

Discussion Paper

by

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on

Paul W. Kuznets'

ECONOMIC DEVELOPMENT IN SOUTH KOREA

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Comments of Dr. Ung Soo Kim on
"Economic Development in South Korea"

By P.W. Kuznets

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The author's observations and evaluations of the process of South Korea's economic development from the end of the Korean War through the four five-year economic development plans (1961-1981) and the current fifth five-year plan which started in 1982 are very comprehensive and cautious. The essence of his observations is that, "Rapid growth, relatively even distribution and wide spread welfare gain," and active and an efficient government role and export-led growth policy have greatly contributed to this achievement. Three stages of restructuring the economy are: 1) its structural change from agrarian economy to urban centered labor-intensive manufacturing industry up to 1973; 2) an ambitious attempt to deeper capital investment in heavy and chemical industry complex up to the end of 1979; 3) the last painful structural adjustment which has been going on since 1980, in the midst of world recession, based on unsettled controversies between liberalizer and traditionalist ideologies. I have some reservations on the distribution and will comment on this later.

The author rightly states that the transferability of the Korean development process to other economies may prove misleading because "the economic results have social, cultural, political and institutional as well as economic causes." Interestingly enough the four successful Asian developing economies mentioned in this paper all share relative political stability, a

relatively highly educated and thus industrious population with a deep rooted confucians culture. Their success has given hope to the third world's future and probably has been a stimulus in shaping the new liberal development policy of the Post Mao Peoples Republic of China.

In my comments I will not only identify the important positive aspects of this paper with respect to Korean economic development but will also point out what I believe are negative factors in this development process which have not been properly treated in this paper. A relatively heavy investment during Rhee's government subjected constant American criticism. However, almost all economists agree that such heavy investment in education has paid off during the development process. Recent statistics show that over 30% of high school graduates are admitted to the college and over 10,000 graduate students are studying abroad. Along with the impact of education on the Korean economy one must not overlook the impact of war and the military establishment. The war brought not only destruction but also new vitality to the Korean people and helped in changing traditional attitude and accepting new changes. Mass mobilization through the military system has elevated the general education of the public, accelerated social mobility and provided the experience of organizational behavior and basic professional skills required for military as well as for industrial development. Big military establishment including United States forces provided a substantial market for the economy.

The government's active role, especially, through direct investment was cited as proof of government efficiency. This is an overstatement. Many industries previously under direct government control, have changed ownership from government to private because direct control of government revealed

inefficiency. Industries which are still under government control are constantly subject to criticism about their lack of efficiency.

Positive Aspects and Results of the Active Government Role:

(1) Capital Formation

The government's role in raising revenues and creating national capital for the direct investment in social structures and in some industries, and the channeling of capital through the banking system, (most all are under government control), as well as guaranteeing debt for foreign loans to the private industries has accelerated the formation of national capital at a greater speed and wider extent. This might not have been possible if private initiatives were left alone.

(2) Open Economic Policy

The open economic policy which the government has adopted has contributed to bringing in joint ventures e.g. Gulf Oil, external financing and technology transfer from outside. The port of Masan has been opened for bonded industries and the government provides guarantee to foreign lenders. The export of educated technocrats to the third world and construction activities in the middle east are results of outgoing economic policy.

One unique characteristic of the Korean development process is heavy external financing which exceeded 37 billion dollars by the end of 1982 and approximately over 55% of its GNP. This external financing made Korean development faster but also is a Korean weakness. The debt service ratio exceeds 20% if short-term loans are included. Under the Japanese occupation, most heavy industry such as electric power, steel and fertilizer were located in Northern

part of Korea. The more rapid growth of the South Korean economy, with its advanced technology, as opposed to the closed economic system of North Korea, can be attributed to the open policy of the South.

(3) Geopolitical Contribution

The division of Korea into two parts is sad for both political and economic reasons. However, the geopolitical environment of South Korea and its contribution to economic development is also unique. The creation of a Nationhood under United Nations resolution and the strong will of the United States in defending the South from the Communist threat from the North has helped both political as well as economic stability during the economic development process of the South. United States Military and economic aid and a credit extension for the food grain and raw material for textile industry are very significant. The United States and Japanese efforts have encouraged other western countries in creating economic stability to finance and extend loans to South Korea. Japanese compensation of Korean occupation was equivalent to one half of the foreign currency requirement during the second five year economic plan. The recent agreement of a 4 billion dollar Japanese commercial loan to Korea will help the current fifth five-year economic plan.

Some Key Negative Aspects:

(1) Inefficient Resource Allocation

Most banks are under government control and the bank rates are never equal to the curb market rates. Credit is controlled by the government and in the early phase of development the loans to the industries which were in the national interest were subsidized by much lower rates than the going bank rates. Considering the high rate of inflation (never below 30% before 1981)

excess demand and political favoritism became a natural course of operation. Government guarantee of foreign loans further encouraged loans. Getting such a loan itself means a success. Naturally, exaggerated market demand and excess capacity of various industries are developed: cement, fertilizer, textiles, automobiles, machine and chemical industries. Loans are leaked out for speculative purposes and continuous loans become more important than improvement in productivity. Many industries have defaulted and gone under government custody because the major portion of liability, including the foreign debt, was from the government controlled bank, consequently government shares more risks than those of entrepreneurs.

Resource concentration in heavy and chemical industries, including military hardware since 1974, can be partially explained by changing economic policy from international comparative advantage to self-sufficient economy after Vietnam shock and reduction of United States Forces in Korea. It is also due to the built-in inefficiency in use of scarce national resources.

(2) Weak Financial Position

Easy availability of credit has made the financial position of industries very weak. Statistics show that the equity ratio of manufacturing industry is not more than 17% in Korea compared to that of 38% in Taiwan. This financial structure will pressure for higher cost of production and force the risk of defaulting unless there is a continuous low-borrowing rate. The pressure to improve productivity in order to maintain an international comparative advantage is a imperative.

(3) Concentration of Capital and Market Structure

The ambitious government venture just described and the inertia of credit allocation has made big conglomerates (Jaebol) within a short time span. They

are products of the requirement of economic scale to survive international competition and inefficient resource allocation system through direct government intervention. About 50% of the total manufacturing output is produced by industries belonging to Jaebol and 90% of them have monopolistic market structure. Therefore it is natural that they maintain discriminatory price structure between world and domestic market. This market structure limits domestic market and therefore export industries rely heavily on government subsidy to compete in the world market. Increase in protectionism and slow recovery of world economy necessitate expansion of domestic market to offset limited expansion of export market. Recent policy changes toward liberal importing is designed to force technological improvement and expand the domestic market potential.

Due to rapid growth policy and inefficient resource allocation increase in the wage rate through inflation is the highest among the four neighboring countries. Concentration of loans to big business deprives the chances of small labor intensive businesses to improve their productivity thus off setting rising costs in wages. Small business is at the present time the main force of labor intensive export industries. Since natural resources are scarce, Korea will require a comparative advantage in labor intensive products for some time to come.

(4) Distribution

Fair distribution, based on international standards, is the author's opinion. There are two problems associated with distribution. The first is that concentration of wealth to the few Jaebol's, through government credit allocation, has skewed toward the big Jaebol against small businesses. The

second is that investment along the southeastern corridor of the country (Pusan-Taegu) has made a regional imbalance of growth. The location of new industries are not necessarily based on economic consideration.

Koreans were never made rich except through land ownership during the Japanese occupation. Land reform was completed just before the Korean War. The capital for the landlords disappeared immediately after the war because the compensation for land reform was paid by the government bond which practically was worthless after hyper-inflation. Added destruction of the entire country and during the Korean War forced Koreans to a fairly even distribution of income. The high level of education and sudden growth of wealth with skewed distribution of capital resources to the few Jaebol, and the regional imbalance through government power, are enough cause for social discontent and political instability.

Connected with the distribution problem is the relationship between Jaebol and political power. The soundness of big corporations is always a public concern. However in Korea's case, all Jaebol are indebted for their major capital to the controlled banks. Therefore, their pressure on the government for their survival is crucial and consequently the defaulting of big corporation on government banks is very serious. This tends to restrict government's policy choice.

In summary, if both strength and weaknesses of Korean economic development policies and government power politics are explained, it is easier to understand recent issues: stabilization policy, market function, productivity improvement through technological change, integration of heavy and chemical