

Lessons from Korean Economic Development and its Implications for China*

Chon-Pyo Lee**

Abstract

Korea achieved a remarkable economic development through export-oriented industrialization strategy over several 5-year economic development plans. The export-oriented industrialization strategy involved various merits which were not recognized at the beginning of adopting it, to rationalize itself in order to survive the competition in international market.

International environment has been changed since middle 1970s. Many developing countries which followed import-substitution strategy in 1960s shifted to export-oriented strategy and joined in the race of exporting for the final goal of industrialization. Game rules have been changed; export subsidy is no longer permissible unlike that of old days, and competition became much tense with increased number of developing countries purporting exportation.

Real sector growth is utmostly important for economic development. Many instruments can be employed to cultivate efficient real sector; financial sector can be organized and managed to assist real sector development. However, it involves misgivings in the form of retarded financial sector.

China joined export race from late 1970s. She made more

*Prepared for the international conference on "The Issues of Development in the Yellow Sea Region," organized by the Institute of Social Sciences, Seoul National University, Korea, and Korea Study Center, Shandong University, People's Republic of China, on June 9-11, 1994, Jinan, China.

**Professor of International Economics, Seoul National University.

than remarkable economic progress ever since in spite of worsened international market environment. At the same time she is considered to have such problems as retarded financial sector relative to real sector, uneven development between coastal and inland areas, institutionalization of several systems of new market economy into her and so on.

International economic situation is anticipated to change further after UR. Newer concerns related with intellectual property right, environment preservation, human rights and working conditions, and rules of competition are to occupy a central position in shaping the new trading rules in the near future. Such changes may not be favorable to developing economies. China, the biggest developing country of the world, is expected to assume a positive role to obtain happy means for both developed and developing nations.

Introduction

This essay purports to briefly review the development process of Korean economy and to suggest some implications for China. It briefly discusses how export-oriented development strategy Korea adopted has led to export liberalization followed by import liberalization, enhancing the efficiency of Korean real sector. The relative retardation of financial sector in the process, as it had to assist real sector development instead of pursuing its own progress, is indicated. In the ever rapidly integrating global financial market, overcoming the disparity associated with retardation of financial sector is pinpointed to be the main challenge to Korea in coming years. A few lessons from Korean experience are obtained and implications for China are suggested.

The World Development Report of 1989 presented that Korea's heavily regulated financial system was a key instrument in the government's industrial policy of 1960s and 1970s. The view considers the controlled interest rates and the directed bank credits as two key features in those days. It also noted that Korea introduced financial reform

programs together with the effort of stabilization and structural adjustment from early 1980s. This essay shares the view of the World Development Report. However, it considers the regulated financial system was a chosen and of some service, but in some respects, it was hindrances to the overall process of progressive development and liberalization necessitated in later stages.

Economic development involves two essential elements; formation of capital such that the economy has some production capacity and related infrastructure, and efficient allocation of resources given the production facilities. For the former element, considerable investments are prerequisite, and the investments have to be productive ones in the sense that individual investment projects are feasible and profitable in themselves and compatible with other projects. For the latter element, competitive market mechanism seems the best device, as it enforces all resources to seek the best opportunity for their employment. Of course, these two elements cannot clearly be separated. But it is obvious that one without the other cannot bring out economic development. Both the investment for structuring of production capacity and liberalization for inducing allocative efficiency must go together.

For economic development Korea has thus far finished six consecutive 5-Year Economic Development Plan mainly based on so-called export-oriented growth strategy and now in the process of New Economic 5-Year Plan, which is a revised version of The 7th 5-Year Economic Development Plan. The New Plan emphasizes self-discipline and creativity of private sector. Through all these Plans she has tried to obtain large productive capacity which would make use of her labor forces. As she was not endowed with various resources, the essence of development strategy had to be securing of ways to attain high value-added. The main base of value-added had, in turn, to be labor, the single abundant resources of Korea in early days. Export-oriented strategy was her basic choice, as the strategy offered her various

opportunities of employment in accompaniment with importation of raw materials and exportation of produced outputs. The strategy has, however, rendered Korea more than what she had initially expected, as will be discussed later.

Being a small open economy Korea must adjust to changing external environment. Pursuing export-oriented growth strategy she was able to swiftly adjust to changes in international market conditions. In addition, she obtained her internal efficiency and rationality in the process of maintaining compatibility with alterations in international market.

By combining the economic planning involving planned allocation (PA) of resources with the export-oriented growth strategy which automatically incorporated market motivated allocation (MMA) of resources, Korea in fact obtained both the development and liberalization altogether. Accordingly Korea has achieved remarkable economic growth as a whole, even if there were several occasions of failure owing to the dominance of PA over MMA or de facto paralysis of MMA.

Policy authorities in any economy are obliged to mitigate fluctuations associated with business cycle and Korea was no exception in this respect. To her the fluctuations were mainly from external sources, even though internal ones to a less extent cannot be overlooked. In order to deal with the business cycle problem she employed policy instruments at her disposal. Two main were exchange rate policy and interest rate policy supplemented with adjustment of money supply, where the former denotes devaluation and the latter official alteration of interest rates for deposit taking and lending by banks.

This essay proceeds as follows. In section (II) major changes in international surroundings important to Korean economy are sketched. Section (III) deals with costs and advantages of export-oriented strategy, with special attention on how it helped Korean economy in rationalizing herself. Section (IV) considers further efforts of adjustment in the

changed environment. Lessons from Korean experience are indicated in section (V). Implications for China from Korean economic development are contemplated in section (VI).

Changes in External Environment Relevant to Korea during Last 30 Years

Korea commenced her development efforts from early 1960s taking export-oriented growth strategy. She was lucky in two aspects compared with those who adopted the same strategy later. Firstly, the international market conditions were relatively stable, when she started her efforts of economic growth without oil shocks and fluctuations in price structure together with world-wide inflation of 1970s or debt crisis, recession and protectionism of 1980s. She could make herself obtain momentum for export-oriented economic structure when international community did not have prejudice against export expansion through various means. Special arrangement such as Generalized System of Preference was available to developing countries' favor during the period, too. Secondly, not many took import substitution growth strategy, influenced by Prebisch thesis. Consequently, competition for exporting based on cheap labor by developing economies was not too excessive as that of later days.

Since there was no prejudice against using export subsidies she was free in employing several export assistance measures in the process of establishing structure for exportation. She was very much able to substitute export subsidies for devaluation, when the side effect of devaluation leading to inflation was to be avoided.

During 1970s external environment for her exporting was a little worsened than that of 1960s with the two oil shocks and ensuing stagflation especially in advanced economies. But with the so-called petro-dollar recycling, plenty of financial resources were available to front-runners of developing economies in the international financial market.

Accordingly, Korea utilized external funds which were cheap (in the sense that the real interest rates were low) and available to developing economies (due to the reduced demand from the advanced countries along with the stagflation there).

During the 1980s debt crisis and new protectionism constituted further worsened environment for export-oriented developing countries. Furthermore, many developing economies joined the export race based on cheap labor. At the same time, unlike previous years, even developing countries had to face the request of market opening from advanced countries, especially from the U.S. Korea had to really adjust herself to this altered environment. She experienced hard transitional period, but unlike others who started export-oriented development later she retained quite much of adjustment flexibility around this time. She still had to struggle with rigidities in herself in pursuing both internal and external liberalization.

One thing important for Korea in 1980s was that her currency value was made to alter a little more flexibly in response to market conditions than before. The value of Korean won had been de facto linked very closely to the value of dollar. It was not changed much even if it was made to vary from 1980 a little more flexibly than before through a basket formula. Thereupon, her currency was quite much appreciated during the first half of 1980s when dollar was strong, and then depreciated from September 1985 to late 1988 as dollar became weak. For the latter period interest rates were low together with lower oil price. Being quite a debtor, big oil importer and price-sensitive exporter, Korea enjoyed these 3 lows (low exchange rate, low interest rate, low resource price) obtaining remarkable current account surpluses she had never experienced before.

Advantages and Costs of the Export-Oriented Growth Strategy to a Small Open Economy

Korean economy followed export-oriented growth strategy from early 1960s when many other developing countries pursued import-substitution strategy. The export-oriented strategy rendered following beneficial effects to Korea, not all of which she took into her account when she adopted the strategy.

Firstly, it enabled a small open economy like Korea to realize scale economy in several lines of production, whereas the realization of scale economy would not be possible with the limited internal market of a small open economy. Furthermore, the strategy enforced the firms of the country following it to maintain constant contact on foreign markets and to devise means for survival. International markets are much more competitive than domestic markets of any single country, and in order to survive in those markets firms of small nations had to rationalize themselves. Firms engaged in rent seeking would have less chance to succeed in the environment of export-orientation.

Secondly, it provided freedom in managing foreign exchange. Small developing economies usually experience difficulties in mobilizing foreign exchange for importation of critical materials and equipments due to shortage of foreign exchange reserves. They would often lack flexibility in preserving foreign trade smoothly due to mismatches of foreign exchange inflows and outflows over time. However, with the export-oriented strategy the economy can maintain rather stable inflows of foreign exchanges from various sources, and with these inflows it can enjoy quite much flexibility in continuing importation of key resources.

Thirdly, it could obviate the tendency of overvaluation of the country's currency. The export sector could get stronger with the adoption of the strategy. It constitutes a strong lobbying power, which in turn prevents what does harm to

exportation from occurring. Overvaluation or reluctance to devaluation, so often observed in many developing countries, is one of serious barriers to smooth exporting. But, the overvaluation can usually be avoided in the country with expressed export-orientation.

Fourthly, and probably most importantly, it restricted the abuses of administrative arbitrariness commonly observed in developing economies. Developing economies are in its nature more heterogeneous than advanced economies, and in many aspects of economic affairs administrative interventions significantly influence the fate of economic undertakings in one way or another. However, when the paramount importance of exporting is recognized and a variety of conditions for maintaining successful exporting is consented by many, restrictive measures for inhibiting export expansion can easily be publicized and then removed sooner or later. Public administration changes its feature from arbitrary constraining of export-related activities to supporting them, especially when assistance to exporting is encouraged by top authority and delaying of exporting is penalized.

Due to these beneficial effects of adopting export-oriented strategy, the small economy can rationalize itself very much. Export-orientation is thus turned equivalent to export liberalization. Most activities related with exporting were liberalized with limited interference from government; quite much of real sector is made to be dominated by competitive market mechanism thereafter. In short, export liberalization constituted a catalytic element to the transformation of the whole economy by propagating its essence of competition to other sectors with benefits consequent to it.

Export liberalization brought partial import liberalization immediately: import restrictions of raw materials and equipments indispensable for exporting activities, as they are unavailable at home, could easily be eliminated, even under the general structure of import restriction associated with balance-of-payments consideration. It also induced other

sectors to imitate liberalizing, since liberalized activities could be regarded as the central feature of the growth and expansion of respective sectors through the success of them. Thus, the range of market motivated allocation were broadened. Export-related activities played the role of a locomotive which injected a momentum for rationalization in the whole real sector, including the liberalization of importation.

Korea achieved quite much of rationalization in her real sector by adoption of the export-oriented growth strategy. Export liberalization obtained in the process of export expansion was succeeded in by import liberalization, which incidently was conformable to the import liberalization demanded by other countries. Consequently, Korea obtained efficient real sector which was reasonably competitive with other economies in international market. However, Korean way of export orientation required the financial sector to serve the real sector, and thus resulted in lagged status of financial sector. Alas, liberalization in real sector was not automatically succeeded in by the liberalization in financial sector as will be shown shortly.

Newer Adjustments in a Changed Environment

During 1990s Korea is expected to face very different environment from what it experienced before. Previous system of export-oriented development strategy would no longer be sustainable due to a couple of factors.

Firstly, new rivals with export orientation like China, Thailand, and Malaysia will be more active in 1990s; they have already materialized their export-oriented system and they are in a better position than Korea in the sense that their wage rates are lower than that of Korea. This situation is very different from that of 1970s and 1980s when they were less accustomed to international trade.

Secondly, rules of game of international trading has been changed. In the previous years of 1960s and 1970s export

subsidies were no longer forbidden; on the contrary, they were welcomed by the importing nations. But these days every country is concerned with securing of employment and therefore the export subsidies of trading counterparts are considered as the exploitation of their own employment opportunities. Last Uruguay Round Negotiation of December 1993 has, with respect to subsidy issue, decided to differentiate allowable subsidy from forbidden subsidy and countervailable subsidy, with the intention of clarifying the problem to some extent. Furthermore, additional restraints might appear to constrain the expansion of exportation from developing countries to developed ones. They are; environmental concerns associated with so-called Green Round; technological concerns associated with restriction of free movement of technologies, strengthening the tentative provisions associated with the intellectual property rights of UR talks with the purpose of limiting the convention of somehow free use of easily available technologies; and labor market concerns associated with the observance of human rights up to the similar level of advanced countries irrespective of national differences in stages of economic development and historical background.

Korea is a little more advanced in all these respects than other Asian countries including China; therefore she may suffer less due to the above three new issues. But she will surely be restricted in maintaining her previous system and must undergo considerable transformation. She has to learn to live with less energy, more loyalties for borrowed technologies, and knowhow, with enhanced adoption of the welfare-related measures.

Lessons from Korean Development Experience

Following lessons can be drawn from Korean experience.

First, for a less developed country to develop into a more advanced country, real sector development ahead of financial sector development is recommendable, because the former is

much more fundamental than the latter. In order to obtain a solid real sector based on rationality and competition with the rest of the world, every effort should be devoted to it. For the early years of economic expansion, somewhat suppressed financial sector in the process of assisting real sector may be indispensable.

Second, in order to supplement the insufficient domestic savings, importation of external capital may also be indispensable. However, in relation to capital import, careful attention and due supervision are required, because without it there would appear unjustifiable energies seeking capital gains associated with capital transactions. In Korea lots of things have been debated in relation with this issue; the status of less than optimal distribution of income, especially to some in radical camp, is diagnosed to be the cause which could produce troubles with the aggressive capital import with insufficient care.

Third, some degree of financial development would better accompany the real sector development. The financial sector should not be left suppressed too much. Once the balance between the two is lost, it may be very hard to regain. In order to obtain the objective steady introduction of various instruments together with letting people accustomed to them are regarded very much desirable

Not all of the above will be relevant to other countries. The negligence of the interrelationship between real sector and financial sector in the posture of employing the latter to serve the former may be less sustainable in these days of greatly activated cross-border capital movements. But some of them would still be relevant, and most important of them is: small or developing countries should adapt to changing surroundings like it or not, adjusting the speed of adaptation corresponding to the rapidity of external changes.

Implications for China

Since 1978 China has pursued export-oriented

development strategy, it is judged, opening her coastal areas. Thereupon she has obtained her remarkable growth, alas in a worsened conditions than before. Being an extremely big country she now has many disequilibria among various provinces in the dimension of income distribution, fulfillment of basic needs, construction of productive capacities and so on.

Compared with Korea, she is less lucky in the sense that export environment has been deteriorated and more rapid external liberalization has been demanded by foreigners. On the other hand she is in much better position in the sense that she possesses very advanced technologies as a developing economy, together with more than abundant labor and natural resources.

Her financial system may be in disarray, as evidenced by the very recent reordering of her exchange rate system, eliminating the separation of Linminbe and foreign exchange certificate. Financial assets would be insufficient in supply, especially in internal areas. The imbalance owing to the insufficiency in financial instruments could involve bubble-like features, and the uneven concentration of capital gains arising from uneven possession of assets could cause serious difficulties, as the past state of equality among most of Chinese in terms of real income and wealth could be destroyed. In order to avoid the misgivings Korea experienced due to her weak financial sector, China would better strengthen her finance sector as earlier as possible.

Up to now she is considered to have achieved partial export liberalization. Full scale liberalization including import liberalization should be pursued, followed by financial liberalization. The degree of suppression in her financial sector should be carefully examined to make it compatible with external conditions in the near future.

Needless to say, the task may not be easy. The strong pressure to financial opening by the U.S. and EU, together with globally mobilized capital movements would not allow enough time for China to follow the prime lesson on

economic liberalization in the literature: securing of internal liberalization ahead of external liberalization. However, being the biggest developing country in the world, China is obliged to fight for the rooms of developing countries to retain some degree of freedom in deciding the speed of liberalization not in much disharmony with external circumstances and wishes of external partners, not only for herself but also for other developing economies.

The internal disparity among provinces in China formulated during last 15 years or so might also stand in the further rapid progress in coming years. The disequilibria and their fundamental causes can be overhauled in a single stroke of strong order by the central government. But a simple and quick solution may never solve the problems in their root. Some grand orchestration of diversified interests from various provinces and regions must be sought. Autonomy of regional governments in systems friendly to market mechanism of outside China should go together with broad orchestration of the central government in maintaining harmony through China.

References

- Bhagwati, J.
1970 *Anatomy and Consequences of Exchange Control Regime*. NBER.
- Chon-Pyo Lee
1992 *Lectures on Korean Financial Liberalization* (in Korean), Bupmunsa.
- Chung H. Lee and Ippei Yamazawa
1990 *The Economic Development of Japan and China*. Praeger.
- Ik Soo Kim
1993 *Industrialization Strategy and Industrial Policy in China* (in Korean). Korea Institute of International Economic Policy.
- Keun Lee
1993 *New East Asian Economic Development*. M. E. Sharpe.
- Krueger, A.
1970 *Liberalization Attempts and Consequences*. NBER.