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1 Introduction

In 1981 South Korea was the world's fourth largest debtor country and in the midst of an economic crisis. It had accumulated $17.6 billion of debt within three years, raising its debt stock to $32.4 billion and its debt/GDP ratio to 49 percent. Output had declined by 4.8 percent in 1980, compared to average growth rates in excess of 9 percent during 1970–79. Inflation had doubled from 14.4 percent in 1978 to 28.7 percent in 1980.[1]

Korea's adjustment to the 1979–82 debt crisis has been remarkable. Some of the key elements in the adjustment are shown in table 1.1. By 1986 it had substantially reduced the debt burden. Inflation had fallen to just 3 percent, while the government budget deficit had been cut in half. Exports grew by 26.6 percent, fueling a 12.5 percent increase in output and a current account surplus (4.9 percent of GNP). At the same time, real wages, per capita income, and consumption all increased, and the country maintained historically high levels of fixed capital formation.

In stark contrast, the World Bank's *World Development Report* (1986, 54) describes the plight of seventeen of the middle-income debtor countries as follows:

> The bulk of the adjustment has been undertaken through lower demand, which has meant, in practice, reducing imports and investment. The volume of imports for the heavily indebted middle income countries in 1985 was 32 percent below its 1981 level. The ratio of investment to GDP fell from 25 percent in 1981 to 18 percent in 1985. GDP has stagnated since 1980, and per capita incomes have declined substantially. The

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Table 1.1 Korea's Economic Recovery

A: Average Growth Rates	1970–79	1980–82	1983–85		1986
GNP growth	9.5	2.3	8.5		12.5
Consumer prices	14.9	18.8	2.7		2.3
B: External Indicators (selected years)	**1978**	**1980**	**1982**	**1985**	**1986**
Debt (billions U.S. $)	14.8	27.2	37.1	46.8	44.5
Debt/GNP	28.5	45.0	53.5	56.3	46.8
Current account/GNP	−3.0	−9.6	−4.5	−1.8	4.9

> reduction in demand has pushed the collective trade balance of these countries into a large surplus, which has brought their current account into rough balance. Yet the main indicators of debt at the end of 1985 were close to their previous peaks. Despite their adjustment efforts, these countries seem to be as far as they ever were from reconciling growth and creditworthiness.

Thus, it is not surprising that Korea's experience has been labeled "a case of successful adjustment" (Aghevli and Marquez-Ruarte 1985) raising a number of important and provocative questions. What were the secrets of Korea's performance? How important were economic structure, policy choices, social and political factors, and external developments? Are there lessons to be learned which could help other debtor countries to achieve a more favorable balance between growth and external adjustment?

This study analyzes Korea's macroeconomic performance, policy, and prospects so as to provide answers to these questions. Particular emphasis is given to the role of external debt in contributing to the crises as well as to the recoveries.

Korea's position in the limelight is not new. The remarkable transformation from a war-devastated economic "basket case" heavily dependent on foreign aid in the 1950s to a newly industrialized "economic miracle" with impressive growth rates during the 1970s has been well documented.[2] Clearly, this historical development is linked to Korea's ability to adjust to the recent crisis so rapidly. We pay close attention to the implications of Korea's structural development in putting together the pieces to explain the 1980s performance.

Korea has also received international attention due to labor unrest and to opposition to the slow progress toward a democratic political process. While an in-depth analysis of the interactions between politics and economic performance is beyond the scope of this study, we recognize that political and social factors are integral forces in the process of economic development. Thus we have attempted to integrate some of these factors into our discussion in places where we found them to be especially relevant. For example, the sociopolitical environment seems to have had an influence over wage determination, over the extent to which announced economic plans have been viewed as credible, and over the enforceability of economic policy.

The purpose of this chapter is to provide an overview of the key elements of Korea's experience so as to set the stage for the remaining chapters. It is composed of two sections. The first section briefly reviews Korea's macroeconomic performance, identifying the central issues to be analyzed. The second section outlines the rest of the chapters in the study.

1.1 Overview of Macroeconomic Experience

Korea's macroeconomic history can be divided roughly into five periods. The early period, from 1945 to 1953, was one of continued disruption. First came the division into North and South Korea at the 38th parallel after World War II. The South was left with rich agricultural lands and light manufacturing industries, but almost no heavy industry or power facilities. Attempts to begin economic recovery were interrupted by the devastation of the Korean War which is estimated to have killed over one million people and destroyed over one-third of South Korea's physical capital.

Another development during this period, with lasting implications for Korean development, was a major land reform. During 1947–49, farmland previously owned by Japanese landlords was either redistributed or sold, dramatically decreasing the concentration of land ownership. This is perhaps the most important factor in explaining the relatively egalitarian distribution of income in Korea.

The second period (1953–60) was one of slow recovery financed by massive foreign aid, primarily from the United States. Foreign aid inflows averaged nearly U.S. $300 million per annum during 1955–59, reaching 16 percent of GNP in 1957. Inflation rates jumped to 60 percent immediately following the war, while output growth remained moderate. Under the complex system of trade restrictions erected by the Syngman Rhee dictatorship, exports grew by only 1.3 percent per year.

In contrast, the third period, from 1960–73, saw a dramatic economic turnaround fueled by rapid rates of export growth. Exports grew by 40–50 percent per year during 1960–73, while output grew by more than 10 percent during 1965–73.

The economic transition coincided with a change in political regime and economic policy. Syngman Rhee was forced to resign in 1960 after a student uprising. The new government, led by Chang Myon, collapsed in May 1961 following a military coup led by General Park Chung Hee, who remained president of Korea until a second coup in 1979.

Under General Park, Korea switched from an import-substitution strategy to an active export-promotion strategy. The first of a series of five-year plans, initiated in 1962, identified investment and economic growth as the number one priorities. Other hallmarks of the strategy were extensive government intervention in domestic and international capital markets, the development of close links between government and industry, import liberalization, and the more active use of exchange rates to maintain competitiveness.

Foreign aid inflows fell dramatically during the period. During 1960–64, they averaged $210 million per year, over ten times the average annual accumulation of external debt. This inflow dropped to $110 million per year during 1965–69, just one-third of the average annual debt accumulation, and to only $28 million per year during 1970–74, or 0.03 percent of the debt accumulation. Foreign aid to Korea had essentially ended by 1975.

Gross fixed investment was raised from 15 percent of GNP in 1965 to 26 percent in 1969. To finance the investment, declining foreign aid flows were replaced by increased reliance on external borrowing and by increased domestic saving. Firms (especially exporters) were given strong incentives to borrow abroad. A system of loan guarantees substantially reduced the risks. Furthermore, the real cost of borrowing abroad (in won) turned negative. External debt jumped to 27 percent of GNP by 1969.

Difficulties emerged during 1970–72. As growth slowed, domestic savings dropped, increasing the current account deficit and reducing Korea's debt service ability. A devaluation to stimulate exports exacerbated repayment difficulties for externally indebted firms. The government bailed them out and continued to pursue its investment strategy. Further depreciation was combined with some monetary and fiscal restraint. Taking advantage of strong world demand, exports grew by 90 percent in 1973. Output growth rose to a record 16 percent, stimulating a spurt in domestic saving and pulling Korea out of the first period of debt difficulties.

The fourth period (1973–78) included a second period of rapid debt accumulation, economic difficulty, and recovery. It also coincided with a major shift in economic strategy—a renewed industrialization, coupled with increased government intervention.

The "Big Push" was a massive investment program in heavy and chemical industries initiated in 1973 both because policymakers feared that Korea's comparative advantage was shifting away from light industry and because they wished to strengthen Korea's defense capabilities. The program coincided with a resurgence in inflation, a slowdown in export growth, a rise in the incremental capital output ratio, and a deterioration in the distribution of income. Import restrictions and credit rationing increased, and the exchange rate was fixed (1975–79) and allowed to appreciate. Although widely viewed as a policy mistake, some of the investments (e.g., autos) have begun to pay off.

Economic growth slowed during 1974–75 in the aftermath of the oil and commodity price rise. Again, there was a drop in domestic savings, increasing the borrowing necessary to finance the investment program.

Korea elected to "borrow its way" through the crisis so as to fulfill planned investment and to relax monetary and fiscal policies. As world demand recovered during 1976–78, high growth rates resumed, raising domestic savings and improving the debt position.

In 1979 Korea underwent another shift in economic strategy. Motivated by concern over rising inflation rates and economic distortions from the Big Push, the new stabilization plan included monetary and fiscal restraint plus the gradual reduction of price controls, import restrictions, and financial market interventions.

However, 1979–82 were years of crisis for Korea. The 1979 assassination of President Park together with a disastrous agricultural harvest and the second oil shock all contributed to a severe economic and political crisis in 1980. The military assumed effective control of the country in May 1980 under General Chun Doo Hwan. Chun formally assumed power in September, promulgated a new constitution in November, and became president in March 1981 when his Democratic Justice Party (DJP) won a majority of seats in the new National Assembly. Chun was succeeded by Roh Tae Woo after the DJP won the December 1987 presidential election.

The poor performance in 1979–82 is documented in table 1.1. Output stagnated, actually declining (−4.8 percent) during 1980. As domestic savings plunged, the current account deficit mushroomed, financed by massive external borrowing. Korea accumulated over $22 billion of debt during 1979–82, raising its debt stock to 53.5 percent of GNP. Unlike the earlier episodes, the 1979–82 period was an economic crisis, comparable to the crises experienced in many other large debtor countries after the second oil price rise.

During 1980–81 the exchange rate was devalued, while the position of monetary and fiscal policies alternated. Korea continued to borrow heavily to maintain investment. By 1982 growth was still low by Korean standards (5–6 percent) and exports stagnated, but inflation and the current account deficits had fallen significantly. The government initiated a more expansionary policy to stimulate growth.

As world demand recovered and the terms of trade improved during 1983–84, Korea again underwent a remarkable economic recovery. Growth rates spurted. Savings rose reducing the current account deficit. Authorities responded to the 1985 slowdown in export growth as world demand stagnated with a 6 percent real depreciation and a further 15 percent real depreciation in 1986.

By 1986 the economy was booming, inflationary difficulties had been resolved, and there was a substantial trade surplus. In contrast to many of the other large Third World debtor countries currently negotiating rescheduling arrangements with their creditors, Korea not only met all debt service obligations, but began to repay the principal, reducing its debt stock by nearly 5 percent.

1.2 Overview of the Chapters

Four questions emerge from our summary:

1. What caused Korea's debt crises?
2. How was Korea able to achieve rapid, successful recoveries?
3. What role has external borrowing played in Korean development?
4. What are the lessons for other debtor countries?

Answering these questions involves examining and synthesizing a number of interrelated factors. We focus on the individual factors in the body of our study, bringing them together to address the four questions above in the final chapter.

The study is composed of three parts. The first part, chapters 2–5, provides a detailed discussion of Korea's macroeconomic experience and the role of external debt. The historical background given in chapter 2 is a review of the experience prior to 1962 which set the stage for the impressive economic developments during the 1960s.

Chapter 3 gives an overview of external debt, presenting a variety of debt statistics. It highlights the fact that external debt has gone primarily to finance current account deficits and not capital flight. The point is important because it focuses attention on the domestic counterpart to current account imbalance—an excess of domestic investment over savings. It also discusses the process of borrowing in Korea.

Chapter 4 examines the three periods of rapid debt accumulation in detail. It reviews the economic and political developments during each cycle of debt accumulation, difficulty, and recovery, discussing the roles of policy and external shocks. Chapter 5 provides a further analysis of the current account deficits which triggered the heavy external borrowing during 1974–77 and 1979–82. Using both accounting decompositions and simulations from a macroeconomic model for Korea, it examines the importance of external shocks in the current account deteriorations.

The chronological analysis in part 1 identifies a number of key factors in the experience to be examined individually in the second part of the study (chap. 6–12). After a brief introduction in chapter 6, we examine economic growth in chapter 7. Chapter 8 analyzes saving behavior and the role of investment and Korea's five-year plans. Exchange rate, trade, and industrial policy are studied in chapter 9, while in chapter 10 we discuss the important linkages between wages, productivity, and international competitiveness. Chapter 11 examines monetary and fiscal policy, and income distribution is discussed in chapter 12. Finally, we provide a synthesis of these pieces in part 3 (chap. 13) and discuss the lessons from Korea's experience.