
What Happens to Economic Growth when Neo-classical Policy Replaces Keynesian? The Case of South Korea

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Introduction

Superficially, Korea has vindicated both Keynesian and monetarist predictions since the early 1960s. The economy has grown by leaps and bounds as the money supply was allowed to expand beyond growth and inflation rates combined. Similarly inflation has been persistent—generally ranging between 10 and 20 per cent per annum [Michell 1979: 150-64].

In January 1979, a new deputy prime minister, Shin Hyon-hwak, became head of economic planning in South Korea, and a gradual shift of policy ensued. Although Shin, like politicians in many parts of the world, was personally seduced by the simple formulae of monetarism, it would be wrong to think of Shin himself as doing more than reflecting a changing consensus in world opinion.²

Shin's predecessor, Dr Nam Duck-woo, had been a distinguished academic economist before joining the government service. He was himself a Keynesian, and had published a significant study of the *Determinants of Money Supply and the Scope of Monetary Policy: 1954-64* [Nam 1968]. He was in effect dismissed because of popular feeling in the country about inflation, not because of the failure of any other economic policies.

That Shin came to office in 1979 at a time when public concern was centred on inflation rather than growth is important. Ironically he had last been economic minister in 1959 under Syngman Rhee, and perpetuated the stabilisation programme which led to the virtual stagnation of the economy at the end of the 1950s. Nevertheless during the later 1970s economics graduates of schools throughout the USA, where neoclassical orthodoxy reigned supreme, were reaching positions of decision-making responsibility. At the same time, senior officials who had previously embraced a form of Keynesian economics were gaining the impression that no-one took Keynesian policies seriously any more. This impression was fed by the world press, a stream of visiting missions from the World Bank, the IMF, and economists coming to see the Korean miracle for themselves, although as far as I know, Milton Friedman did not visit Korea during this period. The

impression that Keynesianism was dead was further confirmed by conversations with more highly qualified juniors and Korean academics returning from the US.

In accounting for the shift in policy it is important to realise how the middle ground between monetarism and what are described as Keynesian policies had shifted strongly towards the former. The belief in the efficiency of the market over all other possible options does not necessarily entail an obsessive concern with the money supply. Indeed, it can be argued that popular monetarism was much more extreme than the views Milton Friedman was putting forward in the early 1970s. Friedman argued that an economy experiencing a constant rate of inflation of 15-20 per cent was not necessarily in a worse situation than one experiencing a very low rate of inflation, merely that the economy and money supply should be adapted to the prevailing rate of inflation [Friedman 1969: 1-50; 1973: 48-58].

Apart from rapidly outnumbered economists such as Dr Nam, who argued that growth was much more important than inflation, the strongest support for interventionist policies of a Keynesian character came from President Park Chung-hee—described by a long term (and Keynesian tinged) IMF observer as the best amateur economist in Korea—and the spending sections of the Korean bureaucracy, notably the Ministry of Commerce and Industry and the Ministry of Agriculture. It should be noted that an economic theory which encourages government intervention accorded much more closely with the Confucian notions of the Korean bureaucracy. Conversely, talk of leaving the economy to market forces sounded like dangerous anarchy.³ In the internal dynamics of the public and private debate the key victory for the monetarists was the annexation of the word 'stability' to their cause, whereas previously government intervention and Keynesian policies had appeared more likely to lead to stability than reliance on market forces beyond government control.

The other strand to the argument against a change in government policy was the appeal to past performance. One would have thought that it would be difficult to

¹Most of the information in the article is based on my work at the Economic Planning Board (EPB) July 1978—January 1980. and subsequently at various government research institutes.

²Normally Korean government ministers are not politicians, but bureaucrats. Shin Hyon-wak was, however, an elected member of the National Assembly.

³It is impossible to enter into the question of Korea as a Confucian economy in an article of this length. It is not intended to imply that the government bureaucracy is steeped in the Confucian classics, as it was in the nineteenth century. Rather that through the Confucian culture certain key words and concepts have been handed down with different persuasive values from their English translations.

argue that Korea's annual average growth rate would have been higher under a monetarist regime than its actual 9.9 per cent. However, even this was beginning to be urged. For instance, Arthur Little was reported in Korea as having suggested that under alternative policies, Korea could have averaged 15 per cent per annum. Moreover, Shin began his term of office boldly by declaring that it was time to tackle Korea's 30-year history of inflation, not its 18-year history of rapid economic growth.

Inflation in 1978

Psychologically, 1978 was the breaking point for Keynesian policies. On the face of it, this was another successful year for the Korean economy, with a growth rate initially reported as 12.5 per cent, but adjusted downwards to 11.6 per cent. Import controls were deliberately relaxed and loans repaid ahead of schedule to run a current account deficit, after the disconcerting effects of a small current account surplus in 1977. Targets set for 1981 under the Fourth Five Year Economic Development Plan (1976-1981) were already close to attainment [Michell 1979: 40-47].

But inflation had become a matter of greater public concern than ever. This enhanced perception of inflation stemmed from several causes. As a result of growth since 1975, for the first time, domestic rather than overseas demand was clearly leading the economy. This led to dramatic price 'hikes' and panic buying of items assumed to be in short supply. Simultaneously there was an extremely poor vegetable harvest which sent up the price of many foodstuffs. Finally there was a boom in housing demand, sending house prices up by as much as 100 per cent and filtering down to the mass of Korean households as increases in rent.

According to popular opinion, inflation was running at around 40 per cent. The official consumer price index rose by only 14.4 per cent (24.1 per cent for food items excluding grains), and the GNP deflator was finally estimated at 20 per cent. However, employers and employees subscribed to popular opinion, and wage settlements ran at 35 per cent. From the point of view of ordinary household budgets this probably exceeded inflation, but as in any other country high price increases were remembered more clearly than low ones. Because overseas demand was slack, due to the overvaluation of the won, and because of excess capacity in industries affected by quotas, the prices of many manufactured commodities rose little, while food and housing leapt forward. Thus inflation affected the ordinary consumer very unevenly. Households could afford television sets and fridges for the first time, and still grumble about the high price of food and the impossible price of housing.

Stabilisation Measures of March 1979

Although on assuming office in January, Shin Hyonhwak announced a stabilisation policy, it was not until March that the economic ministries could agree on a set of measures to that end. Worries about the effect of a deflationary policy on output and hence growth were overcome by adopting a full monetarist outlook. That is, as well as a policy of tight money, the government was to tackle the question of 'repressed inflation', of decontrolling the economy so that there would be greater freedom for market forces in all parts of the economy. Hence although there would be a period of deceleration, this would cover a simultaneous period of restructuring that would lay the foundations for long-term stable rapid economic growth.

The notion of 'supply side economics' was however taken much more literally in Korea than elsewhere. It was taken to mean that where there was a price rise due to a supply shortage, the supply was to be increased either through imports, or through the acceleration of investment in domestic industries manufacturing the relevant items. This was in the tradition of previous Korean policies and an accurate recognition of the Korean problem [Krause and Sekiguchi 1980:219-41]. Cutting direct taxes would have had little effect in Korea, given that the income tax threshold is so high as already to exclude 66 per cent of the working population.

On two issues, the exchange rate and interest rates, no agreement could be reached, and no change effected. The exchange rate was left at 484 won to the dollar, despite a high rate of domestic inflation compared to world prices. Korean exports were thus facing increasing competition, and export manufacturers in traditional exports were rapidly pricing themselves out of international markets. One wing of the Keynesians argued for a devaluation to restore the value of the dollar. Surprisingly, the neoclassicists joined forces with the President and the Ministry of Commerce and Industry, arguing that the inflationary effects of devaluation would eliminate any export advantage within six months. Further, they argued that the won should have been revalued during the favourable current account balance of 1977, and should not be devalued for temporary reasons.

On the question of exchange rates, the Korean monetarists (like their Chilean counterparts) show their distance from Friedman, who consistently stresses that 'the greatest damage is done by trying to repress exchange rates' [Friedman 1973: 60]. Several leading economists expressed views much closer to Harry Johnson's thesis: that devaluation was an essentially Keynesian strategy based purely on short term considerations, whereas 'changes in relative national price

levels can only be transitory concomitants of the process of stock adjustment to monetary disequilibrium' [Johnson 1976: 154]. The combination of forces in favour of maintaining the existing exchange rate were extremely diverse. Besides the new monetarists, the President was concerned with national prestige, others with the comparison with Taiwan which had consistently revalued, many with the implications for the heavy overseas borrowing necessary to build up Korea's heavy and chemical industries.

Where interest rates were concerned the forces were reversed. The monetarists argued for a dramatic increase in interest rates to restore a positive real interest rate and promote domestic savings. The Keynesians argued that the whole structure of Korean industry rested on the existing interest rates. Thus a tight money policy was inaugurated without any change in official interest rates! This was possible only because the government owned the major clearing banks (or city banks, as they are referred to in Korea) and a large array of special banks. Credit control would continue as before through credit rationing under government direction, rather than market forces.

By the standards of most western governments, Korea was unusual in not officially having a budget deficit. According to ministry of finance figures, revenues consistently exceed expenditure. However, this conceals the fact that unlike western countries, government loans and investments, many of them within the public sector, are not included in normal budget statistics. For instance, in 1978, 50 per cent of loans and investments were not covered by the budget balance, but by creating credit through government banks, or by printing money (see Table 1). Moreover, through the grain management account, the government created highly seasonal movements of money, paying out huge quantities of cash to farmers in the third and fourth quarters.

Under the March stabilisation measures, it was decided that investment would be reduced, and attempts made to run a much larger budgetary surplus. Investment in heavy industry was to be slowed down, and the grain management fund deficit reduced. Finally, through the alleged mediation of the KCIA, measures for the direct alleviation of absolute poverty in the form of extended medicare, schooling and direct food relief were introduced for the very poorest in society.

The change in policy was therefore half complete. The monetarists faced a strong rear-guard action from a series of vested interests determined to ensure that certain measures would never be implemented. How much the new policies were challenged later in the year will be indicated below.

To what degree were these policies appropriate? When an economy grows as rapidly as Korea's its structure is in a continual state of flux, since private enterprise is continually responding to changing conditions. Korea suffered considerably from a lagged response to the problems created by import controls, especially in areas where domestic industries could not hope to match demand. This was especially true both in agriculture and in certain intermediate goods, such as aluminium production. Indeed the Korean economy experienced inflation during the later 1970s from Keynesian imbalances closely matching those described by Keynes in *How to Pay for the War* [Keynes 1940: 61-70]. As will be recalled, Keynes pointed out that during war, full employment creates a situation of rapidly rising demand, without the means to satisfy that demand, because production is diverted to war purposes (in the Korean situation read 'to export industries'). Keynes proposed increased direct taxation for this sort of situation, arguing that the use of taxes to control demand and reduce consequent inflation would result in no-one being worse off than if inflation had taken place (the opposite of the Friedman argument that inflation is a tax from which no-one benefits) and the government would actually be better off. In Korea the obvious measure in 1978 might have been to begin to collect contributory social security charges for old age pensions or medicare, which had been postponed in 1974 just after the legislation had been enacted, and never implemented.

When it was decided that a tight money policy was appropriate, no-one had a model of the economy which showed how monetary controls would affect the system. The Bank of Korea, which had the best forecasting model, had argued as recently as 1977, that a 10 per cent increase in the money supply (M1) produced only a two per cent increase in inflation, lagged over a two year period [BOK 1977:252-4]. The two competing government economic research institutes, KDI and KIEI, were less certain. The KDI model required so much interpretation that it was frequently asserted in jest that the entire model existed inside the head of the president of KDI; that of KIEI was still in an experimental phase.

It was somewhat embarrassing that in the autumn, two leading Korean experts, Roger Norton and Rhee Seung-yoon published a *Macroeconometric Model of Inflation and Growth in Korea* which concluded:

as regards the role of money in inflation and growth, perhaps three cautious conclusions may be ventured from this study: a) money significantly influenced real GDP growth, b) transactions demand absorbed most of the 1973-77 growth in the money supply, and c) small year to year variations in the money supply growth are not likely to influence inflation rates [Norton and Rhee 1979:52].

Although creating minor ripples in economic academic circles, this conclusion had no effect on government policy which was already having a profound impact on the Korean economy.

Had the Korean policy-makers read their Friedman more carefully they might have decided on a form of monetarism more appropriate to Korea. Friedman has argued that the actual rate of inflation is much less important than the degree to which all actors in the economy anticipate it. On the whole, both employers and workers had long since adjusted to inflation. The major actor who had not was the government, which continually set unrealistic price targets. By concentrating on the exchange rate, a simpler solution to many of Korea's problems might have been found which still lay within the Friedmanite canon, though it might have proved unsatisfactory to those who took Johnson's view of exchange rates, rather than Friedman's [Gray 1974:104-108].

Worse, the government, like many others, had seriously underestimated the effects of changing an economy reasonably well adapted to one rate of inflation into one adjusted to a lower rate. Friedman himself warned:

once an inflation has become anticipated, an unanticipated slowing down of an inflation will have extremely harmful effects as well. For a time prices of commodities and wages of labour will continue to rise at the earlier anticipated rates, both because of long term contracts and because the anticipations will affect new prices or wages being set. Many debt contracts will bear high interest rates that allow for the expected inflation. Until anticipations change, and until long-term contracts expire, the effect is likely to be a severe set-back to business activity, with unemployment of men and machines and discouragement of new capital investment.

[Friedman 1972:58]

Since in practice the policies adopted in March 1979 have yet to produce the desired effect of actually reducing inflation, this problem may yet have to be faced.

The Effect of the March Stabilisation Programme

Norton and Rhee had concluded: 'regarding the inflation equation alone, expectations (positively) and real output growth (negatively) are important determining factors' [Norton and Rhee 1979:53]. The March programme had however, brought about a situation in which real output growth was likely to decrease, while, through higher prices for electricity, higher indirect taxes etc, actually increased inflationary expectations. The government had furthermore given overt support to a

theory which placed them in a position in which it was almost impossible to respond to the 1979 oil price increase in the way the government had done in 1975.

Growth in the first quarter of 1979 had reached 13.6 per cent, lower than the 17.1 per cent of 1978, but higher than in 1977 and almost equal to the first quarter's growth in 1976. From there on there was a steady decline, 9.2 per cent in the second quarter, 4.8 per cent in the third, and slightly less in the final quarter. The recession accelerated, reaching -6.3 per cent in the second quarter of 1980, and -5.7 per cent for the whole year, the first year of negative growth since the Korean war.

Apologists for this disastrous result pointed first to the oil price increase of mid-1979 in both its domestic and overseas effect, secondly to the aftermath of the assassination of President Park in late October 1979, and finally to an unexpectedly bad harvest in 1980. The fact is that the economic policies adopted also contributed significantly. Although it lay within the government's power to absorb or delay the impact of the oil increase to industry and consumers by reducing taxation, the new policy of realistic market pricing prevented any such decision, and the price increase was put into effect long before tankers carrying the higher priced oil reached Korean shores, and pushed the domestic price of oil above the actual 1979 price increase. Prices of downstream chemical products were increased at the same time, although existing stocks could have saved this increase from being passed on for several months.

The effect heightened inflationary expectations. This was accentuated by the fact that the wholesale and consumer price indices in Korea bear little relation to one another. While the movement of the wholesale index is usually a good guide to coming increases in the consumer index, in Korea, the wholesale index is heavily weighted towards petroleum products. But with only five per cent of households owning cars, and domestic heating and cooking provided by anthracite briquettes, the average Korean household consumes no oil products directly. Moreover, a far sighted measure, pressed by President Park and the KCIA, had excluded the average household from the electricity tariff increase. In the stabilisation package, households consuming below a minimal threshold of very modest proportions had their electricity price held. Thereafter the price rose sharply. Households using electricity for lighting one or two rooms and running a television fell below the threshold.

Nevertheless the newspapers' reaction to these policies was to proclaim dramatic price 'hikes' and heighten inflationary expectation. Consequently employers and employees agreed that inflation was high and settled

for an average increase of 28.3 per cent, whereas the consumer price index, which was adjusted to reflect prices more accurately than previously rose by less than 20 per cent. Employers found themselves squeezed on all fronts, costs of raw materials, especially energy, had risen sharply, as had wage bills, overseas markets were still contracting, and consumers seemed to be saving rather than spending.

The response was that of employers in every country experiencing such policies, even though in fact, the contraction of the money supply was relatively modest. They laid off workers, reduced investment to a minimum and ran down their inventories as quickly as possible. Wholesalers too, delayed reordering to minimise stock lying idle on the shelves. In other words, what the monetarists had completely left out of account was the reaction of industry to the announcement of a monetary squeeze which in itself led to a recession.

The assassination of President Park in late October 1979 had very little effect on production. The country continued normally, managing a remarkable transition from what might be termed a constitutional dictatorship to what was declared by the acting President to be the moment when Korea's political progress would catch up with her economic progress. In terms of economic policy it may have had a much greater impact.

During the summer, pressure was building up for a reversal of the March measures in favour of those initiated during the first oil crisis, of continued economic growth. The pressure was led by the Ministry of Commerce and Industry, which was reluctant to cut back on any investment, and the Ministry of Agriculture, which was determined to protect farmers from the risk of increased imports. Both appeared to be gaining influence with the President. His death removed this possibility, and opened the way to reconsidering the exchange rate.

The battlelines were much as before, the neo-classicists being solely concerned about interest rates, the Keynesians with the exchange rate. This time the result was a compromise; a devaluation and an increase in interest rates. The exchange rate shifted to 650 won to the dollar, but was now pegged to a basket of currencies, while interest rates rose from about 21 per cent to about 28 per cent. The effect was complex. Industries involved in exports were revived, whereas imports rose in price, increasing inflation in 1980. However, even exporting industries were hit by the increase in interest rates, and exporters claimed that one change cancelled out the other. Although exports revived during 1980, whereas in 1979 the volume had actually declined, the total effect of the measures was to deepen the domestic recession, and in the end interest rates were actually reduced again in November 1980.

In May, political events intruded into economic affairs as the man about to become President, General Chon Doo-whan, came into the public limelight and provoked opposition from students and others. By the end of May, the entire government decision-making machinery had changed, as power was transferred from the ministries to the National Security Council and its economic sub-committees.

The National Security Council offered a much more effective medium for economic change than anything previously existing in the Korean government machine, yet because of its effectiveness it enhanced the prevalent view amongst the Korean bureaucracy that an economy could be changed by simple government fiat. Economic decisions streamed from the economic sub-committee, but the way in which they were to be implemented often remained unclear.

In June 1980 it was clear that the interest rate increase was having a serious effect and that any attempt to keep to the existing monetary targets would lead to a slowdown in the economy of dramatic proportions. Accordingly interest rates were lowered by one to two per cent, and the monetary targets for M2 raised from 20 to 25 per cent and for M1 from 15 to 20 per cent. When it is remembered that strict monetarists had argued for an even lower rate of increase than the original targets, it can be seen how far off track the economy had gone.

In September 1980 a further set of measures was introduced. Further reductions in interest rates were announced, and implemented in November. While the new economic minister, Shin Byong-hyun, was at pains to stress that 'it would be a great mistake if the invaluable gains made by the stabilisation policy over the past year and a half were lost in an indiscriminate implementation of a reflationary policy', he announced further government spending, in particular in the direction of housing construction and adjustment loans as well as further infrastructure spending [*EPB Bulletin* 1981:80-23]. Although no new monetary targets were announced, as Table 1 shows, even the revised figures were exceeded, and the rate of monetary increase in 1980 was actually higher than in 1979.

The Reaction to Oil Crises: 1974-75 and 1979-80

In the opinion of Lawrence Krause and many others, 'for the (1974) oil crisis, Korea gets the gold star for the best handling of policy' [Krause 1978:9]. Krause observes:

the January 14 1974 program was well designed and extremely well handled. It was addressed to the most serious problem of Korea at that moment, which was the loss of domestic demand and

table 1

Selected macroeconomic data 1973-81

	1973	1974	1975	1976	1977	1978	1979	1980	1981 _p
GNP growth %	14.9	8.0	7.1	15.1	10.3	11.6	6.4	-5.7	5
Increase in M ₁ %	40.6	29.5	25	30.7	40.7	24.9	20.7	22.8	20
Increase in M ₂ %	36.4	24	28.2	33.5	39.7	35	24.6	27.9	25
Consumer price increase %	3.1	23.8	26.3	15.4	10.2	14.4	18.1	30.1	n.a.
Wholesale price increase %	6.9	42.1	26.6	12.1	9.0	11.7	18.8	44	20-25
* Gross domestic fixed investment as % of GNP	25.6	25.4	26	25.9	29.7	37.1	38	31.7	31.1
Increase in gross domestic fixed investment %	29	22.7	18.9	9.7	24.0	35.9	9.7	-14.8	4.0
Increase in value of commodity exports in dollar terms %	95.2	38.0	10.8	56.2	28.6	26.5	15.7	17.7	n.a.
Unemployment %	4.0	4.1	4.1	3.9	3.8	3.2	3.8	5.0	4.9

*=at constant 1975 prices.

p=current projections

Source: figures collated from EPB *Handbook of the Korean Economy* 1979, *Major Statistics of the Korean Economy* 1980, *Economic Bulletin* 1979-81.

approached in a way that was successful. At the end of the year, when different aspects of the crisis became more serious, that is, when the balance of payments and consequent heavy borrowing were becoming serious, the won was devalued and exports promoted [Krause and Sekiguchi 1980:219-241].

According to the latest estimates of national income, Korean GNP grew by 8 per cent in 1974 and by 7.1 per cent in 1975. It had grown less in 1972 under a previous stabilisation programme.

In 1974 the government had concentrated on maintaining investment and allowing manufacturers to stockpile against the eventual world recovery. These measures not only sustained production and employment, but also laid the foundations for 15.1 per cent growth in 1976.

By contrast, in 1979 the government was determined to constrain domestic demand, seeing it as a disturbing influence on the stability of the economy and diverting resources from exports. Equally, there was no concern for loss of industrial investment, which is perhaps the most serious implication for the long term health of a rapid growth economy like Korea, especially since investment by the late 1970s needed to be in capital-intensive industries, rather than labour-intensive industries in which Korean ICORs have been remarkably close to unity.

The performance of the economy under the two crises can be seen in Table 1. There can be no doubt that in every case, performance in 1979-80 was inferior to that of 1974-75. It should also be remembered that the crisis struck in mid-1979, not in late 1973, so that although the rates of GNP growth for 1974 and 1979 are comparable, in 1979 the economy had the benefit of six months' crisis-free growth, in which the deceleration was solely due to government policy. Finally, it can be seen that even in the case of prices, consumer price increases were as high under the monetarist policies as under the Keynesian policies of 1974-75.

What Happens to Economic Growth?

At the presidential economic briefing on April 15, 1981 it was reported that real consumption measured in wholesale and retail sales had declined by 3.7 per cent and 5.0 per cent respectively between February 1980 and February 1981, while construction activity was 43.8 per cent lower than a year previously. Nevertheless, the industrial production index was slightly up, and exports appeared to be performing well.

Since January 1979, the quest for 'long term stable growth' has been the declared goal. Whenever current performance is criticised, the response is that these sacrifices are required in order to reach the long term goal. Provided there is a good harvest it seems possible that Korea will achieve about 5-6 per cent growth in

1981, and real GNP by the end of the year will then stand where it did at the beginning of 1980. Wholesale prices are still expected to rise by 25 per cent. Can this be the beginning of long term stable growth?

The share of gross investment in GNP expenditure fell to 31.7 per cent in 1980, compared with 38.0 per cent in 1979, and 37.1 per cent in 1978. It is still commendably high—higher than in any year before 1976. So the sources of continued rapid growth are arguably still there. However, to keep it at this level, the government has consistently had to exceed its M2 target, and will doubtless continue to do so in the future. Moreover, as Table 1 shows, although the ratio to GNP remained high, the rate of increase became negative.

In short, if growth resumes, it may well be under much the same conditions as before, with inflation running at its historic rate, and the money supply growing faster than the government wishes. Just what has changed in this painful two-and-a-half year experiment?

The answer is that some radical changes in the degree of government control over the economy have been initiated. It must be stressed that the process is slow and has only just begun. In 1979 the prices of a large number of items were decontrolled. Further measures were announced in September 1980, enacted during the winter and came into force in April 1981 as the Fair Trade and Anti-Monopoly Act. This is supposed to minimise government control even over monopolistic or oligopolistic prices. In August 1981 it was even announced that meat prices would be decontrolled. However, even at this stage it was stated that 'during the period of transition to a full market economy the government will continue to stabilise the price of basic necessities by paying special attention to the availability of their supplies'. In short, the main change is from the government setting the price in agreement with manufacturers to the manufacturers setting the price at the risk of government intervention.

The reason for so many price controls in the past has been partly the instability of supply during particularly rapid spurts of growth, and the large number of items in which Korean companies have a monopoly due to stringent import controls and high tariffs. Further import liberalisation has taken place, but the big change has been in the rules for foreign investment which now allow foreign enterprises to manufacture solely for the domestic market, and even hold 100 per cent of equity. These measures are new, and as yet untested, and it is consequently impossible to judge how far the bureaucracy will interfere in their implementation. In theory, through allowing foreign competition in this way, monopolistic tendencies will be minimised, although the attendant dangers are obvious.

During the past three years considerable uncertainty has existed over the Fifth Five-Year Economic Plan, due to come into operation in 1982. This has been compiled during a period of dramatic changes in government economic strategy and faced a fundamental dilemma: what is the place of economic planning in a 'free market economy' governed by neo-classical precepts? In early 1980 the dilemma was partly modified by adding the words 'and Social' after Economic, on the grounds that there were large areas of socio-economic policy to be planned.

Despite these dilemmas, most parts of the bureaucracy proceeded to compile their part of the plan on exactly the same basis as before, while the leading policy-makers debated whether a plan was needed at all. The final version of the plan was announced at the end of August 1981, and advance publicity suggests that the route out of the dilemma is that the plan is a five year programme to create a 'free market economy'. The plan includes an announcement that by 1986 'the import liberalisation ratio will be pushed up to the level of advanced countries' [*Korea Herald*, 22 August 1981]. The tax ratio will increase from 18.4 per cent of GNP to 22 per cent, while the financial market 'will be granted more autonomy.'

Superficially however, the plan looks very much like previous ones, except that it is a little less optimistic than its predecessors in every direction except inflation, where it is rather more realistic. Underlying the assumption of 7-8 per cent growth and 20 per cent nominal growth of exports (11.4 per cent real growth) is the belief that despite the announced liberalisation of foreign investment and continued restructuring, the government will still be able to force the pace of investment in the leading edge of export industries, while discouraging domestic demand to match supply, inducing an increase in domestic savings.

Conclusion

According to the Deputy Prime Minister's announcement of August 1981, the government would continue to concentrate on 'restructuring the economy basically and systematically for the first two years and then settle down to bringing the "second leap forward"' (*Korea Herald*, August 1981). The period of restructuring is therefore not yet over. What has Korea gained in the last two years? The answer depends on whether one is sympathetic to monetarism or Keynesian theories, and might be summarised thus.

Neoclassicist

Korea has begun the process of restructuring the economy for stable growth based on low inflation rather than high inflation. Inevitably during the first two years, as repressed inflation was released, inflation

rates were high, and the business structure disturbed. From now on the process of reconstruction will accelerate rapidly, with the particular advantage that the price of Korean exports will be stable, thus not damaging the economy by increasing the balance of payments burden. Although in the short term sacrifices have been made, in the long term these sacrifices were essential, and it was much better to make them in 1979-80 than later, when the economy would have been stagnant.

Keynesian

Korea has foregone production amounting to at least 10 per cent of GNP over the past two years. In other words, GNP could have been 10 per cent higher than it was in January 1981. There is little evidence that inflation would have been significantly higher under Keynesian policies. Investment, and consequently future growth, have also been lost. Worse, the so-called release of repressed inflation has fallen heavily on those least able to afford it. This is shown by the drop in the share of income for the bottom 40 per cent, from 16.85 per cent in 1976 to 15.4 per cent in 1980. The policy of monetarism is powerless to deal with one area of prime importance to the Korean people, housing, where the recession had led to a decline in house building at a period of accelerating household formation for demographic reasons. It has also raised the unemployment rate to 4.8 per cent from 3.2 per cent in 1978, and even at the end of the Fifth Five Year Plan, employment is projected to remain at 4 per cent.

Neither viewpoint is provable except in the court of economic history. Clearly, Keynesians gladly discount uncertain future growth in favour of present growth at any price. The change in policy is likely to be less favourable to the poor in a relative sense, even if the monetarist assertion that everyone will be absolutely better off than under traditional policies is correct. This is already clear that where wage increases are lagging behind inflation. Whether this will prove acceptable to Korean public opinion which remains innately suspicious of rich men remains to be seen. Furthermore, there is still the Friedman prediction quoted earlier to be faced. If the present plan proves correct, and inflation drops rapidly in 1982 or 1983, how fast will inflationary expectations fall? Will the

Friedman prophecy of disruption as inflationary expectations remain high be borne out? Finally, will not the completion of the programme for a free market economy lead to the abandonment of government sponsored export-led growth as it has been experienced in South Korea during the last 15 years?

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