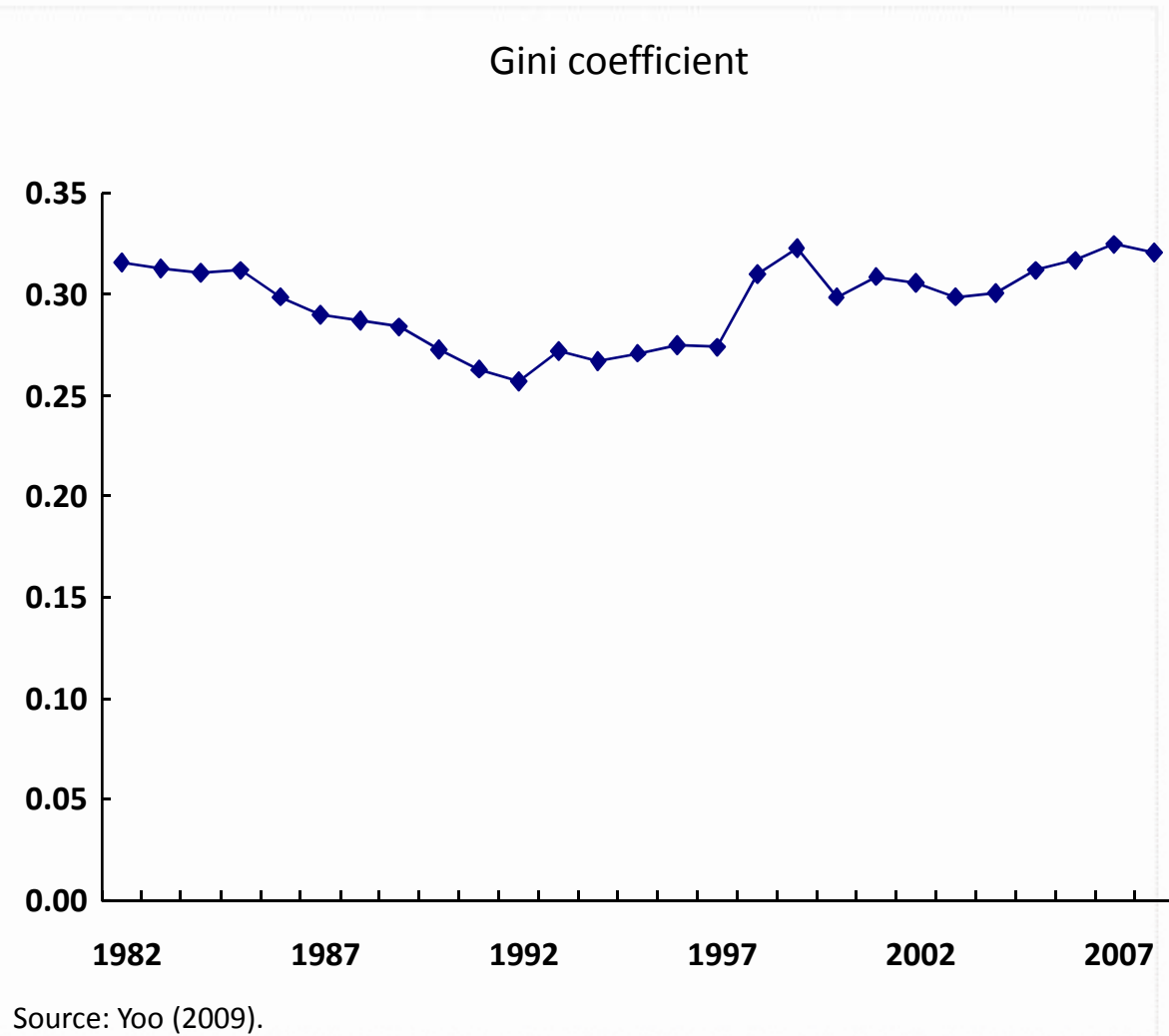
■ Korea's IMD Education Competitiveness Ranking

Criteria	2005	2010	Criteria	2005	2010
Total public expenditure on education (per GDP)	33 /51	36 /58	Educational system meets the needs of a competitive economy	34	31
Pupil-teacher ratio (primary education)	51	51	University education meets the needs of ...	43	46
Pupil-teacher ratio (secondary education)	42	51	Management education meets the needs of ...	-	43
Secondary school enrollment	24	8	Illiteracy (% 15+ old)	31	32
Higher education achievement (% 25-34 old attained tertiary education)	4	2	Language skills are meeting the needs of enterprises	35	39
Educational assessment (PISA survey of 15-year old, mathematics, science)	3,4	4,4	Qualified engineers are available in your labor market	37	47
English proficiency (TOEFL scores)	-	48	Knowledge transfer is highly developed between companies and universities	19	24

Worsening income distribution

■ Income inequality and poverty on a rising trend since the early 1990s

- Globalization
- Knowledge-based economy
- Productivity gaps
- Stagnant employment growth
- Inadequate social safety net
- Population aging





The role of government

■ Fast economic growth with heavy investment in...

- Physical capital
- Human capital
- Technology

■ Indispensible role of the government

- Leadership commitment to growth
- Eliminating opportunities for rent-seeking
- Promoting exports
 - Competitive pressure on producers
 - Positive externalities on other firms
- Small government, focused on growth

■ Negative side of the government-led growth

- Public-private risk partnership
- Financial weaknesses in the corporate and banking sector
- Lack of proper prudential regulation based on an arm's-length principle
- Chronic inflation
- Oppressive labor market policy

■ New challenges

- Eliminating remaining interventions in the market
 - Regulatory reform in the service sector to promote market competition
 - Direct financial and fiscal support to SMEs to be reexamined
 - Privatization of SOEs
- Improving the education system and expanding the social safety net
- Ensuring financial market stability

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