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Republic of Korea's experience in pursuing import substitution policy

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The phenomenon of Korea's economic development in the XX century was widely reflected in academic literature ante omnia in the light of the export promotion policy achievements, belonging to the category of newly industrialized countries and the internationalization of chaebols. Meanwhile there is a number of subjects on various aspects of Korean economy that do not seem to be so popular with researchers but at the same time definitely may be deemed as mark worthy and deserve to be analyzed in detail. One of these subjects is Republic of Korea's experience in pursuing import substitution policy. The import substitution approach dominated in Korean economic policy for a rather short period of time — from 1953 through 1960, however it was the very period, when the manufacturing base, that secured the success at the first stages of export promotion in subsequent years, was established. It should be noted that some elements of import substitution were incorporated in the First, Third and Forth Five-Year Economic Development Plans (1961–1966, 1972–1976 and 1977–1981, respectively) — at the time when the growth of the export sector was unconditionally proclaimed as the top priority. According to *Korea Development Institute* in the period of establishing Heavy and Chemical industries (the Third Five-Year Economic Development Plan, 1972–1976) the strategy of the 60s focusing on comprehensive export promotion was temporally replaced with import substitution policy.However we find it necessary to dispute this point of view: the dynamics of the exports during the Third Five-Year Plan indicates the persisting outward orientation of Korean economy, and more conspicuous elements of import substitution were not the consequence of the return towards this kind of strategy but dealt with drastic changes in the structure of exports. Thus it is the period of 1953–1960 that can be considered as the time when the growth of Korea's economy was shaped by the strategy of import substitution.

Impulses for import substitution in the Republic of Korea

Albert Hirschman defined four impulses that launch the processes of import substitution: a) wars and the associated disruption of trade relations; b) balance-of-payments difficulties; c) growth of the domestic market (frequently as a result of export growth); d) official development policy by the state authority. The Republic

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of Korea's experience is made all the more remarkable by the fact that every of the aforesaid impulses affected the launch or activation of the import substitution in the manufacturing.

The Korean War enormously impoverished the economic potential of the Republic of Korea. During the first year of the War alone (1950) the industrial sector of the country suffered the losses of $354 million; up to 43% of all manufacturing facilities, 41% of power generating capacities, 50% of coal mining facilities were destroyed. With allowance made to the devastation in the public sector, transport and dwellings the total damage was valued at about $1,8 billion. Meanwhile the Korean War in itself cannot be looked upon as a fundamental impulse for import substitution in the Republic of Korea. The issue of import substitution became actual much earlier — immediately after the liberation of Korea in 1945 when the peninsula was divided into two parts, each of which started the formation of the antagonistic political and socio-economic systems. The partition resulted in North Korea getting 95% of basic chemical production, 99% of chemical fertilizers, 97% of steel output.The situation for South Korea got more aggravated in the mid-1948 when the electric power supply from the northern part of peninsula was disrupted. Not coincidentally, among the top-priority tasks of *ECA* (Economic Cooperation Administration, 1949–1952), one of the US aid programs for the Republic of Korea, there were two that virtually launched import substitution processes in Korea — expansion of electric power generating capacities and establishment of fertilizers production. Thus, the Korean War just spotlighted for the Korean authority the previously existing necessity of the development of import substitution in the industrial sector, but now it was in the context of the large-scale task of reconstructing the destroyed economy.

During the major part of 1953–1960 for the Republic of Korea the balance of payments deficit was not an acute problem that could have actualized the necessity of launching import substitution. In spite of the stagnating exports, Korea earned a sizeable profit from selling its overvalued national currency to the US troops that based in the country; on top of that the vast majority of the imported products (by 1957 over 84% of the total imports) was channeled to the Republic of Korea through international (predominantly from the USA) aid programs and it is the resources that formed counterpart funds which played a core role in covering budget deficits.However, the situation radically changed in 1957, when the USA revised the aid policy towards the Republic of Korea that entailed to gradually decreasing volume of imports under aid programs starting from 1958.It was that very momentum, which made it reasonable to consider the inevitability of the aggravating balance of payment as an impulse for the development of import substitution in Korea. As then noted by *Kyŏnghyang Sinmun*news paper, "under the conditions of the steadily shrinking foreign aid it is necessary to mobilize all the internal resources and in the shortest time possible develop the base of the independent economy".

The growth of the domestic market should be deemed as the main prerequisite for the launch of import substitution processes in the Republic of Korea. At the same time, a number of specific features can be defined here. Firstly, in Korea's post-war environments the expansion of the domestic demand was secured not by the revenues from export oriented industries but by the Bank of Korea emission activity and imports under aid programs.Secondly, under the conditions of tight tariff and non-tariff restrictions on imports, as well as a limited access to foreign exchange resources, an excessive internal demand made importing extremely lucrative. In terms of very high entry barriers in importers' realm, in Korea took shape objective prerequisites for establishing domestic production of substitute goods. Thirdly, as noted by some researchers, during the immediate post-war years the demand for certain imported goods in Korea was so high that the domestic output virtually did not substitute the imports but just eliminate the deficit of the supply in the market.

As to the forth impulse — official development policy by the state authority, it is necessary to point out that the import substitution in the Republic of Korea was never proclaimed as the only priority (and a goal in and of itself) of the economic strategy. Korea's government only in individual cases undertook specially tailored complexes of measures aimed at substituting imports in some selected sectors, as it was in "Three white production" (*Sambaeksanŏp*). In this vein the impact of this impulse on launching import substitutions processes in the Republic of Korea was rather limited and can be traced only during the first years after the War.

Economic policy of Korean authorities in 1953–1960

The economic policy by Rhee Syngman administration (1948–1960) is often characterized by researchers as inconsistent in terms of long-term developmentand marked with "economic failures".However, it is since 1953 that Korean government managed to establish and maintain the conditions for the expansion of import substituting sectors, as a result of which the production of cement, glass, chemical fertilizers, paper, as well as light and food industries, were set up. All these achievements along with the increase in the electric power generating capacity and improvements in the infrastructure became a cornerstone for the further economic growth based on export promotion during the period of Park Chung-hee administration (1961–1979).

Korean government activities in 1953–1960, aimed at securing the growth of import substituting sectors, were underpinned by three core constituents — foreign trade policy, foreign exchange policy and credit policy. During the period under consideration each of these policies obtained some new elements but did not undergo any meaningful changes.

In the context of the post-war Korean economy reconstruction the growing demand for imports (especially for consumer goods and finished products) was essential. In such a situation Korea's government in the foreign trade policy prioritized the regulation of imports aimed at securing more or less efficient distribution of resources in the national economy, on the one hand, and protecting some domestic industries, on the other hand.At that, instruments of tariff and non-tariff restrictions were widely applied in regards to imported goods. It is worth noting, that the import tariff system introduced in 1949 remained virtually unchanged till 1957: it implied 0% rate for foodstuff, raw materials and capital goods that were not produced domestically and quite low rates (10–20%) for semi-finished products. Taken as a whole, the average tariff for imports at that time remained rather high (40%) and tended to grow (up to 44% starting from 1957) whereas in 1952 equipment imported for the development of key industries was completely exempted from import duties.

Another important instrument of commercial imports regulation was a system of quantitative restrictions that was introduced in 1949 and was kept functioning with meager changes through the mid-1955. Under the system, during a year a list of goods (and their volumes) eligible for importing was published on a periodical basis. Moreover, in order to proceed with an import deal an importer had to get a special license that confirmed the presence of the product to be imported in the aforesaid list. Since 1955 the goods eligible for importing were divided into two groups — special imports and ordinary imports: the first one (special imports) included the commodities that could be purchased exclusively with the funds earned from exports; the second one (ordinary imports) consisted of products to be bought with both the funds earned from exports and the foreign exchange purchased from the Bank of Korea. At the same time the Ministry of Commerce and Industry in some cases was entitled to issue permissions for importing the goods not indicated in any of these two categories. In 1958 the system underwent one adjustment — the right to import a product from the first or the second group started to be defined not by the source of the foreign exchange but by the special license.

An important role in regulating the volume and structure of the imports was played by the foreign exchange policy: amidst the vastly appreciated wonit was tackling the task of the distribution of scarce foreign exchange among importers. For example, from the end of 1952 through the mid-1954 there was a special loans system functioning in Korea: under this system, an importer could obtain the necessary volume of foreign exchange from the loan funds after putting the equivalent in won on the deposit in the Bank of Korea. Through these funds about 75% of the total commercial imports were financed during the period of this mechanism functioning.

In the mid-1954 the system of special loans was abolished and foreign exchange started to be distributed among importers through auctions, where dollars were acquired the exchange rate 2,5–3,5 times higher than the official one. In as little as one year this mechanism was replaced with the distribution system based on the lottery principle. In this case the sale of dollars to importers was implemented at the official exchange rate (so that enable to maximize the profit from selling the imported goods in the domestic market). In 1957 the order of providing importers with foreign exchange altered once more: since that moment the volume of dollars available for an importer was determined by the sum, which the importer was ready to spend on state bonds.

While instruments of the foreign trade policy and foreign exchange policy kept Korea's import substituting industries away from any meaningful competition from imports, the credit policy of the state during this period was aimed at providing these import substituting sectors for the further growth with financial resources through three channels — Korea Development Bank, specialized banks and commercial banks.

Korea Development Bank (*HanguksanŏpŬnhaeng*) was established in 1954 with the main goal of granting middle and long-term loans to the industrial sector. A particular feature of this credit institution was its formal independence from the Bank of Korea (*HangukŬnhaeng*) and direct subordination to the Ministry of Finance. However, in actual fact, Korea Development Bank, facing the shortage of funding, had to borrow from the Bank of Korea which appeared to secure about two thirds of the total Korea Development Bank liabilities (the rest one third was formed with counterpart funds). As early as 1955 the share of Korea Development Bank in the total outstanding corporate loan portfolio in Korea accounted for 40%, peaked at 45% in 1957 and in general was not below the level of 39% through 1960.

As to the second channel for providing financial resources — specialized banks, during the period under the analysis it was represented only by one institute — Korea Agricultural Bank (*HanguknongŏpŬnhaeng*). This bank was established for the purpose of not only granting loans to the agricultural sector but also of developing certain elements of the import substitution. Korea Agricultural Bank share in the total outstanding corporate loan portfolio in the country was steadily increasing in 1955–1960 and got to 32% by the end of the period.

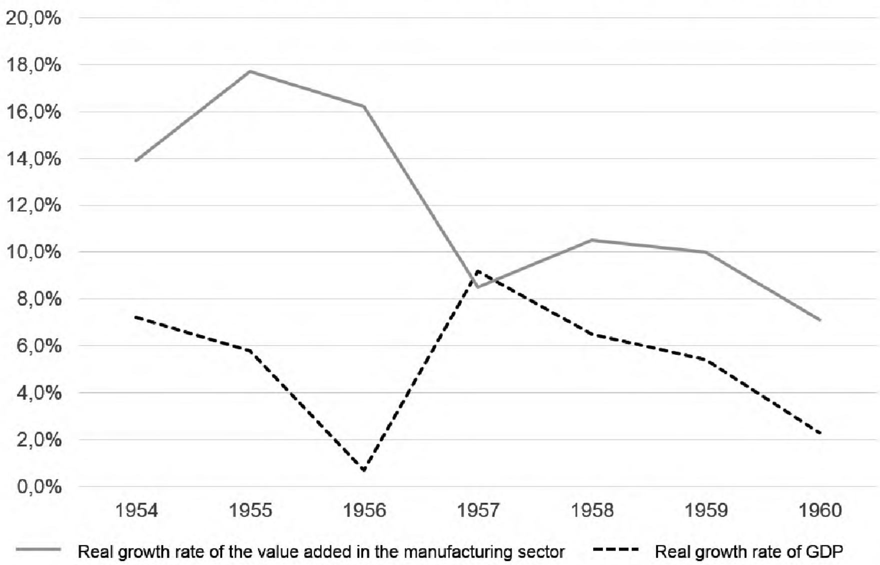
Commercial banks in the Republic of Korea before 1957 were owned by the state and dominated in crediting the national economy. However, after their being privatized in 1957 the situation drastically changed: Korea's government put the scale of commercial banks growth under control, that entailed to their share in the total outstanding corporate loan portfolio decreasing by 13 percentage points (to 30%) as early as 1957 and remaining on this level till 1960.

The result of this credit policy was a steep increase in the outstanding volumes of loans granted to national economy — from 6,0% of GDP (6,9 billion won) in 1955 to 16,1% of GDP (40,2 billion won) in 1960with the manufacturing sector as the largest recipient of this financing resources. A particularity of the policy resided in rather low interest rates of loans: under the law, their ceiling was not allowed to exceed 20%, and therefore for the most of the period of 1953–1960 the rates were substantially lower than the wholesale prices inflation.

The Republic of Korea economic development in 1953–1960

The economic development of the Republic of Korea in 1953–1960 is widely agreed to be divided into two stages — the period of the post-war reconstruction (till 1958) and the stagnation period (starting from 1958). It is since 1958 that the US aid in the form of imports started steadily decreasing: its volume as early as 1960 ($ 225 million) accounted for 70% of the 1957 level. It was a key reason for Korean economy slowing down (the average annual GDP growth rate in real term diminished from 5,7% in 1954–1957 to 4,7% in 1958–1960). The commodity supplies under the US aid programs played a significant role in expanding and maintaining the manufacturing base of the Republic of Korea. Therefore it got obvious that amidst the diminishing aid volume since 1958 Korean economy faced the stagnation in the gross fixed capital investment: its real growth rate was negative in 1958 and slightly exceed the level of 4% in 1958–1960 (CAGR), whereas in 1954–1957 the CAGR (in real term) got to 25%.The situation was dramatized by the fact that in order to secure an appropriate growth rate of gross fixed investments under new conditions the Republic of Korea would have expanded the commercial imports, and that, in its turn, would have aggravated the issue of the balance of payment deficit. That was getting even more depressing in the light of meager and stagnating growth rates of Korean exports (the exports to GDP ratio for the Republic of Korea in 1953–1957 was below 1,3% and CAGR of the exports accounted for minus 14%).

Figure 1: Real growth rate of GDP and the manufacturing sector in the Republic of Korea



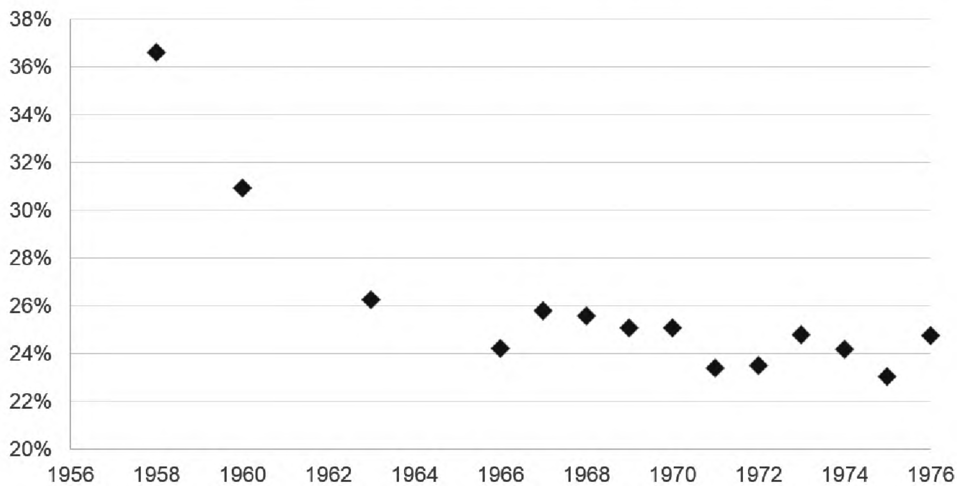
Source: *Korean Statistical Information Service* (http://kosis.kr/statHtml/statHtml.do?orgId=301&tblId=DT_102Y002&language=en&conn_path=I3)

Another important reason for Korean economy stagnating during the period under consideration should be an almost unchanging level of the labor productivity in the manufacturing, which since 1958 alongside with the service sector had become the key driver of the economic growth. For instance, the real average annual growth rate of revenue in the manufacturing per one employee in 1955–1960 got to only 1,4%, whereas in 1960–1963 it rocketed to 8,6%.

It should be noted that in 1954–1960 the real growth rates of the value added in the manufacturing, despite their steady decrease, tended to outperform the real GDP growth rates that resulted in the expansion of this sector share in Korea's GDP — from 7,8% in 1953 to 12,1% in 1960. In this regard there is no ground to state that by the end of the period Korea's development model with the dominance of import substitution faced crisis, however the stagnating labor productivity in the manufacturing amid quantitative and structural changes in the industry indicated that the potential of this very model was approaching its exhaustion.

As to specific features of Korean manufacturing sector development in 1953–1960 three of them should be noted as the most important. Firstly, during that period there was a steep decrease in labor intensity of the sector: the share of labor cost in the total value added diminished from 36,6% in 1958 to 30,9% in 1960.

Figure 2: The share of labour cost in the total value added of the manufacturing sector



Source: Calculation based on *Korean Statistical Information Service* (http://kosis.kr/statHtml/statHtml.do?orgId=101&tblId=DT_1F1501&language=en&conn_path=I3)

Secondly, five industries with the highest penetration of import substitution demonstrated the accelerating real growth rates of the output: the rates (as annual average) increased from 13,5% in 1954–1957 to 22,3% in 1958–1960, while for the manufacturing sector as a whole the inverted trend was witnessed (18,0% and 8,1%, respectively). This fact can be looked upon as an additional argument for the statement that at the end of the 50s the import substitution model in the Republic of Korea so far was not ridden with crisis.

The third particularity was a model of the financial resources distribution among various agents in the manufacturing sector. So, for example, 59,5% of the loans, granted to the manufacturing in 1955, fell on the five aforesaid industries. The available data enable us to state that through the period under consideration manufacturers had rather significant debt burden and companies, attributed to the sectors with higher dominance of import substitution, were increasing their indebtedness even more actively: in 1955 their ratio of the loans obtained during the year to the production value got to 8,0 (for the whole manufacturing sector this indicator was at 5,8).

Since 1955 in the light of the decreasing volumes of the commodity supplies under aid programs the discussion on models of the further economic development intensified in Korea. So, for instance, the strategy for 1959 pointed out to the necessity "to keep on nurturing import substituting industries" and "pave the way for the expansion of the exports". The plan of the imports of high-priority raw materials for 1960 stated that "in order to remove the persistent balance of payment deficit the prior goal should be importing production equipment that is crucial for import substituting and export oriented industries". A major milestone was reached on April 15, 1960 when the government of the Republic of Korea approved the First Five-Year Economic Development Plan (1962–1966) and in that way put the priority on the export promotion. And though the implementation of this plan appeared to be postponed for two years due to the political instability in Korea, neither Chang Myŏn administration, that came to power after April Revolution of 1960, nor the military regime of Park Chung-hee, set after the coup d'état of 1961, changed any main principles of the new strategy of Korea's economic development.

Conclusion

The period during which the economic development of the Republic of Korea was determined by the strategy of import substitution was relatively short — from 1953 through 1960. Nevertheless it is in this time span that production facilities were established and the infrastructure was expanded in Korea and all this provided the launch base for the booming growth of the national economy under the new export promotion strategy. It should be noted that this change in the vector of the economic development was caused not by the crisis of the import substituting model, whose potential had not been exhausted yet, but by the US decision to start gradually decreasing the aid volumes to the Republic of Korea that might have entailed to the severely aggravating balance of payment and large scale crisis in Korea's industrial sector which was then heavily dependent on the supplies of raw materials and equipment under aid programs.

Notwithstanding criticism of the economy policy pursued by Rhee Syngman administration, the latter managed to introduce and maintain functioning of instruments of foreign trade policy, foreign exchange policy and credit policy to the extent sufficient for securing appropriate GDP growth rates and expanding the production in import substituting sectors.

Republic of Korea's experience in pursuing import substitution policy undoubtedly is unique, however its certain aspects can be successfully used under modern conditions by the states that have to tackle the similar tasks of the economic development in post-war periods.