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Source: *The American Economic Review*, May, 1990, Vol. 80, No. 2, Papers and Proceedings of the Hundred and Second Annual Meeting of the American Economic Association (May, 1990), pp. 104-107

Published by: American Economic Association

Stable URL: <https://www.jstor.org/stable/2006551>

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Lessons From Korean Economic Growth

By SUSAN M. COLLINS*

In 1960, Korea was a poor developing country with a small manufacturing sector and heavily dependent on foreign aid. It had seemingly few prospects to increase and maintain high growth rates. However, between 1965 and 1979, Korea's real GDP growth averaged over 9 percent per year, with manufacturing growth of nearly 19 percent.

In 1981, Korea was the fourth largest debtor country in the world, behind Brazil, Mexico, and Argentina. Output had declined sharply in 1980. With a debt-to-GDP ratio of 50 percent, there were widespread concerns about Korea's ability to meet its debt obligations. However, Korea's economy was booming again by 1986, with a substantial trade surplus due to rapid export growth. In addition to meeting all debt service obligations, Korea had begun to repay the principal on its external debt.

Korea's impressive history of economic growth stands out from the experience of most developing countries that have borrowed heavily in international financial markets. A comparison of per capita income (PCI) growth rates from the World Bank presents the differences starkly. Over 1965–87, Korea's PCI grew at an average annual rate of 6.4 percent. Over the same period, PCI grew on average by just 2.0 percent in the 17 heavily indebted countries, by 2.5 percent in middle-income countries and by 3.1 percent in low-income countries. (In fact, only three World Bank member countries—Botswana, Oman, and Singapore—had faster annual PCI growth rates than Korea.)

As stated in the *World Development Report*, “for most of the highly indebted countries, the debt crisis has become a growth crisis as well” (1989, p. 17). The contrasts in growth performance between these countries and Korea, since 1965 and particularly during the 1980s debt crisis recovery, are striking. This paper examines distinguishing aspects of Korea's economic growth and argues that these factors do contain lessons for policymakers in other countries struggling to revive stagnant economies.

I. Policy Stability

Korea's experience does not provide an example of “quick fix” policy packages, but of a long history of relatively consistent, stable, and sensible macroeconomic policies. At the same time, Korea's history is not completely devoid of policy mistakes. For example, the 1973–79 “Big Push” to develop heavy industry is widely recognized as having contributed to a real appreciation and loss of competitiveness and to distorting allocation of credit and other resources.¹ Instead, what stands out is that macroeconomic policies were adjusted before they became far out of line. The point could be made with a variety of policy indicators; budget deficits, real interest rates and real exchange rates are discussed below.²

First, budget deficits have been kept small in Korea, averaging just 2.3 percent, and

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¹See my paper with Won-Am Park (1989, especially pp. 191–98) for further discussion of Korea's Big Push and also for additional references.

²Data on central budget deficits and real interest rates come from the International Monetary Fund. Real exchange rate data are from Morgan Guaranty.

ranging from 1.0 to 4.2. The average deficit was more than twice as large in Mexico and Argentina. The range between the smallest and the largest deficit was more than 10 percent of GNP in all three Latin American countries.

Korea has also maintained relatively stable real interest rates. Between 1977 and 1987, the real deposit rate (average nominal rate less *ex post* consumer price inflation) averaged 2.5 percent, compared to -2.3 percent in the Philippines, -13.4 percent in Mexico, and -22.3 percent in Argentina. While Korea's real deposit rates were not positive every year, they were negative in only two of eleven years, compared with five years of negative rates in the Philippines, six years in Argentina, and nine years in Mexico.

Relative to other countries, Korea's real exchange rate has remained stable as well. Although a fixed nominal exchange rate was maintained from December 1974 through January 1980, resulting in a 15 percent real appreciation, this appreciation is small when compared to the real appreciations of 23 percent in Mexico during 1977-81, and the 81 percent in Argentina during 1977-80. The standard deviation in Korea's real exchange rate during 1975-85 was just 6.5, less than half of the 14.7 and 16.7 standard deviations in Brazil and Argentina.

II. Breathing Space for Policy Reforms

In 1980, Korea was in the midst of an economic crisis. Real output declined by 4.8 percent and inflation had doubled to 28.7 percent from 14.4 percent in 1978. The debt/GNP ratio had jumped from 28 to 45 percent and the current account deficit had ballooned to 9 percent of GNP. Years of the Big Push to heavy industry had resulted in growing price controls, import restrictions, and regulations distorting financial markets. Korea needed a combination of macroeconomic stabilization policies, trade and financial market liberalization, and economic restructuring. Korea's recovery from this crisis was striking and rapid. Real growth averaged over 7 percent during 1981-84 and, by

1984, inflation had been cut to 2.3 percent, the current account deficit was less than 2 percent of GNP, and there was little remaining concern about Korea's creditworthiness.

Should we believe that other countries could implement the same policy package to rapidly restore creditworthiness and growth? My response has three parts. First, Korea's policy package is a sound one for other countries. However, Korea's history of relatively stable, sensible macroeconomic policies, high rates of investment, and strong growth also played a role in the rapid turnaround. In this sense, Korea's short-lived economic crisis was less severe than the difficulties faced by many heavily indebted countries. The second point, therefore, is that Korea's policies are unlikely to result in as quick and as impressive a recovery in countries with a history of policy reversals and inconsistencies, and which have had low investment rates since 1982.

The third point is that many observers omit a key part of Korea's recovery package. Korea did not implement macroeconomic stabilization and restructuring measures, nor did it revive growth at the same time that it reversed its dependence on foreign borrowing. Instead, Korea had the breathing space of large continued capital inflows (together with some special circumstances) during the first years of its recovery which enabled it to revive growth *before* undertaking restrictive monetary and fiscal policy actions. Korea does *not* provide an example of how to stabilize and restructure an economy, shift from receiving capital inflows to making large resource transfers abroad and raise living standards, all at the same time.

Table 1 provides economic indicators for Korea during 1979-84. It is useful to divide the recovery into two periods: 1980-82 and 1983-84. In the early period, Korean policymakers devalued, liberalized price controls and many import restrictions, and initiated tax reforms. Although monetary and fiscal policies were initially to be restrictive, the tight stance was relaxed because of concerns over flagging investment in 1981, and to bail firms out after a financial crisis in 1982. In fact, fiscal policy was quite expansionary,

TABLE 1—KOREAN ECONOMIC INDICATORS

	1979	1980	1981–82	1983–84
GNP Growth Rate	7.0	–4.8	6.0	10.2
Current Account	–6.8	–8.8	–5.4	–1.9
Fixed Investment	33.2	32.3	29.6	31.3
Domestic Saving	28.1	23.5	23.8	29.1
M2 Growth Rate	24.6	26.9	26.0	11.5
Budget Deficit	–1.4	–3.2	–4.6	–1.5
External Debt	32.5	45.0	53.5	52.3
External Debt (billions \$)	\$20.3	\$27.2	\$37.1	\$43.1

Source: Economic Planning Board, Korea.

Notes: Percent of GNP, unless otherwise indicated; 1981–82 and 1983–84 data are annual averages, except for external debt, which is end of period.

accommodated by strong money growth. Korea continued to borrow heavily to finance imports and investment. Also, a good harvest (following extremely poor harvests in 1978 and 1980) helped to expand output while reducing food imports.

The 1981–82 measures set the Korean economy up to take advantage of stronger world growth in 1983–84. It was not until exports and output were booming that the government reversed its expansionary macroeconomic policies, and the debt-to-GNP ratio stabilized.

Korea's phased policy response, with its initial breathing period, contrasts sharply with the attempts in many heavily indebted countries (for example, in Latin America) to do everything at once. In these countries, trade deficits were quickly transformed to surpluses after 1982 through cuts in imports and investment. This approach has not produced adjustment with growth.

Korea is not the only example that breathing space facilitates a growth recovery from a debt crisis. Turkey, during 1980–82, and Indonesia, during the mid-1960s, also received generous capital inflows as they were implementing their adjustment packages. Like Korea, these countries both got into trouble *before* the 1982 widespread debt crisis, and both benefited from favorable borrowing conditions in international financial markets. However, breathing space is not a panacea. There are also examples of countries that received large capital inflows, but

did not implement necessary reforms, and therefore did not engineer a recovery to sustainable growth and creditworthiness.

III. Investment and Growth

A related feature that distinguishes Korea's adjustment from the experience in many Latin American countries is that Korea maintained high rates of investment. This investment, concentrated in export industries, helps to account for Korea's rapid growth during the 1960s and 1970s, and also for the quick recovery in the 1980s. Korea's gross domestic investment grew at an average annual rate of 15.9 percent during 1965–80 and 10.0 percent during 1980–1987. In contrast, investment growth in the 17 highly indebted countries fell from 8.6 percent during 1965–80 to –5.1 percent during 1980–87. Many analysts have expressed grave concern about their ability to revive growth as the capital stock erodes. External borrowing helped to finance Korea's investments in 1980–82. It was not until the 1983 surge in growth that domestic savings began to rebound, reducing the need for foreign financing. Breathing space contributed significantly to Korea's ability to maintain high rates of investment.

What are the underlying sources of Korea's growth, and how important was capital accumulation? A Denison growth accounting analysis by K. S. Kim and J. K. Park (1985) decomposes Korean growth during 1963–82. They show that factor inputs, and especially capital accumulation, played an increasingly central role. During 1963–72, increased quantity and quality of capital and labor accounted for about half of average annual growth, or 4.2 percent per year. During 1972–82, factor inputs accounted for nearly 80 percent of Korean growth, or 5.6 percent per year. In particular, increased nonresidential structures and equipment augmented growth by 1.5 percent per year more during 1963–72 than during 1972–82, offsetting a decline in factor productivity growth that followed the first oil price shock. On the labor input side, increased work hours and improved education helped to offset slower employment growth. The importance of

physical and especially human capital accumulation distinguish Korea's growth history from that of countries which industrialized prior to 1973.

IV. Concluding Remarks

What, then, are the lessons from Korea's economic growth? First, a stable policy environment provides a solid stage for adjusting to internal and external shocks. Although difficult to quantify, there can be little doubt that Korea's policy history was an important stabilizing factor in the quick 1981–84 recovery. Second, investment in both physical and human capital is a key to economic growth. In Korea, increased factor inputs alone accounted for an average annual growth rate of over 5 percent during the 1970s.

It is against this backdrop that a third, important lesson emerges. Even in Korea, where policies have been stable and high rates of investment have been maintained, breathing space in the form of continued capital inflows played a key role in reviving and sustaining growth after 1980. Korea's

experience should not be construed as an example that a country in the midst of a prolonged economic crisis, with a depleted capital stock and a history of policy reversals and mistakes, can simultaneously undertake structural adjustments together with restrictive macroeconomic policies, transfer resources abroad and revive stagnant growth rates.

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