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2012 Modularization of Korea's Development Experience:

Korea's Stabilization Policies in the 1980s

2013

MINISTRY OF STRATEGY AND FINANCE

KDI SCHOOL
KDI School of Public Policy and Management

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Title	Korea's Stabilization Policies in the 1980s
Supervised by	Ministry of Strategy and Finance (MOSF), Republic of Korea
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Supported by	Ministry of Strategy and Finance (MOSF), Republic of Korea

Government Publications Registration Number 11-7003625-000005-01

ISBN 979-11-5545-033-8 94320

ISBN 979-11-5545-032-1 [SET 42]

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Preface

The study of Korea's economic and social transformation offers a unique opportunity to better understand the factors that drive development. Within one generation, Korea has transformed itself from a poor agrarian society to a modern industrial nation, a feat never seen before. What makes Korea's experience so unique is that its rapid economic development was relatively broad-based, meaning that the fruits of Korea's rapid growth were shared by many. The challenge of course is unlocking the secrets behind Korea's rapid and broad-based development, which can offer invaluable insights and lessons and knowledge that can be shared with the rest of the international community.

Recognizing this, the Korean Ministry of Strategy and Finance (MOSF) and the Korea Development Institute (KDI) launched the Knowledge Sharing Program (KSP) in 2004 to share Korea's development experience and to assist its developing country partners. The body of work presented in this volume is part of a greater initiative launched in 2010 to systematically research and document Korea's development experience and to deliver standardized content as case studies. The goal of this undertaking is to offer a deeper and wider understanding of Korea's development experience with the hope that Korea's past can offer lessons for developing countries in search of sustainable and broad-based development. This is a continuation of a multi-year undertaking to study and document Korea's development experience, and it builds on the 40 case studies completed in 2011. Here, we present 41 new studies that explore various development-oriented themes such as industrialization, energy, human resource development, government administration, Information and Communication Technology (ICT), agricultural development, land development, and environment.

In presenting these new studies, I would like to take this opportunity to express my gratitude to all those involved in this great undertaking. It was through their hard work and commitment that made this possible. Foremost, I would like to thank the Ministry of Strategy and Finance for their encouragement and full support of this project. I especially would like to thank the KSP Executive Committee, composed of related ministries/departments, and the various Korean research institutes, for their involvement and the invaluable role they played in bringing this project together. I would also like to thank all the former public officials and senior practitioners for lending their time, keen insights and expertise in preparation of the case studies.

Indeed, the successful completion of the case studies was made possible by the dedication of the researchers from the public sector and academia involved in conducting the studies, which I believe will go a long way in advancing knowledge on not only Korea's own development but also development in general. Lastly, I would like to express my gratitude to Professor Joon-Kyung Kim and Professor Dong-Young Kim for his stewardship of this enterprise, and to the Development Research Team for their hard work and dedication in successfully managing and completing this project.

As always, the views and opinions expressed by the authors in the body of work presented here do not necessary represent those of the KDI School of Public Policy and Management.

May 2013

Joohoon Kim

Acting President

KDI School of Public Policy and Management

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Summary

Korea is well-known for its rapid economic development since the 1960s, but it is not as well-known that Korea suffered greatly from high inflation and its side-effects during the same period of the 1960s and 1970s.By the late 1970s, it became obvious that high inflation undermined the growth potential of the Korean economy.

Against this backdrop, bold stabilization policies were designed by a group of reform-minded government officials in the Economic Planning Board, but their implementation faced fierce resistance from various groups because such a policy shift had to overhaul the whole economic policy framework that was believed to be indispensible for rapid development until then. There were intense debates among bureaucrats regarding alternative policy frameworks from the mid-1970s, but the camp for stabilization policies could not get over the legacy of the government-led development ideas. Proactive stabilization policies continued to be delayed and the economic situation further deteriorated until 1980. It was only after the leadership change from President Park, Jung Hee to President Chun, Doo Hwan that stabilization policies were finally implemented on a full scale in the early 1980s.

Fiscal expansion was suppressed and monetary policy was liberated from industrial policies and the government's budget deficit. After weathering through the painful recession and balance-of-payments crisis that lasted until 1982, the Korean economy finally began to stabilize from 1983. The inflation rate was brought down and exporting companies recovered their price competitiveness, which is basically how overall economic activities were revitalized. By the mid-1980s, the growth rate surged to double-digits, while the inflation rate stayed around 3 percent. Government budget deficit vanished and a sizable amount of current account surplus was realized, overcoming the balance-of-payments crisis.

All in all, it is clear that the stabilization policy carried out in the early 1980s bore great economic fruits. However, its historical significance was not confined within macroeconomic performances. Perhaps a more important implication of the success of the stabilization policy was to prove that the government-led development strategy was neither the only nor a sustainable policy framework for prosperity, and that inflation is not a necessary evil for growth promotion. A better understanding of the drawbacks as well as the merits of the “Korean model of development” should greatly help many policy-makers in developing countries to shore up their development strategies.

Chapter 1

Introduction

Introduction

Korea is well-known for its rapid economic development since the 1960s. Indeed, the economy took off with a series of five-year development plans led by President Park's regime. Despite a temporary setback due to the First Oil Shock in 1972, the average annual growth rate recorded during the two decades of the 1960s and 1970s was almost 10 percent, which pushed the per capita income from below US$ 100 in 1960 to around US$ 1,700 in 1979. The whole society was truly dynamic and became more and more confident of its own economic success.

However, it is not as well-known that Korea suffered greatly from high inflation and its side-effects during the same period of the 1960s and 1970s. Nam (1991, p.237) observed:

> "From the 1960s through the early 1980s Korea had one of the highest inflation rates in the world. Among over a hundred countries included in the *World Bank, World Development Report*(1983) for which inflation data for 1960-81 in terms of the GDP deflator are available, Korea stood in eleventh place, behind only the Latin American countries that had suffered from hyperinflation. By the late 1970s it became obvious that high inflation undermined the growth potential of the Korean economy."

In particular, doubts regarding the sustainability of the government-led development strategy were rapidly growing in the late 1970s. Heavy and chemical industries, the most important strategic industries selected and favored by the government, were suffering from a vast amount of idle facilities due to over-investment. Inflation was soaring to double-digits due to the monetary policy that was abused to support industrial policies and the government's deficit financing. The current account was running chronic deficits due to the increased imports of machinery to support ambitious development plans, in addition to the heavy reliance on imported oil whose prices skyrocketed in 1973 and 1979. Korea's macro-economy was becoming more and more fragile, finally plunging into a crisis in 1979 when the Second Oil Shock was triggered and President Park was assassinated.

Against this backdrop, bold stabilization policies were unfolded in the early 1980s. Fiscal expansion was suppressed and monetary policy was liberated from industrial policies and the government's budget deficit. It may not be extremely difficult to argue for such a macro-policy shift toward stabilization, but its actual implementation always faces fierce resistance from various groups. The Korea's case in the early 1980s was no exception. As a matter of fact, it was more difficult in Korea because such a policy shift had to overhaul the whole economic policy framework that was believed to be indispensible for rapid development. There were intense debates among bureaucrats regarding alternative policy frameworks from the mid-1970s, but the camp for stabilization policies could not get over the legacy of the government-led development ideas. Proactive stabilization policies continued to be delayed and the economic situation became further deteriorated until 1980. Nevertheless, it was actually after the leadership change from President Park, Jung Hee to President Chun, Doo Hwan that stabilization policies were finally implemented on a full scale.

Convinced of the new framework, President Chun continued to firmly support the stabilization policies despite the fact that the desired results could only be materialized in several years. After weathering through the painful recession and the balance-of-payments crisis until 1982, the Korean economy finally began to stabilize from 1983. First of all, the inflation rate was brought down from double-digits to around 3 percent, which led to the stabilization of the nominal wage growth rate and interest rate. Based on this macroeconomic stabilization, exporting companies recovered their competitiveness and overall economic activities were revitalized. By the mid-1980s, the growth rate surged to double-digits, while the inflation rate stayed around 3 percent. Government budget deficit continued to decline to zero, decreasing the public debt to GDP ratio. A sizable amount of current account surplus was realized, overcoming the balance-of-payments crisis.

All in all, it is clear that the stabilization policy carried out in the early 1980s bore great economic fruits. However, its historical significance was not confined to macroeconomic performances. Perhaps a more important implication of the success of the stabilization policy was to prove that the government-led development strategy was neither the only nor a sustainable policy framework for prosperity, and that inflation is not a necessary evil for growth promotion. A better understanding of the drawbacks, as well as merits of the "Korean model of development" should greatly help many aspiring policy-makers in developing countries to shore up their development strategies.

The purpose of this paper is to document and assess this historic event that took place in the early 1980s. Chapter 2 will review the political and economic environment of Korea in the 1970s that gave rise to the stabilization policies. Chapter 3 will then document the policy-making processes, focusing on the differences in the perception of economic policies between the two presidents, President Park and President Chun. Chapter 4 will describe the contents of the stabilization policy package and Chapter 5 will assess its achievements. Chapter 6 will conclude with implications of Korea's stabilization policies on developing countries.

Chapter 2

Political and Economic Environment in the 1970s

Political and Economic Environment in the 1970s

1. External Environment

The 1970s was a decade of global inflation. The Bretton Woods system, a cornerstone of the international financial order for more than 20 years, collapsed in the beginning of the decade. It was obvious that the abolition of the Bretton Woods system generated a great deal of uncertainty in international transactions, but it also eroded the discipline of monetary policy. Since the ultimate reference of the value of money vis-à-vis gold was lifted, monetary policy was more likely to be accommodative and global inflation surged. By the end of the 1970s, the inflation rates of many advanced countries recorded double-digit figures for the first time in history.

Table 2-1 | Average Anuual Inflation Rates in the 1970s

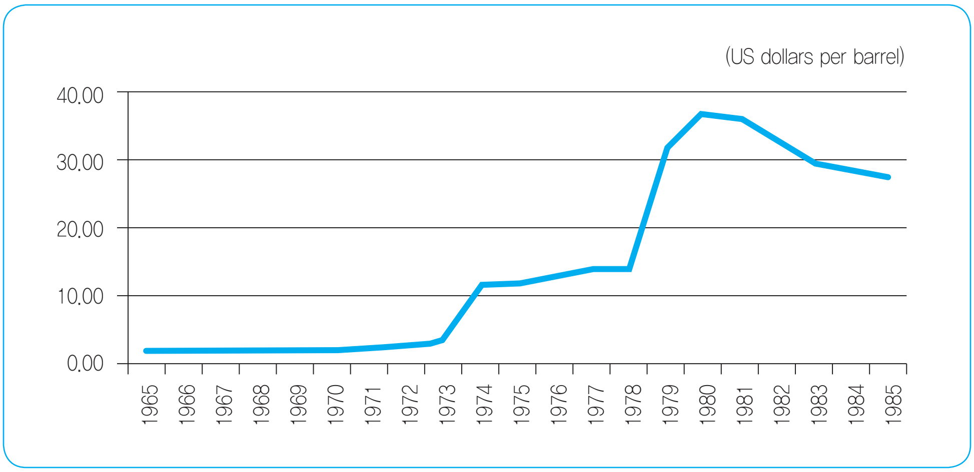
(percent)

U.S	Japan	Germany	U.K.	France	Italy	Korea
6.6	9.6	5.1	13	9	13.5	21

Source: The World Bank

The 1970s was also a decade of resource war. Major oil-producing countries formed a strong cartel, Organization of Petroleum Exporting Countries (OPEC), and quadrupled oil prices to exploit monopoly rents in 1973. For a resource-poor country such as Korea that followed an energy-intensive industrialization strategy, it was a devastating shock. According to Krause and Kim (1991), oil purchases would have required 1.4 percent of Korean GDP (3.7 percent of imports) had the oil price of 1972 prevailed, but actual purchases required 8.8 percent of GDP (22.1 percent of imports), implying that the national cost reached more than 7 percent of GDP. The Korean economy managed to barely survive this First Oil Shock by taking several emergency measures, but finally plunged into a crisis in 1979 when the Second Oil Shock and the assassination of President Park coincided.

Figure 2-1 | Oil Prices in the 1970s



Source: British Petroleum

From the perspective of international relations, the 1970s was a decade of hardship for President Park's regime. Since President Nixon of the U.S., declared the Guam Doctrine in 1969 that urged Asian countries to rely more on themselves for their own security, the U.S. reduced by one-third the ground troops that used to be stationed in South Korea. During the U.S. presidential campaign eventually won by Carter, the idea was further advocated that the U.S. should make another significant reduction of its ground forces in Korea. Although the U.S. reiterated its commitment to come to the aid of South Korea in the event of an external attack and ultimately did maintain its troop strength, President Park's regime felt insecure.

The concern over national security was particularly intensified by the rapidly deteriorating Korea-U.S. relation during the Carter administration. President Park, who had been in power for more than 15 years and severely suppressed opposition leaders, could not get along with President Carter who emphasized peace and democracy in international diplomacy (see Park (2009) for details). It was alleged that Korea was constantly pressed by the U.S. to advance to a more democratic system, which President Park could not willingly accept. The more the Korea-U.S. relations deteriorated, the more the Park's regime had to cling to self-defense from North Korea, which profoundly affected Korea's economic policy in the 1970s.

2. Domestic Political Environment

During the 1970s, Park's regime solidified its power base. In particular, the amendment of the constitution in October 1972 declined the basic principle of democracy, namely, the separation of legal, administrative, and judicial powers. According to the amended "Yushin Constitution," the president was to be elected by the members of the "National Council for Reunification" instead of by the people's direct votes, and the term of presidency was extended from 4 to 6 years with no restrictions on multiple re-elections. The National Assembly was deprived of the right to inspect government offices and one third of congressmen were to be elected by the National Council for Reunification. The Yushin Constitution even granted the president the power to dissolve the National Assembly, and severely restrained basic rights of the people. Under the new constitution, it seemed clear that President Park could indefinitely maintain the presidency and exercise more power than ever.

This event triggered resistance from the people as well as the opposition party, but the degree of political suppression was only increased as the opposition movement became violent. Political opponents, including Kim, Dae Jung (an opposition leader who was later elected as the president of Korea in 1997), were banished abroad, put in jails or under house arrest, and many student leaders of anti-government demonstrations were conscripted into the army.

Nevertheless, the people's resistance did not cease and political legitimacy of the Park's regime was eroded. In May 1979, Kim, Yong Sam (who was later elected as the president of Korea in 1992) was elected as the leader of the New Democratic Party, a leading opposition party at the time, and conducted aggressive democratic movements. As a result, he was expelled from the National Assembly, then under the influence of President Park, in October 1979. A fierce demonstration to protest this incident took place around Busan and Masan (two cities in the Southern region of Korea), which rapidly spread throughout the entire country. Inside the Park's camp, there were intense debates regarding how to cope with the people's resistance. Some argued for a conciliatory stance, whereas others contended for a crackdown by military force. In the midst of this mess, President Park was assassinated by the director of the National Intelligence Service, who allegedly supported the conciliatory position, on October 26th, 1979.

3. Industrial Policy to Promote Heavy and Chemical Industries (HCI)

The most distinctive characteristic of economic policies during Park's entire regime was a strong government leadership, as denoted by the "government-led development strategy." In particular, the government selected "strategic" industries and provided ample support to promote them. For example, exporting manufacturing industries such as textile, shoes, and so forth were given preferential tax treatments and policy loans, as well as preferential access to import licenses in the 1960s.

Entering the 1970s, the main strategic industries were shifted from light industries to heavy and chemical industries (HCI) such as steel, petrochemicals, shipbuilding, machinery, nonferrous metals, electronics, and so forth. The rationale for light industries in the 1960s was simple and clear: Korea had to earn scarce hard currency by exporting goods that could be relatively easily manufactured by an abundant unskilled labor force at the time. However, it was far more controversial to select HCI as strategic industries in the 1970s. The economic justification for this shift was given by the government that Korea had to create a basis for a new comparative advantage in HCI since Korea would lose its competitive position in labor-intensive light industries as the economy developed. It was also argued that the world markets would become more protected for light industrial products. Yet, the rationale for this policy shift rested more on political than economic justifications. As the U.S. foreign policy changed in the 1970s as explained above, Korea needed to be more self-sufficient in national defense, which could not be supported by light industries. From the Third Five-Year Plan that began in 1972, the intention of the government to encourage HCI became clear, and the policy drive to promote HCI was gaining strength as Korea-U.S. relations deteriorated in the late 1970s.

The push given by President Park toward HCI was truly unprecedented. Perkins (1997, p.81-82) describes the situation as follows:

> "The Blue House staff made decisions as to which industries should form the core of the HCI drive. They saw to it that an industrial park (Changwon) was built that could accommodate these new enterprises and they even determined the appropriate scale at which each factory was to be built. … Projects were not put out for bids. Instead individual *chaebol* companies were asked to carry out each project. If they agreed, the government saw to it that they got wide ranging support. There was a major diversion of state bank loans to the HCI sector at preferential interest rates. Favorable access to import licenses was guaranteed. The tax authorities would treat the companies gently using a corporate tax system that was quite "flexible." And the government was prepared to do more if necessary. When Hyundai ships rolled into the water and into a dead market

> for supertankers, the government took steps to create a market giving advantages to oil imports brought in on Korean made ships. Where positive incentives failed, there was President Park's big stick --- the implied threat of the removal of this support system from a company's existing enterprises."

Whether the HCI promotion policy was successful or not depends on what perspective is adopted (see Lee (1991), for example). However, its economic cost was huge, as assessed by Krause (1997, p.119).

> "…the economic dislocations were substantial. Light industries were starved for capital which reduced Korea's international competitiveness since these were the principal export industries at that time. Moreover, many bad investments were made by state-owned enterprises (SOEs) and private firms in heavy industrial facilities that were not fully utilized. These uneconomic investments meant that the firms that borrowed money to create them could not repay their loans, and bad loans accumulated on the books of commercial banks. Also the government's budget was drained to cover losses of SOEs.
>
> Furthermore, a shortage of skilled workers, along with rising domestic protection for heavy industrial products and agriculture, led to an acceleration of inflation. Meanwhile the balance of payments deteriorated requiring even more foreign borrowing. Finally the second oil shock hit early in 1979 which combined with perverse macroeconomic policies --- real interest rates were negative since 1973 and large tax preferences were provided to selected "strategic" industries --- led to serious economic problems."

4. Financial Repression to Support the HCI Drive

In order to promote HCI, every possible policy measure was mobilized. Among many, financial policy tools were very actively utilized. Kim (1997, p.208) describes the situation as follows:

> "President Park had to deal with two crucial issues: first, how to facilitate and ensure the allocation and delivery of funds to the targeted destinations; and second, how to prevent the misappropriation of delivered funds. To cope with these issues, the government devised the system of policy loans and firm-level credit controls. The policy loan system was a credit pipeline to serve at the government's needs, and firm-level credit control system was to keep the pipeline from being leaked at the receiving end."

Naturally, financial markets were severely repressed to serve these government policies and provide cheap credits to the strategic industries. Out of total loans by deposit money banks, the share of policy loans, mainly for heavy and chemical industries, rose to approximately 50 percent by the end of the 1970s. Policy loans to the strategic industries included foreign exchange loans, export loans, and loans to development institutions such as the Korea Development Bank and the Korea Export-Import bank. Bank interest rates were also regulated at low levels in an effort to stimulate investment. The real interest rate on time deposits with a one-year maturity was virtually zero during the 1970s, and policy loans in particular carried preferential interest rates that were even lower than those of general bank deposits, so that the average borrowing cost to firms remained below the inflation rate during the 1970s.

Table 2-2 | Policy Loans of Banks and Interest Rates (Period Average)

(percent)

	Portion of Loan Amount (Deposit Money Banks)			Average Interest Rate			
				Loan (Manufacturing)		Bank Deposit (1-Year Time Deposit)	
	Policy Loan	Loan to Manuf.	Loan to HCI	Nominal	Real[1)]	Nominal	Real[2)]
1971-1975	44.5	52.9	24.5	11.1	-8.6	15.7	0.1
1976-1980	47.3	55.3	29.2	14.1	-6.7	17.9	0.5
1981-1985	41.4	46.5	27.6	15.2	7.8	11.5	4.2
1986-1990	45.9	43.8	27.5	12.9	7.3	10	4.6

Note: 1) Nominal interest rate – GNP deflator inflation rate
2) Nominal interest rate – CPI inflation rate
Source: Nam and Kim (1995, p.133)

In this context, monetary policy was also mobilized as a tool for providing, so called, "growth money." Just like other commercial banks, the Bank of Korea (BOK) was also under the control of the government since the Amendment to the Bank of Korea Act on May 24th, 1962. This Amendment downgraded the function of the Monetary Policy Board from policy-making to policy implementation. The power of the Minister of Finance was increased to request that the Board reconsider a resolution that had already passed. If the request was overruled by the Board, the final decision was to be made at a cabinet meeting. Under this governance structure, the government attempted to direct the maximum amount of credit to the target industries at low interest rates, and the resulting losses of banks were often bailed out by the money-printing power of the BOK. For example, the commercial banks' policy loans were *automatically* rediscounted at the BOK, implying that the costs of policy loans were largely borne by inflation tax.

While subject to the authority of the government, the monetary policy officially targeted monetary aggregates, although the selected monetary aggregate varied over time from M1 to reserve money in 1969, to domestic credit in 1970, and to M2 in 1979. Reflecting the general atmosphere of the authoritarian government and the primitive stage of financial market development, policy actions to achieve the target in practice heavily resorted to direct rather than indirect measures. <Table 2-3> summarizes the BOK's policy measures, based on the explanations in Kim (1997).

Reserve requirement ratios were changed roughly 30 times from 10 to 35 percent, but no clear logic was provided. As explained above, the rediscount policy was almost automatically executed to support the industrial policies, and could hardly be used as a monetary policy instrument. Open market operations mainly with Monetary Stabilization Bonds (MSBs: securities issued by the BOK that are fully guaranteed by the government for monetary policy) were also far from "open" market operations in the sense that open markets for voluntarily selling and purchasing securities did not even exist. For the BOK, selling MSBs was simply assigning the "quotas" to commercial banks, and the MSBs were never sold in the open market. The Monetary Policy Board established a "Monetary Stabilization Account" in the BOK in March 1967, and a certain portion of the bank's fund was deposited in this account when the money supply was increased and withdrawn when it was contracted. In addition to rationing MSBs, direct control of aggregate bank credit was used extensively. The Monetary Policy Board was empowered to set ceilings on the aggregate credit volume for each banking institution in periods of excessive monetary expansion. With traditional indirect tools having little effect on controlling the money supply, the BOK continued to supervise the loans of other banking institutions. Like many other central banks in developing countries, the BOK was also empowered to directly determine the maximum interest rates charged and paid by the banking institutions on their loans and deposits. Due to a chronic excess demand for funds, the maximum interest rate set by the BOK became the actual rate charged by the banks.

Table 2-3 | Monetary Policy Instruments in the 1970s

		Contents	In Advanced Countries	In Korea in the 1970s
Indirect Instruments	Open Market Operations	Selling and purchasing securities in open markets	Most conventional	Not executed
	Reserve Requirements	Manipulating the portion of deposits required to reserve	Rarely exercised	Inconsistently exercised
	Rediscounts and Loans	Making loans with securities as collateral	Frequently exercised	Almost automatically executed
Direct Instruments	Aggregate Credit Control	Controlling the aggregate amount of credit for each banking institution	Almost non-existent	Extensively exercised
	Interest Rate Ceiling	Setting the maximum level of interest rate charged by banks	Almost non-existent	Widely exercised as a *de facto* interest rate guideline
	Monetary Stabilization Account	Manipulating the amount of MSBs that banks should purchase	Almost non-existent	Extensively used to control money supply

5. Soft Budget Constraint of the Government

In order to support the industrial policies, fiscal resources were also mobilized in addition to financial resources. In particular, the government maintained a strong will to construct a foundation for HCI and substantially increased its own spending for this purpose. The statement of Kim and Whang (1997, p.262) indicates how aggressive the government supported the HCI drive:

> "…total fiscal investment and loans increased from 309.8 billion won in 1972 to 4,560.3 billion won in 1981, which is almost 15 times that of 10 years earlier. In terms of the ratio relative to GNP, the low was down to 5.1 percent in 1973, and the high reached 10.0 percent in 1981."

From the taxation side, too, the government applied various tax incentives, including preferential depreciation allowances, tax reductions and exemptions for exporters and strategic industries. For example, Kwack (1984) estimated that the net benefit from tax incentives for investment in key manufacturing industries reached 36.9 percent of expenditure in 1976, which jumped from 7.8 percent in 1970.

In addition, the government had to forcefully increase its expenditure on national defense, the largest item in the government budget at that time, as Vietnam became a communist country and the reduction of the U.S. army was announced. Of the total central government expenditure, its portion ballooned from 27 percent to 33 percent in 1978.

Despite these policy measures that imposed huge burdens on budget, the central government managed to maintain a surplus in the general account by squeezing the budget for education, health, welfare, among others. This was a remarkable achievement, but the picture looks different if the special funds for public projects are taken into consideration. In fact, while the central government's general account recorded a surplus throughout the 1970s, the consolidated budget recorded a deficit every year due to the structural deficits in special accounts.

Special funds were established by law when the government needed to have a separate account from the general account to manage special projects. They were established when needed and abolished when not. However, a more important characteristic of special funds was that they were not directly monitored by the National Assembly, which inevitably caused a laxness of fiscal management. Kim and Whang (1997, p.269) write:

> "Meanwhile, many government funds were established during the 1970s. A notable characteristic of government funds was that they were not dependent on the revenue and expenditure budget, and they were not under the direct control of the National Assembly. The first funds were the Public Servant Pension Fund and the Military Personnel Pension

Fund, which were both established in 1963. Since then, one or two funds were established each year, totaling eleven government-managed funds by 1972 and nineteen by 1979. The increase in funds made fiscal management convenient for the fiscal authority since the funds were managed off-budget, but this brought laxness to fiscal management."

As a result, the government continued to run a consolidated budget deficit of 2 to 5 percent of GNP. The absolute size of the deficit was not small, but it might not have been unsustainably large given the rapid economic growth (and inflation) of Korea in the 1970s. Regarding the laxness of fiscal management, however, a more serious problem than its absolute size was the way the government financed the budget deficit. How to finance deficient resources for special funds in particular was almost entirely decided by government discretion, which always considered borrowing from the Bank of Korea (BOK) as an option. That is, the government could always rely on its money-printing power to finance special projects.

Table 2-4 | Consolidated Budget Balance in the 1970s

(billion won, %)

	1972	1973	1974	1975	1976	1977	1978	1979	1980
1. Central Government	-103	35	-33	-89	-15	-146	-300	-289	-474
General Account	62	143	243	430	706	137	255	222	24
Special Accounts	-155	-112	-252	-409	-556	-93	-239	-144	-202
Other Funds	-10	4	-59	-110	-165	-190	-316	-367	-296
2. Public Enterprises	-35	-89	-130	-353	-201	-50	-325	86	-440
Special Accounts						-1	-59	-49	-325
Gov't Supply & Grain Management Fund						-149	-267	-135	-114
3. Total	-139	-54	-198	-443	-216	-296	-626	-203	-914
(GNP Ratio, %)	(-3.3)	(-1.0)	(-2.6)	(-4.4)	(-1.7)	(-1.7)	(-2.6)	(-0.7)	(-2.5)
4. Off-Budget	-58	-62	-97	-112	-177	-170	-328	-255	-375
5. IMF Standard (3+4)	-197	-115	-295	-555	-393	-466	-954	-459	-1288
(GNP Ratio, %)	(-4.7)	(-2.1)	(-3.9)	(-5.5)	(-2.8)	(-2.6)	(-4.0)	(-1.5)	(-3.5)

Source: Ministry of Finance, *Government Finance Statistics in Korea*, Kim and Whang (1997)

The Grain Management Fund, among others, was the largest fund that heavily relied on borrowings from the BOK. In order to stabilize the farmers' income, the government committed to purchasing rice and rye at pre-set prices. The problem was that the purchase prices were always set at higher levels than the market prices. This 'dual prices policy' was designed to subsidize the farmers' income with public resources, and thus the Grain Management Fund in charge of this project was destined to incur losses, which only increased as the gap between the purchase and resale prices widened over time. By 1976, the gap between the two prices exceeded more than 50 percent of the purchase prices, expanding the Fund's deficit to 250 billion won. However, instead of financing the deficits either from tax revenues or by issuing bonds, the government almost entirely relied on borrowings from the BOK. According to the Economic Planning Board (1977), the Fund's borrowing from the BOK accumulated over five years from 1972 to 1976 and was 626 billion won, which was almost half of the base money outstanding at the end of 1976. In fact, the deficit of a single year in 1976 amounted to 250 billion won, which was more than 60 percent of the increment in base money (1,473.7 - 1,077.0 = 398.7 billion won).

Table 2-5 | Grain Prices Set by the Government

(won per hop≒180ml)

		1972	1973	1974	1975	1976
Rice	Purchase Price	9,888	11,377	15,760	19,500	23,200
	Resale Price	9,500	11,264	13,000	16,730	18,400
	Difference	-388	-113	-2,760	-2,770	-4,800
Rye	Purchase Price	6,357	6,993	9,091	11,100	13,000
	Resale Price	4,300	4,800	6,000	6,900	8,320
	Difference	-2,057	-2,193	-3,091	-4,200	-4,680

Source: Economic Planning Board, *Rationalization of the Grain Management Fund*, 1977. 4. 29. The Bank of Korea

Table 2-6 | Finance of the Deficit of the Grain Management Fund

(billion won)

	1972	1973	1974	1975	1976	1972-76
Total	36.0	50.0	160.0	230.0	250.0	726.0
BOK Borrowing	36.0	50.0	160.0	230.0	150.0	626.0
Long-term	36.0	50.0	160.0	230.0	130.0	606.0
Short-term					20.0	20.0
Bond					100.0	100.0
Base Money	427.5	624.1	775.0	1,077.0	1,437.7	

Source: Economic Planning Board, *Rationalization of the Grain Management Fund*, 1977. 4. 29. The Bank of Korea

Though smaller than the Grain Management Fund, many other special funds, such as the Fertilizer Account Fund, were also run in the same fashion. The special funds were structurally designed to run deficits, most of which were financed by borrowings from the BOK. The government also tried to reduce the BOK borrowings by running surpluses in the general account. However, as long as the consolidated budget was in deficit due to the deficits of the special funds, the easy financing option from the BOK continued to be utilized. It appeared that there was no hard budget constraint for the government in the 1970s.

6. Monetary Expansion and the Surge of Inflation

In any sense, the HCI drive and its supporting policies were not in accordance with an order one would expect in a market-based economy. It was natural that moral hazard proliferated and resources were inefficiently allocated, as the degree of government intervention increased. Perhaps a more serious problem, however, was that the government attempted to achieve multiple goals contradictory to one another. The BOK's monetary policy in the 1970s was a typical example.

As explained above, the financial market was simply regarded as a pipeline to convey the maximum amount of resources to strategic industries under the control of the government. Commercial banks had to provide approximately a half of their deposits as policy loans with extremely low interest rates, and the remaining half were also lent at the interest rate set by the BOK. With this structure, commercial banks could not sustain their profits, and thus the BOK had to support them. In addition, the BOK also served as the government's back pocket for financing structural deficits mainly run by special funds such as the Grain Management Fund. Indeed, there were multiple sources of monetary expansion in this economic policy structure.

Under this environment superimposed by the government, it was a truly formidable task to control aggregate money supply. By directly controlling the amount of bank credits, the BOK tried to achieve two contradictory goals, supplying a sufficient amount of cheap money and suppressing the amount of money under control. Credit allocation of banks was tightly controlled so that consumers could hardly access bank loans. On the one hand, the BOK supplied a massive amount of money to support commercial banks and the government, but on the other hand, it attempted to control the aggregate money supply by directly controlling the amount of bank credits. Obviously, the government policy reflected the government's priority for the strategic industries and deficit financing rather than inflation control, and the efforts of the BOK only aggravated distortions in credit allocation. The money supply was rapidly increased with its growth rate hovering around 30 percent per annum.

Table 2-7 | Money Growth Rates in the 1970s

(%)

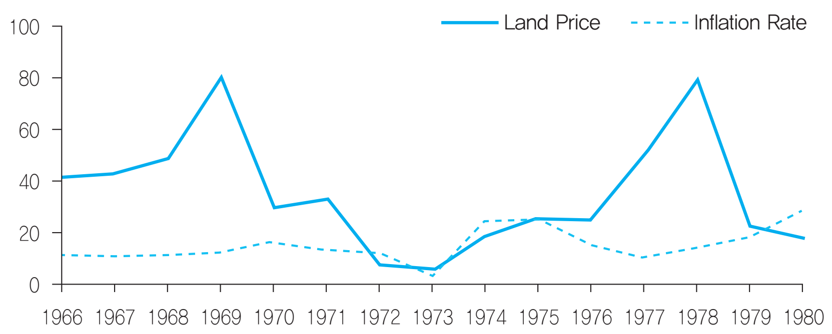
	1972	1973	1974	1975	1976	1977	1978	1979	1980
Base Money	48.3	46	24.2	39	33.5	44.1	35.3	23.8	-6.5
M1	39.9	39.7	26.9	25.3	32.7	45	38.7	23.1	21
M2	33.6	36.1	21.5	25.2	35.1	40.1	35.4	29.7	44.5

Source: The Bank of Korea

As a result, the inflation rate that was expanded to over 20 percent in 1974 due to the First Oil Shock was not stabilized and stayed at a high level. Double digit inflation was taken for granted and economic agents began to reflect inflation in their economic activities such as wage bargaining and financial contracts. A typical pattern of a vicious circle of inflation --- inflation expectation and actual inflation reinforcing each other --- was set off in the second half of the 1970s.

More painful for the poor people during this period, however, were probably the skyrocketing real estate prices. Many business firms who could access policy loans with negative real interest rates borrowed as much money as possible from banks and purchased real estate rather than investing in productive businesses, pushing up real estate prices to unimaginable levels. Although there were no official nation-wide indexes for housing prices in the 1970s, it was frequently observed in many locations that the prices more than doubled within a 1-2 year period. According to Lee (1996) who reported on land price indexes of major cities, the prices rose by 25 percent in 1976, continued to rise by 50 percent in 1977, and further by 79 percent in 1978.

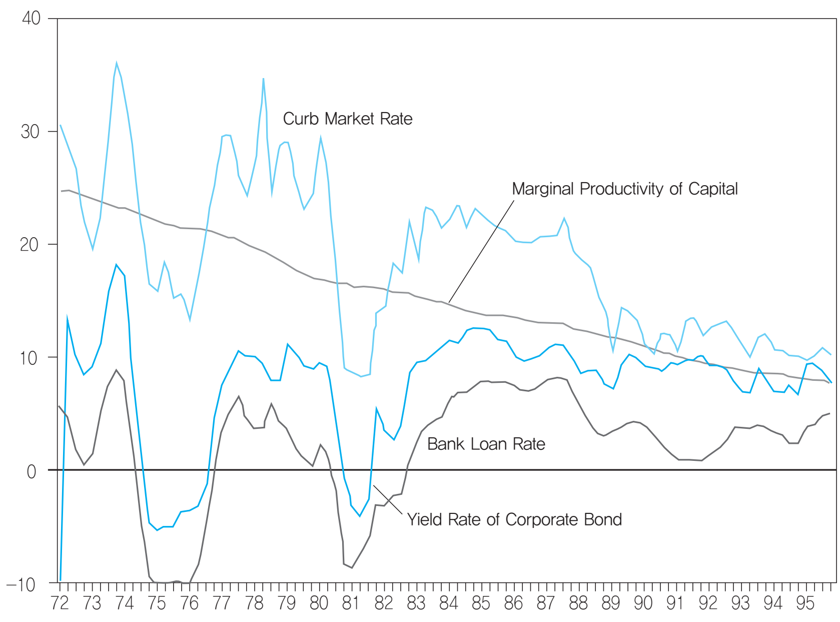
Figure 2-2 | Inflation Rates of Consumer Prices and Land Prices



Source: The Bank of Korea and Lee (1996)

The rise of inflation brought about another dimension of distortions. Although the root-cause of accelerating inflation was the abused monetary policy, the government attempted to control individual prices. An extensive price-monitoring system was run, and a wide range of individual prices could be raised only after being approved by the government. However, such a direct price control system has many implementation problems: troubles in finding the 'right' price based on production cost data that would not force the least productive producers to go bankrupt; difficulty of suppressing firms' rent-seeking behavior to collect extra profits by delaying distribution of products whose controlled prices were imposed at the point of production; and cost of monitoring that was increased as inflation was accelerated and stricter price controls were enforced. More importantly, direct price controls significantly infringed the market rules and eroded efficiency in various dimensions: malfunctioning of price signals that would provide firms to enhance productivity and improve product qualities; losses in social surpluses due to the difference between market and controlled prices since people would be willing to pay premiums for the goods in shortage; and failure of price adjustment that should flexibly reflect market situations as well as locations.

Figure 2-3 | Real Interest Rates



Source: Figure 11.3 of Cho (1999)

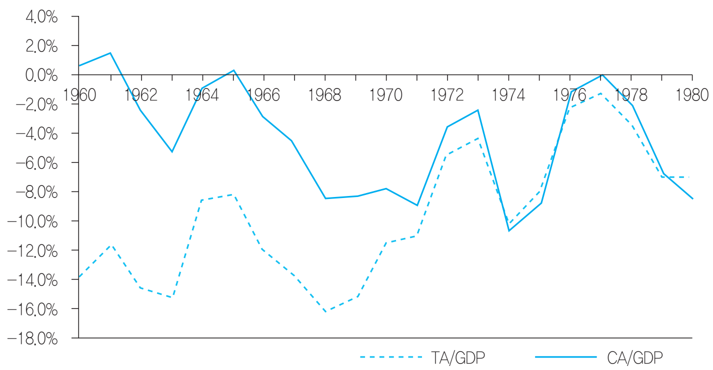
Such an inefficient and inflexible price control system could not be sustainable. In the second half of the 1970s, a high rate of inflation continued, notwithstanding the full-scale efforts of the government to control prices. Not only did the prices of goods and services, but also real estate prices and wages, soared hand in hand, eroding export competitiveness and the balance of payments. This unstable macroeconomic situation in the late 1970s is described by Nam (1988, p.79) as follows:

> "The Korean economy during the later years of the 1970s was full of distortions and resource misallocations typical of any high-inflation country. Financial saving, which usually entailed earning a negative real interest rate, was not attractive. Instead, feverish demand for real estate and other real assets caused their prices to shoot up. Many business firms were preoccupied with borrowing as much as possible from banks, only to invest in real estate by expanding unproductive businesses, leading to an increasing fragile corporate financial structure. The government's attempt to repress inflation through price controls led only to inadequate investment, supply shortages, black markets, and deteriorating product quality. "

7. Deterioration of the Balance of Payments

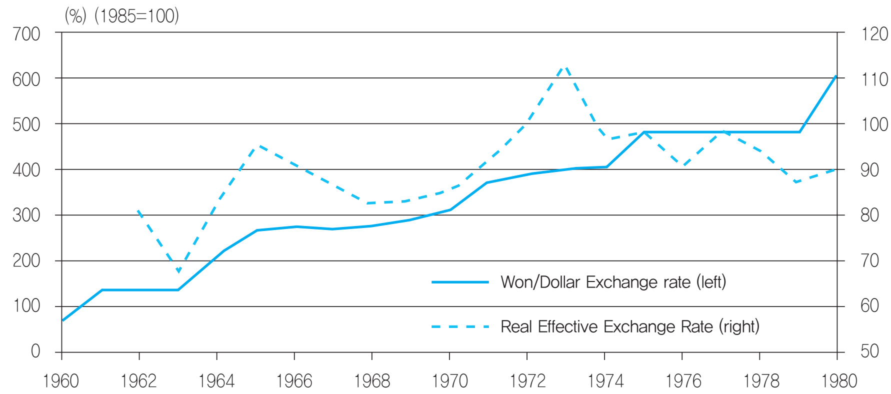
Just like many other underdeveloped countries, Korea heavily relied on foreign aids to balance external payments until the 1960s. While depending almost entirely on imported oil for energy consumption, Korea could not earn as much foreign currencies by exports as needed to settle imports. The trade balance was always in deficit, whose size easily exceeded 10 percent of GDP. A substantial portion of this gap between exports and imports were filled by foreign aid mostly from the U.S.

Figure 2-4 | Trade Account and Current Account as Percent of GDP



Source: Cha, Dong-se (1995), *A Half Century of the Korean Economy: Sourcebook*

Figure 2-5 | Won/Dollar and Real Effective Exchange Rates



Source: Cha, Dong-se (1995), *A Half Century of the Korean Economy: Sourcebook*

However, the size of foreign aid continued to decline since 1957, pressing the balance of payments of Korea. For example, foreign aid could cover trade deficits by 383 million dollars (more than 20 percent of GDP) in 1957, but by only 8 million dollars (less than 0.1 percent of GDP) in 1977. As the amount of foreign aid diminished, it became increasingly difficult to finance the explosive investment demand induced by the HCI drive. The deficit in the trade account was directly translated into the deficit in current account or external borrowing, making the country vulnerable to foreign debt problems. According to Cho and Kim (1997, p.59), the amount of total foreign debt was only 89 million dollars (3.8 percent of GNP) in 1962. With the decrease of foreign aid and the continued trade deficit, however, it was rapidly increased to 2,277 million dollars (23.7 percent of GNP) in 1970 and further to 8,457 million dollars (41.8 percent of GNP) in 1975.

In order to cope with the difficulties in the balance of payments, the government continually devalued the exchange rate from 130.0 won per dollar in 1963 to 398.3 until 1973, more than 200 percent during the ten year period. Despite the high domestic inflation, this devaluation was large enough to depreciate the Korean won in real effective terms by more than 30 percent. Finally, the trade deficit began to respond and reduced from approximately 15 percent of GDP in 1968 to 4 percent in 1972.

Since then, Korea's balance of payments wildly swung depending upon oil price fluctuations. In 1974 and 1975, trade deficits drastically widened to approximately 10 percent of GDP due to the First Oil Shock, seriously destabilizing Korea's external financing since it could not rely on foreign aid any longer. By contrast, as oil prices stabilized and construction demand from the oil producing Middle East countries increased at explosive rates, the deficit size was significantly reduced in 1976 and 1977 to almost zero.

While trade and current accounts were fluctuating along with oil prices, the underlying price competitiveness of Korean exporters was seriously eroded due to the chronic inflation. In particular, during the 1975-1979 period when the HCI drive was at its peak, the nominal exchange rate was not adjusted at the level of 484 won/dollar despite accelerating domestic inflation, which appreciated the real effective exchange rate by approximately 10 percent. This rigid exchange rate policy was maintained essentially to reduce the burdens of HCI industries that heavily relied on imports for its raw materials as well as investment facilities. Under this macro-economic environment, however, it was natural to increase imports from abroad rather than trying to produce domestically, and thus to deteriorate the balance-of-payments. Yet, the government, again, attempted to overcome this macroeconomic imbalance by strengthening direct controls over imports at micro levels rather than by adjusting macro-variables, such as the exchange rate or inflation. Of course, these kinds of micro policies could not successfully tame the desire to import more, just as the tightened controls over individual prices without adjustments in monetary policy could not tame inflation.

Moreover, inflation was naturally accompanied with wage and land price inflation. As the cost of living was increased by inflation, workers demanded higher wages, which could not be refused indefinitely by business firms. Land prices rapidly rose, too, as the cheap credits to support HCI flowed into real estate markets to seek speculative profits. The higher wages and land prices significantly increased production costs of the firms, which was particularly detrimental to exporters who could not pass the higher costs to customers in the international market. While accelerating inflation under the rigid exchange rate management was weakening exporters' competitiveness, the Second Oil Shock broke out in 1979. The trade deficit was sharply expanded again and the Korean government had to hurry borrowing from abroad to cover the deficit. Foreign loans were rapidly accumulating and reached 27,170 million dollars (48.2 percent of GNP) in 1980, driving the Korean economy to the edge of its balance-of-payments crisis.

Chapter 3

Paradigm Shift towards Stabilization

Paradigm Shift towards Stabilization

1. New Ideas Challenging the Government-Led Development Policy

Chronic inflation, among the many problems explained in the previous chapter, became the central concern of leading policy makers, as well as the general public, especially after the First Oil Shock in late 1973. Yet, explicitly recognizing its true causes and thereby designing proper policy reactions were not easy both politically and practically, since it was closely intertwined with the government-led development strategy that was not to be challenged. As a macroeconomic principle, the most orthodox policy measure to cope with high inflation should be the control of money supply in the market through appropriate monetary policies (higher interest rates) rather than direct price controls. However, the government-led development strategy, the HCI drive in particular, left little choice available. As long as the HCI was supported by policy loans with preferential interest rates, commercial banks had to suffer from negative interest rate margins, and thus the BOK had to subsidize the troubled commercial banks by printing money (by automatically rediscounting policy loans). The only way to control the money supply was to transfer this burden of the BOK to the government by retrenching other fiscal spending, but that was also almost impossible due to national defense and the dual-pricing of rice and fertilizers to achieve a self-sufficient food supply. Enhancing competition pressures by opening the economy for free trade as a means of price stabilization was unthinkable since infant domestic industries had to be protected.

In short, controlling inflation would require a paradigm shift in economic policies. In particular, the whole system of controlled economy under the name of the government-led development strategy had to be challenged. The idea of a new economic system was growing among the younger generations of government officials in the Economic Planning Board (EPB) in particular. They were concerned about the effectiveness of the HCI drive, and more fundamentally the government-led economic development strategy in general. They began to believe that the Korean economy could not sustain its economic development with the existing controlled economic system. They believed, instead, that the Korean economy had to transform into a more market-oriented system in order to stabilize the macro-economy and sustain its development.

Yet, the perception that the government-led development strategy was successful reinforced its justification and legitimacy. The core principles of this strategy strongly grasped the minds of top policy-makers, not to mention that of President Park. Naturally, the tension between the old and young generations of policy-makers became intensified as the side-effects of the government-led development strategy were getting more evident. At last, President Park unwillingly accepted stabilization policies in April 1979 when the Korean economy was pushed to a cliff.

The Comprehensive Economic Stabilization Policies (CESP) announced in April 17, 1979 would mark a major turn-around from the previous economic development policies that had wide support from almost every actor: government officials of the Ministry of Commerce and Industry; many of the economic policy advisors to the president; government think-tanks; large businesses; media; the general public; and not-to-mention President Park himself. Persuading everyone, especially President Park, was a quite formidable task, but the deteriorating economic situation at hand created a strong sense of crisis that enabled the CESP to be adopted. Nevertheless, earnest efforts to implement this package were delayed until the leadership was changed to President Chun in 1980.

2. Stabilization Policies under President Park: Passive Implementation

2.1. Initial Efforts to Advocate Stabilization Policy

It was not widely known that the CESP was first adopted under President Park's regime. Although such ideas emerged among young elite officials in the EPB, the adoption of the CESP was made possible by key actors in key positions coming to consensus on the necessity of correcting the government-led economic development strategy. In this regard, the appointment of Kang, KyongShik, a person with strong convictions on the need of economic reforms, to the Assistant Secretary of the Economic Planning Board (EPB) was an important event. The following passage in his book (Kang, 1987, p.28) vividly delivers the sour feelings he had towards the existing policy-making process at the time:

“I assumed the position in December 1977, and the ‘Long-term (15 years) Economic and Social Development Plan’ had been already prepared by the Korea Development Institute (KDI) to be presented to President Park in the beginning of 1978. I made the presentation without making any corrections to the report, but it was quite troublesome to me since, as clearly stated in the report, it was all too rosy outlooks, predicting 10 percent annual growth and a current account surplus from 1981. What was unusual to me was that it assumed a high inflation rate (8.4 percent annually) for the next 15 years as a fact. Such signified, at least to me, the steadfast and unquestioned philosophical approach and faith about rapid economic growth strategy at the time. In other words, almost all of the policy makers were taking the high inflation rate as a condition, not as a problem that needed solutions. So it seemed that we should rethink the current economic development strategy.”

Assistant Secretary Kang strongly believed that Korea had to make a major shift in the economic policy paradigm, but needed allies who shared the ideas to make the necessary policy changes. It was necessary to build a major consensus through strong advocacy; beginning with the working officials and eventually with the key decision-makers.

Therefore, he formed a special task force team with capable junior staff members and selected researchers from the KDI to comprehensively review the current state and issues of the Korean economy. They even stayed many nights together at the guest house of the Korea Institute of Science and Technology (KIST) to analyze almost all of the structural issues that were related to controlling inflation (the increases in money supply) from the fiscal, financial, and trade areas, as well as the existing industrial policies. Those measures to counter the high inflation rate had included issues such as the abolishment of the dual-pricing control system of grains, investments to enhance agricultural productivity, reforming the private finance market system, enhancing independency of the financial institutions, and actively lifting the controls of imported goods market, restructuring the over-investments in the HCI, shifting from the direct supportive industrial policies focusing on strategically selected industries towards more general indirect approaches promoting the advancement of production technology and R&D, development of human resources, and increasing the supply of a skilled labor force.

However, coming up with ideas was one thing, and implementing them as government policies was another. It was obvious that, to adopt the stabilization policy, getting presidential approval would be the first priority given the strong dictatorial decision-making power in government. Yet, the political implication of the stabilization policy would essentially mean acknowledging the failure of the HCI policy, and it would be perceived as directly challenging the unquestioned economic strategies for nurturing HCI that was strongly pursued by the President himself. It almost seemed like political suicide to advocate such policies. Kang (1988, p.91-2) describes his efforts and frustration as follows:

> "Over the two month period, the taskforce came to a conclusion that maintaining the current government-led economic development strategy would not work anymore since the size of the Korean economy grew substantially and there were many changes in the domestic as well as the international market environments. We made a two-part report, 'Current Issues of Korean Economy and Policy Measures' and 'Long-term Policy Goals in the Midst of Transition Period,' and presented them to the Vice Prime Minister (head of the EPB) Nam, Duk-Woo. He approved and expressed his full consent on the conclusion of the report, and agreed to implement the plan fully after getting approval from the Blue House. However, there had been no reaction (from the Blue House) even after one month. It might have been the case that Nam had sat on the report considering the political implication of such a policy and the ripple effect it would have on the general election ahead in 1978."

They made several additional attempts to persuade top policy-makers afterwards. The Minister of Finance, Kim, Yong Hwan, at the time also supported the stabilization policy. However, such attempts did not go through and not much could be done without the official approval by the President. General election in December 1978 did not allow major policy changes and at the same time did not strongly pursue the implementation of HCI. Consequently, it was a stalemate situation that did not produce any visible outcomes in controlling the overheated macroeconomic situation during 1978.

While major policy directions were not changed, the government stuck to rather piecemeal policies. To lessen the pressure of high inflation, the Countermeasure Committee for Liberalization of Imports was established in February 1978, followed by two efforts to deregulate imports in 1978, which increased the rate of import liberalization from 51.5 percent in 1977 to 64.9 percent in 1978. Another measure was introduced in June to reduce the excess liquidity by increasing the interest rates of time deposits from 14.4 to 18.6 percent, while sustaining the interest on a loan from 16 to 19 percent. Many policy measures for controlling the rapidly rising apartment prices were also announced in May and June of 1978, such as regulations on large residential units, commercial and public buildings, an increase in supply of skilled construction workers, allowing the import of reinforcing bars, among others. However, these policy measures turned out to be ineffective in terms of increasing the supply of housing units in the short-term. Recognizing the need for more drastic measures, the government introduced the 'Special Measures for Counter-speculation on Real Estates and Stabilizing Land Prices' on August 8, which mandated obtaining permits and registering real estate (land) transactions, licensing of real estate brokerages, recording the counterparty of real estate transactions in the certification, and establishing the Korea Land Corp. All of these policies to control the rising inflation rates in 1978 were focused on the symptoms rather than the causes of increasing money supply in order to maintain fast growth. For this reason, they had, at best, limited effects.

In the meantime, the efforts to advocate stabilization policies failed to persuade President Park and appeared to drift away. Yet, they were not completely in vain. Perhaps the most important meaning of such efforts can be found in the consensus that was built among a core group of government officials who later promoted the stabilization policies, as Kang (1987, p.29) recollects:

> "Now looking back at the initial process of consensus building, the most successful outcome of such was gaining allies that had agreed upon the fundamental shift in economic development strategy and they had later advanced in ranks throughout the government (under President Chun's regime). I truly believe they contributed continuously to strengthening the market institutions and as a result we the economy blossomed during the late 1980s."

The younger officers in the first task force team included Kim, Jae-ik, Park Yu-kwang, Moon, Hee-Gap, and Lee, Hyung-ku, all of who played major roles in adopting, enforcing and implementing the stabilization policies during the 1980s. Kim, Jae-ik, especially played a critical key role during President Chun's regime, from the early transitional periods of the National Security Council when President Chun served as the head of the Council after the military coup.

2.2. Overcoming Resistance to the Stabilization Policy

Almost a full-year of initial consensus building among the government officials within the Economic Planning Board (EPB) and other ministries had not produced any meaningful results, until Shin, Hyun-Hwak was appointed to Vice Prime Minister as the head of the EPB after the December 12 general election in 1978. This appointment indeed marked the turn of tides since he was highly favorable of the stabilization policy. In order to assess how confident Vice Prime Minister Shin was about economic reforms, Kang (1987, p.30)recalls their official business trip for two weeks to Soviet Union attending the WHO conference in September 1978, just a couple of months before his appointment:

> "Our experience of the side-effects of the planned economy gave us the strength to fight back the resistance since our economy was also exhibiting similar side-effects of a planned economy. It gave us strong belief in the market based economic institutions and its superiority over government-controlled economy. It was clear to us that stabilization, less intrusive government policy (self-governance in short), and an open-economy should be the central concepts of the next generation of government policies."

With the appointment of Vice Prime Minister Shin, the stabilization policy could gain momentum inside the EPB. Yet, the ultimate decision maker was President Park. Recognizing the fact that there was little chance to brief and persuade the President in an informal setting to enhance his understanding and necessities of the stabilization policy, the EPB made efforts to build sound arguments and effective presentation materials.

The main point of the material centered on the choice between growth and stabilization. By citing the change in economic environment such as the rising oil price (beginning of the second oil shock) and raw material prices in the international market, on top of the structural issues contributing to high inflation rates, a list of policy measures were proposed including the actualization of prices to induce an increase in production, increasing investments in the light industry, restructuring of investments in HCI, strengthening the control of money supply through fiscal, financial, and trade areas, and drastically expanding the list of agricultural goods to be imported from abroad based on the comparative advantage arguments. The material also included the lessons from Germany and Japan during their development periods that the inflation control was the starting point of the policy transition from growth orientation to stabilization.

With the strong support of Vice Prime Minister Shin, this material was presented to President Park at the beginning-of-the-year briefing session by the EPB in January 11, 1979. However, his initial reaction right after the briefing session was indeed not positive. Although he did not make any comments on the report right away, his disapproval of the policy became apparent through a number of comments he made on other occasions. For example, he said "Recently some crazy nuts in the government says we should decrease support for the export industry" during his remark at the beginning-of-the-year briefing session of the Ministry of Foreign Relations, and "Today I heard the most promising and ambitious plan that hits the nail right on the head" at the similar session of the Ministry of Commerce and Industry on 'Fostering 10 Strategic HCI Industries.'

Since then, the stabilization policy had to face opposition from almost every corner. The Economic Cooperation Bureau disagreed with the EPB, and the Ministry of Commerce and Industry was against the idea of liberalizing the imports and reducing the amount of export financing. The Ministry of Finance harshly argued against the idea of financial deregulation in that it was too premature to reduce the government control of the financial industry. And there was the Ministry of Agriculture and Fishery opposing the abolishment of the dual-pricing system of rice and fertilizers.

In addition, all of the stakeholders that would be worse off from adopting the stabilization policy tried very hard to lobby against it. Almost all of the business entities that anticipated losing from the stabilization policy opposed raising the loan interest rates. Export industries were against reducing and gradually abolishing the export finance and subsidies. HCI industries were against the policy of restructuring investments and subsidies. Lifting the price controls (actualization of prices) was not welcomed by the producers. Importing agricultural goods was not welcomed by the farmers, as well as the Ministry of Agriculture and Fishery.

Kang (1988, p.143-144) recalled the situation of the EPB at the time as follows:

> "It was as if we (EPB) were alone, surrounded by enemies and there was no way out. And it became so evident that we needed a series of consensus building strategies to adopt and implement the stabilization policy since it would be up to them (government officials in every ministry) to implement the policy once it gets approved by President Park. For this reason, we held numerous conferences on the stabilization policy, and became quite successful initially in gaining the support of the academics and the media."

Reporters assigned to the EPB first developed strong support for the stabilization policy. They even had debates with reporters assigned to the Ministry of Commerce and Industry and the Ministry of Agriculture and Fishery. Complete support by the academics was very helpful since it provided legitimacy of the policy, especially in terms of spreading the policy ideas to the general public. Media began to support the policy as well. As the policy debate became more heated and widespread, there were an increasing number of people supporting the change of the economic development strategy.

2.3. Adoption and Implementation of the Stabilization Policy

Nevertheless, policy measures under the stabilization policy framework could not be implemented at all since President Park could not reach his own conclusion and high-ranking officials knew this. For example, relaxing the price-ceiling on the 110 items out of 150 previously classified as monopoly-priced goods was the first policy measure implemented right after Vice Prime Minister Shin's decision. However, President Park did not give his final approval since there was a possibility of a rise in inflation. This was problematic since the EPB had already announced its intention to implement it by February 1979, although the policy got implemented eventually with the support of firms who anticipated ample short-term profit gains from the relaxation of price-control.

A change in President Park's position was finally emerging right after his visit to Changwon Industrial Park, the center of HCI, in February 1979. After witnessing the hugely idle capacity of the HCI, he ordered Oh, Won-Chul, the Senior Secretary to the President for Economic Policy, to re-examine the HCI policy, especially the possibility of duplicative investments. The EPB used this opportunity to sell its arguments and suggested delaying the second wave of additional investments in HCI.

In early March 1979, after reviewing the over-investments made in HCI, President Park ordered a thorough re-examination of the current state of the Korean economy. It was to be conducted independently by the Bank of Korea (BOK) and the Korea Development Institute (KDI). In addition, he ordered the Economic-Science Council to conduct an extensive survey with scholars in the field. All of these reports were to be delivered to the President by March 31. He intentionally excluded the EPB and even Vice Prime Minister Shin although he resided over the forum. However, all of the three sources reported similar findings and conclusions as the EPB previously had. This reconfirmed the need for making a major shift in the economic policy, and President Park finally gave his approval of the full implementation of the stabilization policy, consolidating all of these reports into a single comprehensive economic stabilization plan. On April 17, 1979, the Comprehensive Economic Stabilization Policy (CESP) was announced to the public with the official approval by the President.

The CESP itself contained specific policy measures to achieve a set of policy goals, and did not highlight the core principles of it. Such can be more readily visible in the statements made by the Vice Prime Minister Shin at the press announcement. Those were:

1. Creating opportunity to cease 30-year chronic inflation
2. Establishing cool-down periods for controlling the speed of development
3. Induce public trust and national harmony by stabilizing the livelihoods of the public
4. Implementing special measures for supporting the livelihoods of the poor
5. Greater flexibility of the scope and diversity of policy options and tools, moving away from stressing the end-results (policy outcome as measured by various indexes)
6. Encouraging efficient allocation of resources through strengthening the market mechanisms and institutions
7. Adhering to retrenchment fiscal principle and developing means to improve the financial system and industry
8. Supporting domestic demands for livelihood goods and services by curtailing large investment projects
9. Limiting speculative real estate investments and nurturing wholesome life style
10. Ensuring ‘true prosperity’ through establishing long-term stability of the economy and social system

Contractionary fiscal policy was in place from the beginning of 1979, which was timely and necessary to cool down the economy of the previous three years. It was implemented along with CESP and naturally almost all business entities complained about the difficulty of securing financial resources. Both policies were very unpopular and the EPB had to overcome persistent oppositions despite obtaining the President's approval. The EPB reasoned that it would require at least three years of consistent implementation for the CESP to produce meaningful outcomes. For them, pains and economic hardship arising from the CESP and contractionary fiscal policy were unavoidable and something that had to be endured patiently.

2.4. Stabilization Policy under the Economic and Political Chaos

Unfortunately, early 1979 marked the beginning of the Second Oil Shock, and by the time of the implementation of the CESP the world economy was moving towards recession. Domestic political environment was also rapidly deteriorating with rising social and political conflicts with a series of events leading to the Pusan-Masan civil riots. These sudden changes in the economic, political, and social environments forced the government to focus more upon reducing policy-induced distortion in the economy and less upon cooling down the overheated economy. It was necessary then to incrementally adjust the CESP while maintaining its basic principles.

Accordingly, those policies on strengthening market institutions through employing less intrusive government policies had to be delayed, and only a limited number of policies were immediately implemented: relaxing price-ceiling and actualization of prices (February 1, April 16, and July 9); increasing savings interest rates, expanding eligibility criteria, and increasing the maximum ceiling of 'nest-egg' saving accounts to induce a decrease in the money supply (April 21); financial support of 100 billion won to those industry producing necessities and basic household durable goods (May 2); lowering tariffs to increase imports of those having supply shortages (May 4); and restructuring investments on parts of HCI such as consolidating electricity generating facilities to Hyundai Trading Company and merging of Daewoo and Samsung Heavy Industry (May 25) (Kang, 1987).

What made the situation worse was the assassination of President Park on October 26, 1979. In a dictatorial governance system, a sudden vacuum of the political power would create chaos because people, including the top decision makers in the cabinet, would not be accustomed to making decisions themselves. Ironically, such a crisis created strong incentives for the top government officials to stand together. Under the direction of Vice Prime Minister Shin, the government prepared a public announcement that there would be no change in the CESP on the very next day after the assassination. Those differences in opinions regarding the CESP disappeared for the following three-months where all of the related state ministers stood together in resolving differences and making decisions to promote national interests rather than their individual gains and losses of regulating authorities.

In the meantime, the political situation at the time was frequently described as the 'Spring Season of Democracy' by the political leaders and the media alike. Prime Minister Choi, Kyu-Ha succeeded the Park's regime assuming the President's office in November 1979, while leading politicians were discussing a new election process by enacting constitutional amendments to signify the end of dictatorship. However, another military coup followed rather quickly on December 12, 1979, led by General Chun, Doo-Hwan and his close followers in the military.

It was fortunate for the fate of CESP that Shin, Hyun-hwak assumed the position of Prime Minister. Recognizing the turbulent political currents, however, the EPB prepared presentation materials (called slides) for the general public in early 1980 to build common perspectives on the structural issues of the Korean economy. They reasoned that building political support by the public would become the critical element for the CESP to overcome the strong opposition from almost every significant actor such as government officials, businesses, media, and political leaders in the policy environment. Since it was so uncertain who would seize political power and subsequent policy decision making power, it became necessary to build a common interpretation of the causes of the economic situation at hand, not only with the ruling party but also with opposition parties and minority political leaders.

This marked the first attempt by the government to generate public awareness and, at the same time, to persuade almost everyone else (other than EPB) on the structural problems of the Korean economy. Contrary to previous public relations materials made by the government emphasizing the miraculous economic achievements and bright future ahead, the slide titled as 'National Economy We Should Think Together' was frankly exposing the problems and structural issues of the Korean economy at the time. Since it was targeting the general public as its audiences, the EPB made sure not to use technical jargon. Instead, the materials used laymen's terms and simple language so that the average Korean person could understand the contents.

3. Stabilization Policies under President Chun: A Full Drive

3.1. Steadfast Implementation of the CESP under the NSC

The fate of the CESP initially seemed unpromising with the rapid changes in political power right after President Park's assassination in October 26, 1979. Within two months, however, the new military power grasped political power through another military coup on December 12, 1979.

Right after the military coup, the National Security Council (NSC) took over the government by expanding martial law throughout the nation in May 17, 1980 (one day after, the Kwangju Civil Revolution in May 18, 1980) until August 27 when the Chair of the NSC, General Chun, finally assumed the presidency officially through an indirect election. During the three-month-period of the NSC, the new political power, consisted mostly of young military officers, relied heavily on strong-arms tactics to push a number of reform agendas such as: enforcement of official discipline in government, public corporations, and financial industry; restructuring the investments in HCI; prohibiting private tutoring and imposing a graduation quota on universities and colleges; screening of books, publications, and newspapers; and the adoption of the 'Sam Chung Rehabilitation Training Program' to arrest anyone deemed anti-social and anti-government (about 60,755 between January and May, 1981), such as criminals, teachers, and even journalists without due process.

It was also the members of the NSC that made all of the economic policy decisions. However, the year 1980 marked a negative 6.2 percent GNP growth rate for the first time since the government collected statistical data on economic performance. The economic situation was getting serious, and overcoming the economic depression became the main target of the new political elites to secure legitimacy of the military coup. For this reason, the NSC hurried to make reforms. As for economic policy, the basic attitudes of the NSC members with military backgrounds were: "You policy specialists make the optimal decisions and we will push them through the political opposition."

Sometimes, this attitude of the NSC helped the CESP be quickly implemented through fierce resistance of interest groups. A good example was the Fair Transaction System Law that was approved by the NSC Legislative Council on December 23, 1980. The agenda had been around since the 1960s, and the EPB reinitiated it but faced severe opposition from the private sector and those within the government that had to give up regulatory power. However, Chun, Yun-Chul, then the working official at the Fair Transaction Division in the EPB, had a chance to raise this issue to NSC members over dinner, and the NSC jumped right on the agenda since it served the image of the new military power that the NSC tried to promote. With the passage of the Law, the Fair Transaction Department was established inside the EPB, despite many difficulties implementing the law due to the lobby from private sector chaebols (large conglomerates).

In other times, however, the rush of the NSC in economic policy implementation hindered securing policy justifications and distorted the outcomes. For instance, there was an attempt to consolidate companies within the same business by the NSC. With respect to the issue of restructuring the automobile industry and electricity-generating equipment industry, the oppositions from Hyundai and Daewoo were the most severe. Both companies disagreed with the NSC's plan for consolidating companies within each industry, but the NSC was persistent in pushing through the solution. The EPB was also against the NSC's plan since it was deviating from the underlying principles of the CESP on strengthening the market institutions and would create monopolistic power over each industry no matter who ended up with either industry. Eventually, the NSC proposed a deal between Hyundai and Daewoo where Hyundai would take over the consolidated electricity-generating equipment companies and ship-building companies, and whereas Daewoo would take over the automobile industries consolidating Hyundai and Saehan (owned by the Daewoo) while prohibiting Kia from producing automobiles. In reality, however, Hyundai claimed the automobile industries to the surprise of those privy to those deals, but in the long-run interest of Hyundai. Even if Hyundai gave up the electricity-generating equipment market, it still had Hyundai Heavy Industries Co. Ltd. Assuming the change of political tides later down the road, it could restart the business, but if it gave up the automobile industry it would be the end (Lee, 2008). Such hastened attempts by the NSC to restructure the HCI did not succeed since the outcome of the deal was contrary to their expectations. Eventually six years later, part of the HCI and other insolvent enterprises had gone through restructuring and consolidation in 1986, following due process and legal constraints over longer periods of time (compared to three months under the NSC).

As such, many of the economic policy agenda under the CESP got adopted and implemented using a strong-arm tactic between April 17, 1979 and towards the end of 1980, piggy-backing the new political power. The adoption and implementation of that agenda took place with the changes in the political environment and macroeconomic conditions at hand, but the underlying spirit of the CESP, namely reforming the basic rules of the game (institutional setups) in the market to promote a market mechanism and fair competition, remained steadfast and persistent. This became more evident with a series of reform efforts that followed since then.

The survival of the CESP as the official economic policy of the government and the NSC throughout the transitional period was partly due to the fact that Minister Shin, a strong supporter of the CESP, remained in the government as the Prime Minister after Prime Minister Choi assumed the presidency throughout this period. A more important reason, however, was that there were a number of economists in the NSC that had strong preferences over making institutional reforms. One of those who believed in strengthening the market mechanism was the late Kim, Jae-ik, the main driving force of the CESP during President Chun's regime in the early 1980s until he was killed along with other important cabinet member by North Korean terrorists on October 9, 1983 at Aung San Martyrs' Mausoleum in Burma.

3.2. Kim, Jae-ik as Economic Advisor to President Chun

Kim, Jae-ik was *the* economic policy decision maker during President Chun's regime. Right after Chun assumed the presidency in September 1980, according to Lee (2008), President Chun wanted to appoint Kim as the Senior Secretary. At the time, Kim asked Chun that he would accept the appointment under one condition, "if you are to implement economic policies as I advise you, you will have to face grave oppositions from almost everyone out there. Would you be willing to accept and implement my words against all others?" Chun's reply was simple and to the point: "No need to say anything else. You are *the* President when it comes to economic policies." It was evident that Kim gained the full trust of President Chun for making economic policy decisions, which was significant in the full implementation of the CESP.

The bottomless trust between President Chun and Secretary Kim developed through an unusual personal relationship they had with each other. The very first contact between Chun and Kim, according to Lee (2008), took place when Chun was searching for his private tutors on economic policy areas during his chairmanship at the National Security Council (NSC). Then, Kim was about to relocate himself from the Director of Economic Planning Department of the EPB to KDI due to his idealistic attitudes towards economic policies and subsequent barriers that he felt during his tenure at the government. After Chun called on Kim, Kim spent at least two hours almost every day commuting to Chun's residence to tutor him about the basic economic principles towards current economic issues and policy solutions. This relationship continued after Chun entered the Blue House (the residence of the president), sometimes spending the whole day teaching Chun about economic policies.

Chun seemed to enjoy Kim's sound logic and his skills of simplifying complex economic issues with plain language, according to Lee (2006). Chun's dedication and enthusiasm about learning economic policies was clearly evident to many around him. Some suggest that his sense of urgency was due to the fact that the only way he could gain political legitimacy was to overcome the chronically worsening economic situation at hand. Subsequently, Chun persistently exercised his unique dictatorial leadership in adopting and implementing economic policies, suppressing any opposition. On the other hand, Kim focused on educating Chun by stressing the limitation of government engagement in the market mechanism, the importance of keeping surpluses that would require patience over pains, the importance of 'real' statistics where the real income would decline with a high inflation rate, and eventually the detailed 'grand design' of reforming the Korean economic structures and systems: namely the CESP.

With the economic education Chun received from Kim, Chun seemed to have developed a strong fixation over controlling inflation, and most of his policy decisions in the early 1980s reflected this. According to Lee (2008), this tendency of Chun's had played a major part in maintaining consistency with economic policies throughout his term during the 1980s. However, he further stated that it created inflexibility and uniformity in economic policies as well. In short, President Chun developed confidence over the economic theories and knowledge, and he wanted the people to follow his leadership with wholeheartedly. His strong will was manifested in his desire to carry out the 'economic education' to every member of the Korean society, even including military soldiers and Buddhist monks.

Despite the deep trust of President Chun, however, Kim, Jae-ik failed to implement a very important reform agenda --- making the central Bank of Korea (BOK) independent from the Ministry of Finance. This initiative led by Kim in the Economic and Science Committee was a direct conflict of interest with the Finance & Tax Committee within the same NSC that represented the interests of the Ministry of Finance. The reason for making the BOK independent was to limit the undue political influences on the financial industry, according to the head of the Bank of Korea Shin, Byung-hyun. This reform agenda went to the extent that the NSC attempted to insert Kim's proposal in the constitution and holding the BOK accountable for controlling inflation through monetary policies. The proposal was presented to the newly elected President Chun as the first official policy to be signed, according to Lee (2008). At the moment, there were four people present including Kim who pushed strongly for the agenda at hand. Without Kim's knowledge, however, Park, Bong-Hwan, the then Vice Minister of the Ministry of Finance and the first economics private tutor to President Chun, lobbied against the agenda. Park, Chul-Eun, one of the Blue House secretaries at that time quickly grasped the political implication of declaring the BOK independent as a part of the constitution and advised President Chun to reconsider approving the agenda. Eventually, the agenda dwindled down to removing the clause from the constitutional amendments. However, learning from this experience of failure, Kim, Jae-ik pushed forward even broader-based reforms after he took his office in the Blue House as Senior Advisor to President Chun.

3.3. Implementing the CESP through Suppressing Oppositions

A revolutionary departure of the CESP from the previous economic development strategies laid in relaxing government-led private sector financing through the control over financial institutions: namely, policy-loan decisions targeting strategically chosen private business sectors. This departure alone created a great deal of conflicts of interest, not just from the private sector that used to benefit from preferential loans but also within the government between the Ministry of Finance and the EPB. For those in EPB, ending the practices of policy loans and establishing independence of the financial sector from political influences were the core goals of the CESP. On the other hand, those in the Ministry of Finance accused them of being too idealistic and not really understanding the real economy and how businesses were run.

The prior failed incident of making the BOK independent signified such conflict of values, and this lingered on as a constant struggle between the Ministry of Finance and the EPB during the early 1980s. There were constant debates between Kim, Jae-ik and Lee, Seung Yoon, the then Minister of the Ministry of the Finance, throughout 1981. President Chun initially supported Kim's position, but over time he was becoming persuaded by the arguments of the Ministry of Finance that the outcome of such drastic reform may affect the performances of the whole economy. However, the political tide was turned by the changes in cabinet members and other positions in the government as advised by Kim, Jae-ik in early 1982.

The reshuffling of the cabinet members was quite dramatic in the sense that those reformists in the EPB got assigned to the Ministry of Finance and vice versa. Kang, KyongShik was promoted from the Assistant Secretary of the EPB to the Vice Minister of the Ministry of Finance; Lee, Jin Sul, from Director of the Fair Transaction Department to the Second Assistant Vice Minister; and Lee, Hyung Ku, from the Director on Economic Planning to the head of the Financial Management Bureau. On the other hand, Ha, Dong Sun, the Vice Minister of the Ministry of Finance got a lateral transfer to the Assistant Vice Minister of the EPB; Jung, Young Eui, the head of the Planning and Management Department was demoted to a member of the standing committee to the Fair Transaction Department; and Lee, SooHyu, the head of the Financial Management Bureau got demoted to Finance Cooperation Officer under the International Finance Division. The media expressed this event as the "Ministry of Finance burned to the ground by the EPB."

In May of 1981, Kang, KyongShik got promoted again to the Minister of Finance, which completed the takeover of the Ministry of Finance by the reformists from the EPB. What followed was another reshuffling of the key positions within the Ministry of Finance with those of a reformist nature. According to Lee (2008), such a change was somewhat inevitable due to the collectivism of protecting the agency's own interests of abusing its power to control financial resources that had long been the target of criticisms and condemnations by the financial institutions and other ministries within the government. All of such changes marked the beginning of reform moves such as the ‘June 28 mark-down of interest rate’ and the ‘July 3 real name regulation.’

The ‘June 28 mark-down of interest rate’ was the government’s announcement that the bank-loan rate would be reduced from 14.0 to 10.0 percent (savings deposit rate from 12.6 to 8.0 percent) and the corporate income tax rate got reduced from 33 to 20 percent overnight. On the outside, this appeared in direct contradiction to the idea of controlling inflation --- one of the core policy goals of the CESP. However, at the time of announcing the interest rate change, the inflation rate declined from 21.6 percent in 1981 to 7.1 percent in 1982 and the reformists from the EPB had confidence in controlling the inflation rate, thereby reasoning that it was about time to reduce the (nominal) interest rates into one digit. More fundamentally, the real purpose behind such a move was to eliminate the preferential interest rates to those of strategic industries by lowering non-preferential interest rates.

This ‘June 28’ policy was also an event that evidently showed that the policy initiative pendulum had swung to the reformists. Just five days before the announcement, Na, UongBae, the Minister of Finance then, had announced a policy to raise the corporate tax rate from 33 percent to 36 percent, but it was announced without prior coordination with the Blue House. The reason for such miscommunication stemmed from the secrecy of the ‘June 28’ policy since it was coordinated among Kim, Jae-ik, Kang, KyongShik, and Lee, Hyung Ku, all from the EPB and had reformist tendencies, without the knowledge of many others including the Vice Prime Minister (the head of the EPB) and the BOK Governor. The BOK also recognized the need for lowering interest rates, but was thinking about 1-2 percent reduction at most. Naturally, the BOK Governor complained that he was informed of the policy in the evening just one day before the announcement. However, the response of the reformists was simple: “it was already approved by the President.” Business entities welcomed the policy because the economy was in a long recession since the second oil shock, but such a hasty change in interest rates created distortion in the financial market where the gap between the official interest rate and private loan interest rate led to a number of financial accidents later.

The ‘July 3 Real Name Policy’ was another example that illustrated the policy-making process and style quite well. Its contents were: (i) all of the financial transactions were to be conducted using real name (not a false name) from July 1, 1983; (ii) financial income would be subject to comprehensive income tax; and (iii) financial assets exceeding 30 million won under false names would be subject to a 5 percent fine to escape audit of the sources of money. Regarding the policy-making process and its implications, Kang recalls in his interview as follows:

> "(The Real Name) policy was developed since June 25, 1982, right after I got promoted to Minister of Finance. Of course, Kim, Jae-ik and I had discussed this agenda long time before this window of opportunity, and he played a critical role in getting the approval from President Chun. It was an attempt to surface the underground economy, and it would also promote fairness and justice by limiting the chances of making unearned income through the comprehensive income tax act."

However, this policy lasted about 4 months before it went back to square one since it proposed to make fundamental changes in every corner of society, including the political world. Due to the seemingly hasty design of the real name policy, the opponents kept nitpicking the worst and unlikely problems that might arise from the full implementation of the policy such as the capacity issue of the tax administration for enforcing the comprehensive income tax act. For example, Huh, HwaPyong, one of the core members of the military coup, argued:

> "On the outlook the policy seemed to promote justice but in reality the outcome might be regressive in nature, just like the value-added tax, where those in power or big conglomerates would not be affected much by it and those of powerless and mid- or small-sized firms would suffer the most from it."

Eventually, with strong resistance from the politicians and other government top officials, the policy faced its demise when President Chun changed his position.

Similarly aggressive strategy could also be found in implementing the CESP that focused on opening up the economy by allowing for more free trade flows of imported goods and lowering tariff rates to reduce potential distortions in market prices. From late February 1983, the Ministry of Finance, headed by Kang, started policy discussions on removing trade barriers and reducing tariffs dramatically. The Ministry of Trade and Commerce immediately rebuffed the agenda, and the two government think-tanks, the Korea Development Institute (KDI) and the Korea Institute for Industrial Economics and Trade (KIET), carried on a policy debate, each representing the Ministry of Finance and the Ministry of Trade and Commerce respectively (Lee, 2008). Whereas the KDI argued that the government should liberate imports of all goods except rice by 1987 and should reduce tariffs drastically, the KIET argued that the government should not make hasty decisions due to the deficit of the balance of payments.

Those liberalists for opening up the economy aggressively advocated the necessity to other officials, first within the Ministry of Finance, and then through various channels to persuade others. Their arguments were that protective trade policy would only weaken the competitiveness of domestic firms by guaranteeing monopolistic power. Therefore, the arguments continued, promoting competition with foreign companies inside domestic markets was necessary, and those that failed to gain competitiveness should naturally go out of business. Eventually, the liberalists succeeded in adopting the new tariff law that gradually reduced tariff rates between 1984 and 1988 in five stages with a publication system.

The idea of opening up the economy had long been discussed among the reformists, including Kim, Ki Hwan, former president of the KDI. To overcome the resistance from the Ministry of Trade and Commerce, Kim, Jae-ik persuaded President Chun to appoint Kim, Ki Hwan to the Vice Minister of the Trade and Commerce in October 1983. Right after his appointment, Kim started designing the yearly plan for opening up the economy and reducing tariffs. He had to face strong oppositions within the Ministry, and had to develop the plan himself without much support by those under him. This policy was particularly unpopular since the media often took the protectionist position, especially from the period when the US started pressing the Korean government to open its doors in late 1983.

3.4. Seeking Legitimacy of the CESP through Advocacy to the Public

A noticeable difference between the Park's and Chun's regimes was the aggressive policy advocacy to persuade the public of the necessities of economic policies. Of the three principles of stabilization (controlling inflation and emphasizing less on growth), autonomy (promoting market mechanism and reforming market institutions), and open-economy (promoting competition and enhancing consumption opportunities), policy measures on the first principle required sharing the burdens and pains among many members of the society. With the political change in power, the new government needed legitimacy, but most of the policy measures to control chronic high inflation were bound to be unpopular.

One of the tools available to overcome the political resistance was to persuade the members of society about the inevitableness of those unpopular policy measures to control inflation, including tight fiscal policy, controlling wage rates, currency retrenchments, and industry restructuring. Kang recollects in his interview the situation at the time as follows:

> "There was simply too much opposition to the CESP since it created more visible losers than unorganized and invisible winners. Balancing of the political power was necessary, and it seemed that the only viable approach at the time was to create favorable public opinions to put political pressures on actors."

Especially, the Chun's regime actively controlled and used the media to deliver the message to the public. One example was the 'Inside Story of Inflation' broadcasted by the MunHwa Broadcasting Company (MBC). Right after the announcements of the CESP as the official policy of the government in 1980, Kang, KyongShik asked Sagong, Il, then the Vice President of the KDI, to develop and organize public relations program with the

MBC to generate political support for those policy measures to control inflation. The core message of the program was to highlight the erosion of real purchasing power by high inflation, enlisting causes of such inflations, and potential policy solutions that would be painful in the short term but necessary for longer term benefits.

At the early stage of the CESP implementation, however, the campaign was made without a structured plan and strategy. The need for strong advocacy of the CESP in a more systematic way was brought up in the meeting with President Chun on the government's purchase prices of rice in late autumn of 1981. A more systematic strategy and contents of economic education to the public were developed from November 1981 by establishing the Economic Policy Public Relations Planning Group. One year later, this group became a permanent organization as the Department of Economic Education Planning under the EPB. Yet, the actual implementation of economic education was led by the Chief Economic Advisor to the President, namely Kim, Jae-ik.

The target audience included not only the civil servants, but also college professors and elementary school teachers. Even those fulfilling their duties in army reserves had to take economic education classes as a part of their military training. President Chun himself was very enthusiastic about providing economic education, and whenever he had a chance to give such lessons, he did not hesitate to provide lectures himself, based on the knowledge that he gained from his private tutors.

An anecdote that well illustrates the campaign efforts that took place during the fall of 1982, where Kim, Jae-ik invited Sagong, Il and Kim, Ki Hwan had lunch at the Blue House. Over lunch, President Chun stressed that the public were aware of the international economic recession and economic hardships all around the world, and demanded the KDI to come up with ways to alert the public of this condition so as to lessen the complaints of the citizens. Sagong, Il, according to Lee (2008), quickly developed another public relations program with the MBC on creating a series of documentary programs. The content focused on the economic situations of five advanced countries including the US, Japan, Great Britain, France, and Germany, where an economist, not a reporter, visited each country and covered the stories.

Right after completing the tour, Sagong, Il made an official report to President Chun that took over two hours. President Chun then ordered him to give a series of lectures to the cabinet members, business people, and political leaders. In January 1983, over 700 leaders from every corner of society gathered together at the Annual Korea Chamber of Commerce and Industry beginning-of-the-year event. The core of the presentation was that "four of the advanced countries except Japan was having economic difficulties, Great Britain was suffering from high unemployment rates, France from a large trade deficit, West Germany from a redistributive welfare policy, and the US from all of the above."

The outcome of such a public campaign could not be accurately accessed since the political environment was suppressive to opposition and no one freely could voice their opinions. According to Lee (2008), however, educating every member of society on the economic situation greatly contributed to enabling the government to implement policies such as aggressive wage control, tight fiscal policy, the price-ceiling on government purchases of rice, among others.

Chapter 4

Contents of the Comprehensive Economic Stabilization Policy (CESP)

Contents of the Comprehensive Economic Stabilization Policy (CESP)

1. Three Principles of the CESP

Stabilization of the economy would normally imply contractionary fiscal and monetary policy to cool down the overheated economy. The CESP in 1979, on the other hand, also included a wide range of institutional reforms and restructuring of industries to make a major shift in economic development strategy. Such a departure from growth-oriented economic development strategy towards economic stabilization was often phrased as a 'Copernicusaceus paradigm shift' that implied a 180 degree difference from the one before.

Partly, the changes in the international economy necessitated such changes, but the Korean government officials, especially those in EPB, had long been questioning the soundness of government-led economic development as the size of the Korean economy grew over time, as stated before. The birth of the Comprehensive Economic Stabilization Policy (CESP) came amidst rapid political, economic, and social changes in Korea, emphasizing three core catchphrases of 'stabilization, autonomy, and open economy.'

The first principle of the CESP, economic and social stabilization, focused upon controlling inflation as the first priority and subsequently improving the wellbeing of the Korean people as the policy goals. Laying the groundwork for inflation control required an actualization of market prices before anything else and, at the same time, very strict fiscal and monetary policy that was highly painful yet unavoidable. Public education on the necessity of enduring the pains for longer-term benefits became an essential part of the implementation.

The second principle, autonomy, focused upon strengthening the market mechanism for allocating resources by reducing government interventions in the market, and at the same time reforming market institutions to promote fair competition. Making the financial industry more independent from the government as well as political influences, the actualization of market prices, reducing inefficiency in the distribution system, moving from a single to multiple basket currency exchange system, and establishing the Fair Transactions Departments were some of the attempts to reform market institutions.

The third principle, open economy, focused on promoting competition in the domestic market and increasing consumption opportunities based on the comparative advantage theory in international trade. Lifting the prohibition of imported goods in stages, simplifying and reducing tariffs, ending the protective industrial and trade policies were also implemented. In retrospect, such an increase in competition in the domestic goods market contributed greatly to the improvement of the quality of goods they used to produce monopolistically, thereby enhancing the overall wellbeing of the Korean people. However, many opposed to the idea of abandoning the protective trade policy at the time.

Every policy under the CESP was designed to follow at least two of the three principles stated above, where these principles are complementary to each other for strengthening the market mechanism and less government interventions in the market to reduce distortions in resource allocations. Furthermore, between the announcement of the CESP in April 17, 1979 and early 1981 most of the policy attentions were directed towards controlling chronic inflation. Once the inflation had been contained by the middle of 1981, the reformists in the government paid more attention to reforming the market institutions that would mark fundamental shifts towards a textbook market economy, such as zero-based budgeting, mark-down of interest rates, and real-name policy.

The early achievements of the CESP to tame the high inflation rate were well documented in "Document Collections for the Comprehensive Economic Stabilization Policy: Concerning the CESP" announced at April 17, 1979, published by the KDI in April 1981. In this book, there was a record of the public address made by Shin, Hyun Hwak that summarized the major points of the CESP as follows:

"To overcome the current economic problems that we have identified, the government is proposing the following sets of policy agendas and options for stabilization.

First of all, regarding the policy goals of the CESP:

a) Price actualization will be fully implemented as soon as possible, and at the same time the number of monopolistic and oligopolistic items will be drastically reduced. The policy goal behind it is to build the foundation for long-term sustainable economic growth by removing distortions in resource allocations and economic activities by restoring the signaling functions of market price and thereby rejuvenating industries.

b) The government will correct the imbalances of financial resource allocation in the market. The current overemphasis on the production-goods industry will be readjusted to allocate more financial resources towards domestic consumption-goods industry to meet the current demands for necessities and short-term excess demand goods. For this purpose, the government previously secured a special fund of 100 billion won, and is willing to increase this amount as the need arises.

c) Review of the over-investments in HCI and large public projects will be carried out to cool down the excess demand for financial resources, and for this purpose the government will establish the Committee for Readjusting Investment Projects, headed by the Vice Prime Minister as the chairperson.

d) The government will maintain the current contractionary monetary policy. And at the same time the government will initiate a taskforce team to identify and propose reform agendas for the overall financial system such as operations of policy financing and restoring the functions of interest rates. The proposed deadline for this taskforce team to complete its mandate will be the end of June of this year, when the final policy measures will be announced publically.

e) The government intends to establish a sound and transparent economic environment by promoting savings and an economy in consumption of every citizen by consistently implementing policies to control the hike in real-estate market booms.

Secondly, regarding the special policy measures for managing daily necessities:

a) The government will oversee the changes in prices of the following 25 daily necessities as special management items to minimize people's burden that may arise from implementing the long-term economic stabilization policy, especially from the recent price actualization . Those are: (13 items of food, 10 items of basic necessities, and 2 items of clothes)…..

b) The government's top priority is to stabilize the prices of the above-stated special management items by all policy tools. First, for agricultural products, the government will continue as planned to construct the clustered production areas and fulfill the forward contracts. For those items in shortage, the government will secure overseas supply and release the stockpiled inventories when it becomes appropriate and necessary. Secondly, in case of special management items, the government will promote imports of final products, raw materials, and related production materials, even to the extent that the tariff on these items would not be imposed at all when it becomes necessary. Thirdly, the government will deregulate the market and reduce the entry barriers to invite new entries into the market to promote competition and thereby to protect the wellbeing of consumers. Fourthly, for importing raw materials, the government will drastically simplify the due process and requirements such as recommendations. Lastly, with regards to special management items, the government will implement policies to modernize the distribution system and strictly enforce rules to prevent those activities that would hinder the usual business transactions such as fabricating production records, avoidance of production, excessive rent-seeking in distribution, etc.

c) The government will reduce the number of special management items accordingly as the market condition improves in accordance with building foundations for long-term economic stability.

Thirdly, regarding the policy measures to protect the livelihoods of the poor, under the executive special order, the government will increase its spending on welfare programs by 28.9 billion won, on top of the 35.8 billion won secured allocated budget for this year, totaling to 64.7 billion won. This increase in spending aims to reduce the frustrations of the poor for maintaining their livelihoods that may arise from the recent series of price actualizations. The major contents of these are:

a) The government will provide cash grants to the poor for the amount equal to the price increase of briquettes caused by the price actualization policy (estimated to be 11.9 billion won based on 25 won increase per briquette, 490 thousands households, and 24,000 won per household).

b) To reduce the burden of schooling, the government will fully subsidize middle school tuition (estimated to be 7 billion won annually).

c) The government will appropriate additional budget to job/work-related programs, expanding the relief activities on the poor in general (additional expenditure of 10 billion won).

Currently, the government is providing medical care to everyone who is classified as eligible for the livelihood program, and also providing cash subsidies for food (grains and other food items) to those having difficulty maintaining their livelihoods. These additional measures would mark drastic improvements on protecting the livelihoods of the poor."

It was quite evident in the above statement that the CESP tried to promote economic as well as social stabilization, and its strong will that the Korean government would rely more on market mechanisms by reducing direct government interventions in the market and promoting domestic competition by deregulation and increased imports of goods. What was more striking in the above statements was the government's intention of making reforms to the financial institutions and market institutions, thereby publicly announcing the end of government-led industrial policies.

In more details, securing of fiscal soundness, contractionary monetary policy, restructuring of investments, increasing imports, promoting competition, actualization of market prices, autonomy of financial industries, all came under the CESP. And once the inflation rate seemed to be under control in late 1981, the government further adopted and implemented policies such as establishing the Fair Transaction Department under the EPB, zero-based budgeting, mark-down of interest rates, real-name policies, staged opening up of domestic market, among others, to further strengthen the market mechanism and institutions. The following subsections will further explain policies under the CESP categorized into three principles: stabilization, autonomy, and open economy.

2. Stabilization to Control Inflation and Economic Growth

Aside from those efforts to stabilize the society, economic stabilization meant controlling chronically high inflation rates. Rapid economic growth (average annual growth of 10 percent) in the 1960s and 1970s based on government-led industrial policy stressing export businesses distorted the market in a number of different ways, and the textbook solution was reducing the money supply in the market. Subsequently, contractionary fiscal and monetary policy was adopted and implemented.

2.1. Retrenchment of Fiscal Spending

Generally, there were three areas of focus in tightening the fiscal spending: first, reforming the structural deficit arising from improper implementation of dual-pricing subsidies to grain and fertilizer industries; second, maximizing the utility of fiscal policy as a policy tool for countering business cycles by enhancing flexibility of budgeting and spending, especially maintaining sound fiscal balance and retrenchment of fiscal spending to stabilize the economy at hand; and third, reallocating resources to lessen the burdens of average citizens and mid/small-sized firms that may arise from implementing the CESP on the cost side such as the exchange rate, oil prices, and interest rates.

Particular attention was paid to reducing the price spread of grains, imposing a ceiling on quantities of government purchases, increasing issues of the grain bond, and any of the tax surpluses of the Grain Management Funds. Accordingly, 268 billion won in tax surpluses was used to repay the debt issued by the Bank of Korea. And under the National Security Council (NSC) further decisions were made to abolish the dual pricing system within three years, shifting towards a target-price system.

For handling the fertilizer account, reducing the excess supply of fertilizers was at the center of policy measures: first, reducing the rate of operations to 75 percent in each of the companies, maintaining about 1 billion M/T of aggregate quantity produced; second, closing down of the first and second facilities; third, imposing ceilings on government purchases of 0.59 billion M/T while maintaining stock reserves around 0.37 M/T; either ceasing or limiting exports of urea nitrogen; and fifth, providing financial resources to compensate for deficits in the fertilizer account, spreading it over a number of fiscal years. Also, the decision was made to increase the retail prices of fertilizers by 50 percent each year over a three-year period to reduce the size of deficits in fertilizer account.

For retrenching fiscal spending, the government targeted 30 billion won of reserve currency redemption, and additionally withheld scheduled expenditures of 5.1 billion won of the government budget, as well as 7.4 billion won of government facility expenditures in 1979. Also, the government used tax surpluses of 452.1 billion won in 1978 for reserve currency redemption of 86.8 billion won, retiring the borrowings under the Grain Management Fund by 268 billion won and under the Government Procurement Fund by 100 billion won. As a result, the government made the reserve currency redemption of 141.6 billion won in 1979, which was almost 5 percent of the outstanding reserve currency at the time. The Second Oil Shock in late 1979 forced the government to relax the tight fiscal policy a little, but still maintained the fiscal soundness.

2.2. Contractionary Monetary Policy

Monetary policy under the CESP was used as supplementary to tight fiscal policy since controlling inflation by monetary policy tools required additional reforms in the financial system as a prerequisite. Henceforth, an increase in the interest rate was the most that the Korean government could implement besides restructuring the investments of the HCI (further discussed in the next subsection). Accordingly, the actual contents of the interest rate increase were: a slight increase in worker's asset building savings rate; increase in ceilings of special fixed household savings accounts; increase of fixed savings rate from 13.2 percent to 16.2 percent; and facilitating short-term checking account market, and relaxing regulations on corporate bond issuance.

In terms of liquidity regulation, redemption of 129.1 billion won of the government account and 488.7 billion won of trade account helped reduce the growth rate of the money supply from 34 percent annually between 1975 and 1978 down to 24.6 percent. But the domestic credit increase rate remained about the same. More important policy measures under the CESP were reforming the financial system.

2.3. Advanced Approach to Inflation Management

The policy measures to control inflation before the CESP was basically regulations such as aggressive price setting and/or price ceilings of monopolistic and oligopolistic goods and implementation of the value-added tax system. Such regulatory policies brought about structural side effects on the distribution system, as well as creating dual price markets for many domestically produced goods. To deal with such structural issues, the government shifted its gears towards employing less intrusive policy tools such as managing aggregate demand (rather than supply), liberalization of imports, and reduction of tariffs. Eventually, it led to adopting the Fair Transaction Act.

To eliminate the distortions in pricing mechanism, the government relaxed its aggressive control on prices by dramatically decreasing the number of items under the price control. Over three times within the year of 1979, the number of monopolistic items decreased from 148 to 35 and the number of price ceiling items decreased from 33 to 2 (briquettes and coals). Furthermore, prices of those 87 monopolistic items, as well as those of public fees and government-licensed charges, were actualized in phases towards market prices within a year. This created short-term price increases in almost all of the goods, but within a relatively short period of time the overall prices of these goods decreased due to an increase in supply. Tariffs on raw materials were reduced and those goods that faced excess demands and supply shortages were secured from overseas markets.

In addition, the government enacted the 'Modernization of Distribution System Thrust Act' to improve the primitive and multi-layered distribution system. The government also provided subsidies to Consumer Protection Organizations, along with enacting the Fair Transaction Act, to promote the wellbeing of the consumers. The Fair Transaction Act further aimed: to limit the abuse of market-dominating power of producers; to prevent excessive concentration of economic power; and to prohibit collusive behavior and unfair transactions. The core purpose behind the Fair Transaction Act was to promote fair and free competition that would lead to heightened creative business activities and at the same time protect consumers.

2.4. Zero-based Budgeting System

Although the zero-based budgeting was not spelled out in the CESP of 1979, it signified the spirit of the CESP, strengthening the tight fiscal policy and maintaining sound and balanced fiscal stance, where contractionary fiscal policy continued until 1985. The idea behind the zero-based budgeting was to review all of the government expenditures from scratch, asking whether government spending for public goods and services could be justified.

In late 1982, a series of reform efforts was directed towards improving the budget process to systemize the stabilization policy and its principle of maintaining a sound fiscal stance by continuing contractionary fiscal policy and reducing the fiscal deficit. Using the budget of 1982 as the base year, the zero-based budgeting system was developed to prioritize government spending, where outdated or less important programs and functions got reduced or stopped. In retrospect, some commentators complained that such a strict contractionary fiscal policy caused a shortage of social overhead capital (SOC) in later periods, but it was clear that such a strict stance served the policy goals of stabilizing the economy and reducing the foreign debt.

According to Cho, KyongShik (then the head of the Comprehensive Budgeting Department), there were three parts of budget reform efforts: first, the analysis of the relationship between budget (including public projects) and industries; second, implementing the zero-based budgeting system; and third, reviewing the budget plan of 1982. The zero-based budgeting system also required a decision-making process that was more open to involving stakeholders, and naturally took more time and effort to evaluate the programs and projects systematically and to determine the priorities among them. Cho stated:

> "The main departure of the zero-based budgeting system from the past was incorporating value-judgment to prioritize government spending, contrary to value-neutral accounting based budgeting that extrapolated past spending. Another major difference was the discontinuous nature of the zero-based budgeting system, where the old ways of budgeting reviewed only the new projects and programs for feasibility, whereas the zero-based budgeting system reviewed everything from scratch, which allowed for cutting the budget relatively easily."

According to Moon, HeeGaep (the successor to Cho):

> "The major source of fiscal inefficiency was the agricultural sector for maintaining a dual pricing subsidy system of grains that eroded the financial resources needed for investment in national defense, SOC, and so forth. Inevitably the government had to rely on an increased issuance of money that eventually led to inflation. So we reviewed the 1982 fiscal year budget that was already approved by the National Assembly to impose further cuts, and we made a budget plan that would generate a budget surplus in 1984 by freezing the budget at the level of the fiscal year 1983. This was possible since we had an authoritarian regime. If we had a democratic regime, we would not have been able to implement such a policy."

Moon further stated:

"Contractionary fiscal policy was politically very unpopular, naturally, among farmers, mid/small sized businesspersons, public school teachers, and so forth. And I proposed to President Chun to hold a public debate session inviting almost every stakeholder who opposed it, debating the necessity of such contractionary fiscal policy. We had an 11-hour-long heated debate session (even calling names) at the KDI, and the MBC agreed to cut the contents into 2 hours and broadcast it across the country. … It turned out such public relations efforts really helped persuade the public, and we expanded the PR program by holding similar sessions all over the nation to persuade the public."

After 3-4 years of strict contractionary fiscal policy, the focus of the budgeting system had shifted towards balancing the tax and spending from 1985. According to Lee, Jin seul (successor to Moon):

> "Over five years, we had contractionary fiscal policy, and it was no longer politically feasible to maintain it. On the other hand, the tax revenue had increased as the size of the economy grew. So we decided to set the budget policy goal as maintaining spending within the boundaries of tax revenue."

This principle had remained intact until the financial crisis in 1997, and the Korean government had become one of the nations that had the soundest fiscal state among the OECD countries.

3. Strengthening Market Principles and Mechanisms

No doubt that the government-led economic development strategies in the 1960s and 1970s had contributed tremendously to rapid economic growth, but also created serious distortions in the market. Government-led investment projects (policy financing) meant strong political influences on the financial sector in allocating scarce capital where the government regulated loan rates and durations, as well as protective trade policies to foster infant industries.

The shift in industrial policies to foster the HCI in the early 1970s was somewhat inevitable due to the changes in international politics and economy, but the actual implementation of such strategy involved favorable treatment of a select number of firms to have them engage in production and management of the HCI. The government-induced entry into the HCI meant guaranteeing a reasonable profit margin for the firms, where the market conditions were highly unfavorable for these firms to make any profit at all.

In recognizing the distortions in the market and subsequent structural problems arising from the government's direct interventions in the market, the CESP attempted to shift the nature of the government interventions towards more market-friendly methods. Promoting competition and ensuring fair rules of the game became the central principle of the CESP, and the government tried to implement a series of reforms in the area of institutional setups to strengthen the market mechanism for self-adjustment: namely, restoring the autonomy of the market.

3.1. Reforming Financial System and Industry

The main areas of focus in the CESP regarding reforms and improvement of the financial sector lay in reducing the policy financing and improving management of the export industry financing. Especially for export industry financing, the government expanded the number of firms eligible to receive favorable rates and strengthened the monitoring and management of exports, but the actualization of loan rates was postponed at the time of the initial implementation of the CESP.

As stated in the CESP, the EPB prepared a report for improving the financial system in August 27, 1979 with the following eight agenda items: 1) restoring autonomy of interest rates; 2) restructuring of policy finance and simplification of interest rate structure; 3) independence of bank management; 4) improving management of the Bank of Korea and the Monetary Policy & Management Committee; 5) comprehensive development of currency market; 6) improving the collateral-based loan practice; 7) effective management of credits of large conglomerates; and 8) establishing mega banks (consolidation of financial institution). The report further stated that the first five agenda items should be implemented before the Fifth Five-year Economic Development Plan (1982).

However, the Ministry of Finance was strongly against the EPB’s report that the positive real interest rates and increase of aggregate savings should be accomplished by managing the inflation rate rather than increasing the interest rate. In addition, for restructuring the policy finance, the Ministry also expressed doubt since it would require a priori review and change in strategic coordination of the industrial policy. Since the Ministry of Finance was responsible for implementing the reform agenda, the whole thing went back to the beginning. Another round of debate continued between the EPB and the Ministry of Finance, but the assassination of President Park in October 26, 1979, halted the process altogether. What followed was a gradual increase in interest rates to deal with the rapidly changing economic situations at hand, coupled with the second oil shock.

Despite the unsettled policy debate over managing the interest rates, there were sporadic attempts to improve the autonomy of banking institutions. In December 3, 1980, decisions were made to provide autonomy in internal management of nation-wide commercial banks, including personnel management and business practices. The government also implemented gradual decrease of policy finance based on three new principles of prohibiting new policy financing, consolidation and simplification of existing ones, and transfer to budget account. Some argued that restoring the function of the interest rates should have happened prior to institutional reforms, but there was little progress on this account.

Due to the low real interest rates in the mid- and late 1970s, many of the large conglomerates invested their wealth in real estate while holding excessive amounts of debt. Recognizing such undesirable behavior arising from the inefficient financial sector, the government announced another policy measure called 'Policies to Strengthen the Financial Structure of Large Conglomerates' in September 27, 1980. The policy proposed eight agenda items: 1) sale of real estate of non-business-purposes; 2) restructuring of affiliated companies under conglomerate 'group'; 3) readjustments of various kinds of business associations and cooperatives; 4) prevention of abusing bankruptcy law; 5) limiting government rescue financing; 6) strengthening the credit management capacity of banking institutions; 7) implementing outside auditing system; and 8) providing tax credits for supporting improvements in the financial structure through cost-savings. These measures can be analogous to 'emergency operations' on cancer cells that arose from mismanaged financial system.

What followed from the above-mentioned reform efforts was the failed attempt by the NSC to make the BOK independent by constitution during 1980 and the occupation of reformists in the Ministry of Finance from the EPB in 1981 (Refer to Chapter 3). The June 28 mark-down of interest rates and the Real-Name Policy were further pursued by the reformists in government to make fundamental changes in the financial system. Unfortunately, such revolutionary attempts failed due to the strong political resistance despite the authoritarian leadership that supported those agenda issues.

3.2. Promoting Competition and Improving Distribution System

Along with the economic growth in the 1960s and 1970s, the management of industrial policies and price controls based on regulatory power continuously exposed limitations in enforcement, creating distortions in resource allocations. The core of the CESP was to abolish the past practices of direct government interventions in the market, and to restore market mechanisms to improve efficiency in resource allocations in society. At the same time, by promoting competition in the domestic market, the government tried to provide strong incentives to incumbent firms to become more competitive in prices as well as in quality.

To achieve such a policy goal, it was necessary to review the existing rules and regulations and nullify those that limited competition. In other words, removing the barriers to new entry into the market became necessary, and at the same time a review of policy measures in the fiscal, monetary, tax, trade areas were needed to ensure that they were geared towards promoting competition. Eliminating monopolistic power stemming from the market structure and limiting non-competitive behaviors of firms also became necessary. To enforce such principles, the enactment of new law and the establishment of implementing body became necessary.

As mentioned in chapter 3, the Fair Transaction Committee was established with the strong support of the NSC in December 11, 1980 and began its enforcement from April 1,

1981. The given mandates of the Fair Transaction Committee were in three areas: regulations on monopoly; regulations on collusive behaviors; and regulations on unfair transactions. This marked the most important effort to restore the market mechanism and promote fair competition, but subsequent reviewing and recoding of existing rules and regulations were not actively pursued, and remained mostly symbolic until very recently.

Another area of inefficiency that limited the effectiveness of counter-inflation policy measures was the primitive distribution system in terms of its channels, its facilities, and its informational flow. To deal effectively with the issue at hand, the EPB developed 'Modernization of Distribution System Act' in September 1979 reasoning: 1) strengthening the coordination of separate efforts of various ministries; 2) enabling long-term planning; 3) systemizing government support for modernization of distribution system; and 4) establishing the process of constructing distribution centers. The law was passed in December and publicly announced in January 4, 1980.

What followed was a series of implementation plans to modernize the distribution system, along with the necessary investments. Such a series of implementation plans eventually became part of the Fifth Five-year Economic Development Plan and subsequently implemented as planned.

3.3. Reducing Government-led Industrial Policy

The first attempt to restructure the HCI investments was in May 25, 1979, where the plan focused on three areas: electricity generating equipment and facility sector; heavy equipment for construction; and petrochemical industry. All three areas showed over-investments relative to the size of the domestic market, and little chance of exporting final products.

The electricity generating equipment and facility sector was characterized as having too many firms relative to the size of the domestic market, and therefore the consolidation of existing firms was the optimal solution. For the heavy equipment for construction sector, Hyundai was the only firm producing the product but overcapacity of the production facility became the issue since it prevented a new entry into the market. For the petrochemical industry, the existing plan for the expansion of processing facilities was delayed until market conditions improved.

Subsequently, additional industries such as steel, machinery, shipbuilding, and automobile were identified as having financial stress from over- and duplicative- investments based on excessive borrowings. Practical solutions for these industries were withholding additional investments, extending construction periods, downsizing production capacity, closing down or consolidation of facilities, while reducing the financial burdens by converting investments and converting to long-term loans with lower interest rates. Additionally, within the estimated financial resources available, investment priorities were determined based upon export potential in the short-term future.

These restructurings of the HCI were a highly political decision, however, since it involved direct material benefits of involved stakeholders. As described in Chapter 3, the eventual settlement had to be imposed upon involved stakeholders through the authoritative pressure of the NSC.

3.4. Income Policy and Human Resource Development

With the booming economy in the 1970s, the Korean economy faced a gradual shortage of a skilled labor force in certain industrial sectors that increased mobility and wage levels of college graduates. Since 1974, the average rate of increase in nominal wage exceeded 30 percent per annum, and the average rate of increase in real wage surpassed that of productivity and economic growth between 1976 and 1978. Such a rapid increase in income contributed negatively towards controlling inflation and weakened the price competitiveness of domestically produced goods.

Imbalanced industrial development such as HCI also contributed to the shortage of skilled labor, on top of the overseas construction boom since 1975 that caused an outflow of skilled labor in the construction industry. Consequently, wages showed increasing discrepancy across different industrial sectors and different educational levels. The government announced a wage stabilization plan to control the wage increase rate by: setting the upper limits (reflecting each firms' financial constraints) and lower limits (at par with the minimum cost of living), also reflecting the productivity increase; and reducing the discrepancy across industry, size of firms, as well as across individual characteristics such as educational attainment, occupations, and gender.

Salaries of public servants were fixed at 10-15 percent increase annually since 1979, to serve as a model for the private firms. In estimating the regulated prices of monopolistic goods, the labor cost (wage) increase was fixed at 10 percent annually, and the government tried to prevent a spillover effect by aggressively guiding leading firms and industries that were believed to be the sources of wage increases. At the same time, the government expanded job training programs and tried to enhance job security. The student admissions quota of colleges and universities were raised dramatically since the in-house training capacity of each industry was relatively less developed. Specialization of five national engineering colleges in the areas of machinery, electronics, and chemical engineering was implemented while strengthening the education function of the Korea Advanced Institute of Science.

In addition, the number of vocational high schools was increased to 97 while inducing specialization of fields into machinery, industry-specific skills, and model schools. Financial support for these high schools was also increased dramatically. At the same time, 24 new publicly operated job training centers were opened along with plans to promote the in-house training capacity by industry. Subsidies were provided, for the first time, by the government for making job transitions easier for the unemployed into the necessary skilled labor force. However, due to a number of practical constraints, it failed to completely achieve the desired policy outcome.

4. Open Economy to Promote Competition and Consumption Opportunities

There were multiple policy goals behind shifting from protective industrial policy towards an open economy: relieving pressures on inflation by expanding imports; promoting domestic competition by allowing final products to be imported, thereby putting pressures on price and quality competition; and enhancing the wellbeing of citizens by giving them consumption opportunities of higher quality products at lower prices.

The principles behind liberalization of imports were: 1) moving away from direct regulations on line items and prioritizing those items that showed larger discrepancy between the domestic price and imported price; 2) moving away from protective industrial policy by limiting imports towards utilizing tariffs that would be lowered in the long run; 3) providing adjustment periods of domestic firms by advance announcement of import liberalization items; and 4) simplifying the trading procedures.

In late 1979, the import liberalization items were selected based on: 1) internationally competitive domestically produced items; 2) items that would provide incentives to domestic firms to enhance its international competitiveness; 3) items where import regulation would not be realistic or effective; and 4) items and related raw materials and parts that could contribute to price decreases. Subsequently in 1980, those necessity items that would enhance the livelihood of average citizens (including raw and base materials), and items that became relieved from monopolistic price controls were prioritized to be imported.

Further efforts were made, as described in Chapter 3, to expand the list of imported goods up to 90 percent by 1986. Naturally, there was strong political resistance to the idea of abandoning protective industrial policies since it affected almost every domestic firm. However, the government pushed aggressively for the idea of an open economy, believing that it would strengthen the international competitiveness of domestically produced goods and also contribute greatly towards stabilizing inflation.

Chapter 5

Macroeconomic Performances in the 1980s

1. Inflation Stabilization and Macroeconomic Policy
2. Factor Price Stabilization and Income Policy
3. Stabilization of the Balance of Payments
4. Revival of Growth
5. Structural Changes toward Market-Oriented Economy

Macroeconomic Performances in the 1980s

1. Inflation Stabilization and Macroeconomic Policy

The first half of the 1980s was probably the most successful stabilization period in Korean history. The inflation rate in terms of the Consumer Price Index (CPI) that hovered around 20 percent per annum was stabilized to around 3 percent from 1983. This rapid moderation of CPI inflation could have severely affected the firms' profitability, had production costs not been stabilized in line with their sales prices. However, the production costs represented by the Producer Price Index (PPI) virtually stopped rising from 1983, providing firms with room for profit margins. Along with prices of consumers and producers, feverish speculation on real estate began to subside and their prices were also stabilized.

Table 5-1 | Inflation Rates

(%)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
CPI	10.1	14.5	18.3	28.7	21.4	7.2	3.4	2.3	2.5	2.8
PPI	9	11.7	18.7	39	20.4	4.7	0.2	0.7	0.9	-1.5
Land Price										
Nation	33.6	49	16.6	11.7	7.5	5.4	18.5	13.2	7	7.3
Seoul	31.7	135.7	6.4	13.4	3.6	8.7	57.7	23.3	8.1	3.7

Source: The Bank of Korea

It is true that the 1970s was a decade of global inflation while the 1980s was that of disinflation. However, the performance of Korea (15.0 percent lower from the 1977-81 period to 1982-1986) stands out compared to those of other major countries. During the 1982-

1986 period, Korea became a country whose inflation was as stable as in major advanced countries.

Table 5-2 | CPI Inflation Rates of Major Countries

(Period Average, %)

	Korea	France	Germany	Japan	U.K.	U.S.
(1) 1977-1981	18.6	11.3	4.5	5.8	13.5	9.9
(2) 1982-1986	3.6	7.5	2.6	1.9	5.5	3.8
(1) – (2)	15	3.8	1.9	3.9	8	6.1

Source: OECD

1.1. Stabilization of Oil Prices

There were many factors that contributed to the successful stabilization in the early 1980s. Among others, the fall of raw material prices including oil was definitely one of the biggest contributors. International oil prices, which soared from below 15 dollars per barrel to over 30 dollars in 1979 and further rose to over 35 dollars in 1980, began to stabilize to 30 dollars from 1981.

Thanks mainly to the fall in oil price, the overall import price inflation rate (in dollar terms) was drastically brought down from around 27 percent in 1979 and 1980 to 4 percent in 1981 and -5 percent in 1982. In Korean won terms, the situation was more dramatic. Since the won was devalued against the dollar by more than 20 percent (from 484 to 580 won/dollar) in the beginning of the year, the import prices rose by almost 60 percent in 1980 before it was brought down to 17 percent in 1981 and 2 percent in 1982.

Table 5-3 | Inflation Rates of Import Prices

(%)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
In Dollar	1	4.2	26.7	27.5	4	-5.1	-4.4	0.1	-4	-6.7
In Won	1	4.3	26.6	58.9	17.2	1.9	1.5	4.1	3.5	-4.2

Source: The Bank of Korea

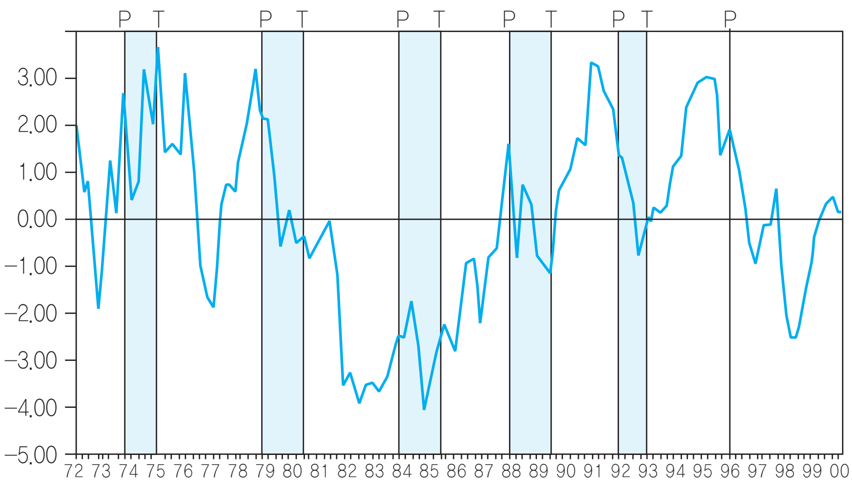
This drastic change in import prices operated as the most direct source of the inflation fluctuation during 1980. According to the estimation of Corbo and Nam (1986b) who made counterfactual simulation exercises using a macro econometric model, the oil price hike and the exchange rate devaluation raised CPI (PPI) by approximately 4.5 percent (9.0 percent) in 1980, respectively, or 9.0 percent (17.7 percent) together. This result implies that both the CPI and PPI inflation rates would have been around 20 percent instead of 28.7 percent and 39.0 percent, had the oil price hike and exchange rate devaluation not taken place. Similarly, they estimated that the inflation rate in 1982 would have become 17.8 percent in CPI and 23.0 percent in PPI instead of 7.2 percent and 4.7 percent, if the imported prices had continued to rise at the same rate as in 1980. In short, the dramatic drop in the inflation rate in 1982 greatly benefitted by the drastic stabilization in import prices, which were largely driven by the fall of oil prices.

It is clear that such chance factors operated as the biggest contributors to domestic inflation stabilization in 1982. It is also clear that inflation stabilization due to luck is not sustainable. Theoretically, the fluctuations of oil prices as well as the exchange rate (so called 'cost shocks') only affect the *level* of prices, not its *rate* of change (or inflation), which implies that their impacts on inflation rates should be temporary (though persistent for several years) rather than permanent.

Empirically, the evidence for the temporary nature of the impacts of oil prices on inflation can be found from Korea's own experience after the First Oil Shock in 1974. Although the oil prices became stabilized from 1975 at around 12 dollars per barrel after a big jump in 1974, Korea's domestic inflation rate was not significantly lowered and bounced up again. In contrast, the inflation rate was permanently stabilized in the early 1980s even after the effects of oil prices dissipated over the years. The key differences between the two periods lied in macroeconomic policy stances.

Results from formal empirical studies confirm this argument. For example, Kim and Cho (2001) disentangled 'aggregate demand pressures' from cost- or supply-side pressures, employing a structural vector auto-regression technique and showed how significantly demand contraction contributed to stabilization in the early 1980s. That is, the demand pressures, which had fluctuated above zero (or inflationary) for the most of the 1970s, were drastically lowered from 1979 and maintained below zero (or deflationary) throughout the early 1980s. This result indicates how earnestly the Korean government tried to control aggregate demand in the early 1980s.

Figure 5-1 | Aggregate Demand Pressures



Source: Kim and Cho (2001)

1.2. Fiscal Contraction

One of the most impressive achievements in the early 1980s was fiscal consolidation. Recognizing that the budget deficit was a main source of monetary expansion, the government exerted itself to reduce inefficiencies. For example, by adopting the 'zero-base' budgeting system, the government could save a substantial amount of taxpayers' money and reduce the deficit from 1983. Under this system, the government reset its priorities every year by appraising the costs and benefits of the projects from a zero baseline, even for the continuing projects from the previous year. This concept was distinguished from the traditional budgeting system in that the latter appraised the costs based on the previous year's budget.

At the same time, the government continued to rationalize operation schemes of the special funds, and gradually eliminated their structural deficits. For example, the Grain Management Fund, whose borrowing from the BOK once accounted for more than one third of the total increase of base money in the 1970s, finally began to run a surplus from 1985. As a result of all these efforts, the consolidated budget deficit was gradually reduced and turned around to a surplus in 1985. Even by IMF standards that included off-budget accounts, the consolidated budget virtually attained balance in 1986.

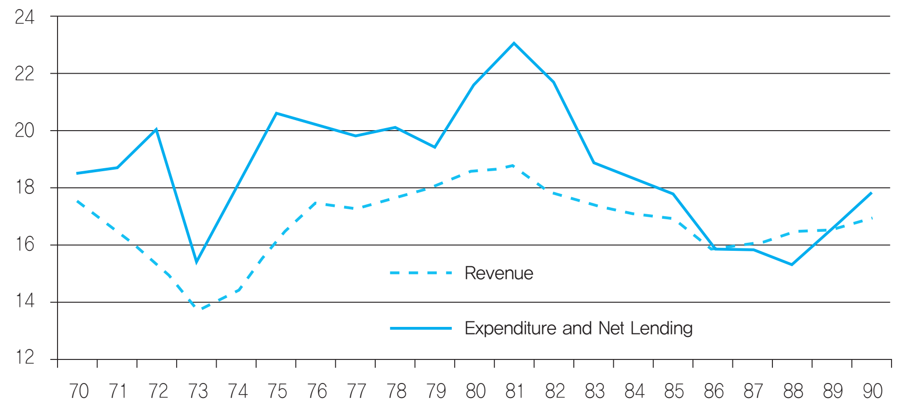
Table 5-4 | Consolidated Budget Balance in the 1980s

(billion won, %)

	1980	1981	1982	1983	1984	1985	1986
1. Central Government	-474	-1,020	-1,060	-162	-170	-25	418
General Account	24	286	182	901	974	840	1,233
Special Accounts	-202	-310	-221	-336	-212	-341	-387
Other Funds	-296	-997	-1,022	-727	-931	-524	-428
2. Public Enterprises	-440	-884	-531	-234	-128	176	-7
Special Accounts	-325	-331	-82	-45	1	28	-95
Gov't Supply & Grain Management Fund	-114	-526	-449	-189	-129	148	88
3. Total	-914	-1,904	-1,591	-396	-298	151	410
(GNP Ratio, %)	(-2.5)	(-4.2)	(-3.1)	(-0.7)	(-0.4)	(0.2)	(0.5)
4. Off-Budget	-207	-207	-631	-555	-625	-864	-475
5. IMF Standard (3+4)	-1,288	-2,111	-2,222	-951	-923	-713	-65
(GNP Ratio, %)	(-3.5)	(-4.6)	(-4.4)	(-1.6)	(-1.4)	(-1.0)	(-0.1)

Source: Kim and Whang (1997)

Figure 5-2 | Expenditure, Net Lending and Revenue



Source: Cha, Dong-se (1995), *A Half Century of the Korean Economy: Sourcebook*

This fiscal consolidation was truly remarkable in that it was not achieved by the increase in tax revenue; in fact, the ratio of tax revenue relative to GDP was lowered from 19 percent in 1981 to 16 percent in 1986. In order to achieve the consolidated budget balance, the government reduced its total spending (including net lending) to GDP ratio by 7 percent point during the five years --- from 23 percent in 1981 to 16 percent in 1986. Since then, sound management of the government budget became a long-lived tradition in Korea, although both revenue and expenditure have been increasing relative to GDP.

It is also notable that the government attempted to flexibly respond to business fluctuations while maintaining efforts to remove structurally inefficient spending. In particular, the government expanded supportive policies to business sectors in response to the slow recovery in 1980 and 1981. Financial supports for public construction, small and medium sized enterprises, residential construction for low-income families, and exports of heavy industrial products on a deferred payment basis were augmented. The tax system was also actively utilized with temporary investment tax credits, lower personal and corporate income taxes, and selective use of capital gains and excise taxes. These fiscal measures temporarily increased the budget deficit in 1981, which can be regarded as a rational response of fiscal policy to cope with the recession. According to Corbo and Nam (1986a) who analyzed the fiscal policy stance using the measure of fiscal impulse, Korea's fiscal policy was fairly expansionary (by approximately 1.6 percent of GNP) in 1981, while contractionary in 1982 and 1983 (by almost 2 percent of GNP in 1983). That is, the government tried to boost the economy while the adverse effects of the Second Oil Shock lingered in 1981, but began to reduce overall spending in earnest as economic recovery secured momentum from 1983.

It is clear that the fiscal consolidation in the early 1980s greatly contributed to stabilizing inflation, but critical assessments also exist. Some commentators have criticized that the consolidation process was too drastic for the economy to adequately adjust to. In particular, they argued that the retrenchment of government spending also reduced public investment on infrastructure, which increased the logistical costs of industries.

1.3. Monetary Contraction

As fiscal deficit and policy loans were scaled down, pressures on monetary expansion were gradually reduced and the rooms for discretionary monetary policy were widened. In 1980 and 1981, the expansion in current account deficit happened to operate as a factor to contract base money supply (Although the Korean government introduced a 'managed floating exchange rate system' in 1980, the exchange rate was still under government control and the current account deficit contributed to the contraction of the base money supply). Yet, genuine contraction in monetary policy was delayed until 1983 as in fiscal policy. In terms of the growth rate of M2, the official target of monetary policy at that time was still staying at around 40 percent until 1982. The growth rate of M1 in 1982 even exceeded 60 percent.

This delay in monetary contraction was intentional, just as in fiscal contraction, in order to mitigate the adverse shocks from the oil price hike and resulting recession. Instead of pulling down the already shaky economy by abruptly tightening monetary policy, the BOK maintained the previous pace of M2 growth through weakening credit controls over bank loans until 1982. From 1983, however, the M2 growth rate was substantially lowered to around 20 percent. Corbo and Nam (1986a) quantitatively assessed how restrictive this change in monetary policy was. They estimated several specifications of money demand function with quarterly data up to 1982, and generated forecasts of money supply in 1983 and 1984 using the estimated models. The results indicated that the actual amount of M2 supply was 3-4 percent lower than the forecast values in the first quarter of 1983 and 4-15 percent lower by the fourth quarter of 1984, which clearly shows that the monetary policy stance was restrictive since 1983. Furthermore, considering they estimated real money demand functions that already incorporated the effects of lowered inflation on demand for money, the results seem to be more impressive. That is, this estimation essentially assumed that people already adjusted downward the amount of desired money holdings, reflecting the lowered inflation. Therefore, the estimated gap between the expected (or forecast) and actual money supply might have become wider if people had not been able to expect such fast stabilization in the inflation rate.

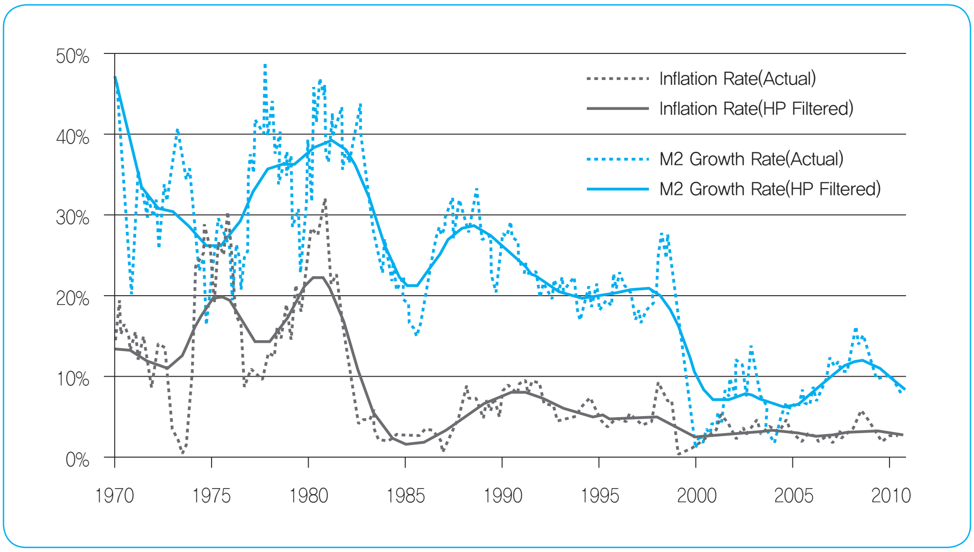
Table 5-5 | Money Growth Rates in the 1980s

(%)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Base Money	44.1	35.3	23.8	-6.5	-13.6	36.5	7.1	3.7	1.7	16.2
M1	45	38.7	23.1	21	23.4	62.8	16.3	5.7	22.8	34.3
M2	40.1	35.4	29.7	44.5	36.1	37	22.9	19	18.1	29.5

Source: The Bank of Korea

Figure 5-3 | M2 Growth Rate and Inflation Rate



Source: The Bank of Korea

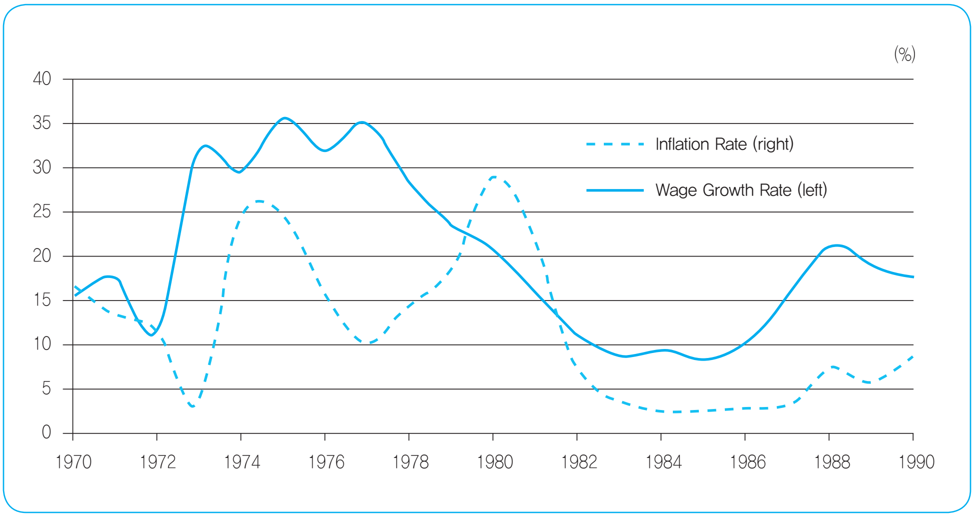
Since this bold adjustment made in 1983, monetary policy of Korea has been structurally changed. By witnessing the successful outcome of the contractionary monetary policy in stabilizing inflation, ordinary people, as well as policy-makers, could recognize that the chronic inflation in the 1970s was a monetary phenomenon, which was what they had been taught by the government. This general perception about the relationship between monetary policy and inflation then served as a social pressure against lax monetary policy. Although the money supply growth rate temporarily rose to around 30 percent due to the huge current account surplus in the late 1980s (which resulted in the blip in the inflation rate up to almost 10 percent in the early 1990s), it was stabilized again in the 1990s with the introduction of a more flexible exchange rate system and the reduction in current account surplus. As the money supply growth rate was permanently lowered, chronic inflation vanished and never returned to the Korean economy.

2. Factor Price Stabilization and Income Policy

As inflation subsided, factor prices such as wages and interest rates were also stabilized. Economic agents began to realize that a lower increase rate in *nominal* wages and a lower *nominal* interest rate could secure higher *real* purchasing powers, if inflation rates were sufficiently stabilized.

For example, nominal wage growth rates in the second half of the 1970s, over 20 percent per annum, were far higher than those in the first half of the 1980s, around 10 percent. However, the real growth rates of wages in terms of purchasing power were even higher in the first half of the 1980s with around 3 percent inflation rates than in the second half of the 1970s with around 20 percent inflation. In fact, according to an empirical study by Chun (1992), employing a structural vector regression analysis for Korea's data from 1970 to 1990, a shock that increased nominal wages in the short-run reduced real wages in the long-run via higher inflation, while a stabilization policy shock that slowed the nominal wage increase rate in the short-run yielded higher real wages in the end.

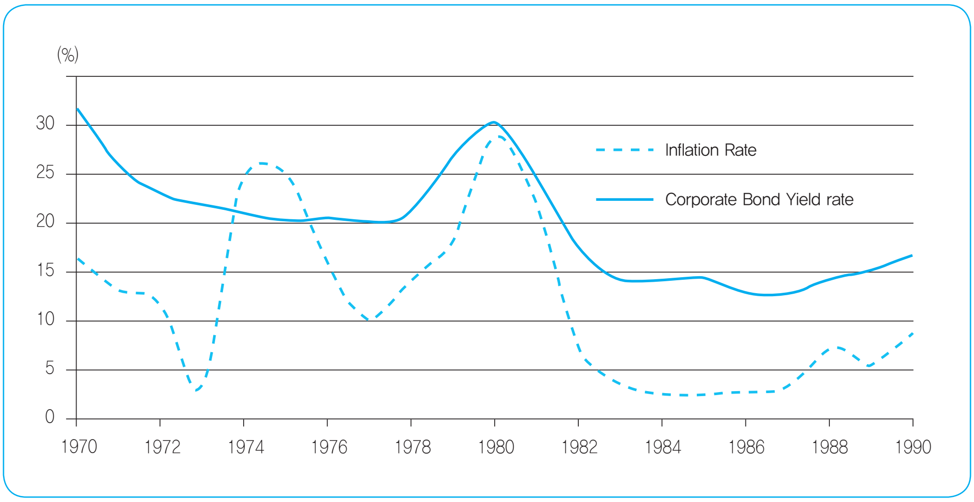
Figure 5-4 | Nominal Wage Growth Rate and Inflation Rates



Source: Cha, Dong-se (1995), *A Half Century of the Korean Economy: Sourcebook*

The same was true for interest rates. Although market interest rates (for example, three-year corporate bond rates) were lowered to around 15 percent in nominal terms in the first half of the 1980s, they could secure higher real purchasing power than 20 to 30 percent of nominal interest rates during the second half of the 1970s when double-digit inflation eroded the real return rate. Realizing this, people began to come back to formal financial markets to deposit their savings even at lower nominal interest rates, and the financial market could be deepened and developed.

Figure 5-5 | Nominal Interest Rate and Inflation Rate



Source: Cha, Dong-se (1995), *A Half Century of the Korean Economy: Sourcebook*

However, this process was not entirely smooth in the early stage of the stabilization policy period. Agreeing to a lower rate of wage increase prior to actual inflation stabilization could imply the loss in workers' purchasing power if the inflation rate were not lowered as expected. Conversely, inflation stabilization could imply the loss of business profits if wages were not stabilized as much. The government efforts to transform the vicious circle of wage-inflation into a virtuous circle of stabilization evidently entailed sharp conflicts between workers and businesses.

Apart from the natural (or endogenous) adjustments to the changes in the macroeconomic environment, therefore, the government made additional (exogenous) efforts to stabilize factor prices. That is, the government urged pain-sharing by imposing informal wage guidelines to moderate wage increases and controlling interest rates and dividends, as well as adjusting its purchase prices for grains. This income policy was intended to keep inflation expectation from creating a bottleneck in the stabilization process, but triggered hot debates among interest groups. As for the wage guidelines in particular, Nam (1991, p.231-232) describes the situation as follows:

> "Since the fall of 1981, government announcements of planned pay increase for public servants have served as informal wage guidelines for the private sector. The announced increase rates were nine percent for 1982, six percent for 1983, and a freeze for 1984. Acting through the Bankers' Association of Korea, the government also tried to keep wage increases low by having banks restrict credit to firms that increased wages beyond government guidelines. This move in late 1980, however, faced strong resistance from the

> Federation of Korean Trade Unions. Whenever there was a more explicit confrontation over this issue, the government would say "There is no official guideline. It is just a suggestion on the part of the government." That rather insincere and evasive attitude did not help build a consensus for wage guidelines. Consequently, workers have become suspicious of any suggestion of wage guidelines, and government efforts to stabilize wages have been ineffective. In spite of a variety of educational programs geared toward stabilizing wages, the rate of wages did not slow as fast as the government had hoped."

The government's motivation for the wage restraint was clear: stable wages were essential for export competitiveness as well as price stability because many of Korea's exports were still labor-intensive. The wage guidelines can also be justified by a well-established macroeconomic theory such as the wage-contract model. According to this model, recessions in the early stage of the disinflation period are caused by wage increases exceeding productivity increases due to the inertia in inflation expectation, and therefore the magnitude of output loss can be minimized if the inflation expectations are lowered in line with the actual speed of disinflation. Nevertheless, it was an extremely difficult task to enforce the wage guidelines by adjusting workers' expectation on the inflation rate before it was actually lowered. Nam (1991, p.232) continues to describe how difficult it was to enforce the policy:

> "Under government influence, negotiated base salary increases in the private sector in 1982 and 1983, which averaged 9.5 and 6.9 percent, respectively, were very close to those for public servants. However, de facto wage increases in the private sector were much higher than the negotiated rates --- 15.8 percent in 1982 and about 12 percent in 1983 --- indicating that effective wage guidelines depend on a broad consensus among labor, management, and the government. Otherwise, businesses can easily circumvent guidelines under the existing complicated wage structure."

The effects of the income policy are controversial. Some empirical research indicates that the wage guidelines appeared to lower the wage increase rate by 1 to 2 percent, though this result was far from being statistically significant. While inconclusive, the following comment of Nam (1988, p.87) seems to be warranted:

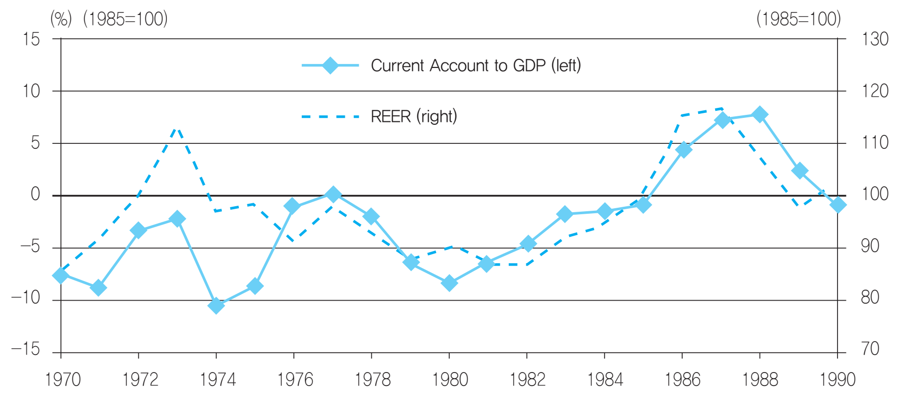
> "…the fact that the real wage increase was slightly lower than the labor productivity gain during the 1981-84 period of sharp disinflation is strong evidence of a flexible labor market. As can be expected, however, the income policy was not without side effects: it produced a wider wage gap between public servants and private employees, and some disintermediation (away from financial savings) during 1982-83."

3. Stabilization of the Balance of Payments

Inflation stabilization also made a great contribution to resolving the balance of payments crisis that overshadowed the Korean economy. The amount of foreign debts to finance trade deficits explosively increased in the 1970s as explained in Chapter 2. By 1980 when the trade deficit substantially deteriorated due the Second Oil Shock, this amount reached 27,170 million dollars, or 48.2 percent of GNP.

The first response of the government to cope with the crisis was to devalue the exchange rate from 484 to 580 won/dollar in January 12, 1980. This was the first devaluation since 1974. At the same time, the fixed exchange rate system was replaced by a multiple-currency basket system to continue to depreciate the currency value. As a result, the average exchange rate was raised to 731 won/dollar in 1982, approximately a 50 percent depreciation compared to 484 won/dollar in 1979. Nevertheless, it was estimated that the exporters' price competitiveness did not improve much in terms of the real effective exchange rate because of high inflation during the 1980-82 period. In fact, it was 1983 when the real effective exchange rate indeed began to depreciate, although the magnitude of the nominal exchange rate depreciation was rather mild. For example, the won/dollar exchange rate was depreciated to 801 won/dollar by 1984, approximately 10 percent from 1982, but the entire 10 percent of nominal depreciation could be translated into the real effective exchange rate depreciation, or the recovery of exporters' price competitiveness, because the domestic inflation rate was stabilized to those of competing countries.

Figure 5-6 | Current Account to GDP Ratio and Real Effective Exchange Rate



Source: Cha, Dong-se (1995), *A Half Century of the Korean Economy: Sourcebook*

In fact, exporters' price competitiveness represented by the real effective exchange rate reflects many aspects of macroeconomic adjustments. For example, if factor costs such as wages are stabilized along with the general inflation, exporters can secure profit margins although the nominal exchange rate does not depreciate. According to Nam's (1988) estimation, the rate of increase in unit labor cost (= wage divided by labor productivity) substantially declined from 20 percent or more per annum in the 1970s to around seven percent in the early 1980s. Even this seven percent increase in unit labor cost was fully compensated for Korean exporters by the same seven percent of currency depreciation per year during the 1981-84 period. That is, Korean exporters were completely free from the wage cost increase in dollar terms in the early 1980s.

As price competitiveness of exporting firms improved, trade (as well as the current) account narrowed its deficit and finally turned around into a surplus of 4.2 billion dollars (4.0 percent of GNP) in 1986 --- the first time in Korea's history. The size of surplus continued to expand to 11.4 billion dollars (6.4 percent of GNP) in 1988, resolving the balance-of-payments problems. The amount of foreign debt, which had only accumulating to 46.7 billion dollars to finance deficit until 1985, began to decline in 1986 with the trade surplus and reduced to 31.7 billion dollars by 1990. The absolute size of foreign debt decreased by approximately one third during the five year period. Its relative size to GNP substantially dropped from 56 percent in 1985 to 13 percent in 1990 as the economy rapidly expanded. Having seen this performance, no foreign creditors doubted the credit worthiness of the Korean economy.

Table 5-6 | Wages, Labor Productivity, and Unit Labor Costs in Manufacturing

(Annual Increase, %)

	1974-75	1976-78	1979-80	1981-84
Nominal Wages	31.1	34.3	25.7	13.7
Labor Productivity	2.1	8.4	5.2	5.9
Unit Labor Cost (Korean won)	28.4	23.8	19.4	7.4
Exchange Rate (won/dollar)	10.2	0	12	7.3
Unit Labor Cost (US dollar)	16.5	23.8	6.6	0.1

Source: Table 5 of Nam (1988)

It is indisputable that the substantial depreciation of REER and the associated expansion of the current account surplus in the late 1980s were crucial for paying back foreign debt and stabilizing external fronts of the Korean economy. However, they also generated some side-effects, and the rigid exchange rate policy to preserve the current account surplus in particular caused another round of macroeconomic instability afterwards. After the Plaza

Accord in 1985, the value of the US dollar collapsed against major currencies, including the Japanese yen. Yet, the Korean won was roughly pegged to the US dollar, implying a huge depreciation against other currencies. This was the main driving force of the jump-up in REER by almost 20 percent in 1986 and 1987, in contrast to the gradual depreciation of REER in the first half of the 1980s that was driven by domestic inflation stabilization. Thanks to this unexpected REER depreciation, many marginal firms that would otherwise have lost competitiveness re-surfaced, but fell into difficulties again as soon as the exchange rate was re-aligned. Also, the policy to support the exchange rate at a weak level substantially complicated monetary policy and eventually increased the money supply, which led to asset price hikes in the late 1980s and a surge of inflation to almost 10 percent in the early 1990s.

4. Revival of Growth

As inflation was stabilized and export competitiveness was secured, the Korean economy regained its growth momentum. Although the growth rate rebounded to around 8 percent in 1981 and 1982, they were largely due to technical effects of low base in 1980. As the economy stabilized, however, the Korean economy could continue to grow at a 10 percent rate per year during the 1983-85 period, and further thrived with almost 12 percent of annual growth during the 1986-88 period. In fact, the three years from 1986 to 1988 were the most memorable heyday of the Korea economy: it enjoyed fast growth, maintained low and stable inflation, and achieved sufficient amounts of trade surplus to resolve the balance of payments problem.

Table 5-7 | Growth Rates of Main Aggregate Demand Components

(Annual Average, %)

	1971-75	1976-79	1980	1981-82	1983-85	1986-88
GDP	9.7	11	-1.9	7.9	9.9	12.1
Consumption	7.2	7.4	1.2	6	7.2	8.4
Private	7.3	7.7	-0.2	6.3	8	8.6
Government	6.6	5.9	9.1	4.5	3.4	7.3
Investment	11.7	25.7	-12	3.7	11.1	15.2
Construction	9.3	17.8	-4.5	6.3	11.4	11.6
Facilities	16.5	35.3	-20.1	0.9	10.4	19.5
Export	29.3	18.2	8.6	10.6	10.5	19.4
Import	15.5	21.4	-4	4.7	6.4	17.2

Source: The Bank of Korea

Note: All figures are from the most updated national accounts, and thus different from the growth rates that policy-makers in the 1980s were actually reporting at that time. For example, the GDP growth rate in 1980 was reported -6.2 percent at the time (see Subsection 3.1.1), not -1.9 percent.

Several facts are noteworthy from the national account data. First, government consumption growth did not slow down in 1980 despite negative GDP growth. Rather, this value was significantly lowered during the 1981 to 1985 period, indicating that the government deliberately delayed fiscal consolidation until the economy began to recover. Second, investment in facilities could not pick up until 1982 even after it was contracted by 20 percent in 1980. This indicates how serious the over-investment problem in the late 1970s was, as evidenced by the 35 percent of annual increase during the four years from 1976 to 1979. Third, the growth rate of import was suppressed throughout the early 1980s, which was also the reaction of excessive demand in the late 1970s. As the economy was over-heated, the import base was rapidly expanded at an annual rate of over 20 percent in the late 1970s, with which the trade account could hardly turn into a surplus despite rapid export growth. It took more than five years until 1985 to adjust the situation by moderating import growth to a rate far lower than that of export. It was only after 1985 that Korea could sufficiently increase imports without deteriorating the balance-of-payments.

5. Structural Changes toward Market-Oriented Economy

Efforts made in the early 1980s were not confined to macroeconomic adjustments. As a matter of fact, they included an extremely wide range of structural policies from import liberalization to financial deregulation. Yet, the whole theme was clear and simple: making the Korean economy more market-oriented. Various regulations and controls imposed under the government-led development era were lifted. More economic freedom was allowed and the market function was established.

These structural reforms, though pursued for the sake of economic efficiency, were also reinforced by macroeconomic stabilization. As inflation was stabilized, needs for the government to resort to administrative measures for individual price controls were reduced to a substantial degree. As factor prices were also stabilized, the government did not have to attempt to keep wages or interest rates under control. As the expectation of inflation was tamed, the discrepancy between the regulated interest rate in the formal market and the unregulated rate in the black market was substantially reduced, providing a favorable environment for liberalizing the interest rate. As the fixed exchange rate system was abolished, the discrepancy between the official and black market rates was also reduced, paving the path for foreign exchange market liberalization. Indeed, the macroeconomic stabilization achieved in the early 1980s was an indispensible infrastructure for Korea to further develop into a market-oriented economy.

Chapter 6

Conclusion and Lessons

Conclusion and Lessons

The comprehensive stabilization policy in the early 1980s was one of the boldest reforms in Korea's economic policy history. It was not just a macroeconomic adjustment. Indeed, it was a paradigm shift that overhauled the economic policy framework from the government-led development strategy to a market-based economic policy.

Of course, the primary goal of the stabilization policy was to control chronic inflation, which was a result of monetary expansion. The monetary expansion, however, stemmed from the accommodative role of the Bank of Korea (BOK) supporting the banking and fiscal sectors that were mobilized for the Heavy and Chemical Industry (HCI) drive. The stabilization policy, therefore, had to begin with the negation of the heavy involvement of the government in the market system, which had been regarded as the backbone of the 'Korean Miracle' for almost two decades. Industrial policies that had been at the heart of the government-led development strategy were weakened, and the financial market began to secure its own breathing room from the government's repression. A full-scale restructuring of government spending was carried out to eliminate another source of monetization. Many prices that had been under government control were liberalized, and the import market was actively opened. Freed from the distorted task to support industrial policies, the BOK reverted to its original position that focused on price stability.

As such, the inflation stabilization policy of Korea in the early 1980s was an extremely complex process far beyond a simple monetary contraction. There was a great deal of opposition not only from interest groups but also from some elites. It may be true that the stabilization policy would not have been politically feasible without the full support and commitment of the dictator, President Chun. Though born from the same military blood, President Chun was convinced of the importance of the stabilization policy that could not be appreciated by President Park who designed and implemented the government-led development strategy.

One may say that Korea was lucky to have a new leadership at a critical moment, but it was not entirely a matter of luck. The conviction of President Chun about the stabilization policy did not come by chance; rather it was a precious outcome of unremitting efforts by the awakened economic advisors. With clear understanding and logical reasoning of the economic system's big picture, they kept teaching and persuading President Chun about why the stabilization policy was so crucial for the sustainable development of Korea. Finally convinced, President Chun could then push through the reforms that called for a long waiting period before bearing fruits.

There must be many important lessons from Korea's experience that can be learned by developing countries. Yet, some lessons need to be adapted to different global environments and political systems between Korea in the 1980s and developing countries of today. For example, a political leader's sound understanding of economic policies was crucial under the dictatorship in Korea at that time, but a more broad-based institutional approach should be considered under current democratic systems. Taking this point into account, the following can be recommended to developing countries.

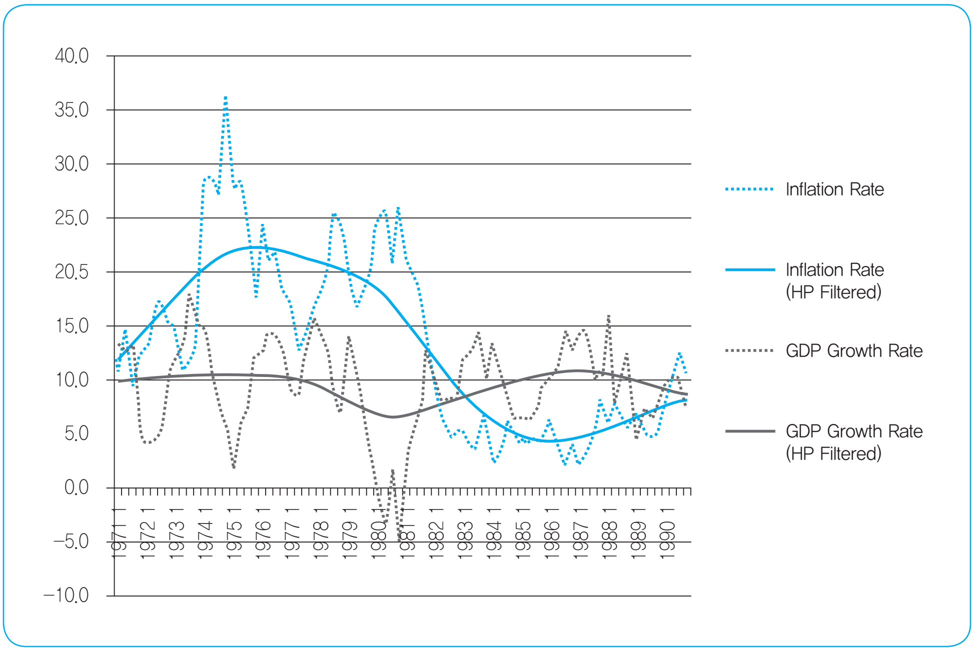
1. Policy-Makers' Understanding about Macroeconomic Policy

Many developing countries are desperate to achieve economic growth, but an immediate constraint they commonly face is the shortage of resources for investment. Financial repression and budget deficits, often supported by money printing power, can be regarded as attractive options to finance necessary investment for the country's development. Then the policies with good intention of growth promotion are likely to end up with 'unintended' side effects of chronic inflation and wide-spread inefficiency. It is particularly so, when policy-makers do not clearly understand the complex and complicated mechanism of macroeconomic policy. The case of Korea in the 1970s is a good example. In this regard, it is extremely important for key policy-makers to better understand macroeconomic policy and the dynamics of inflation, in order to carry out sound policy-making.

- <u>Recognize that macroeconomic policies can boost the economy only in the short-run; hence they should be used for short-term stabilization rather than long-term growth.</u> Macroeconomic policies such as monetary, fiscal, and exchange rate policies are basically re-allocating resources between the present and future, rather than permanently changing the growth path. The easiest example to understand this point is budget deficit: government's spending over its revenue (or budget deficit) increases today's resources at the cost of the increase in tomorrow's burden. Therefore, macroeconomic policy tools should be used to mitigate short-term economic fluctuations rather than longer-term development. That is, monetary or fiscal expansion is needed when the economy is faltering into recession, but a symmetric contraction is equally necessary when the economy is recovering. Instead of relying on macroeconomic policies, long-term economic growth should be promoted by structural policies such as better governance to reduce corruption, opening up of markets to increase market efficiency, and proving better education to cope with intense international competition.

- <u>Recognize that macroeconomic policies have short-term trade-off effects on growth and inflation, but chronic inflation is not a necessary evil for long-term growth</u>. It is now widely understood that macroeconomic policies have trade-off effects on growth and inflation. Therefore, policy-makers who are mostly concerned about imminent issues tend to perceive that inflation is not desirable but has to be sacrificed to an extent for growth. However, economic theories and empirical analyses of the past half century have firmly established that chronic inflation is detrimental to long-term sustainable growth, though it may help boost short-term growth for a couple of years. Korea's experiences in the 1970s and 1980s prove this point: the average growth rate was similar over the two decades (9.1 percent in the 1970s vs. 9.6 percent in the 1980s), while the inflation rate was dramatically stabilized (16.5 percent in the 1970s vs. 6.4 percent in the 1980s). These experiences clearly show that inflation is not a necessary evil for growth in the long run; rather, inflation produces serious side-effects that hinder sustainable growth.

Figure 6-1 | Inflation and Growth: Case of Korea



Source: The Bank of Korea

- Recognize that central banks cannot add real resources. Many enthusiastic policy-makers in developing countries are desperate about resources for investment and tend to become tempted by the credit (or money) by the central bank. However, the central bank's money cannot increase aggregate resources: the purchasing power of the central bank's money is obtained only by reducing the purchasing power of other savings through inflation. That is, the more money a central bank supplies, the more resources are transferred from private to public sectors (inflation tax) with no increase in aggregate resources.

- Recognize that chronic inflation is always a macroeconomic phenomenon, hence should be dealt with by adjusting macroeconomic policies. Impressed by the hikes in prices of several individual items such as oil and agricultural products, policy-makers tend to attribute inflation to micro-economic problems and became reluctant to take contractionary macroeconomic policies. However, chronic inflation simply means a decline in the purchasing power of money, which is a result of supply of and demand for money rather than a result of microeconomic structures in individual markets. That is, without an appropriate adjustment of the money supply, or more fundamentally without eliminating the root causes of monetary expansion, it is impossible to control chronic inflation. Korea's experiences showed that any authoritarian government could not control inflation by administrative power.

2. Institutions that Can Protect Sound Macroeconomic Policy

Korea's experience in the 1970s showed how politically motivated macroeconomic policies could ruin overall economic stability. Of course, the stabilization policy in the early 1980s was also driven by President Chun, but it was an exceptional rather than general case in economic history. Most governments, including advanced ones, are likely to be affected by short-sighted political factors, while macroeconomic policies need to be conducted free from politics. Therefore, in order to ensure that macroeconomic policies can be implemented more soundly, institutions need to be improved.

2.1. Monetary Policy

- Clearly set "low and stable inflation" as the mandate of the central bank. Ambiguity in the mission of the central bank is often used to justify allowing inflation as a cost of boosting the economy. The idea of "growth money" in the 1970s in Korea was an example. A clear mission for the central bank can help rule out the possibility that monetary policy is abused.
- Announce a numerical inflation target range regularly (for example, every two to three years). This can help protect monetary policy from being influenced by other motivations, and easily monitor whether the central banker performs his/her responsibility. It also helps the public to adjust their inflation expectations, which can reduce uncertainties about the macroeconomic environment. In this case, however, it is important to carefully select the target inflation index, particularly in developing countries where uncontrollable cost-side shocks from agricultural sectors and imported goods play major roles in short-term fluctuations of headline inflation. Desirable index for target inflation should: (i) include core prices directly related to the economy's aggregate demand; (ii) exclude non-core prices mainly driven by cost-side shocks; and (iii) nonetheless cover a substantial portion of the headline CPI basket.
- Guarantee the terms of monetary policy-makers, as long as the announced inflation target range is observed. In order to protect monetary policy from political influences, the terms of policy-makers need to be honored. In many advanced countries, as well as in Korea, the terms of the Monetary Policy Board Members are guaranteed by law.

2.2. Fiscal Policy

- Cut off the link through which the government budget deficit can be directly financed by borrowing from the central bank. This appears the most attractive option for the government, but at the same time it is the most dangerous for macroeconomic stability. In most developed countries in which the central bank's independence is institutionally protected, this kind of risk is practically obsolete. Yet, in many developing countries, this risk still exists and has been realized from time to time. Korea's experience in the 1970s --- almost 50 percent of the base money increase was used to finance the deficits from a single special fund (Grain Management Fund) --- was a typical example. Therefore, it is the first step for macroeconomic stability, as well as sound monetary policy, to establish a strict budget constraint on the government budget. If the government is to run a deficit, it should be financed by issuing bonds so that the accountability of the deficit clearly belongs to the government.

- Control the budget on the basis of project performances. Budgeting of fiscal spending, by its nature, goes through a political process. This implies that fiscal spending is likely to expand and difficult to contract, unless it is tightly controlled by well-established systems or legal forces. The 'zero-base budgeting system' introduced by the Korean government in 1982 is a good example. By applying this zero-base budgeting, the government could reduce the waste of taxpayers' money and finally eliminate the chronic budget deficits in 1986. Since then, Korea's fiscal soundness has become a long-lived tradition.

- Include semi-fiscal activities in consolidated budget statistics to reduce taxpayers' money diverted to the projects that are not reviewed by the public. Politicians would like to increase the budget they can use without being monitored by third-parties. Various special funds in Korea in the 1970s were such examples. Though eventually the burden of taxpayers as well, these funds were not included from the general government budget. As a result, the government budget appeared in surplus despite deficits in consolidated budgets, and weakened the monitoring power of the National Assembly. Therefore, it is recommended to include such semi-fiscal activities in the consolidated budgeting process so that fiscal spending can be monitored more tightly.

3. Communications with the Public

Convincing a dictator of necessary policies was the most critical step for policy implementation in Korea in the 1970s and 1980s, but that is no longer the case in democratic societies. As a society develops and democratizes, public assent is required for policy implementation, making effective communications with the public more important.

- Kindly explain the expected effects of policies to the public. Effectiveness of macroeconomic as well as financial policies critically depends on the public's expectations about the future policy effects. For example, if workers believe that stabilization policies can pull down inflation in the future, they are more likely to agree to a lower rate of (nominal) wage increases, which will in turn reduce the society's cost of macroeconomic adjustment (less severe recession). In the case of Korea when the stabilization policy was implemented in the early 1980s, a full-scale campaign on the policy effects was made through the media, public schools, and even in the army. Along with this campaign, the government earnestly appealed to the public to participate in sharing the burden for a better future, and asked workers not to demand high wage increases --- income policy. It is difficult to quantify the effect of this income policy, but it is a fact that the Korean economy did not plunge into deep recession during the period of stabilization.

- Disclose as much information as possible and enhance the quality of statistics. Secrecy is the biggest enemy to the trust between the government and the public. Yet, individual bureaucrats have disincentives in releasing relevant information because it would only increase their responsibility while reducing monopoly power. Therefore, it is necessary to force them to disclose as much information as possible. At the same time, it is equally important to improve the quality of information. Provision of reliable statistics is most essential for the credibility of policies.

- Strengthen the intellectual capacity of the government to enhance the leadership in policy-making. Policies are not implemented by force, but by convincing the public in democratic societies. In order to deliver effective policies, therefore, policy-makers should enhance their intellectual capacity to better understand operation mechanisms of the market that become more and more complex as the economy develops.

- Enhance trust from the public. Perhaps most important of all is to maintain the public's trust. Without trust, it would be extremely difficult that policies in general and stabilization policy in particular can effectively deliver desired outcomes. For example, income policy to reduce the social cost arising from dis-inflation processes can get a wider range of cooperation from the groups involved (both workers and businesses) if the government is trusted by the public. Of course, in order to maintain trust, the government should be honest and free of corruption.

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