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Legacies and Lessons of Korea’s Macroeconomic Management*

1. Introduction

Chapter 2 introduced the main theme of this volume by stating the importance of a government that recognizes its boundaries and, in doing so, limits itself to maintaining a sound institutional environment for the operation of a spontaneous market order, rather than trying to substitute for market forces itself.

The Korean government has been actively involved in almost every important aspect of the decision-making process during Korea’s economic development. Simply put, government-led order has always dominated over spontaneous market order in Korea. However, as the previous chapter has shown, even if it is agreed that the government should hand over some of its roles to market mechanisms, it is still unclear just how much of a role the government should take in the economic development process.

To note the implications of so-called government-led economic development strategy on macroeconomic management, one has to highlight the fact that the Korean government has played a very active role in resource mobilization, culminating in a very peculiar macroeconomic management pattern. Investment has almost always outpaced domestic savings (Figure 3.1), leading to the borrowing of foreign credit in order to meet excess demand for funds. Credit extensions to targeted industries, particularly in the export sectors, have made up an important part of the central bank operations and growth in monetary

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aggregates was typically strong, hence the double-digit inflation of the 1960s and 1970s. The rather single-minded pursuit of continued growth effectively ruled out the customary employment of standard fiscal and monetary policy tools as a means of controlling aggregate demand. As a result, for macroeconomic stabilization, the government had to rely on some other non-traditional instruments, such as price regulation and direct controls on economic activities within the private sector.

However, Korea’s macroeconomic policy environment has undergone a rapid change in recent years. The Korean economy is becoming increasingly open and integrated with the global economy, through measures such as capital flow liberalization, and can no longer rely upon non-traditional regulatory microeconomic measures for macroeconomic stabilization.

This chapter focuses on the government’s intervention in the macroeconomy with an overview of Korea’s macroeconomic developments and patterns of macroeconomic management and seeks a new system of macroeconomic policy making. This last objective is particularly appropriate in view of the more recent developments in macroeconomic policy environments such as the liberalization and globalization of the domestic economy and the onset of the 1997 exchange crisis. Some reform issues are discussed and the chapter closes with a discussion of macroeconomic policy issues, including sterilization policy and the policy mix, in the open economy setting.

2. Some features of macroeconomic developments

Korea’s economic development experience often reveals several notable characteristics of macroeconomic management. One is that the Korean economy has demonstrated outstanding economic growth as well as a steady and considerable increase in the investment rate. In the period 1961–1972, the investment ratio was 19.4 per cent. This rose to 30.1 per cent in the 1973–1980 period and, after staying close to the 30 per cent range in the 1980s, started to rise again in the early 1990s and remained in the 35 per cent–40 per cent range until 1997 (Figure 3.1).

The rising expansion of investment helps the economy to accumulate capital. The neoclassical growth theory argues that capital accumulation is a key factor in explaining economic growth. According to various growth studies, capital accounts for about 2.2 per cent to 3.7 per cent of manufacturing output for the sample periods ranging from the late 1960s to the 1980s (Kim and Hong, 1997; Kim and Park, 1985;