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"The Korean Model" and the Political Economy of Structural Adjustment

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Korea's remarkable success in economic development is one of the most widely acknowledged facts among development economists. She stepped very quickly up the ladder of economic development from a poor rural society to a Newly Industrializing Economy. In only 35 years, Korea's GNP increased more than sevenfold. But even Korea's development was not free from economic crisis. During the two oil crises of the 1970s accompanied by recession and interest rate increases in developed countries, most of the oil-importing developing countries experienced an adverse balance of payments, increased inflation, slowing down of economic growth, and debt crisis. Korea too did not escape from these widespread disasters. Particularly since the late 1970's, Korea has been largely affected by "external shocks" and has experienced the fueling of inflation, mounting current account deficit, and accumulation of foreign debt. In 1980, Korea experienced a minus 4.8 percent growth rate and in 1981 Korea became the fourth largest debtor country in the world followed by Brazil, Mexico, and Argentina.

However, the Korea's performance in structural adjustment to this economic crisis was also quite remarkable. In contrast with the heavily indebted countries of Latin America and stagnant economies in many countries of South Asia and Africa, Korea was able to restrain inflation and improve current account deficits in a very short period without significant sacrifice of growth. By 1986, Korea'-s balance of trade went in the black and her debt burden was substantially reduced. Korea was able to quickly overcome the economic crisis with a set of structural adjustment programs. Today, her successful structural adjustment experience has been recognized as the model case for growth-oriented structural adjustment programs which are known as the Baker Initiative.

This paper is to make a survey of the political economy of structural adjustment in the light of Korea's experience.

1. Korea's experience as the export-oriented industrialization model

Korea experienced notably rapid growth by promoting labour-intensive manufacturing for exports which was in line with her comparative advantage from 1960 to 1973. Exports grew 40 to 50 percent per annum and production increased more than 10 percent annually during this period. In addition, it has been said that Korea's growth had not suffered adverse income distribution effects.

These facts validate the export-oriented development stategy to be accepted by developing countries in general and ousted the old fashioned import-substituting development strategy which depended on an export pessimism. The export-oriented development strategy became the new orthodoxy in development economics in 1970s. Korea's policy reforms towards an export-oriented development strategy in mid-1960s

formed the basic prototype of the "Korean Model".

However, although most development economists recognized the superiority of the export-oriented strategy over the import-substituting strategy, it was also clear that, in Korea, the export-orientation was not the only factor which had contributed to the rapid growth without deteriorating income distribution. In other words, the question of exactly what factors made possible the policy shift to the successful export-oriented strategy was raised (Findlay,1988). Many studies have pointed out many factors which might have contributed to the Korean miracle. Among the main factors which most studies note are: first, the existence of ample cheap and highly qualified labour; second, the existence of a strong government which has firm resolve and commitment to pursue economic development supported by excellent bureaucratic leadership; third, a favourable international environment. Two favourable initial conditions are added to the list. These are the land reform, which is said to have contributed to relatively egalitarian asset distribution, and the massive US aid during the 1950s. Recently, many studies stress the critical role of the state and methods of state intervention in economic development (Datta-Chaudhuri,1981; Sen,1981; Bradford,1987).

The second big issue in the Korean Model is related to the contents and explanations of the export-oriented development strategy itself. Worldwide recession and rising trends of protectionism in the developed countries after the oil crisis casted doubts on the effectiveness of export-oriented development strategy and a new export pessimism appeared. The Nobel Lecture by Lewis (1980) was a pioneer work for this new export pessimism. In such a situation, Streeten (1982) asserted that the faults of import-substitution policies resulted not from the misallocation of resources between export-orientation and import-substitution or inefficiencies arising from such allocation, but rather from inefficient use of the resources allocated to the given objective of import substitution. The dichotomy between outward-looking and inward-looking strategies might focus attention on a less important set of decisions relating to the quality of management, scale, technology, product-mix, product design, types of education, recruitment and training, administration, and so on. So, Streeten said, the ultimate test of the respective merits of the outward-looking and inward-looking strategies was not their ability to allocate resources between sectors, but their power to mobilize domestic resources and skills and to create and activate incentives, attitudes and institutions for development. Streeten also argued, following the study of Cline (1982), that if all developing countries were to be as successful as Taiwan and South Korea in increasing exports, trade barriers would quickly be erected or terms of trade would deteriorate and the demand constraint would become operative. Cline called this "a fallacy of composition".

Against Cline and Streeten, Balassa (1983a) and Ranis (1985) defended the position of export-oriented strategy. Balassa rejoined that Streeten's characterization that the proponents of outward-oriented development strategies advocated discrimination in favour of exports and against import substitution were simply attacking a straw man. Balassa elaborated that outward-oriented strategy meant the equal treatment of sales in domestic and foreign markets and the distinction was based on whether sales in domestic and export markets received similar incentives, or whether import substitution was favoured over exportation. Balassa wrote, "South Korea and Taiwan, as well as Singapore have provided similar incentives to exports and to import substitu-

tion, on the average. What is more, if appropriate domestic policies are applied, export expansion and efficient import substitution will go hand in hand. Thus adopting an outward-oriented strategy would also involve reducing the bias of the incentive system against primary activities. Such a change in incentives would promote exports as well as import substitution in primary products". Against Cline and Streeten's "fallacy of composition" hypothesis , Ranis (1985) argued that Cline understood the East Asian Model as that of "exporting as much as possible", but that Cline's analysis was flawed. Rather, the East Asian Model was one of "moving in the direction of market liberalization as quickly as possible". So, Ranis continued, "different LDCs [would] arrive at a substantial manufactured goods export capacity at different points in time, producing goods with different attributes, even if they should start in this direction as of now". We may characterize this debate as one over the definition of the outward-oriented strategy, but the appropriateness of such definitions by Balassa and Ranis also must depend on the historical realities of the Korean export-oriented strategy since the mid-1960s. Whether the Korean strategy since the mid-1960s was that of "exporting as much as possible" or that of "moving in the direction of market liberalization" is another question.

Critisizng the dichotomy of export-orientation versus import-substitution, Sachs (1985) argued it was important to work within a framewark of at least three sectors, *i.e.*, importables, exportables, and non-tradables, to assess the allocation of resources. This is because in the two-sector model, all policies that protect the import-competing sector necessarily hurt the exporting sector. Here protectionism is nothing more than anti-export biased, since resources pulled into importables must come from exportables. On the other hand, in the three-sector framework, it is possible for protectionist policies to go hand in hand with export-promoting policies if resources are drawn from non-tradables into both the tradable sectors. According to Sachs, the export-promotion policies of Korea had this character. Bhagwati (1987) elaborated Balassa'-s definition of export-oriented strategy (EP). According to Bhagwati, EP is "a matter of setting price incentives in such a fashion as to ensure that the home market does not become more lucrative than the foreign market". In other words, EP is that the effective exchange rate for the country's exports (EER_x) is less than for its imports (EER_m). If $EER_x < EER_m$, this implies that sale in the home market produces more revenues than sale abroad, so that the price incentives are set such that there is a bias against exports. On the other hand, EP ensures $EER_x \simeq EER_m$, and is synonymous with neutrality of relative incentives for home and export sales. And if EER_x significantly exceeds EER_m, it is called as ultra-EP strategy. And Bhagwati attached five comments on these definitions. (1) The definitions relate to average incentives. The pursuit of either EP or ultra-EP strategy does not preclude import substituting in selected sectors. (2) One should not equate the EP strategy with the absence of government intervention. (3) The incentive-defined EP strategy has to be distinguished from the traditional concept of export-led growth. (4) The concept of EP relates to trade incentives but does not imply that the EP strategy countries must be equally outward-oriented in regard to their foreign investment policies. (5) The pattern of incentives is a result of not just of trade but also exchange rate policies.

Bhagwati's argument is in line with that of Sachs. He recognises the possibility of pursuing the import substituting strategy in some selected industries in EP countries, and also he recognises the importance of state intervention in successful EP countries.

2. Export-oriented development strategy and the external shocks

The third big issue on the Korean Model of export-oriented development strategy is whether or not the outward-looking economy is more vulnerable to external shocks than the inward-looking economy. Many critics, including the dependent school, have long asserted that once the world economic situation got worse the superiority of the export-oriented strategy should erode away. Oil crisis and subsequent world recession during 1970s and 1980s put this assertion and the validity of the Korean Model to a severe test. If the favorable international environments were lost, would the Korean Model still be viable?

Against this critical question, the World Bank led by Balassa responded most vigorously. A number of studies on the performance of structural adjustment in developing countries from the viewpoint of "the policy response to the external shocks" were published (Balassa, 1981, 1982, 1983b, 1984 ; Balassa & Williamson, 1987). In these studies, the following points are stressed again and again.

(1) There were considerable differences between the NICs and the rest as regards the policies followed in response to external shocks between 1973 and 1978. The NICs offset three-fourths of the adverse balance of payments effects of external shocks through domestic adjustment policies of export promotion, import substitution, and deflationary measures, with additional net external financing accounting for the remainder. The remaining groups had been dependent on external financing to meet the combined adverse balance of payments effects of external shocks, losses in export market shares, and increased import shares.

(2) Among the NICs, the three Far Eastern economies—Korea, Singapore, and Taiwan—adopted an outward-oriented development strategy in the early 1960s and continued with this strategy after 1973. Faced with the external shocks, these countries devalued their exchange rate to a considerable extent, eliminated quantitative import restrictions, lowered industrial tariffs, and abolished price control.

(3) Among the LDCs and, in particular, among the NICs, outward-oriented economies suffered substantially smaller terms-of-trade losses in relation to the average value of their exports and imports than inward-oriented economies. Furthermore, outward-oriented economies experienced a smaller export shortfall than inward-oriented economies did.

(4) Within the NICs, however, the ratio of the export shortfall to GNP was higher in outward-oriented economies than inward-oriented economies, because the share of exports in GNP was substantially larger in the former than in the latter.

(5) Outward-oriented economies relied to a much greater extent on domestic adjustment than inward-oriented economies. The difference is particularly marked among the NICs. Outward-oriented economies not only gained export market shares but also did better in import substitution than inward-oriented economies. Outward-oriented developing economies had a more favorable growth performance after 1973, even though they experienced substantially larger external shocks than outward-oriented developing countries.

(6) Outward-oriented economies were willing to accept lower rates of economic growth in the wake of the quadrupling of oil prices and the world recession in order

to stabilize their economies and to avoid large foreign indebtedness. In turn, inward-oriented economies, foreign borrowing were in part used to increase consumption and the efficiency of investment deteriorated under the policies followed.

Balassa stressed that from the viewpoint of the policy responses to the external shocks, outward-looking economies suffered much more than inward-looking economies, but the former could respond far better than the latter. This viewpoint clarified the relationships between long-term development strategy alternatives and the short- as well as medium-term structural adjustment measures.

But if we look at his argument carefully, the Korean adjustment measures after the first oil crisis do not fit in his analytical framework, albeit Balassa characterizes Korea as a representative case for export-oriented NIEs. His assertion that "by and large, outward-oriented economies were willing to accept lower rates of economic growth in the wake of the quadrupling of oil prices and the world recession in order to stabilize their economies and to avoid large foreign indebtedness" could not apply to the Korean case. At one place, he said that "on the whole, inward-oriented economies biased the system of incentives against labor-intensive activities; such a bias did not exist, or it was less pronounced, under outward-orientation", but in another place he stated that Korea during the late 1970s was "an exception" because of the real appreciation of the Won exchange rate. Although he contrasted inward-oriented economies with outward-oriented economies by saying that the former used such measures as credit rationing and tax preferences to promote import-substituting industries, and that this was not the case for the latter. He confesses in footnote in the same paper that "Korea provides an exception toward the end of the period "(Balassa, 1983b). If the Korean structural adjustment is an exception to NIEs and at the same time the Korean development strategy is a representative case of NIEs, we are faced with nothing less than a logical contradiction.

3. The Experience of Korea's structural adjustment and the Baker Initiative

The oil crisis in 1973 and subsequent world recession severely damaged the oil-importing developing countries and brought to them a slowing down of economic growth and external debt crisis. Korea was no exception.

Korea's crisis management during this time has nothing in common with the orthodox monetarist stabilization policy advocated by the IMF which consisted of restrictive demand management and devaluation. Not only that. It was also substantially different from the typical structural adjustment program of the Asian NIEs according to Balassa's framework. Rather it was an aggressive adjustment similar to that of Latin American countries. In this sense Korea's adjustment was very unique and was "an exception" to the export-oriented Asian NIEs. According to Balassa, the contents of Korea's adjustments methods are as follows.

First, Korean government shifted her development strategy from labour-intensive light manufacturing industrialization for exports to the big-push for heavy and chemical industrialization. This policy shift has occured because the policy-makers have recognized that the Korean comparative advantages in light manufacturing exports have been lost. Second, as a result of the above policy shift, government intervention has increased. Third, the exchange rate of the Won against the US *dollar*

was fixed during the period between 1975 and 1979. So the real exchange rate in terms of purchasing power appreciated 14 percent in this period. As a result of this, inflation accelerated, and exports slowed down, ICOR increased, and the income distribution deteriorated. Fourth, import restrictions and credit allocations increased.

Balassa explained these phenomena as "policy reversals" in Korea's development history (Balassa, 1985). For him, the policy shift to heavy and chemical industrialization was nothing more than a bad policy choice, which would abandon the comparative advantages Korea inherently had, *i.e.*, a deviation from the "Korean Model". He pointed that the capital productivity in manufacturing industry has declined because of the real appreciation of the Won and excessive investment allocation to the heavy and chemical industries, and there appeared excess capacity in those sectors in the face of the small domestic markets, while the expansion and upgrading of labour-intensive exports have been hampered.

Haggard & Moon (1983) suggested three factors which would constrain the outward-looking growth of a "small trading nation" such as Korea: first, "dyadic dependence" on the economic performance of the US and Japan; second, "sensitivity", meaning domestic economic performance determined by the performance of and trends in the international economy; third, "reliance", which refers to the need for external inputs — capital, technology, raw materials, and energy — to pursue a given development strategy. They also payed attention to a number of serious problems produced by heavy and chemical industrialization strategy, and said that these problems demonstrated "the difficulties of an aggressive adjustment strategy for a small trade-oriented economy" and they indicated the "inherent limitations" of such a policy. The reasons they pointed out are: first, most of the technology demanded was to be imported, and high royalty payments raised productivity costs without improving the technological capabilities of the participating firms; second, the reliance on debt, both domestic and foreign, had resulted in a weakening of the financial structure of many firms.

Contrasting with these viewpoints, Dornbush & Park (1987) presented another evaluation on the policy shift to the heavy and chemical industrialization in Korea. They wrote that "Korea now serves as a model for the export-oriented strategy of development that multilateral institutions are urging on countries of Africa and Latin America", and for that reason they stressed that Koreans "have adjusted successfully to both the oil shocks of the 1970s and the debt shock of the early 1980s". They also stated that Korea was "the only major debtor that has overcome the debt problem and has done so with a vengeance" in the latter half of the 1980s. They casted doubts on the idea that "widespread agreement that the heavy and chemical industry investment campaign of the 1970s involved a misallocation of resources". They said that "there is no hard evidence that Korea's investments were in fact poor", and followed that "today it is apparent that many of these industries have gained in export share. The automobile industry is a case in point". They praised highly the heavy and chemical industrialization policy saying that "improved technology has come with high investment level". Collins & Park (1989) too pointed out that the investments in heavy and chemical industries were beginning to pay off today.

Balassa's arguments are too static and too much adhered to the prototype of the Korean Model. Because he stressed the importance of selecting trade regimes too much, he ironically enough seemed to miss the dynamic advantages which the trade

would produce.

In 1980, Korea was in the midst of the worst political and economic crisis since its independence. Added to the external shocks, there appeared a series of unfavourable events; the appearance of distortions of excessive capacity in heavy and chemical industries, the political instability following the assassination of President Park in October 1979, poor agricultural performance in 1980, and the decision by the Carter administration to cut US troops in Korea. The external debt accumulated beginning in 1979, and the external debt stocks rose up to 52. 3 percent of GNP in 1982.

Nevertheless, as early as 1983~84, Korea was able to recover from the crisis followed by the revival of world demand and the improvements in terms of trade. In 1986, Korea not only experienced a resumption of inflation but also accumulated a trade surplus. She met her debt service, and her debt stock was reduced to US $ 2.2 billion. This unique experience attracted the attention of development economists on the policy response of Korean government.

Faced with a crisis, Korean government introduced a comprehensive stabilization policy in 1979 and 1983.

Aghevli & Marquez-Ruarte (1987) of the IMF observed with satisfaction that "Korea's experience following the second wave of oil price increases is an excellent example of how orthodox stabilization policies, effectively implemented, can help a country adjust to domestic and external shocks". According to them, the aim of the Korea's orthodox stabilization policy is "to revive economic growth, while reducing domestic inflation and the current account imbalance", and that policy consisted of strict financial discipline, which sharply reduced the public sector deficit, tight monetary policy, substantial devaluation of the Won and the adoption of flexible exchange rate, a comprehensive energy policy which aimed to reduce the dependence on the imported oil, the liberalization both of the trade and financial systems, and so on. This set of policy reforms was supported by a series of IMF stand-by credits as well as by SAL from the World Bank. Aghevli & Marquez-Ruarte evaluated these programs as representing "a significant departure from Korea's traditional development strategy, which had aimed at maximizing growth through substantial recource to inflationary finance and external borrowing".

Comparing the first structural adjustment period from 1973 to 1977 to that of the period from 1979 to 1983, Park (1985) made nearly the same evaluation as that of Aghevli & Marquez-Ruarte. He said that in the first adjustment period, Korea adopted an "expansionary policy response" or "growth-first policy", which was to promote exports by depreciation of the Won and export subsidies as well as by accepting heavy dependence on foreign borrowing. As a result, while growth and employment were guaranteed, economic stabilization were lost and inflationary trends became institutionalized. Contrasting with these policy responses, he said, in the second adjustment period, Korean government adopted tight demand management policy, devaluation of the Won, an upward adjustment of bank interests, and increases in energy prices to improve the current account.

For the economists of the IMF and the World Bank, the policy response to the crisis after 1979 in Korea is one of the best examples to prove the correctness of the new-orthodox structural adjustment programs in line with the Baker Initiative. The process was to work as follows. First would come a stabilization program such as demand management and devaluation of the exchange rate to combat the inflation ,

and with it or following it, would come a period of structural adjustment such as the liberalization of the supply side, "to combine short-term stabilization and long-term structural changes to improve the economy's efficiency" (World Bank, 1988, p. 17) . For them, Korea's first adjustment experience during 1973 to 1978 should be considered an exception to the typical outward-oriented NIEs because it produced misallocations of resources, and that it was Korea's second adjustment experience, which was based on the stabilization program, that should be the model to be studied by other debt ridden developing countries.

4. Political economy of structural adjustment

Today it has been widely accepted that the nature of the structural adjustments is in essence political-economy. In this situation Streeten (1987) advocated that the Radical/Reformist Adjustment Loans (RAL) which supported the political leaders of reformist beliefs was more important than the Structural Adjutment Loans(SAL). His assertion is that it is necessary to go "beyond adjustment" to make any adjustment.

Park (1987) questioned if the IMF & World Bank type of liberalization policy would facilitate adjustment with reasonable growth, "why haven't many countries embarked on economic liberalization ?" The reasons he suggested were : first, that international environment was not suitable ; and second, economic liberalization could cause considerable macroeconomic instability. He also stated that although "the Korean experience has been heralded in many places as the prime example of a successful case of adjustment through liberalization, it is not clear whether liberalization is the result of good economic performance or vice versa". He stressed the gap between economic theory and actual policy making. An actual policy maker himself, he suggested on the issue of the sequencing of liberalization that "the best policy is to choose the [target] that is most convenient and practical to liberalize first". Also he stressed that the World Bank's operation should not have forced the policy-makers of receiving countries to accept the World Bank policies as a package, but should encourage governments to develop programs themselves. He criticized the excessive belief in economic theory which the economists of the IMF and the Word Bank tended to embrace.

Nam (1987) noted that not only demand management policy but also income policy were used in the stabilization efforts in 1980s in Korea. That is, the Korean government adopted low-wage policy to maintain the international competitiveness of her manufactured exports.

Haggard & Moon (1983) focused attention on the political prerequisites of export-led growth, and questioned what the domestic political basis which made possible the policy shift to export-led growth in Korea were. According to them, the domestic political prerequisites ignored by liberal economists were: first, the strong government which was able to impose stabilization and to resist pressures from domestic business and other groups favored by closure; second, the ability of the government to have channelled adequate resources which it possessed selectively to ease the reorientation of the economy in an outward direction; third, the existence of a reformist leadership which saw economic reform in its long-term political interest. They concluded that these political prerequisites could not be easily transferable to other

cases.

Collins (1990) divided the Korea's adjustment experiences into two periods: 1980~82 and 1983~84. And she found that Korea has had the breathing period of large continued capital inflows before undertaking restrictive monetary and fiscal policy. She stressed Korea did not do everything at once but did a phased policy response.

Sachs (1985) proposed the political economy of exchange rate management. He compared macroeconomic management and economic performance in developing countries of Latin America and East Asia. In doing so, he compared economic policy in both regions, and found that, in contrast with Latin America, where both importables and non-tradables have benefited at the expense of exportables, in East Asia, both exportables and importables have benefited at the expense of non-tradables. Again he compared exchange rate management in both regions from the viewpoint of resource distribution and income distribution. And he asserted that it was the rural political power that made possible the devaluation of exchange rate in East Asia, while in Latin America, it was the urban industries and urban workers who got benefits from the overvalued exchange rates and impeded the devaluation of exchange rate. So, according to Sachs, "the difference in labour market organization certainly plays an important role in the political calculus". His argument suggests the importance of the analysis of class structure which might limit the choice of economic policy of the developing countries.

5. Conclusion

It was the decisive role of active state and class structure which made export-oriented strategy feasible in Korea. The Korean government has always been able to devaluate the real exchange rate of the Won and to restrain the real wages to maintain international competitiveness of her products. Korea's miraculous economic development and her successful structural adjustmnt was possible only in a politico-economic system by which the state suppressed the labor movements and the human rights of the laborers to create and maintain free labour markets. These are the characteristics of a Leviathan today, a new merchantilist state.

If these are the lessons which can be drawn from Korea's experience of structural adjustment, the future of the common people in the developing world looks dim indeed. An authoritarian regime might be good for economic development, but this pattern of economic development belongs to the old world. The driving force to "A New Global Order" cannot emerge from the soil of old measures.

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