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Boogak Mansion 1-203
Pyungchang Dong
Chungno Ku
Seoul 110, Korea
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Free-Market Capitalism in Korea: The Future of the "Miracle"

Mr. Peter Bird Martin, Director
Institute of Current World Affairs
4 West Wheelock St.
Hanover, N.H. 03755

Dear Peter,

I have been hard on the Korean government lately in my reports, so I am due for a corrective, a well deserved one because the Korean government can be brilliant. In contrast to its frequent political bumbling and miscalculation, it has managed the economy over the past five years with rare finesse and patience. American-trained economists who believe in free-market capitalism captured the ear of the President soon after he came to power in 1980. They have guided the economy since with an extraordinarily steady hand, devising long-range strategies to reduce government control over the economy.

Part their success, ironically, is a story of authoritarian government. They have paid no more than passing heed to domestic critics, who have objected consistently to tight money, import liberalization, a rising foreign debt, inequality of income distribution, and concentration of industrial ownership. Some of the government's insulation from political pressure is now eroding. In contrast to the early years of the Chun government, the political opposition has become strong and vocal. A current slowdown in the economy has also raised doubts about whether too heavy a price has been paid. Both the opposition and big business have begun to criticize economic liberalization as too costly.

The achievements are nonetheless real, in many ways comparable to the well publicized and politically more dramatic economic reforms taking place in China. China has very haltingly introduced some market mechanisms into a highly centralized planned economy. The verdict on how far those reforms will go, and whether they will succeed is still uncertain.

In Korea, economic-policy makers are trying to ease the nation from a centralized capitalist system, in which the government dominated allocative decisions, to a system that is driven by the market. That transition is painful, both to businesses that grew with government help and protection, and to government bureaucrats, many of whom learned their jobs in the 1970s and now have to unlearn basic habits. The reforms also cut against deep notions about the

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Steven B. Butler is a Fellow of the Institute of Current World Affairs studying political and economic developments in Korea and Northeast Asia.

role of government, notions that derive from centuries of Confucian paternalism.

After nearly five years, the reforms are beginning to produce some of the long-range benefits that they promised. But as in China, the final verdict is still out because the obstacles to reform have proved more stubborn than anyone expected.

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When General Chun Doo-hwan became President in September 1980, Korea faced an economic crisis. After nearly two decades of stunning growth, Korea's economy was shrinking, at a rate of 5.2% for the year. Consumer prices were galloping away at a rate of 28.7%, wholesale prices at 38.9%. International oil prices had already jumped way up. That and the sudden decline of the domestic savings rate, from 28% to 22%, forced Korea into the international market to borrow more money.

Korea discovered painfully in 1980 that its rapid growth of the 1970s was unsustainable without basic changes. The government had made errors that resulted in costly excess capacity in some industries, and that had severely weakened market institutions, especially the banking and financial system. Despite five years of corrective policies, Korea today still pays a heavy price for those errors.

In the early 1970s, Korea grew concerned about a possible withdrawl of U.S. support in the wake of Viet Nam and the "Nixon doctrine," which foresaw a gradual drawdown of U.S. forces in the Pacific. It also worried that protectionism would hurt the nation's exports in its staple of labor intensive, light industrial goods. The result was a plan to become self-sufficient in defense-related industries, and to diversify export products and markets.

The government provided long-term financing for the development of heavy and chemical industries. It mobilized bank savings and pension funds and lent them at artificially low interest rates. The low cost of the funds created an excess demand for bank credit and the Bank of Korea, Korea's central bank, accommodated the demand. The money supply grew rapidly, fueling an inflation that made bank interest rates negative in real terms and discouraged savings. Speculation in real estate followed quickly. Corporations built factories and exported goods in order to qualify for low-interest loans, and they used as much cash as they could scrape together from the loans to buy property. Property, in turn, became collateral for more loans. Real estate transactions provided the only real source of profits for some companies.

In retrospect, it is easy to see why the policies produced severe distortions in the economy. Easy money encouraged businesses to invest in industries where the underlying economic advantages were not very compelling, leading to overinvestment in automobiles, petrochemicals, shipbuilding, and heavy machinery. Underinvestment in light industries, in turn, reduced Korea's strength in traditional export areas. Easy money greased the system and produced enviable growth statistics for a few years--statistics of the sort that discourage politicians from taking drastic steps. But in time they had no choice.

The political crisis that followed the assassination of President Park in October 1979 created social instability that made the economic downturn even worse. Businessmen hesitated to invest money, and lacked the authority to resist wage demands by workers. The imposition of martial law and harsh measures taken against the opposition did eventually restore some order after, at least initially, creating more chaos. The military authority that lay behind the government gave it a powerful writ to push through reforms that in a more democratic society would have provoked strong resistance. (Even the American Ph.D.s who led the reforms readily admit this point, although not for attribution.)

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The government faced two broad sets of problems: how to trim back industries with excess capacity, and how to rebuild financial institutions that had been critically weakened by extended high inflation and government domination.

Trimming back excess capacity proved to be easiest. The government ordered some companies to shut down their factories. Other companies were forced to merge with their competitors, reducing competition and allowing for a more rational use of resources in a single stroke.

The government was especially effective in the automobile industry. Between 1976 and 1979 the production of vehicles in Korea more than quadrupled to reach 204,447 units. But in 1980, production suddenly fell to 123,135 units, putting the country's three major vehicle producers on the edge of bankruptcy.

The government reduced competition by dividing up the market among the companies. Daewoo Motors (then Saehan) and Hyundai were allowed to produce passenger cars. Kia Motors was forced to shut down its auto line, but was given a monopoly over vans and small trucks. The industry gradually nursed its way back to health. Domestic demand picked up to take a larger share of production capacity and the quality of Korean vehicles improved enough to make them competitive internationally at the bottom of the market. Next year, the competitive restrictions will end. Kia will start producing small cars again, and Hyundai, at least, will begin to manufacture small trucks. In 1987, auto imports are scheduled to be liberalized.

Auto companies bitterly resisted the government's interference in their business at the time, but as one Kia executive now says, "The fact that we are still here tells you that it [the restructuring plan] worked." The motor industry has become one of the most promising areas for potential growth in Korea.

Reinvigorating financial institutions has proved far more difficult, and despite five years, the efforts have produced few results. The announced policy goal is to pursue "financial liberalization." The government would reduce its influence over financial markets to let them function efficiently. The government would issue no more directives on credit decisions and eventually allow banks and other financial institutions to determine interest rates freely. The government has pursued these goals with a public ideological zealotry, but it has quietly tempered that zealotry with a fine sense of realism.

Policy makers knew that if they moved too quickly the institutions would buckle, leading to widespread disruption in the economy, bankruptcies, and unemployment. Those policy makers admit today that the obstacles to financial liberalization were far greater they they had anticipated. The basic financial institutions, the banks and the capital markets, had to be strengthened before they could be let off on their own. But today they remain very weak and the government has set its sights far to the future for a day when a market-driven financial system becomes a reality.

Koreans, during the 1970s, lost the habit of putting their money into banks because interest rates did not keep up with inflation. The purchase of real property provided the only investment of security. Korean savers would have to be convinced--they could not be ordered--not only that inflation would stay below bank rates, but also that they could do no better by putting their money elsewhere, at least not without significantly higher risk.

Korean companies, on the other hand, had developed a fairly insatiable appetite for credit. They borrowed large volumes of money at negative real interest rates during the 1970s, pushing average liquidity ratios for Korean companies (the ratio of their debt to paid in capital) from about 275% in 1972, to nearly 500% in 1980. Most U.S. companies are well under 100%. After acquiring so much debt, the companies could not easily pay it off, even though the rise in real interest rates gave them a strong incentive to reduce debt. Declining industries or industries with excess capacity came under heavy pressure. Many companies faced a choice of borrowing money at virtually any interest rate or going bankrupt. In the economist's jargon, the demand for money was highly interest inelastic, meaning that companies would pay high interest rates outside the bank system if they could not obtain sufficient funds within it.

Precisely that happened. Inflation and money supply growth rates came down as government policy prescribed. Bank interest rates rose sharply in real terms while nominal rates fell. The government, however, could not control the money supply sufficiently by manipulating interest rates so it in effect rationed bank credit. Companies in need of money turned to the quasi-legal curb market or to a secondary market of short-term finance companies where interest rates were significantly higher. Smart savers did likewise, and the higher bank savings rates did not attract proportionately more savings.

As lending rates rose and Korean companies became strapped for cash, the banks faced an unpleasant choice. They could continue lending to the companies and in effect increase their portfolio of bad debt, or they could call in previous loans, force the companies into bankruptcy, and write off their losses. In reality the banks had no choice. Their exposure to bad debt was large enough to threaten the solvency of the banks, perhaps too large even for a major government bailout. In many cases, debt problems were most severe in industries that had been fostered by the government in earlier years--in construction, shipping, and shipbuilding. Many people felt the government would have to assume some responsibility. A bankruptcy in overseas construction would damage the credibility of Korean companies in an industry that continues to be a major foreign-exchange earner. If a major corporation failed, it would

Economic Performance

	1980	1981	1982	1983	1984
GNP Growth Rate	-5.2%	6.2%	5.6%	9.5%	7.6%
Consumer Price Increases	28.7%	21.3%	7.3%	3.4%	2.3%
Real Interest Rates*	-2.7%	3.4%	3.8%	5.0%	5.1%

Source: Economic Planning Board
*Equivalent to interest rates on one year time deposits minus GNP deflator.

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lead to a chain of other bankruptcies domestically, and would cause major disruption and unemployment, which was politically unacceptable.

The banks continued lending money to insolvent companies (making them solvent once again, of course). In the past year alone, the banks have lent hundreds of millions of dollars of concessionary loans to companies in deep trouble. The government refuses to disclose how much "bad debt" the banks have now accumulated. They admit that it exceeds one trillion won, and private reports indicate that it actually is over five trillion won (some six billion U.S. dollars, which is about equal to the total capitalization of the Korea Stock Exchange, or one fifth of M2). Finance Ministry officials say the problem is likely to be around for ten to fifteen years before the banks can accumulate enough profits to write off the loans. In the mean time, the Bank of Korea has begun to lend money to commercial banks at concessionary rates to insure that the banks do not go under and continue to earn a profit while they carry so much bad debt on their books.

Most of the debt is not bad in a technical sense because rather than allow the companies to default, the banks just issue new loans. That has turned the banks into caretakers of large insolvent companies instead of allocators of credit based on normal risk-assessment criteria. The large companies have taken a disproportionate share of relatively cheap bank credit, forcing small companies into expensive secondary markets or shutting off their access to credit altogether. After years of acting as executors of government policy, the banks lack the technical abilities to evaluate credit risk based on financial information about companies. That also puts small companies at a disadvantage because they often lack the property that Korean commercial banks require for collateral before they issue loans. The heavy burden of bad debt thus prevents the banks from serving as efficient market institutions.

In short, financial liberalization has run into a dead end for the time being. The government continues to intervene heavily in financial markets because they cannot stand on their own.

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For several years the government's program of financial liberalization appeared to be virtually cost free because of astute macroeconomic management. Bank interest rates fell from 20% in 1980 to 10% in 1983, while inflation, measured by the consumer price index, fell from 28.7% to 3.4%, and is under 3% today. Money was becoming more expensive, but the government did permit enough expansion in the money supply in those years to allow for growth. Only in 1983 did the money supply (M2) begin to slow down, from 27% growth in 1982 to 15.2% in 1983. Last year M2 grew at 7.7%, the lowest in over 20 years.

The economy began to recover in 1981. Exports grew at 21.8% (not especially high by Korean standards) helping the GNP to expand by 6.2%. The government managed to ride out the deep international recession of 1982 by tolerating a high current accounts deficit, borrowing money from international lenders, and running a large government deficit to pay for public works construction. The economy expanded by 5.6% in 1982, despite a mere 2.8% increase in exports. Exports have usually been the principal stimulus for economic growth in Korea. By 1983 and 1984, the strong international recovery led to a revival of export growth, and allowed the government to cut back on fiscal stimulants. The national budget was frozen for fiscal 1984. The economy grew by 9.5% in 1983 and 7.6% in 1984.

Korea has been blessed to date with good timing. In the early 1980s, Korea found the international banking community receptive to its new borrowing needs. Korea's total outstanding debt increased from $8.5 billion in 1975, to $27.3 billion in 1980, to 40.45 billion in 1983. Foreign bankers rarely question Korea's ability to repay such a large debt. The nation's debt service ratio (the ratio of the annual loan-repayment bill to foreign exchange earnings, the most widely used measure of a nation's ability to repay foreign loans) has always been under 20%, which bankers say is safe. Today, with an outstanding debt total of 44 billion dollars (the fourth highest in the world), Korea has a debt service ratio of about 15%. The World Bank has suggested that Korea could safely borrow more money internationally with little worry.

The World Bank may be right. But as a practical matter, bankers agree the money is no longer there. International banks are cutting back third-world debt exposure because of the overall difficulties with highly-indebted nations and are lending more money in the industrialized world. Most foreign banks in Korea have already reached their country-lending limits. Korea could not borrow substantially more money overseas, at least not without paying a sharply higher cost.

Korea's high foreign debt is also a volatile political issue at home. The opposition recently introduced a bill to dismiss the Deputy Prime Minister over "mismangement" of the economy. They blame him in part for the high debt which, they say, places Korea at the mercy of international banks. Policy makers are also concerned about the severe effects that fluctuations in interest rates have on the current account balance and on their economic planning. They do not want to expose themselves more heavily. In short, Korea cannot borrow more money as a device to stimulate investment and demand.

When Korea's debt reached a point that made bankers uneasy, the timing was again good. The strong U.S. recovery came along to rescue Korea as well as much of the rest of the world. Korea was able to continue sweetening the bitterness of economic reform with strong economic growth. But in 1985, Korea's economic reformers have come to the end of an easy ride.

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In the first six months of 1985, Korea's exports declined by 4% on a customs clearance basis. Korea has not experienced a full year decline in exports since at least 1962, when the current series of statistical tables begins. This year too exports are likely to finish showing at least a small gain. But exports will fall far below original expectations, and will cause the nation to miss all major economic targets for the year. Economic growth for the first half of the year is likely to fall below 5%, compared to an annual growth target of 7.5%. Although most nations would be delighted with that sort of growth, Korea is disappointed. The population in Korea is relatively young, and economists say the nation needs real economic growth of about 7% to create jobs fast enough to absorb new entrants into the market. Unemployment has already risen to its highest level in five years.

The sluggishness this year hardly signals an end to the Korean economic "miracle." Slow growth in the U.S. and Japan, Korea's most important export markets, is largely to blame, and U.S. economic growth is expected to pick up in the second half of the year. That should help Korea, although it remains to be seen by how much. Government economists are far more optimistic than businessmen or foreign bankers.

The slowdown has, however, highlighted the weaknesses of the Korean economy--particularly its vulnerability to swings in the international economic cycle. And it has drawn greater attention to the price that Korea has paid for the achievements of the reforms.

Most important, the reform program has produced a major change in the savings habits of Korean people. The national savings rate jumped from 22.4% in 1982 to about 27% today, a rapid response to the considerable rise in real returns on savings. The government does seem to have convinced people that inflation is down to stay. The increase has closed the gap between national savings and national investment by billions of dollars, translating directly into reduced foreign borrowing.

So far, relatively little of that increased savings has gone into the banks. Most of it has gone to the secondary financial market, where interest rates have been substantially higher. The trend is illustrated by the ratio of M3 (the broadest measure of the money supply) to M2 (which includes time deposits in the banks, but not the secondary market), which rose from 1.42 in 1980 to 1.90 at the end of March.

Finally, however, the government seems to be providing medicine strong enough at least to tame the symptoms, if not cure the disease. Government officials said for years that bank interest rates were high enough to attract savings, with real returns on time deposits of about 5%. The trouble was that savers could still do better elsewhere. So in April, the government caved in and raised the interest rates on some types of long-term savings accounts to 13%, putting it within two percentage points of returns at short term finance companies. The results have been impressive. M2 grew at 10.3% in May and 12.4% in June, reflecting in large part the movement of money into the new accounts, some of it from M1 (money in circulation, which shrank) and some of it from the secondary market. An improved deposit base for the banks is a prerequisite to freeing them from government control and support, and they cannot function as efficient allocators of capital until that happens. But the gain is rather abstract, especially from the viewpoint of many businessmen.

As the government raised savings rates, it also had to raise bank lending rates, from a previous maximum of 11.5% to 13.5% for some types of long-term loans. Government officials say the eventual result will be lower average borrowing costs to businesses, since they expect the higher rates to draw more money into the banking system from secondary markets. But businessmen have predictably shrieked about the new higher rates, especially since they come in the midst of a serious business downturn. They say that high rates have made new business investments prohibitively costly, a claim born out at least in part by very low rates of business investment over the past year and a half. Even government officials admit that recent increases in business investment, at just 5%, are not enough to keep Korean industry competitive.

The government appears to have worked itself into a box. It does not want to pump money into the economy. That could touch off a new round of inflation that would threaten to wipe out five years of gains in convincing Korean people to save money. It would also increase imports very rapidly, and cause an unacceptable worsening of the current accounts deficit. One economist in a government-sponsored think tank told me, "If we want higher growth we can get it." But this year the government plans to stick to its guns and accept a decline in the rate of economic growth, as well as the unpleasant political consequences that can stem from that.

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If I had to place bets on the future, I would risk my money on Korea's economic reformers eventually achieving real liberalization in the economy. What distinguishes Korea's economic leaders, and gives them a touch of brilliance, is not just a clear vision of the future, but a firm grasp on the present. They have tossed away the textbook models of development and concentrated on what works.

Earlier in July the government decided to bend ever so slightly to the pressures of big business. It introduced subsidies in the form of lower interest rates for new investment, and improved financing for exports. It decided to continue a trend set earlier in the year, of gently pushing down the exchange rate in order to make Korean goods more price competitive.

The changes fly against the spirit of economic liberalization. They are a step backwards from eliminating government domination over the economy, as was June's decision to bail out the commercial banks with low-interest loans. Yet they are a sensible accommodation with Korea's economic reality, in which Korea's central bank, and eventually the Korean taxpayers, indirectly support a whole range of basically insolvent industries. Some bankers and economists say the steps should have come much earlier. In retrospect they may be right. Korea could have avoided some of its current economic difficulties if the <u>won</u> had been cheapened last year, and if businesses had invested more money. But to date, Korea's leaders have done far better ignoring their critics. They have carefully accommodated economic reality without jeopardizing their long range goals. (As one government economist told me when I asked him about business complaints over tight money, "Big business has been complaining about tight money for the past twenty years.")

The future holds clear risks. Economists do not have any real power in Korea. They serve at the pleasure of the President. In the coming months they may well be sacked to take responsibility for the economic slowdown (probably after the annual IMF-World Bank conference here in October). They often come up for ridicule because of their Western orientation. (They have the gall to argue publicly that import liberalization, free trade in both directions, is actually good for Korea.) But if the President decides to free himself of a political liabililty, he will likely draw replacements from the dozen plus other like-minded American Ph.D.s waiting in the wings for their chance at serving as senior advisor to the President or Minister of Finance.

In truth, no one has offered any coherent alternative to their policies, from big business or from the political opposition. In the unlikely event that the opposition ever comes to power in Korea, it would probably introduce a few new faces, but they would be men who served up the same sorts of pitches with only a slightly different spin on the ball.

The most serious threat to free market-capitalism in Korea comes from the sheer magnitude of economic obstacles--the high levels of business indebtedness and the strain it puts on the banking system. The concentration of resources and debt in big industry, such as steel, shipbuilding, high-tech electronics and automobiles, has left Korea with a range of export items that are especially sensitive to swings in the international economic cycle. The companies cannot respond to changes in the marketplace and retool their factories nearly as quickly as businesses in Taiwan, for example, where average firm size is much smaller. The government is trying to change that structure of industry by intervening in credit markets and directing funds to smaller firms. But it can do relatively little without upsetting plans for the growth of the money supply.

Korea needs most a sustained period of worldwide economic growth, and a continued willingness of the world to accept a rising volume of Korean exports. Current international protectionism puts that into jeopardy. A deep international recession, if it comes too soon, could cripple the Korean economy and make the pain of continued economic reform, and the political costs that go with it, unacceptable. Korean companies need repeated years of good profits in order to whittle down their huge debts.

Korea's economic reformers are now in a race for time. They have accepted the reality that the final fruits of their efforts will not come for ten or more years. They are willing to move slowly--forward here, backward there, forward again. But a recession on the magnitude of 1974 or 1981 could bring their efforts to a halt.

If I had to place my bets, it would be with economic reform in Korea. But still, with a choice, I would find a safer place for my money.

Best,

Steven B. Butler

Steven B. Butler

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