Macroeconomic Policy and Adjustment in Korea 1970-1990

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Preface

Fifteen years ago the Korea Development Institute (KDI) and the Harvard Institute for International Development (HIID) jointly researched, wrote, and published ten book-length studies on the first three decades of Korean economic development (1945–1975). Several years ago, the reception of these volumes encouraged the two institutes to think of a sequel. In considering that sequel, we decided to focus on a number of studies that went in-depth into several of the key features of the post-1975 period.

We chose three themes that dealt with central features of Korean development, which were either not present in the pre-1975 period or were present in only muted form. The first of these studies deals with macroeconomic policy during the difficult period of the 1970s when oil prices were rising sharply, and with the aftermath of these macro problems in the 1980s. The second study deals with Korea's move away from generalized support for exports of manufactures to a policy of targeting specific industries, the heavy and chemical industry drive of the 1973–1979 period, followed by the retreat from industrial targeting in the 1980s. The final study deals with some of the strains of rapid economic growth. Special attention is paid to labor relations and the labor market in the 1980s when Korean democratization led to the end of government efforts to suppress the labor movement, and labor and management had to learn new ways of working together.

These three studies differ from the earlier ten-volume series in another important respect. The earlier series dealt only peripherally with the politics of the economic changes that were analyzed. The three recent studies include political economy issues as central themes. Technical economic analysis continues to play an important role, but many chapters are devoted to how and why key economic policy decisions were actually made, a process that involved more than purely economic considerations.

In completing this volume on macroeconomic policy in Korea, the authors are grateful for the assistance of Professor Chung-In Man. We owe special thanks to David Lindauer, who has borne the principal responsibility for managing the research and production of these volumes. We also want to thank the three past presidents of KDI who helped initiate these studies and bring them to fruition, Dr. Park Yung Chul, Dr. Koo Bon Ho, and Dr. Song Hee Yhon. Funding for these studies was provided from KDI funds and from the unrestricted income of HIID. The editorial process was under the overall direction of HIID's editor, Vukani Magubane.

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Understanding Korea's Macroeconomic Policy

Stephan Haggard, Richard N. Cooper, and Susan Collins

Because of the extraordinary performance of the Korean economy, economists have scrutinized it from every angle (Table 1-1). Trade and industrial policy have received particular attention, but several excellent studies are available on various aspects of macroeconomic policy and performance as well.[1] Given the plethora of material, what can yet another study add to our understanding of Korea's development?

This book, which examines macroeconomic policy and performance in South Korea from 1970 through the end of the Roh administration in 1992, makes two contributions. First, it provides a political economy perspective on Korean macroeconomic policy. Studies of Korea's rapid growth and successful adjustment in the early 1980s have given particular weight to credible and cohesive policies. Yet the work on Korea's macroeconomic performance provides a relatively narrow economic analysis of the adjustment experience, paying little attention to the institutional and political setting in which policy decisions were made. Part II of this book provides an analytic history of Korean macroeconomic policy over the past two decades that integrates political and economic analysis.

Our second contribution is to draw lessons from the past two decades that are of relevance to the performance of other developing countries; this study is thus implicitly, if not explictly, comparative. The initial motivation for this project was both to update the original Harvard Institute for International Development–Korea Development Institute studies on Korean development and to examine Korea's experience in managing the external shocks that buffeted the world economy beginning with the first oil crisis. Although Korea is a large debtor and an extremely open economy, when measured by the share of exports in total output, it adjusted relatively smoothly to the international turbulence of the 1970s

Table 1-1. Korea: Basic Indicators of Economic Performance

	1970	1980	1990	1970–1980	1980–1990
				(Annual % Rate)	
GDP (trillion won)	2.72	37.9	169.7	30.1	16.2
Real GDP (trillion 1985 won)	23.74	52.4	121.7	8.2	8.8
Real GDP per capita (000 1985 won)	736.0	1,374.0	2,844.0	6.4	7.4
Labor force (million)	10.2	14.5	16.9[a]	3.5	2.2
Consumer price level (1985 = 100)	15.7	70.9	130.2	16.3	6.3
Real wage (1985 = 100)	34.4	76.7	219.3	8.3	8.2
Exchange rate (won/U.S.$)	311.0	607.0	708.0	6.1	1.6
Exports (U.S.$ billion)	0.88	17.2	63.1	34.6	13.9
External debt (U.S.$ billion)	2.24	28.8	33.1[b]	29.1	1.6
International reserves (U.S.$ billion)	0.61	2.92	14.8	17.0	17.6

[a]1987.
[b]1989.
Source: IMF, *International Financial Statistics;* World Bank, *World Debt Tables;* and author calculations.

and 1980s, maintaining robust growth in the face of external adversity. Given the disastrous experience of most Latin American economies in the 1980s, Korea's successful adjustment process raises important comparative policy issues.

The Political Economy of Macroeconomic Policy in Korea

Most studies of macroeconomic policy take policy choice as exogenous and examine the effects of policy on performance. Yet this begs the crucial question of why certain policies were chosen in the first place. Given that Korea managed to adjust quickly and efficiently, why was it able to do so?

To answer this question, Chapters 2 through 4 provide a historical narrative of Korea's macroeconomic policy since 1970. Chapter 2 focuses on the first half of the 1970s and the government's response to the first oil shock. Chapter 3 analyzes the development of the Heavy and Chemical Industry Plan of the second half of the 1970s, with particular emphasis on the emergence of the stabilization plan of April 1979 and the government's response to the second oil crisis. Chapter 4 outlines the developments of the 1980s, focusing on the stabilization and structural adjustment efforts of the first half of the decade. A brief epilogue to the book provides an overview of some of the political issues surrounding

Korea's adjustment to balance-of-payments surpluses, which occurred under the new democratic government of Roh Tae-Woo (1988–1992).

This historical narrative is built around two types of analyses that are generally foreign to purely economic treatments. The first is a historical reconstruction of the perspective of the policymaker. In analyzing a given policy juncture, analysts enjoy the luxury of knowing what ultimately transpired. The rationality or irrationality of a policy choice is easily gauged by subsequent events and performance. For the policymaker, though, the future is clouded in uncertainty. Decisions must be taken with less-than-perfect information and often pose high political as well as economic risk. Ex post facto, this drama of the policymaking process is easily lost.

In attempting to reconstruct events, the analyst must be particularly sensitive to both the information available to policymakers at the time and the theoretical frameworks they have at their disposal. We have therefore relied in part on interviews with a number of the principal policymakers who held office during the period under review. Their policy frameworks, as much as economic conditions per se, play a crucial role in explaining the logic of policy choice.

Although Korea's economic policy has been broadly outward oriented, the thinking of its top economic policymakers has departed in a number of ways from economic orthodoxy.[2] During the 1970s, two contending policy lines coexisted. A number of officials in the economic bureaucracy argued for a more market-oriented style of economic management. The top political leadership and advocates of an activist industrial policy supported a more dirigist approach, emphasizing exports but also industrial planning and the use of a variety of controls and direct interventions in order to deepen the industrial sector in heavy and chemical industries.

At the end of the 1970s, reformers took advantage of declining export performance and rising inflation to advance their liberalizing program. They gained ground within the economic bureaucracy, but their economic program was not fully realized until the 1980s under a new military government. Even during this period, certain policy areas, such as exchange rate management and financial market policy, continued to exhibit a penchant for state control and guidance that had characterized Korea's growth from the initiation of an export-led growth strategy in the 1960s.

The empirical reconstruction of the policy process provides the raw material for our second line of analysis: a focus on the institutional and political constraints on policy choice. Despite the emphasis that has been given to economic policy as an "input to development," economists generally treat the government as a black box.[3] When they do consider politics, it is assumed that the pursuit of economically optimal policies is also politically rational. An efficiency-enhancing economic reform may have distributional consequences in the short run, but the overall gains should permit the government to compensate the "losers" so that all are better off.

The emergence—or more accurately the reemergence—of a political economy has called these assumptions into question.[4] Electoral, interest-group, and international political pressures generate conflicts between economic and political rationality. Macroeconomic adjustment is particularly interesting in this regard, since it can involve the imposition of short-term costs that have important political consequences. To the extent that policy does show consistency and coherence in formulation and implementation, as it frequently has in Korea, this outcome constitutes an important puzzle to be explained.

Two broad theoretical insights guide our political economy analysis. The first grows out of the renewed interest in how institutions affect the coherence of decision making. The second, more traditional political economy approach focuses on the interests of relevant social groups and the process through which politicians build and sustain coalitions of support.

One theme in our analysis is the unusual degree of institutional centralization in Korea, of both political power and economic policymaking.[5] Prior to the transition to democracy in 1987, political power was strongly concentrated in the hands of two presidents, Park Chung Hee and Chun Doo Hwan, who took an active interest in economic management. Within the bureaucracy, economic decision-making authority was also centralized in a powerful Economic Planning Board (EPB).

This institutional structure had both advantages and drawbacks. On the one hand, the centralization of power permitted a high degree of flexibility in the formulation and implementation of policy. With little interference from interest groups, the legislature, local governments, or competing bureaucratic forces, the top leadership could respond swiftly to events if it chose. The centralized, authoritarian system also allowed tight control to be exercised over the operations of the government itself. Korea's unusual ability, among the developing countries, to control its fiscal policy has been an important factor in maintaining relative macroeconomic stability, an outcome that can be traced to a highly centralized budgetary process.

On the other hand, any centralized system is a captive of the outlook of its chief executive. In general, both Park and Chun chose to forge close working relations with top technocrats, giving the economic bureaucracy the political space to operate relatively free from political constraints. In the absence of institutionalized checks on executive power, however, the technocrats enjoyed little independence from the president. When the chief executive chose a certain course of action, such as Park's launching of the Heavy and Chemical Industry Plan, the technocrats' ability to resist was marginal, and influence could be wielded only when economic changes exposed the disadvantages of the chosen path.

An analysis of institutions can tell us about the capacity of government officials, but it provides few clues on what they are inclined to do. For insight into this question, we must examine not only the strategies of policymakers and the economic constraints they face but the political constraints that politicians face and their strategies for managing them.

For part of the period we are concerned with here (1964–1972), Korea was at least nominally a democracy. During that time, electoral strategy had an important influence on economic policy, affecting both the timing of policy measures (the delay and reversal of stabilization efforts in 1970) and their content (agricultural subsidies after 1969).

For much of the time we are concerned with, however, including both the Yushin constitution (1972–1980) and the Fifth Republic period (1980–1987), Korea was an openly authoritarian country. But even authoritarian leaders must build bases of political support—a coalition that benefits from the basic political and economic order and thus provides stability not only to the economy but to the polity itself.

In the absence of free interest-group and legislative representation, characterizing these coalitions is difficult. But we argue in Chapters 1 and 2 that Park Chung Hee constructed a growth coalition in the 1970s that included the military, large export-oriented firms, conservative rural constituencies, and at least some members of the growing middle class of professionals. Excluded or controlled were intellectuals, students, opposition politicians, and the growing urban working class. Although labor showed impressive real wage gains throughout the 1970s, the government severely curtailed the ability of workers to organize. This political equilibrium was sustained through policies that favored supporting groups, including extensive subsidies to farmers and large conglomerates. These measures, in turn, had implications for macroeconomic policy and efficiency.

Park's coalition proved politically unstable because of its distributive consequences and its authoritarian political assumptions. In 1979, the political order came under increasing pressure from a resurgent democratic opposition. Following Park Chung Hee's assassination and a brief political interregnum, Chun Doo Hwan faced the problem of constructing a new political coalition.

For several reasons, this proved extremely difficult to do. First, Chun came to power through a coup d'état, and thus his legitimacy was challenged from the beginning. Like Park, Chun faced steadily increasing pressure from democratic political forces in society. Second, because Park's policies had produced both relatively high inflation and various inefficiencies, there were strong internal and external pressures to stabilize the economy and move policy in a more market-oriented direction. These liberalizing initiatives involved both short-term costs and major dislocations for some groups.

We argue in Chapter 4 that the authoritarian political structure was at least one factor in the "successful" adjustment of the early 1980s. But stabilization and structural adjustment also had political costs, reducing the discretionary instruments with which Chun could secure bases of political support among farmers, portions of the bureaucracy, and even the private sector.[6] The regime was able to restore rapid growth with price stability, but Chun's economic program was the subject of virulent attack by opposition forces and contributed to his political downfall.

Political institutions and the coalitional base of politics underwent substantial change following the political opening in 1987. For the first time since the early 1970s, and arguably since the early 1960s, political leaders and economic policymakers had to operate in a democratic milieu. In contrast to the new Latin American democracies, however, Roh Tae-Woo enjoyed the political advantages of booming economic conditions and large external surpluses. Moreover, the early choice of an outward-oriented growth strategy created strong pressures for policy continuity.

Nonetheless, democratization did imply institutional changes, toward greater decentralization of power, and coalitional changes, as new groups articulated demands on the government for the first time. The resulting tension between political and economic imperatives was visible in a number of policy areas that had macroeconomic implications, including exchange rate management, wage policy, rice pricing policy, and trade liberalization; we discuss these briefly in the epilogue.

Korean Macroeconomic Policy and Performance: Some Lessons

Part III approaches the same period through the lens of specific issues. Chapter 5 outlines Korea's fiscal policy, paying particular attention to the puzzle of why the government was able to pursue a relatively consistent fiscal stance. Chapter 6 analyzes Korea's monetary and financial market policy, and Chapter 7 addresses the relationship between labor markets and inflation. Chapter 8 explores several alternative hypotheses concerning investment and savings behavior in Korea. Chapter 9 concludes this book by looking at the external accounts and the balance-of-payments adjustment process. Our findings both confirm and modify existing analyses. Yet even where we tread on familiar ground, the lessons are worth reiterating.

Fiscal Policy

It is important to emphasize that Korea was in many ways still a developing country as it entered the 1970s. Over half of the labor force was engaged in agriculture, and per capita national product was only $250 (about $750 in 1988 dollars), despite nearly a decade of rapid growth. The country's financial structure was primitive by the standards of developed countries, and by the standards that Korea itself was to attain by the late 1980s. Like many other developing countries, Korea pursued an activist industrial policy, though one oriented heavily toward the expansion of exports.

In its management of fiscal policy, however, Korea stands out sharply from other developing countries. First, both the development and the implementation of the budget were highly disciplined processes, framed with an eye to overall resource availability. Government spending was relatively small; total government expenditures equaled only 13 percent of gross domestic product (GDP) in the early 1970s, despite exceptionally heavy military expenditures. These rose over the subsequent fifteen years, as they did in both developing and developed countries, but still reached only 17 percent by 1988, well under levels in most other countries of roughly comparable income levels. Moreover, tax revenues grew more rapidly than expenditures in percentage terms, so the budget deficit generally declined relative to GDP.

The government was consistently a net saver, in the sense that total revenues exceeded the government's noninvestment expenditures. It is true that Korea typically ran budget deficits, reaching as high as 3.3 percent of GDP in 1981. But deficits were used either to finance government investment or for relending for private sector investment. By 1985 Korea had the fourth largest external debt among the world's developing countries—$44 billion. But the government's external borrowing was also typically directed toward project financing of some sort and was not used for general budgetary support. In short, although the government played a substantial role in steering the economy, it did so through policies that placed a high priority on investment.

Korea's budgetary discipline throughout two decades would not be remarkable except for the fact that it is so unusual among developing countries. Few others have a comparable record, and none with so much to show for it. How did such discipline come about? It may have been in part a reaction to the political and economic failures of periods of relatively high government spending during the 1950s under Syngman Rhee and in the early years of military rule. To be sure, a rapid growth in revenue made possible by a rapidly growing economy also made it easier to accommodate competing claims than would have been the case in a stagnant economy. But the key point is that honoring these claims was kept within the resources available.

Decision-making institutions appear to have played a central role. Spending by ministries was generally under tight control by the powerful EPB. Budgetary discipline was maintained by concentrating authority over total spending in the hands of a group of qualified EPB officials and, above all, providing them with continual presidential support.

The second noteworthy feature of Korean fiscal policy, related to the first, is that it was generally stabilizing from a macroeconomic point of view. Fiscal policy tended to damp down fluctuations in national income coming from a variety of sources, although stabilization of the economy was not the government's principal objective. Again, this feature is hardly remarkable to those trained in Europe, Japan, or the United States, where the stabilizing character of fiscal policy is taken for granted, mainly through the short-run elasticity of government revenues. But it is highly unusual among developing countries, where fiscal policy tends to be procyclical rather than countercyclical and is often a major source of macroeconomic disturbance.

A stabilizing fiscal policy arises partly from the structure of expenditure and taxation and partly from the priority policymakers accord to stabilizing the growth of income. Again, however, such a role presupposes a high degree of budget discipline. Higher-than-expected revenues must be protected from spending ministries and used to dampen exuberant growth.

Monetary Policy

Although the government generally did not need to borrow extensively from the central bank, monetary policy in Korea was not truly independent of fiscal policy. First, the banking system was the residual lender to the government; second, and more important, the Bank of Korea was under the direction of the ministry of finance, which, in turn, was under the control of the EPB. During the period under review, the most