

THE KOREAN ECONOMY

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CONTENTS

Part I	Introduction	4
Part II	Economic Performance from the 1960s through the 1980s	5
Part III	Economic Performance during the 1990s	11
Part IV	Recent Economic Developments	16

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Part I Introduction

Korea was a typical underdeveloped, largely agrarian country up until the turn of the 1960s. However, thanks to the success of export-oriented industrialization within a short period of three and a half decades, it was transformed into a modern industrialized country. Helped by the rapid growth, which averaged over 8 percent per annum for more than thirty years, its GDP volume soared from only 2.1 billion U.S. dollars in 1961 to 557.4 billion U.S. dollars by 1996, while its per capita GNI also leapt from 82 U.S. dollars to 12,197 U.S. dollars over the same period.

Based on this remarkable development, Korea emerged on the world stage as one of the front runners among the newly industrializing economies so that it was able to become a member of the OECD in 1996. This outstanding economic achievement was truly remarkable considering the poor endowment of natural resources and the limited domestic market. For these reasons, the economic development strategy of Korea was widely held up as a suitable model for other countries on the road to development.

However, structural weaknesses accumulated in the process of concentrated growth. These underlying fractures were abruptly revealed toward the end of 1997 with the transformation of the internal and external economic environment. Consequently, the Korean economy experienced a currency crisis and faced severe difficulties. In order to overcome the crisis, Korea pressed ahead with the thoroughgoing structural reform of the entire economy. At present, Korea is focusing on maintaining stable growth trends while establishing a solid economic recovery.

This script first looks back upon the development strategies and performance of the Korean economy since the 1960s. It then goes on to describe Korean currency crisis, the policy initiatives taken to overcome it, and recent economic trends.

Part II Economic Performance from the 1960s through the 1980s

Launch of Economic Development Plans & Industrialization in the 1960s

In the early 1960s, the Korean economy remained locked into what was literally "a vicious circle of poverty". In order to escape from this absolute poverty, the government launched an ambitious Five-Year Economic Development Plan in 1962.

In the early stage of economic development, the government fostered import-substitution industries which produced such basic intermediate materials as cement and fertilizers. After that, it promoted labor-intensive export industries such as textiles and plywood, which had international competitiveness because of cheap labor costs, and were capable of absorbing the unemployed and underemployed human resources.

In order to support export industries, extensive export promotion measures were taken. Low-interest rate policy loans were granted to help export firms facing financial difficulties. Various forms of preferential tax treatment, such as tax exemptions and tariff rebates, were given to export industries.

The government also focused on the efficient mobilization and allocation of investment resources. Several specialized banks were established to finance such underdeveloped strategic sectors as small and medium-sized enterprises (SMEs) and housing construction. Together with this, to encourage foreign capital inflow, the Foreign Capital Inducement Act was passed in 1966 and foreign banks were allowed to open branches from 1967.

Throughout the 1960s, the Korean economy, in a rapid process of industrialization under the firm guiding hand of the government, exhibited impressive performance.

Exports, the engine of growth, expanded by over 40 percent annually. With this backing, Korea was able to register high average growth rates of above 8.5 percent a year. Per capita GNI increased dramatically from 87 U.S. dollars in 1962, when the first economic development plan commenced, to 210 U.S. dollars in 1969.

In the course of growth-oriented industrialization, a large amount of foreign capital had to be induced since domestic savings were insufficient to finance the enormous investment demand. Together with this, the money supply was rapidly increased to finance various government projects. As a result, there was chronic inflation throughout the decade. The annual average inflation rate in terms of consumer prices was above 12 percent during the period from 1962 to 1969.

On the whole, however, the Korean economy had successfully laid the foundations for industrialization in the 1960s and was well prepared for a second take-off.

KEY ECONOMIC INDICATORS IN THE 1960s

	1962	1969	ANNUAL CHANGE 1962~69(%)
PER CAPITA GNI(US\$)	87	210	13.4
REAL GDP GROWTH RATE(%)	2.1	13.8	8.7
CURRENT ACCOUNT BALANCE (MILLION US\$)	-55.5	-548.6	-
TRADE BALANCE	-335.3	-991.7	-
EXPORTS	54.8	658.3	41.5
IMPORTS	390.1	1,650.0	24.7
GROSS DOMESTIC INVESTMENT RATIO(%)	11.8	27.9	-
GROSS SAVING RATIO(%)	11.0	21.4	-
CONSUMER PRICE INFLATION(%)	6.6	12.4	15.4

Promotion of Heavy and Chemical Industries & Emergence as a Newly Industrializing Economy in the 1970s

In the early 1970s, Korea experienced dramatic changes and challenges both at home and abroad. Internationally, a new climate of protectionism spread rapidly, along with the world-wide stagflation caused by the first oil crisis. Labor-intensive light industries, whose competitiveness was gradually weakening as a result of rapid wage increases, faced fierce competition from other developing countries.

These circumstances forced the Korean economy to modify its strategic objectives. The government induced industrial restructuring by promoting heavy and chemical industries such as shipbuilding, iron and steel, automobiles, machinery and petrochemicals. Investments in these newly favored sectors were encouraged by tax and financial incentives. As a result, the share of heavy and chemical products in exports expanded from 13 percent in 1970 to 39 percent in 1979.

In parallel with industrial restructuring, Korea expanded construction and manufacturing exports to the oil producing countries of the Middle-East, whose import demand had increased due to abundant oil revenues. The construction boom in the Middle-East contributed to an improvement in the domestic employment situation and served as an important source of foreign exchange.

By virtue of the successful transformation of heavy and chemical industries into new export sectors, Korea was able to retain a strong pace of growth throughout the 1970s. Exports increased rapidly at the rate of approximately 40 percent per annum. The amount of exports, which was well below 1 billion U.S. dollars in 1970, crossed the 10 billion U.S. dollar mark in 1977, and reached 15 billion U.S. dollars in

1979. The Korean economy grew at a high average rate of above 8 percent a year, and per capita GNI rose from 254 U.S. dollars in 1970 to 1,676 U.S. dollars in 1979. This remarkable progress allowed Korea to emerge as one of the Asian newly industrializing economies (NIEs), along with Taiwan, Singapore and Hong Kong.

However, in carrying out ambitious economic development plans with a conspicuously insufficient rate of domestic savings, the economy was handicapped by a serious lack of funds. This investment-savings gap was typically bridged by inducing inflows of foreign capital or by expanding the money supply, despite recognition of the importance of prudent monetary management in avoiding inflationary pressures in the process of economic development. In consequence, foreign debt kept piling up and chronic inflation lingered on.

These side-effects caused a shift in the government's policy stance to a stability-oriented growth strategy.

KEY ECONOMIC INDICATORS IN THE 1970s

	1970	1979	ANNUAL CHANGE 1970~79(%)
PER CAPITA GNI(US\$)	254	1,676	23.3
REAL GDP GROWTH RATE(%)	8.8	6.8	8.3
CURRENT ACCOUNT BALANCE (MILLION US\$)	-622.5	-4,151.1	-
TRADE BALANCE	-922.0	-4,395.5	-
EXPORTS	882.2	14,704.5	36.4
IMPORTS	1,804.2	19,100.0	27.7
GROSS DOMESTIC INVESTMENT RATIO(%)	24.8	36.0	-
GROSS SAVING RATIO(%)	17.8	30.2	-
CONSUMER PRICE INFLATION(%)	16.0	18.3	14.9

Strengthening of Economic Stabilization Efforts and Shift to Current Account Surplus in the 1980s

At the outset of the 1980s, the side effects of growth-oriented economic management became conspicuous. The second oil crisis and domestic political turmoil also took a heavy toll. By 1980, consequently, the nation faced many difficulties throughout the entire economy. These included its first ever negative growth since planned development was launched, and a huge current account deficit.

To cope with these difficulties, the government undertook a series of structural adjustment measures to enhance economic efficiency. Firstly, it shifted the priority in economic policy from growth to stability, and actively encouraged the adjustment of duplicated investment and liquidation of troubled enterprises. Together with these policies, the opening-up of the economy and deregulation were pursued on a stage-by-stage basis, as part of the move to private-initiative in economic management.

Efforts for both deregulation and opening-up at that time, unfortunately, did not make great progress owing to the immaturity of the political and economic environment. However, tight monetary and fiscal policies contributed greatly to the construction of a stable foundation for the Korean economy, as did the renewed stability of international oil prices. Consumer price inflation, which had risen at a rate of 29 percent in 1980, dropped to single digit from 1982, and the current account deficit narrowed significantly. At the same time, GDP growth, which had registered negative figures in 1980, turned positive again.

Especially from 1986 onward, GDP growth accelerated swiftly and the current account, which had shown a chronic deficit, moved substantially into surplus. This was owing to the so-called "three

lows"; namely, low oil prices, low international interest rates and the low value of the U.S. dollar in terms of the Japanese yen, as well as the greater degree of price stability attained in the first half of the 1980s.

However, the continued high economic growth led to renewed price instability. In consequence, consumer prices, which had shown only a 2~3 percent increase in the middle of the 1980s, rose by 7.1 percent in 1988. Together with this rekindling of consumer price inflation, wages rose sharply with the emergence of a strong labor movement amid the democratic reform of Korean politics and society.

KEY ECONOMIC INDICATORS IN THE 1980s

	1980	1986	1989	ANNUAL CHANGE 1980~89(%)
PER CAPITA GNI(US\$)	1,645	2,643	5,418	14.2
REAL GDP GROWTH RATE(%)	-1.5	10.6	6.7	8.7
CURRENT ACCOUNT BALANCE (BIL.US\$)	-5.3	4.7	5.3	-
GOODS ACCOUNT	-4.6	4.3	4.3	-
EXPORTS	17.2	34.1	61.8	15.2
IMPORTS	21.9	29.8	57.5	11.3
SERVICES ACCOUNT	-0.7	1.4	0.4	-
GROSS DOMESTIC INVESTMENT RATIO(%)	31.9	29.4	33.8	-
GROSS SAVING RATIO(%)	24.7	34.9	37.6	-
CONSUMER PRICE INFLATION(%)	28.7	2.8	5.7	6.0

Part III Economic Performance during the 1990s

Weakening of Economic Constitution

As the Korean economy moved into the 1990s, the structural fault-lines of its "high-cost, low-efficiency" industrial structure deepened amid a sharp increase in competitive pressures. High costs had become endemic with high wages, high land prices and high interest rates, due to repeated waves of price instability and the rigid adherence to firms' management strategies of external expansion. The financial and real sectors became markedly less efficient, because market principles could not operate properly in a socio-economic environment characterized by over-regulation and government meddling in the financial and corporate sectors. Efforts to improve productivity, such as technological development, were likewise inadequate. Moreover, Korean companies faced intense competition with foreign companies in both domestic and international markets, owing to the rapid catch-up growth of late-starter developing countries, the launch of the WTO, and the acceleration of market opening to meet OECD entry criteria.

Coping effectively with these tough new domestic and overseas economic environments required a strong drive for economic stability and structural reform. Policies along these lines were pursued only half-heartedly, however, and the previous growth-oriented strategies tended to persist.

As a result, economic growth raced ahead, while the current account shifted deeply into the red and price instability continued. GDP growth topped 7.7 percent per annum on average during the period from 1990 to 1996. The current account, though, which had continued in surplus since the mid-eighties, slid into deficit from 1990 onward. Most markedly, in 1996 the current account deficit widened

sharply to 23.1 billion U.S. dollars, which amounted to 4.1 percent of GDP. Total foreign debt also rose sharply from 29.4 billion U.S. dollars as of the end of 1989 to 104.7 billion U.S. dollars at the end of 1996. Consumer prices rose at a rate of 6.0 percent per annum during the period from 1990 to 1996, much faster than that of Korea's major competitors.

KEY ECONOMIC INDICATORS(1990~96)

	1990	1993	1996	ANNUAL CHANGE 1990~96(%)
PER CAPITA GNI(US\$)	6,147	8,177	12,197	12.1
REAL GDP GROWTH RATE(%)	9.2	6.1	7.0	7.7
CURRENT ACCOUNT BALANCE (BIL.US\$)	-2.0	0.8	-23.1	-
GOODS ACCOUNT	-2.5	2.2	-15.1	-
EXPORTS	63.7	82.1	130.0	12.6
IMPORTS	66.1	79.9	145.1	14.0
SERVICES ACCOUNT	-0.6	-2.1	-6.2	-
GROSS DOMESTIC INVESTMENT RATIO(%)	37.4	35.7	39.0	-
GROSS SAVING RATIO(%)	37.5	36.7	35.5	-
CONSUMER PRICE INFLATION(%)	8.6	4.8	4.9	6.0

NOTE : 1) Break in continuity of time series.

Outbreak of Currency Crisis

From early 1997, foreign currency liquidity conditions continued to worsen. By November that year, Korea was on the verge of defaulting on its debts. Consequently, the government had to turn to the IMF to request stand-by funds. If just one point has to be cited as the primary cause of the currency crisis, it would be the country's loss of credibility in the eyes of international investors.

From the beginning of 1997, non-performing loans of financial institutions had rapidly accumulated due to a string of large corporate insolvencies. The Southeast Asian currency crisis that

started in July further unsettled foreign investors who had been apprehensively eyeing the weakening of both companies and financial institutions in Korea. Reflecting this, the leading international credit rating agencies such as S&P and Moody's downgraded Korea's sovereign rating very sharply in October. Accordingly, foreign investors repatriated their capital from Korea and the country's usable foreign exchange reserves became severely depleted.

The large mismatch between demand and supply in the domestic foreign exchange market was also attributable to the heavy external debt taken on to finance the current account deficit, and to the excessive reliance on short-term external borrowings. Besides these factors, the building of expectations of a massive depreciation of the Korean won, due mainly to the persistently wide current account deficit, played a substantial part in the worsening of the foreign exchange situation.

TRENDS OF EXTERNAL DEBT AND ASSETS¹⁾

	1995	1996	1997			
			MAY	JUN	SEP	DEC
GROSS EXTERNAL DEBT(A)	119.4	156.9	165.2	174.0	177.0	173.9
LONG-TERM	64.9	81.5	85.9	90.8	97.0	110.5
SHORT-TERM	54.9	75.9	79.8	83.7	80.5	63.8
GROSS EXTERNAL ASSETS(B)	93.9	110.6	106.3	115.1	112.0	105.7
NET EXTERNAL DEBT(A-B)	25.5	46.3	58.9	58.9	65.0	68.2
FOREIGN EXCHANGE RESERVES	32.7	33.2	29.1	33.3	30.4	20.4
USABLE FOREIGN EXCHANGE RESERVES	..	29.4	21.1	25.3	22.4	8.9

NOTE : 1) End of period.

Overcoming the Currency Crisis

In signing up for the financial aid package on December 3rd of 1997, the Korean government agreed with the IMF that it would pursue macroeconomic stabilization and structural reform in the financial sector, the corporate sector, and the labor market, and accelerate trade and capital account liberalization.

On the basis of these agreements, Korea pressed ahead with thoroughgoing reform, while pursuing macroeconomic stabilization. To restore confidence in the overall financial system, prompt and effective action was taken to close down unsound financial institutions whose severe shortages of liquidity were disrupting the stability of the financial markets. And public funds were injected into financial institutions considered viable, on the condition that they make intensive efforts themselves for turnaround by cutting staff and branches, mergers, recapitalization and so on. In a further move, prudential supervision over financial institutions has been constantly strengthened. In the corporate sector, the government has pursued structural reform based on five principles: the enhancement of transparency in corporate management; dramatic improvement in capital structure; the abolition of cross payment guarantees; the selection of core sectors and the strengthening of cooperative link-ups between large enterprises and SMEs; and heightening the accountability of majority shareholders and management. To remove rigidities in the labor market, legislative provision was made for layoffs and the leasing out of manpower. Meanwhile, there has been an active drive to enhance the efficiency of the public sector by downsizing the organizations and staff of central and local government and privatizing public enterprises. Besides this, the government accelerated the liberalization of foreign exchange and capital account transactions and also abolished the remaining restrictions on foreign investment.

Bolstered by these restructuring efforts, the Korean economy pulled itself out of the crisis from 1999 and began to regain vitality and stability.

Having suffered a severe recession during 1998, the economy saw real GDP growth register 9.5 percent in 1999 and 8.5 percent in 2000 thanks to the briskness of domestic and overseas demand. The current account posted a large-scale surplus of 40.4 billion U.S. dollars during 1998. With the economic recovery and the subsequent increase in imports, the scale of the surplus narrowed to stand at 24.5 billion U.S. dollars in 1999 and 12.3 billion U.S. dollars in 2000. The unemployment rate remained high in 1999, registering 8.8 percent in February that year. Spurred on by the revived briskness of production activities, however, it declined to the 3~4 percent level during 2000. Consumer prices showed a rapid pace of increase during January~February 1998, due to the increased cost of imports following the steep depreciation of the Korean won. They then gradually moved to a more stable pattern of movements.

KEY ECONOMIC INDICATORS(1997~2000)

	1997	1998	1999	2000
PER CAPITA GNI(US\$)	11,176	7,355	9,438	10,841
REAL GDP GROWTH RATE(%)	4.7	-6.9	9.5	8.5
CURRENT ACCOUNT BALANCE (BIL. US\$)	-8.3	40.4	24.5	12.3
GOODS ACCOUNT	-3.3	41.7	28.5	17.0
EXPORTS	138.7	132.3	145.4	176.2
IMPORTS	142.0	90.6	116.9	159.3
SERVICES ACCOUNT	-3.2	1.0	-0.7	-2.8
GROSS DOMESTIC INVESTMENT RATIO(%)	36.1	25.2	29.3	31.1
GROSS SAVING RATIO(%)	35.5	37.5	35.3	33.7
CONSUMER PRICE INFLATION(%)	4.4	7.5	0.8	2.3
UNEMPLOYMENT RATE ¹⁾ (%)	2.6	7.0	6.3	4.1

NOTE : 1) Unemployment rate surveyed by 1 week job search duration criterion

Part IV Recent Economic Developments

Economic Developments during 2001~2004

After having overcome the currency crisis and pulled out of the post-crisis recession, the Korean economy experienced a slowing of growth in 2001 due to sluggish facilities investment and reduced export growth. During 2002, as domestic demand turned brisk and exports recovered rapidly, the annual growth rate rebounded. However, it decelerated significantly again in 2003 as private consumption and facilities investment were both sluggish. During 2004, the GDP growth rate rose from the previous year's 3.1 percent to 4.7 percent. Viewed by sector, exports regained a strong momentum, but the components of domestic demand were subdued. Private consumption showed a shrinking trend while the upward trend of construction investment was blunted and facilities investment staged only a feeble recovery. GNI per capita registered well above 10,000 U.S. dollars (10,841 U.S. dollars) during 2000 for the first time since the 1997 currency crisis, but it fell back to 10,160 U.S. dollars in 2001, rising again to 11,499 U.S. dollars during 2002 and continuing to rise to mark 14,193 U.S. dollars in 2004.

The current account remained in surplus although the scale of the surplus shrank. In 2002, it narrowed to 5.4 billion U.S. dollars due to the sharply widened service account deficit. However, the current account surplus widened to 11.9 billion U.S. dollars during 2003. In 2004, helped by the expansion of the goods account surplus, the current account surplus widened to 28.2 billion U.S. dollars.

The unemployment rate remained on an underlying downward trend during 2001~2002 as the number of persons employed in the service and construction sectors increased. The annual average unemployment rate declined from the previous year's 4.4 percent to

4.0 percent in 2001, and to 3.3 percent in 2002. However, during 2003, the unemployment rate rose to 3.6 percent, reflecting the worsened economic situation. In 2004, there was little improvement in labour conditions because of the lackluster state of domestic demand and diffusion of labor saving production method.

Consumer prices(CPI basis) showed a relatively rapid rising trend during 2001 to stand at 4.1 percent (on an annual average basis). In 2002, however, their upward pace slowed and consumer price inflation registered 2.7 percent (on an annual average basis), despite the rising trend of wages and rises in housing prices. The improved price stability was largely attributable to the appreciation of the Korean won and reductions in charges for some public services. In 2003, the rate of increase in the CPI accelerated to 3.6 percent due to a hike in the international oil price, a rise in public utility charges, and the persistently high rate of increase in wages. During 2004, consumer price inflation was 3.6 percent, the same level as the preceding year. This was attributable to the impact of supply shocks, such as the run-up of international oil prices and the rise in agricultural, livestock & marine products prices, which more than offset the sluggishness of domestic consumption.

Economic Developments in 2005 and 1st half of 2006

Over the course of 2005, the Korean economy grew by 4.0 percent as the export growth rate slowed down owing to a base-period effect, even though private consumption and facilities investment showed a mild recovery. From the second half, however, the Korean economy recovered at a rapid pace due to balanced growth of private consumption, facilities investment and exports.

There was some improvement in labor market conditions, but this was less than adequate because of the reduced rate of GDP growth.

Despite a surge in international oil prices, the pace of increase in consumer prices slowed to an annual level average of 2.7 percent, affected by the stable prices of agricultural, livestock and marine products and the appreciation of the Korean won against the U.S. dollar.

Viewing the movements of the Korean economy during the first half of 2006, the current account shifted into deficit, but the GDP growth rate accelerated and the employment situation continued to improve while prices showed stable trends.

The GDP grew by 5.7 percent year-on-year, due to sharp rise in exports and facilities investment in addition to the robust growth of private consumption.

The general picture in regard to employment showed an improving trend with the unemployment rate standing at 3.6 percent, a slight fall from the previous year's 3.7 percent. The current account was 0.4 billion U.S. dollars in the red as the surplus on the goods account narrowed and the deficit on the services account widened.

The rate of increase in the CPI registered a lower level than in the same period of the previous year, owing to a fall in prices of agricultural, livestock & marine products and the slow-down of the increase in the prices of industrial products.

KEY ECONOMIC INDICATORS(SINCE 2001)

	2001 year	2002 year	2003 year	2004 year	2005 1st half	2005 year	2006 1st half
PER CAPITA GNI(US\$)	10,160	11,499	12,720	14,193	-	16,291	-
REAL GDP GROWTH RATE(%)	3.8	7.0	3.1	4.7	2.9	4.0	5.7
CURRENT ACCOUNT(BIL. US\$)	8.0	5.4	11.9	28.2	8.5	16.6	-0.4
GOODS ACCOUNT	13.5	14.8	22.0	37.6	17.8	33.5	12.6
EXPORTS(FOB)	151.5	163.4	197.3	257.7	138.7	289.0	157.9
IMPORTS(FOB)	138.0	148.6	175.3	220.1	120.9	255.5	145.3
SERVICES ACCOUNT	-3.9	-8.2	-7.4	-8.0	-6.2	-13.1	-8.9
CONSUMER PRICE INFLATION(%)	4.1	2.7	3.6	3.6	3.1	2.7	2.4
UNEMPLOYMENT RATE ¹⁾ (%)	4.0	3.3	3.6	3.7	3.9	3.7	3.6

NOTE : 1) Unemployment rate surveyed by 4 week job search duration criterion

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