

II Historical Background

The Period of Rapid Economic Growth

Korea made remarkable economic progress during the 1960s and 1970s. In the early 1960s, the economy was characterized by low per capita income and a high level of unemployment. The country was densely populated, the natural resource base thin, and the small and outmoded manufacturing sector could not make full use of available resources. Although domestic investment was minimal, the scarcity of domestic savings and foreign loans made the country highly dependent on foreign aid. The situation changed dramatically during the next two decades. Real gross national product (GNP) increased at an average annual rate of 9 percent during 1961–78 and per capita income more than tripled in real terms. The growth of the economy was sustained by a sharp expansion of domestic investment, which was financed largely by domestic savings and foreign borrowing.

Economic development was propelled by the growth of exports, which were concentrated initially on labor-intensive manufactured goods. Real exports of goods and services rose by 26 percent a year during 1961–78, and manufacturing output by 18 percent a year (Table 1). During the same period, the share in GNP of exports of goods and services rose from 4 percent to over 30 percent, while the share of manufacturing output in GNP rose from 9 percent to 25 percent. By 1978, the country was exporting a large variety of products, ranging from light manufactured goods to heavy machinery, ships, and electronic goods.

The product composition and directional pattern of exports changed markedly over the years. The trend was toward more skill-intensive products with higher technology, because Korea's traditional light industries, such as textiles, clothing, and leather goods, faced increasing competition from other developing countries and became the principal targets of protectionist measures in major foreign markets. The emerging exports were iron and steel, transport equipment (including ships), electronics, industrial machinery, and chemicals. There was also a shift within the

traditional light industries in the direction of more sophisticated, higher-quality products. While the United States and Japan remained Korea's two most important markets, their relative importance diminished as Korea succeeded in gaining new markets in Europe, the Middle East, Africa, South America, and Southeast Asia.

Rapid economic growth was accompanied by a considerable increase in the ratio of investment to GNP, which doubled to nearly 30 percent from the early 1960s to the late 1970s (Table 2). Higher investment was financed primarily through substantial growth in domestic savings, both in the private and public sectors. The increase in the rate of private savings was associated with the development of financial institutions and domestic capital markets. In the public sector, the savings ratio increased substantially in the late 1960s and again in the late 1970s, as the tax to GNP ratio rose in response to changes in the tax system and improvements in tax administration. A liberal credit policy directed to the industrial sector supported economic development, but it led to high rates of inflation. The rate of increase of the consumer price index averaged about 14 percent during 1961–78.

With the notable growth of domestic savings, there was less reliance on foreign savings. The share of foreign savings to GNP declined from 7 percent during the first half of the 1960s to 4.5 percent in the second half of the 1970s. Nevertheless, these savings remained an important source of funds, particularly after the

Table 1. Korea: Pattern of Growth, 1960–78

	1960–62	1976–78	1961–78
	Shares of GNP in Percent		Annual Percentage Change
Real GNP	100	100	9
Exports of goods and services	4	33	26
Manufacturing	9	25	18
Agriculture	85	23	4

Sources: Bank of Korea, *National Income Accounts*, 1984; and Fund staff estimates.

first wave of oil price increases, which raised the need for foreign resources. The use of foreign savings was characterized by heavy reliance on borrowing from commercial sources, with limited resort to concessional sources or to direct foreign investment inflows.

The benefits of growth were broadly shared. Income of urban households increased significantly as both employment and real wages rose rapidly. The rate of unemployment fell from 8 percent in the early 1960s to less than 4 percent in the late 1970s. During the same period, large gains in productivity in the manufacturing sector made possible wage increases of about 10 percent a year in real terms. Considerable productivity growth in agriculture, together with government policies to support farm incomes, ensured a broadly parallel growth in rural and urban incomes. Within the rural sector, a vast redistribution of land in the late 1940s helped to spread widely the expansion of agricultural income. The incidence of poverty declined markedly, with the share of the population under the poverty level dropping from about 40 percent in the mid-1960s to 15 percent in the mid-1970s.¹ Korea also made admirable progress in meeting basic needs, particularly nutrition, health, and education.

Korea's outstanding growth performance can be attributed to a number of structural factors, including a relatively well-educated labor force and homogeneous society, and a strong agricultural sector, which established a firm foundation for industrialization. These favorable initial conditions helped the expansion of labor-intensive manufacturing production by permitting a substantial shift of population from rural to urban areas without adversely affecting agricultural output.

The development process was greatly enhanced by the Government's firm commitment to export-led growth. Government policies provided a powerful stimulus to exports. These policies included maintaining a realistic exchange rate during most of the period under review and the introduction of a series of export incentives, ranging from tax measures to the provision of credit in support of marketing efforts. Another factor contributing to Korea's rapid growth was its access to the international capital market. The availability of private foreign capital, in turn, was facilitated by Korea's excellent export performance and its relative political stability. Consequently, the Government was able to resort to substantial foreign resources in financing its investment programs.

Some of the very policies which contributed so importantly to Korea's rapid development and to a balanced sharing of the benefits of growth also created

Table 2. Korea: Investment and Savings, 1960–78

(In percent of GNP)

	1960–66	1967–73	1974–78
Gross domestic investment	15.1	25.0	29.2
Gross national savings ¹	7.9	19.3	24.6
External current account	–7.1	–5.7	–4.6

Sources: International Monetary Fund, *International Financial Statistics*; and Fund staff estimates.

¹ Defined as the sum of gross domestic investment and the external current account surplus.

problems. Over time, the heavy reliance on government-directed preferential financing for channeling resources to priority sectors gave rise to serious side effects, such as chronic excess demand for bank loans, excessive investments in certain sectors, and an inflationary environment. The policies to support farmers' incomes led to, among other things, large deficits in the operations of public agencies, namely the Grain Management Fund and the Fertilizer Fund. Furthermore, various tax incentives tended to weaken the efficiency of the tax system.

The Emergence of Difficulties

During most of the period of rapid growth, an adequate balance had been maintained between the demand for resources and their availability. During 1977–78, however, a number of structural imbalances emerged in the economy. These were due largely to the Government's efforts to restructure the composition of exports toward more sophisticated products and to develop defense industries. Substantial loans were granted on very generous terms to investors in heavy and chemical industries. The availability of cheap credit, combined with an overly optimistic assessment of domestic and world market prospects, resulted in a duplication of investment by competing companies and the creation of substantial excess capacity in some industries, particularly those in power generation, transport equipment, and heavy machinery. At the same time, a neglect of light industries weakened the efforts to improve the quality of traditional export goods. Another source of pressure on the economy was a rapid expansion of housing. Demand for residential housing was spurred by increased inflationary expectations and a sharp growth in workers' remittances associated with the increase in construction contracts obtained by Korean firms in the Middle East.

During 1977–78, total fixed investment in real terms rose at an average annual rate of over 30 percent and accounted for about three quarters of the growth of real GNP, which averaged 11 percent a year. The

¹ See Sang Mok Suh, "The Pattern of Poverty," in Chong Kee Park, *Human Resources and Social Development in Korea*, Korea Development Institute, Seoul, 1980.

investment boom was accompanied by heavy strains on the country's resources. Domestic credit expanded rapidly, resulting in considerable excess liquidity in the economy and an acceleration of inflation. A buoyant domestic economy and the departure of a large number of skilled construction workers to the Middle East created a degree of tightness in the labor market previously unknown in Korea. Nominal wages were pushed up rapidly, and the rise in real wages outstripped productivity gains by wide margins. Korea's external competitiveness was gradually eroded. The loss of competitiveness, compounded by a slower growth of external markets and greater protectionism

abroad, led to a steady reduction in the rate of growth of exports.

In the face of these difficulties, the Government introduced a series of stabilization measures in the second half of 1978. Interest rates were increased and direct restrictions were imposed on domestic construction activity in mid-1978. At the same time, the Government stepped up the liberalization of the trade and exchange system and lifted a number of price controls to improve domestic supplies. The effect of these measures, however, was to be muted by the internal and external shocks of the next two years.