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the estimation was corrected for serial correlation. The model consists of six blocks of equations: GNP, government sector, labor market, wages and prices, balance of payments, and financial sector.

Real gross national expenditure is composed of private consumption expenditure, private fixed investment, inventory investment, government expenditure, exports and imports of commodities and nonfactor services, and net factor income from abroad. Real GNP is divided into two components: production from agriculture, forestry, and fisheries, and other production.

The supply and demand for money are determined in the financial block, where interest rates in the unorganized money market adjust to equilibrate the market. The overall balance of payments and the government budget deficit are both linked to the money supply.

Prices are subject to both demand-push and cost-pull factors. Wholesale prices are determined by firm's production costs. The unit value index for exports in dollar terms is assumed to be influenced by world demand for Korean exports as well as by export production costs (wages and intermediate input costs). Import unit values are determined by the prices of capital goods imports and raw materials, including oil. The wage equation is an expectations-augmented Phillips curve.

Finally, the unemployment rate is determined by the gap between potential and actual output, a variant of Okun's law.

6 Introduction to Part Two

Korea's macroeconomic performance, with its three cycles of debt accumulation and recovery, presents a number of puzzles which will be examined in the remaining chapters. Thus, in summarizing the experience (particularly during 1979–85) described in the first part of our study, we will introduce part 2 (ch. 7–12).

The first puzzle is how Korea has managed to consistently maintain such high growth rates. Certainly its rapid growth rates for output and exports have helped to hold in check the burden of external debt. A related issue is how Korea was able to achieve a substantial improvement in the current account while output was growing strongly. In practice, most debtor countries have improved their current accounts through a domestic recession which cuts imports. Improvement with growth is a much more palatable option.

Another puzzle arises from the large fluctuations in domestic savings. How was Korea able to increase saving rates so dramatically from the

mid-1960s to the mid-1970s? Why have there been periodic drops in saving rates, and what has determined the rates of investment? These questions are important because each of the three debt crises was precipitated by a large drop in domestic savings relative to investment and because most of Korea's external debt has been used to finance the savings/investment gap.

A third puzzle is why Korea was able to combine a real depreciation with improved competitiveness and an increase in real wages. Policymakers elsewhere often resist devaluation precisely because they expect it to reduce real wages and the standard of living. We shall argue that one of the most interesting and important aspects of Korean development has been the interrelationship between exchange rates, wages, and labor productivity.

In addition to these three puzzles about macroeconomic performance, our study will consider the distribution of income to Korea. And finally, we will look at the role of domestic policy. How did exchange rate, trade, and industrial policies influence growth and external balance? How did monetary and fiscal policies contribute to economic performance and to the accumulation of external debt? One view is that "Korea's experience following the second wave of oil price increases is an excellent example of how orthodox stabilization policies, effectively implemented, can help a country adjust to external shocks" (Aghevli and Marquez-Ruarte 1985, 1). An alternative view is that "domestic stabilization measures were at best a way of muddling through, and contributed little to improving the current account during 1982–83 (Y. C. Park 1985c, 308).

Part 2 is composed of six remaining chapters. In chapter 7 we examine the sources of growth. Chapter 8 is an analysis of the rapid rise in Korean savings and looks at the role of investment and the series of five-year plans. In chapter 9 we discuss exchange rate, trade, and industrial policies. The important link between wages, productivity, and international competitiveness are explored in chapter 10. In chapter 11 we examine monetary and fiscal policies, and then discuss income distribution in chapter 12. In part 3 (ch. 13) we will provide a synthesis and discuss the lessons from Korea's experience.

7 Korea's Rapid Growth

One of the most notable features of Korea's experience has been its consistently high rates of growth. Growth rates for Korea and a number of other countries are given in table 7.1. The sample includes developed as well as developing countries, Asian as well as Latin American countries, and