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From Hermit Kingdom to Miracle on the Han: Sources of Policy Change in Korea's Trade Transformation[†]

By DOUGLAS A. IRWIN*

In 1960, South Korea's exports were about 1 percent of GDP, and its ability to import depended almost entirely on U.S. aid. After changing its foreign exchange policies in the mid-1960s, Korea's exports surged to more than 10 percent of GDP by the end of the decade. This paper explores the political and economic context (as well as the individual actors) behind the shift in policy that enabled this dramatic export growth to occur. The United States helped initiate the process by withholding financial assistance, pressuring Korea to devalue its currency and reform its foreign exchange regime. The Korean government initially resisted taking these steps but in 1964 it became firmly committed to an export promotion strategy to boost foreign exchange earnings and end its dependence on American aid.

Key Words: Export Promotion, Export Orientation, Devaluation, Foreign Exchange reform

JEL Code: F13, F31, N75

I. Introduction

In the early 1960s, South Korea was close to being considered a failed state. The country suffered from political turmoil and economic stagnation. One of the poorest countries in the world, it had a lower per capita income than North Korea and its standard of living was not much higher in 1959 than it had been in 1945. Domestic savings were virtually nonexistent, and foreign aid was required to finance most domestic investment. Exports were less than 1 percent of GDP, and it could

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afford imports of about 10 percent of GDP only because of U.S. foreign aid.

Today, of course, South Korea is an economic success story and an export powerhouse. The key transition period is widely agreed to have been the mid-1960s, when Korea began a sustained period of rapid economic growth. While the many factors behind the country's transformation are still debated, Korea's decision to promote exports is generally accepted to have been a key part of its success. In 1959, Korean exports were just 0.7 percent of GDP; a decade later exports were nearly 10 percent of GDP, and by the early 1970s they reached 20 percent.

The contribution of exports to South Korea's economic performance has long been studied.¹ Less well known are the reasons why policymakers decided to undertake a policy of export promotion that contributed to the country's remarkable transformation. Who were those policymakers and what were the motivations for the policy changes that they introduced?

This paper examines the policy decisions and policymaking context of Korea's shift to export promotion in the mid-1960s. Credit is often given to President Park Chung-Hee, who seized power in 1961 and presided over Korea's high growth period, for demanding that exports increase. However, the previous, short-lived administration of Chang Myŏn introduced, with U.S. encouragement, some of the liberalizing reforms that Park later embraced. These included a devaluation to stimulate exports and reduce the rent-seeking that came with government allocation of foreign exchange. Furthermore, in his first three years in power, Park did not adopt export-oriented policies, aiming instead to promote capital-intensive manufacturing through state-led industrial policies. He also pursued expansionary macroeconomic policies and refused to devalue an increasingly overvalued currency, which led his government to impose stringent import controls to stop a precipitous decline in foreign exchange reserves.

The United States opposed the military government's initial policy stance and withheld economic aid to force it to devalue the won and liberalize the foreign exchange regime. These changes were deeply unpopular in Korea and resisted by government officials, but the United States had enormous leverage because it financed most of the country's desperately needed imports. In 1964, the Park government, in a weakened position due to domestic crop failures, relented and appointed an economic reform team that was strongly committed to export promotion as a national priority. Expanding exports was seen as a means of earning foreign exchange to pay for imports, ending the country's excessive dependence on the United States.

This paper seeks to contribute to our understanding of the political economy of trade policy reform by examining why and under what circumstances such reforms take place. The paper is close in spirit to Haggard, Kim, and Moon (1991), who look at the domestic political economy of Korea's move toward export promotion, and Yoo (2017), who provides a detailed analysis of the export expansion of the 1960s.

¹See Frank, Kim, and Westphal (1975), Hong (1979), Krueger (1979), Jones and SaKong (1980), Westphal and Kim (1982), Haggard (1990), and Kwang Suk Kim (1991), among many other works. Connolly and Yi (2015) suggest that Korea's trade reforms between 1962 and 1989 can explain 17 percent of South Korea's catch-up to the G7 countries in value-added per worker in the manufacturing sector and contributed to investment and productivity gains through the adoption of better technology.

This paper focuses more on the policies and policymakers themselves and highlights the role played by the United States, which consistently pushed successive Korean governments to adopt a realistic exchange rate and reform its foreign exchange system.² The Korean authorities were reluctant to undertake these unpopular measures until President Park became fully committed to an export promotion strategy in 1964-65. Neither South Korea nor the United States wanted the country to remain so dependent on American aid. South Korea appears to be an example of where external pressure and encouragement helped activate the movement toward reform.

This paper is organized as follows. Section 2 provides an overview of Korea's foreign exchange and foreign aid policies in the 1950s, which included the deliberate overvaluation of its currency to maximize American aid along with foreign exchange rationing. Section 3 examines the tentative reforms under the short-lived democratic government of Chang Myŏn in 1960-61, which presaged many of the later changes, particularly a major devaluation to reduce the political graft associated with the rents from import restrictions and a unified exchange rate. Section 4 covers the first three years of Park Chung-Hee's military government, which resisted American advice and was forced to tighten import controls and to return to multiple exchange rates in the face of mounting balance of payments difficulties.

Section 5 turns to the 1964-65 policy changes that included a large devaluation, adoption of a unified and flexible exchange rate, the relaxation of foreign exchange controls, and numerous export-promotion policies, most of which had been urged by U.S. advisers. The implementation of these policy changes was led by Chang Ki-Young, Korea's leading economic policymaker, who led a reform team that was deeply committed to increasing exports. Section 6 discusses why the reform period came to an end in 1967, also offering a brief discussion of how industrial policy played a role during this period. Section 7 offers some concluding observations.

II. Floundering in the 1950s

Since 1392, Korea banned private foreign trade and only allowed limited, government-controlled trade. Korea became known as the "Hermit Kingdom" and rebuffed mid-nineteenth century attempts by the West to engage in trade, choosing instead to remain economically isolated and avoid Western domination, as had been the case with China.³ Although it succeeded in avoiding Western domination, Korea failed to avoid Japanese domination. Japan forced Korea to open its ports in 1876 and then annexed the country in 1910.⁴ Trade grew to become a significant fraction

²This paper draws on earlier studies by USAID officials who worked in Korea in the mid-1960s, including Cole and Lyman (1971), Brown (1973), Mason, Kim, Perkins, Kim, and Cole (1980), Cole (2014), and others. In addition, the Korea Development Institute (2016) compiled an oral history of many of the Korean policymakers involved in government at this time. The reminiscences of Kim Chung-Yum (1994, 2011) also provide important insights into the reform process.

³Lee and Temin (2010) explain this economic isolation on grounds that engagement through trade produced negative political effects that the country's leaders were trying to avoid.

⁴In lieu of measures of income, Kim and Park (2021) show that biological living standards improved as a result of the opening of trade.

of Korea's economic activity. In 1940, exports were 31 percent and imports were 43 percent of Korea's GDP (Hong, 1979, p.45).

Korea regained its independence after World War II but was partitioned into an American-backed South and a Soviet-Union-backed North. South Korea, at that time, was significantly poorer than North Korea, which had most of the peninsula's industry and natural resources.

The Korean War (1950-53) was a further economic setback to the already destitute South. Wade and Kim (1978, p.246) describe the state of the country after that conflict:

"In 1953, Korea was an extremely poor country in every sense of the term: it was over-populated, productivity was low, subsistence living standards prevailed, natural resources were meagre, the economy was primarily agricultural, and illiteracy was still high; moreover, savings and investment were low, foreign trade was nil, a comprehensive development strategy had not been formed, public institutions were arbitrary, inchoate, inexperienced, and both elite and popular morale was demoralized and often cynical. Few countries in the world offered fewer ostensible prospects for broad, rapid and prolonged economic development."

South Korea limped through the 1950s with lackluster economic growth (about 4-5 percent), high unemployment, large budget deficits, chronic inflation (around 30 percent a year), and a persistent balance of payments shortfall that was filled by U.S. foreign aid. Between 1953 and 1961, U.S. foreign aid financed about 70 percent of Korea's imports and 75 percent of total fixed capital formation (Haggard, Kim, and Moon, 1991, p.852). For most of the 1950s, exports amounted to only about 1 percent of GDP while imports were closer to 10 percent of GDP (Nam, 1995, p.154).

The policies of the South Korean government were a major part of the problem. President Syngman Rhee, who was elected in 1948 and served until 1960, neglected the country's economic development. Instead, his overriding goal was to unify the country through military conquest – reflected in the slogan "March North for Unification" – something the United States strongly opposed.⁵ Rhee sought to ensure the continuation of U.S. military and economic assistance until the day reunification arrived.⁶

Korean economic policy in the 1950s was built around "the three lows" – low grain prices, low interest rates, and a low price of foreign exchange – and the controls needed to maintain them. While the controls led to perpetual shortages of grain, capital, and foreign currency, each had a rationale. The government sought low grain prices to keep the cost of living down, relying on grain imports from the United States made available through P.L. 480 grants. The government maintained interest

⁵There was "an unwillingness to build up the South as an independent and integrated economy. The possibility of unification again giving access to the electric power and heavier industries of the North was given as a reason for holding down the growth of such facilities in the South," Cole and Lyman (1971, p.166) observed.

⁶The few Korean economists who recommended a different approach were ignored. As Cole and Lyman (1971, p.79, 81) note, "the regime as a whole remained resistant to the ideas of those within its ranks who had professional economic expertise, blocking their advance in the bureaucracy and otherwise failing to encourage their work." These factors "contributed to a general sense of despair and pessimism about the prospects for economic growth in the South, even among advocates of improved policies."

rate ceilings ostensibly to help borrowers and promote investment, but negative real interest rates meant there was little incentive to save, diminishing investment and financial development. The government kept the price of foreign exchange artificially low to make imported goods, particularly capital goods, cheaper than they would be otherwise.

The low price of foreign exchange meant the Korean currency was significantly overvalued and the excess demand for foreign exchange was substantial. The overvaluation priced Korean goods out of the world market and kept exports at less than 1 percent of Korea's GDP for most of the decade. It also greatly lowered the price of foreign goods and fueled strong demand for imports. Such imports were needed to maintain South Korea's minimal standard of living and to keep domestic production going. The dominant source of foreign exchange came from U.S. grants and loans, which allowed Korea to afford imports of about 10 percent of GDP.

The shortage of foreign exchange led the government to introduce import controls to conserve foreign exchange reserves. Import licensing was introduced in 1946 to prevent imports of nonessential goods. In 1949, the Ministry of Finance began preparing a quarterly foreign exchange budget to determine how export earnings and aid inflows should be allocated in purchasing imports. In 1954, the government briefly introduced competitive bidding for foreign exchange. The bidding rate in 1954 was 460-690 won per dollar when the official rate was 180, but the government soon returned to rationing (Yoo, 2020, p.7). In 1955, the Ministry of Commerce and Industry began categorizing imported goods as automatically approved, granted to less than 10 percent of total importable items; restricted, which required government permission; and prohibited, where local production could satisfy domestic demand, to guide decisions about foreign exchange allocation. The government maintained high import tariffs, about 40-45 percent on average, to capture as revenue some of the rents that accrued to importers who reaped a large scarcity premium when they received permission to import foreign goods.⁷ The government also maintained a complicated system of multiple exchange rates which differed according to the sources of export earnings and the uses of the foreign exchange.

These import restrictions were not part of a deliberate plan to promote infant industries or pursue an import substitution strategy for development purposes. Rather, the restrictions simply emerged from an ad hoc effort to manage the balance of payments.⁸

Of course, a devaluation to establish a realistic exchange rate may have encouraged exports and discouraged imports, thereby relieving the balance of payments problems. However, the Rhee government resisted any devaluation

⁷As Kim (1991, p.36) notes: "Because the domestic currency was almost always overvalued in the face of rapid domestic inflation, tariffs were not really effective in discouraging imports during this period even though their rates were reasonably high. For this reason, the government relied mainly on the system of semiannual trade programs to control imports quantitatively. However, a complicated system of multiple exchange rates was used to offset some of the disincentive effects of the won overvaluation on exports."

⁸"There was little conscious effort on the part of the government to formulate economic policies from a strategic perspective," according to Lim (2004, p.9). "Import substitution in Korea was more a result of crony capitalism than a strategy for economic development." The government was also not trying to use selective policy to promote infant industries. As Hong (1979, p.96) notes, "In the actual execution of import controls, this concept of infant industries seems to have been used in the vaguest possible way in Korea. Instead of selecting an infant industry and protecting it, any protected industry seems to have been regarded as an infant industry."

because it benefited from the overvaluation of the won. Under the “advance agreement” reached just after the outbreak of the Korean War in 1950, Korea would advance won to the United Nations Command for its expenditures in Korea and would be reimbursed by the United States in dollars. The Korean government had a strong financial incentive in keeping the domestic currency price of the dollar as low as possible to maximize the dollars received from a given amount of won advance (Yoo, 2017). For example, a disbursement of 100,000 won to support American military operations in Korea would yield \$10,000 if the exchange rate was 10 won to the dollar but only \$5,000 if the exchange rate was 20 won to the dollar.⁹

The Rhee government also benefited from the overvalued currency because import controls helped build domestic political support for the regime. Those granted access to foreign exchange earned scarcity rents by importing goods at artificially low prices and then selling them at a high scarcity premium at home. The government’s control over foreign exchange allowed the Rhee government to distribute favors to businessmen and other favored constituencies who would provide kickbacks to the Liberal Party.¹⁰

However, the artificially low Korean exchange rate meant that the United States was paying more dollars than necessary for every won spent for local expenses. At a time when Congress was seeking to reduce the foreign aid budget, U.S. economic advisers repeatedly pressed the Korean authorities to devalue their currency. The goal was not simply to economize on American foreign aid expenditures but to stimulate Korea’s export earnings so that it would be less dependent on foreign assistance in paying for imports. The overvalued currency had a devastating effect on the country’s merchandise exports, which declined from \$40 million in 1953 to \$16 million in 1958 – a year in which imports were \$370 million. Korea did little to promote exporters aside from a variety of haphazard and ad hoc measures, such as partial and selective export subsidies to compensate for the overvaluation and tariff exemptions on some raw material and intermediate goods imports.¹¹

To the frustration of U.S. officials, the Rhee government ignored repeated calls for a devaluation of the won.¹² For example, in 1957, the official exchange rate was

⁹As Yoo (2020, p.4) notes: “The agreement determined the direction of the exchange rate policy from the rest of the decade. Throughout the 1950s, despite rampant inflation, the official exchange rate was kept low and devaluation was delayed as long as possible, obviously to maximize the dollar receipt for a given amount of won advance. The lower the won-dollar exchange rate, the greater the amount of dollars received.”

¹⁰See Lim (2004, p.8). Haggard *et al.* (1991, p.855) argue that “The government was poorly insulated from the demands of the private sector and was penetrated by patron-client networks. The economic bureaucracy was subject to political interference from both the executive and the ruling party.”

¹¹A more significant change was the introduction of an export retention scheme in which exporters had the right to retain foreign exchange earnings at the official exchange rate. Another tentative step in the direction of liberalization was the 1959 tariff exemption on imports of some raw materials and intermediate goods to help exporters.

¹²The top U.S. economic adviser in Korea from 1956-60, Edwin Cronk, recalled: “the exchange rate was way, way off a realistic limit. ... such that there was no money to be made in exporting anything, because with the official exchange rate you wouldn’t end up with enough to pay for your raw materials or your labor. But millions could be made by importing anything; anything that was usable – say rice, or cement, or any of the basics. If you were one of the lucky ones to get an import permit, which was of course issued by the government, you were an instant millionaire! It was this distortion of the exchange rate which was one of the central problems, and we couldn’t do anything about it. Now, I felt then – and I feel even more strongly now – that if we had just laid the law down, and said, ‘You either [adjust] the exchange rate, or we’re going to cut the AID program back to the very bone, and let you take the consequences.’ We could have been tougher, much tougher.” (<http://www.adst.org/OH%20TOCs/Cronk,%20Edwin.toc.pdf>).

50 won per dollar when the equilibrium rate was thought to be 80-100. Rhee issued a directive that "all necessary economic adjustments" be made to keep the exchange rate at its current level. The "defense of the overvalued exchange rate seemed almost a matter of life and death for the Rhee government," Woo (1991, p.64) writes. The government argued that increasing the price of foreign exchange would raise the cost of imported goods and thereby fuel inflation. The unstated Korean concern was that a more realistic exchange rate would reduce the inflow of aid dollars from the United States.

In 1957, Congress decided to reduce spending on U.S. foreign assistance and shift from military aid in the form of grants to economic assistance in the form of loans. U.S. aid to Korea was pared back from \$383 million in 1957 to \$222 million in 1959 (Brazinsky, 2007, p.105). Yet American officials were particularly concerned about the reluctance of the corrupt Rhee government to take steps to improve its stagnant economy. South Korea was the largest recipient of U.S. foreign aid and was often disparaged as a corrupt "sinkhole."¹³ Officials worried that South Korea would never become a self-sustaining economy and would always be dependent on the United States. For U.S. officials worried about Cold War competition, the fact that North Korea's economy looked in better shape than South Korea's was particularly alarming.¹⁴

American advisers began to put increasing pressure on the Rhee government for policy changes, not just to stop the endemic corruption but to increase exports and close the enormous gap with imports. Despite this U.S. pressure, Korea continued to delay entering into consultations on the matter. In January of 1960, the U.S. Embassy in Seoul unilaterally changed the exchange rate at which it would reimburse expenses to 65 won per dollar, a move that the government made the official the next month.

While the aid reduction and devaluation threatened Rhee's domestic political position, he responded not by embracing economic reforms but by engaging in political repression.

III. Tentative Reforms under the Chang Myŏn Government

Mass student protests against political repression and the blatant rigging of the March 1960 national elections forced Syngman Rhee to step down. In July of 1960, an election brought the Democratic Party, headed by Prime Minister Chang Myŏn, to power.

¹³A U.S. Comptroller General (1962) report expressed concern about widespread corruption in Korea due to the foreign exchange allocation. The report (p. 11) concluded that "the present state of Korean political and economic sophistication and the history of the aid program over the past years do not offer any reasonable basis for believing that the formidable task of carrying through the hard internal measures vital to Korean economic development in correlation with the prudent management of aid funds so substantially beyond the normal range of the Korean economy, is within the capability of the Korean Government without cooperative guidance, forceful support, and effective surveillance by the United States." See Krueger and Ruttan (1989) for an evaluation of U.S. aid to Korea.

¹⁴As Kim and Baik (2011, p.60) observe: "The North Korean threat ... was psychological and political, making the South look like a hopeless case of poverty, social anomie, and political instability that was destined to lose the inter-Korea competition to become the sole legitimate government of the entire Korean peoples. In 1961, North Korean per capita GNP stood at \$160, twice that of the South, and the gap in economic performance was rising."

The Chang government was committed to a more open and liberal political and economic system. Rather than hold out hope for Korean reunification, the government vowed to focus on economic development and root out political corruption. The objectives were closely related: the Democratic Party had long called the low exchange rate a “disguised subsidy” for cronies who were close to the government (Yoo, 2017, p.17). The new finance minister was in favor of liberal market reforms as a way of ending corruption stemming from the non-transparent allocation of foreign exchange and government loans.

The United States was relieved that Rhee was no longer in power and pledged to support the new government’s reform efforts.¹⁵ Under Secretary of State Douglas Dillon offered \$35 million in assistance if the government agreed to raise the exchange rate and increase transport and electricity rates (to reduce costly government subsidies and shrink the budget deficit), among other conditions. Of that sum, \$20 million was earmarked help to deal with the fallout from a devaluation, \$10 million to purchase U.S. agricultural products to keep food prices from rising, and \$5 million in additional defense support.¹⁶

The “Dillon Package” was set out in an October 25, 1960 letter from Dillon to Chang with the requirement that the reforms be implemented by March 1, 1961. Although officials worried about the political fallout from these policies, the Chang government desperately wanted American backing and agreed to the proposal, working quickly to meet the deadline.¹⁷ The government devalued the won in two steps, the first in January of 1961, taking the exchange rate from 65 won per dollar to 100 won per dollar. A month later, the government undertook another devaluation, to 130 won per dollar, nearly eliminating the black-market premium. The February 1961 devaluation was made in conjunction with a major reform of the foreign exchange system.¹⁸ The government rationalized the complicated multiple exchange rate system and began to relax import controls, paving the way for a fully unified exchange rate in June of that year.

The devaluations of 1960 and 1961 significantly reduced the overvaluation of the won. As Figure 1 shows, the black-market premium dropped from 150 percent to about 30 percent. This increased the profitability of exports, and the payoff came quickly: exports jumped from \$19.8 million in 1959 to \$32.8 million in 1960 and then reached \$40.9 million in 1961, finally surpassing their 1953 dollar value.¹⁹

¹⁵As a telegram (August 20, 1960) from the State Department to the U.S. Embassy in Seoul stated: “We have been pleased to note that the Democratic Party recognizes the need for basic exchange reform. The US has long believed that the establishment of a realistic unitary rate system is essential to the sound development and stability of the Korean economy. The US government attaches so much importance to this that we expect to discuss this subject in detail with the ROKG in near future.” *Foreign Relations of the United States, 1958-60*, Vol. XVII, p.688.

¹⁶In November of 1960, National Security Council document 1068 stated that a primary U.S. goal was to ensure that Korea would become a “self-supporting” economy. To do so, the United States should press for “reforming the foreign exchange system so as to reduce the tendency to import and stimulate domestic production for both export and domestic use; Normalizing commercial relations with Japan; Eliminating excessive bureaucratic controls; Reforming the tax structure, improving business practices and rationalizing utility rates.” U.S. Department of State. *Foreign Relations of the United States, 1958-1960. Japan; Korea*. Volume XVIII. Washington, D.C.: U.S. Government Printing Office, 1958-1960, p.702. (<https://history.state.gov/historicaldocuments/frus1958-60v18/d334>)

¹⁷“Having witnessed the influence of the threat of withdrawal of U.S. aid on the collapse of the Rhee government, the new government’s first concern was to secure American backing by being highly solicitous of American interests and advice,” Kim (1975, p.212) notes.

¹⁸On the politics behind the devaluation, see Ryu (2017).

¹⁹The main driver of exports was the devaluation, as the exchange rate went from 65 percent of its realistic

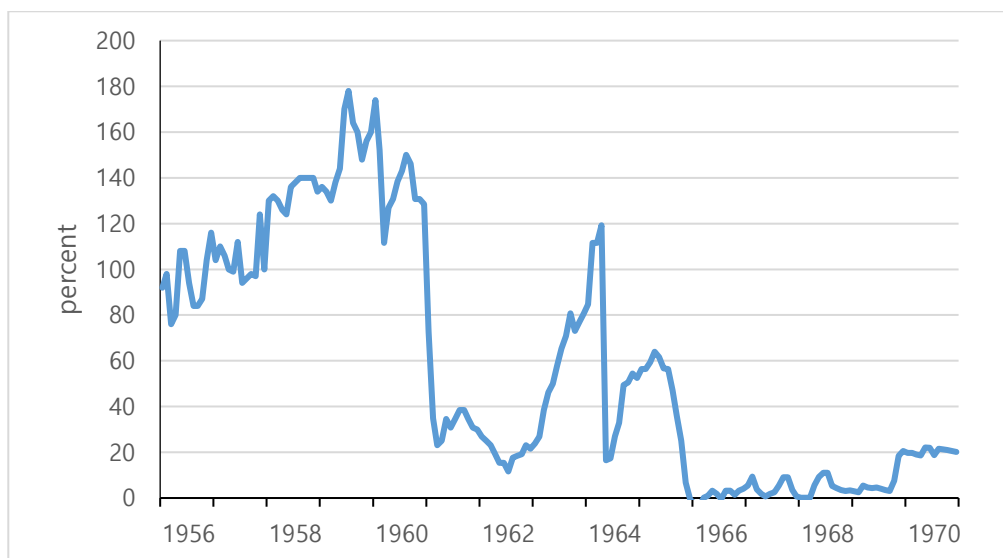


FIGURE 1. BLACK MARKET PREMIUM ON THE KOREAN WON, 1956-1970 (MONTHLY)

Source: Carmen Reinhart, based on *Pick's Currency Yearbook*; <https://carmenreinhardt.com/exchange-rates-official-and-parallel/>.

More importantly, non-traditional, labor-intensive manufactured exports started to surge in 1963 (Yoo, 2017, pp.3-4).

The Chang government devalued mainly as part of its anti-corruption campaign, as it sought to eliminate the rents associated with the currency's overvaluation and the government's allocation of foreign exchange. There was some hope that the devaluation would stimulate exports, but few believed that it could fundamentally transform the economy into an export-led growth model.²⁰

However, the immediate impact of the Dillon package was short-term pain. In the first two months of 1961, prices rose 15 percent and industrial production, which depended on cheap imported intermediate goods, fell.²¹ The politically divided government went through several major cabinet reshuffles during its short period in

value to 98 percent in 1961, according to Brown (1973, p.133). Yoo (2017, p.14) also suggests that the foreign exchange reform of early 1961 was the initial trigger for the rapid expansion of exports that continued over the next decade: "it is highly likely that the reform made it possible for those who had not been in the export business to see for the first time the profitable export opportunities, which had been hidden behind the veil of the complex and distorted foreign exchange system."

²⁰According to Yoo (2017, p.17): "The Democratic Party for years had labeled the unrealistically low official exchange rate a "disguised subsidy" to their cronies by those in power. For instance, if a politician, by exercising some influence on the relevant ministry, had a certain amount of government-held dollars be allocated to his political supporter(s) at the official exchange rate, far below the on-going market rate, it certainly would be an egregious example of corruption. The Democratic Party had promised to eradicate this source of widespread corruption, if it seized power. Apparently, it was not even dreamed that the reform would start the rapid export expansion that eventually led to the great economic transformation called the 'East Asian Miracle.' Daily newspapers of those days carried no reports to the effect that the Democratic Party anticipated or promised an increase in exports, the creation of new jobs, progress in industrialization, and so on as the economic effects of the reform. It seems certain that the reform of the foreign exchange system was meant to be, more than anything else, an anti-corruption measure."

²¹According to Kim (1975, p.212): "The results were disastrous. When the exchange rate changed, the costs of imports on which the economy depended doubled, producing panic and spiraling inflation."

power and never enjoyed strong public support. The government was widely seen as inept, and public dissatisfaction with the country's situation led to protests.²²

IV. President Park Takes Over

After growing political unrest and renewed street demonstrations by students, a military coup overthrew the nine-month-old Chang Myŏn government on May 16, 1961. The military government under General Park Chung-Hee declared martial law and pledged to oppose communism, eliminate corruption, seek unification, and build a self-sufficient economy.²³

The military leaders believed the state should bring discipline, stability, and order to the nation. They made economic development an essential priority and brought energy and a sense of urgency to the task. At the same time, the military leaders “had only the vaguest notions of economics and politics,” according to U.S. Ambassador Samuel Berger (1966, p.4).²⁴

The military government pushed forward with two unfinished initiatives from the previous administration. In June of 1961, they established the Economic Planning Board (EPB), an economic super-ministry designed to streamline economic policymaking and bypass the old corrupt bureaucracies. A month later, they released the First Five-Year Economic Plan, which updated the various targets and goals for the Korean economy as developed by the previous administration.²⁵ The new plan did not emphasize export expansion but “called for constructing a self-reliant economy through inward-looking import-substitution industrialization” (Kim and Baik, 2011, p.75). The government envisioned state investment to build up heavy and chemical industries for reasons of national security and to end the country's dependence on U.S. aid and foreign sources of supply. Given Korea's enormous trade deficit and tiny export base, the government thought it easier to replace imports by expanding domestic production of those goods rather than to try to make up the gap by exporting more. The plan was to make the country “self-reliant” in its ability to pay for its imports, but as Kim and Baik (2011, p.75) note, the plans were formulated “without due consideration of South Korea's short supply of capital and

²² As one former official put it: “We had simply let the people shout for political reforms and further democratization: We didn't have the time to address domestic political demands while the entire cabinet was focused so heavily on implementing the Dillon memo” (Satterwhite, 1994, p.329).

²³ See Jungwan A. Kim (1975, p.227). Among the many detailed assessments of Park's government and its economic policies are Kim (2004), Kim and Vogel (2022), Kim and Sorenson (2011), and Cho (2019).

²⁴ “The junta's leaders were bold, nationalistic, and determined to improve conditions in their country,” Brazinsky (2007, p.128) writes. “But at the same time they were truculent, autocratic, and mistrustful of American advice.”

²⁵ The EPB played a coordinating role above the various ministries that were responsible for executing policy. According to Kim (2011, pp.213-14): “It is important to emphasize that the significance of economic planning lay less in offering a technical master plan of industrial growth, with intricate modeling of targets and instruments, than in establishing institutional channels of communication and cooperation and institutional procedures for systematic agenda formation, resource mobilization, and policy feedback among the EPB, the MoF, the sectoral ministries, and the auxiliary ministries on an ongoing basis.” “The real significance of economic planning was not technical but political, authorizing the EPB to intervene in other ministries' affairs and inculcate society with Park's brassy ‘can do’ spirit and his daring ‘grow-at-all-costs’ strategy,” Cole and Lyman (1971, p.218) suggest. Even as late as 1964, “planning as such was definitely not a well-established or influential process in the Korean government” but it soon became important.

technology.”²⁶

The plan ran into stiff U.S. opposition. American advisers worried that large-scale investment in capital-intensive production was the wrong strategy for a poor, low-saving country that had an abundance of unskilled labor and a severe shortage of capital. U.S. advisers had long argued that Korea should focus on increasing productivity in agriculture and promoting labor-intensive export industries. While they did not envision an export-led growth model for Korea, they certainly did not think that import substitution was appropriate given the country's circumstances.²⁷

Korea's military leaders not only ignored the American advice but did not want to hear it. The U.S.-Korean Economic Coordination Commission failed to meet from 1961 to 1963. President Park was just as stubborn as Rhee had been when it came to accepting economic guidance from the United States. “They were strongly nationalistic and resentful of their dependence on the United States,” Ambassador Berger (1966, p.5) recalled. “They recognized that Korea must tolerate the Americans, but they resented our advice as interference.”²⁸

The United States stood in the way of the military's attempt to pursue an industrialization strategy based on heavy industry.²⁹ Korea abandoned a plan to construct an integrated steel mill after the United States refused to provide financing and blocked a potential loan from West Germany. The military government tried to bypass the United States and raid the supposed “idle cash” in Korean banks by freezing all bank accounts in June of 1962. The theory was that massive unused funds in the banking system could be directed to state-supported investment projects. U.S. advisers in Korea had not been given advanced warning of the plan, thought it was a terrible idea, and immediately stopped the disbursement of aid until the government unfroze the bank accounts, which it soon did.

The military government also considered initiating the local assembly of automobiles, television sets, and watches through the use of imported components

²⁶As Kimiya (2011, p.67) writes: “the military junta initially adopted an autarkic industrialization strategy known in Korean as ‘inward-looking industrialization.’” According to the memoirs of the individuals who played an important role in drafting the original five-year economic plan, “they had the clear intention to construct a self-reliant national economy by investing huge sums of capital in basic industries.” The export projects were wildly optimistic and “it is doubtful that the planners had much of an idea as to how the targets might be achieved,” Cole and Lyman (1971, p.211) observe. “While the original plan mentions the desirability of and some policy measures for export expansion, it explicitly states that the policy's priority was import substitution,” Yoo (2020, p.23). “Simply, the government did not consider export promotion as a development strategy in 1961,” notes Yoo (2017, p.15). That said, there were hints of a new policy direction in the plan. As Cole and Lyman (1971, p.218) write: “Although the First Five-Year Plan did not present a well-worked-out set of economic policies, it did imply a number of policy directions that were subsequently followed and that provided the real impetus for Korea's rapid growth. These included the encouragement of exports and domestic savings and the maintenance of realistic, market-oriented interest and exchange rates. While it is difficult to assess the importance of these policy suggestions in the plan in bringing about the actual implementation of the policies, and it would undoubtedly be misleading to attribute a significant role to them, it can at least be said that the tendencies expressed in the plan were not contrary to the policy directions followed, mainly after 1964.”

²⁷“Rather than directly dictate an export-oriented industrialization strategy, the United States only voiced its opposition to the inward-looking deepening strategy,” Kimiya (2011, p.69) notes.

²⁸A June 1961 presidential task force on Korea noted: “the new regime will be tough, determined and difficult to deal with. Its authoritarian and nationalistic stamp suggests that it will not be readily receptive to U.S. guidance and will seek to search for South Korea's independence in military, economic and political affairs.” Presidential Task Force on Korea, Report to the National Security Council, June 5, 1961, pp.35-36. (<https://www.jfklibrary.org/asset-viewer/archives/JFKNSF/127/JFKNSF-127-011>)

²⁹“Among the various factors that led to the failure of inward-looking development, the most important was the U.S. government's opposition,” notes Kimiya (2011, p.71).

and assembly kits. These plans were also shelved because they would have required large amounts of foreign exchange. Not only would the final products be of insufficient quality to be exported and earn foreign exchange, but the imported components would be expensive and cost foreign exchange. As a result, the projects would have been a net drain on the country's scarce reserves.³⁰

The military government also departed from the U.S.-backed stabilization program and began to run up deficit spending. As a result, inflation picked up, with wholesale price inflation jumping from less than 10 percent in 1962 to nearly 30 percent in 1963. With the value of the won having been fixed since the 1961 devaluations, the Korean currency became overvalued once again, as indicated by the rising black-market premium shown in Figure 1. The stimulus to domestic demand led imports to soar from \$316 million in 1961 to \$560 million in 1963. With U.S. aid being curtailed, the growing gap between export receipts and import payments was financed through the steady depletion of foreign exchange reserves, which fell from \$214 million in March of 1962 to \$107 million by September of 1963. Figure 2 shows that by 1963, Korea's foreign exchange reserves had fallen to level that could finance only about three months of imports.

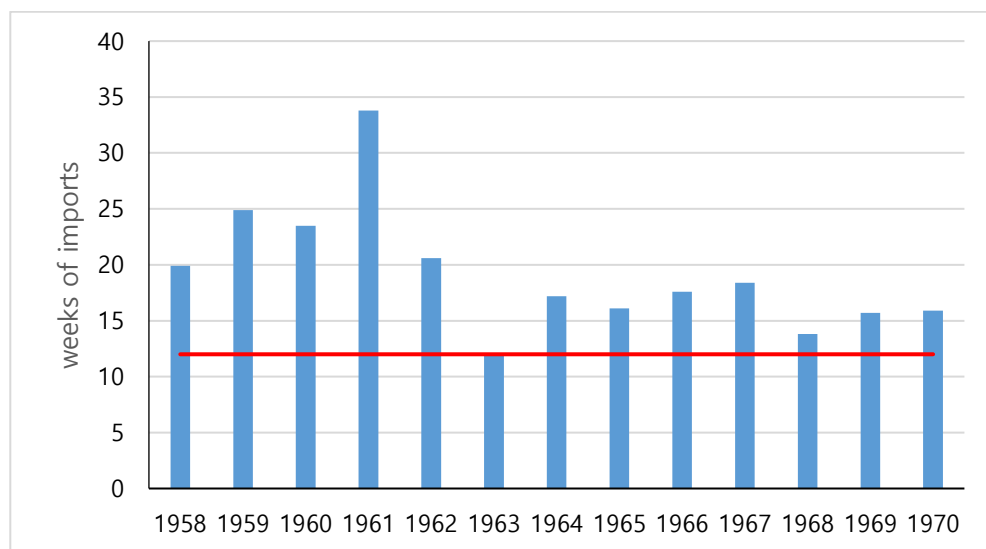


FIGURE 2. KOREA'S FOREIGN EXCHANGE RESERVES, WEEKS OF IMPORT COVER, 1958-1970

Note: The red line indicates the foreign exchange reserve level capable of financing three months of imports, a rough minimum standard suggested by the IMF and other institutions.

Source: International Monetary Fund, *International Financial Statistics Yearbook 1988*, pp.48-49.

³⁰As Luedde-Neurath (1986, p.55, 86) noted, "What all these projects had in common was that they were prestigious, foreign exchange intensive, and likely to neither save nor earn significant amounts of foreign exchange, while arguably not being urgently necessary. ... The purpose of citing the above examples is to show that in its early days at least, the Korean government did start off down the road towards a questionable form of industrialization involving inessential projects, excessive commercial credit, questionable technology transfers, and above all a massive foreign exchange burden." Notably, however, these projects were quickly terminated because of their costs rather than perpetuated despite their costs as happened in other developing countries.

The situation was exacerbated by a food crisis that Korea found itself in the spring of 1963. A poor rice crop in 1962 was compounded by a barley crop failure in the spring of 1963, putting the country on the brink of famine. The country lacked the resources to buy sufficient food from the rest of the world, leaving the country even more dependent on the United States.

Despite the growing balance of payments problems, the government ruled out any devaluation; the public unrest after the 1961 devaluation was still a recent memory. Therefore, to conserve foreign currency, the government turned to various export promotion schemes to boost export earnings and used more stringent import controls to restrain spending on foreign goods. It introduced export subsidies ranging from three to eight percent in September 1961 and later expanded them to compensate exporters for the growing currency overvaluation.³¹ It reduced the tax on export earnings by 30 percent in 1961 and then by another 50 percent in 1962. It established the Korea Trade Promotion Agency (KOTRA) in May of 1962 to collect and disseminate information on foreign markets in order to help exporters overcome the difficulty of entering foreign markets.

As the balance of payments situation worsened in 1963, the military government started clamping down on imports. The government reintroduced multiple exchange rates through an export-import linking mechanism in which exporters would earn non-transferable rights to use a portion of their foreign exchange earnings to buy imports, a means by which to tie imports to exports automatically and thus eliminate the task of allocating foreign exchange among importers. This was an indirect subsidy to exports given that imports could be sold in the domestic market at a profitable premium. However, by second half of 1963, exporters were only allowed to keep 20-25 percent of their foreign currency earnings and had to turn over the remainder to the government at the official exchange rate.³² In the first half of 1963, the government slashed the number of automatically approved imports in half; by the second half of the year, the government suspended the automatic approval system altogether and all imports needed official permission. In November, it required a 100 percent advance deposit on goods imported on credit.

As Korea's economic difficulties mounted, relations with the United States deteriorated. U.S. advisers were dismayed by the economic policy choices being made by the military government. Even before the problems of 1963 emerged, the United States was frustrated by the lack of progress that Korea had been making in improving its economy, in particular its inability to reduce dependence on U.S. aid.³³

The Kennedy administration came into office prepared to take a tougher line with Korea, including the scaling back of aid (Park, 1999; Lee, 2006). For example, the U.S. Operations Mission in Korea reduced economic development grants to Korea

³¹See Kim (2019, p.127). "Although it started to promote exports in the face of declining foreign aid, most of the export promotion measures adopted during that period had the characteristic of ad hoc measures to offset the disincentive effect of an overvalued exchange rate on exports," says Kim (2019, p.131).

³²Cole and Lyman (1971, p.189) note: "The linking rights in addition gave exporters special access to import licenses for the most restricted, and therefore the highest profit, imported goods. These two types of subsidies made possible continued rapid growth of exports in 1963 and 1964, despite the increasingly overvaluation of the exchange rate and the high levels of domestic demand associated with the inflation."

³³"Throughout the tenure of Killen and Berger, U.S. pressure for stabilization remained high, which provoked strong resentment from South Korean officials" (Kim, 2011, p.77). For American attempts to educate Park on economic policy, see Brazinsky (2005).

from \$178 million in 1961 to \$92.5 million in 1962 (Brazinsky, 2007, p.130). Moreover, a June 1961 National Security Council task force report mentioned something that would soon become a key part of U.S. strategy. The report noted that “experience has shown the effectiveness of sanctions based upon withholding of increments of economic aid as a means of ensuring Korean performance. Accordingly, United States influence should be reinforced by making economic development assistance (as distinguished from supporting assistance) available in increments which can be withheld in the event of a Korean failure to carry out the agreed-upon programs.”³⁴

At the U.S. Embassy in Seoul, Ambassador Samuel Berger and U.S. Operations Mission (USOM) director James Killen, a tough labor negotiator, were prepared to do this when dealing with the military authorities.³⁵ Korea’s precarious economic situation in 1963 put the United States in a particularly strong position to influence Korean policy. Berger and Killen began to use aid as leverage to force the military authorities to do two things that they did not want to do: (i) hold democratic elections and return to a civilian government, and (ii) adopt policies to achieve stabilization and lay the foundation for economic growth so that Korea could become self-sustaining.

The first objective was political. The United States did not support the 1961 coup and had long pressed the military to step aside and hold elections to transition to a civilian government. In March of 1963, Park surprised the United States by announcing that a referendum would determine if the military should stay in power. Berger immediately suspended aid. A few weeks later the announcement was rescinded, an election was scheduled for October, and the aid was released.

To get the stabilization program back on track, Killen also withheld economic aid from Korea, including food assistance at a time when food was in desperately short supply. Korea agreed to a new stabilization program in April of 1963, with the government pledging to increase tax collection and restrain spending, thereby reducing the budget deficit with the hope of bringing inflation under control. The government also agreed to dismantle trade controls and move toward a floating exchange rate at some point. Aid was released, but by July it was clear the government was not living up to terms of the agreement. Therefore, Killen requested and received authorization to stop the scheduled stabilization assistance disbursement of \$15 million and to suspend approval of new development assistance if an August review was not satisfactory.

The International Monetary Fund (IMF) echoed U.S. concerns about the direction of Korea’s economic policy. In October of 1963, after an August staff mission to Seoul, the IMF suggested that the complex export subsidy and import control measures were not a long-term solution to the balance of payments problems, hinting that an exchange rate adjustment was appropriate. “A more lasting solution to Korea’s payments problem not in these piecemeal incentive measures, but in the attainment of internal financial stability through sound monetary and fiscal policies, including the establishment of a unified [exchange] rate at a realistic level,” the IMF

³⁴Presidential Task Force on Korea, Report to the National Security Council, June 5, 1961, pp.35-36. (<https://www.jfklibrary.org/asset-viewer/archives/JFKNSF/127/JFKNSF-127-011>).

³⁵The USOM was the precursor to the U.S. Agency for International Development (USAID).

(1963, p.14) staff concluded.³⁶ Korean officials conceded that the exchange rate was too low for exporters but said there were no plans to devalue the won because, they argued, that would simply fuel inflation.

Park was narrowly elected president in the October 1963 elections. He campaigned on a nationalist "Korea first" policy that recognized that, as long as it was dependent on American aid and therefore subject to U.S. influence, the country was not fully sovereign. In a campaign book, *The Country, the Revolution and I*, Park (1963) set out his vision for a modernized, industrialized Korea. Park said that Korea was only "nominally" independent because half of the government's budget came from the United States.³⁷ As he put it:

"Just imagine one person depending on another for half, or more, of his living expenses for ten years or twenty years; having no other reason for so doing than that the other person once helped him or is still helping him or that he has no ability to help himself. ... For twenty years we have kept our house in this manner! One full generation has passed! Are we to sit down and spend our livelong days like this forever? Are we to stand by and watch, without any resolution or courage, this process with indifference? What would we do if U.S. aid were cut off tomorrow?" (Park, 1963, p.21).

Park (1963, p.22) admitted that "our government would have to instantly close down if U.S. aid were withheld or withdrawn." Something had to be done to "preserve our self-respect as a sovereign nation." Park (1963, p.35) believed that the construction of "an independent economy and to achieve economic self-sufficiency" was "a task that must be accomplished, at all costs." By self-sufficiency, he did not mean autarky but simply that the country could pay for its necessary imports with the earnings from exports instead of depending on U.S. aid.

V. The 1964-65 Policy Changes

In January of 1964, a new civilian government under President Park took over with the hope of addressing the country's seemingly intractable problems: rising inflation, a dire food shortage, and falling foreign exchange reserves, all of which made the country even more dependent on American assistance.

Having ensured that Korea returned to a civilian government, U.S. officials were ready to push Korea into making what it saw as long-overdue changes in economic

³⁶The IMF (1963, p.16) concluded diplomatically: "While appreciating the constructive efforts made by the Korean authorities, particularly as regards stabilization, the staff team noted that in order to serve the economy well, the exchange rate should be fulfilling more adequately the purposes of promoting exports and restraining imports. ... The staff team observed further that the present restrictive system appeared to be too complex and tended to cause various economic distortions." Furthermore, the following was noted: "As more significant expansionary pressures have been generated, the resulting price movements have tended to make the [exchange] rate less representative of the true price relationships between the country concerned and the rest of the world. In this sort of situation and in the absence of a large cushion of international reserves, it is difficult to maintain an exchange rate solely by tightening restrictions [on imports] and by using special devices [to support exports]."

³⁷"In campaigning for Korea's autonomy, free from US intervention linked to foreign aid, Park set about systematically eliminating US influence on Korean Government affairs," Hyung-A Kim (2004, p.98) points out.

policy. A January 21, 1964 telegram from the U.S. Embassy in Seoul to the State Department stated: “We are forcing or trying persuade the ROK Govt. to make a number of difficult decisions during the first half of this year: A tough economic stabilization program alongside reduced US aid; a ROK-Japan settlement; and devaluation.”³⁸

In February, the government revised the First Five-Year Plan and emphasized the importance of increasing manufactured exports. A few years earlier, the idea of expanding such exports would have seemed farfetched, but it in February of that year it seemed feasible in light of their rapid growth after the devaluations of 1960-61.³⁹ The attention paid to exports reflected not just their economic contribution but their political importance as well. Because Korea’s ability to import still depended on U.S. aid, the United States was able to use its economic leverage to force the military government to step down in 1963. President Park wanted to ensure that the government would never be in such a position again, which meant increasing exports enough to pay for imports. While Korea’s exports had been growing rapidly, they started from a very small base and still only generated enough foreign exchange to pay for 15-20 percent of the country’s imports.

Despite the growing overvaluation of the won since the 1961 devaluation, the Park government still resisted any devaluation on the grounds that it would exacerbate inflation. But with foreign exchange reserves having fallen to precariously low levels and the United States holding back tens of millions of dollars in potential aid, the Park government could not avoid making some adjustments to policy.

In March of 1964, President Park, Ambassador Berger, and Director Killen agreed to establish a joint task force to design a new exchange rate system.⁴⁰ Of course, the two sides disagreed on the details. The United States wanted a large devaluation, from 130 won to a figure in the range of 285 or even 300 won to the dollar, with the subsequent adoption of a floating exchange rate.⁴¹ The Koreans wanted a much smaller devaluation to a new fixed rate.

In the end of March, Berger and Killen held up another tranche of economic aid but offered additional support if policies were changed, much like the Dillon letter of 1961. If Korea devalued its currency and adopted a flexible exchange rate, the United States promised to provide \$30 million in immediate assistance and release 250,000 tons of wheat. At the end of April, Korea agreed to these conditions.⁴²

³⁸ <https://history.state.gov/historicaldocuments/frus1964-68v29p1/d1>, On February 13, 1964, the embassy reported: “In the economic sphere, the primary goal for 1964 should be the pursuit of sound monetary and fiscal policies and the stabilization of price levels. The exchange rate will have to be adjusted to a realistic level some time not later than mid-summer 1964.” Ibid., document 4.

³⁹ As Yoo (2017, p.15) notes: “the government did not consider export promotion as a development strategy in 1961. ... This revision of the First Five-Year Economic Development Plan is clear evidence that the policy switch to export promotion was inspired by the rapid export expansion that had begun earlier.”

⁴⁰ Joo (2017) provides an excellent account of the negotiations and discussions about the Korean exchange rate during this period.

⁴¹ In January of 1964, Professor Irving B. Kravis of the University of Pennsylvania completed a report for USAID on economic reforms in Korea, indicating that it should revise its exchange rate to 240 won per dollar to account for inflation since the 1961 devaluation (MacDonald, 1992, p.296; Joo, 2017). The exchange rate calculation was made by C. Fred Bergsten, then a young staffer at the Department of State.

⁴² This outcome was largely the result of negotiations by James Killen. As David Cole (2014, pp.148-49) recalled: “The OSM director, Jim Killen, had negotiated a very tough stabilization program with the Korean government. He had forced the Koreans to agree to a large devaluation in May and a very tight money supply target for the end of the year. One of his bargaining chips was to hold up shipments of PL480 food supplies in the face of

On May 3, 1964, Korea devalued the won from 130 to 255 won per dollar, somewhat less than what American officials had proposed. It also notified the IMF that it was planning on adopting a floating exchange rate.⁴³ Secretary of State Dean Rusk praised the devaluation as “an important step toward the strengthening of Korea’s foreign exchange earning capability and the establishment of equilibrium in her external accounts. ... A new basis now is being laid for investment in industry, expansion of exports, rising employment, and the broad economic and social progress which Korea’s energetic and capable people can achieve.”⁴⁴ In Korea, the devaluation was widely denounced – in the press, in business circles, and in the National Assembly. “A major South Korean newspaper contended that the devaluation would lead to a ‘vicious price spiral,’” Brazinsky (2007, pp.145-46) reports, “while members of the assembly called the decision a ‘complete mistake’ and contended that it would cause the people great hardship.”⁴⁵

The 1964 devaluation was the first step in what proved to be a decisive shift in Korean economic policy. U.S. pressure also persuaded Korea to open negotiations to normalize relations with Japan. Despite the fact that normalization promised to increase bilateral trade and bring in investment, such a step was deeply unpopular in Korea owing to the resentment of Japanese colonialism in the past and the fear of Japanese domination in the future. When news of the negotiations was made public, massive anti-government demonstrations led to the suspension of the talks and the declaration of martial law.

With protests in the street and his government beset by political factions jockeying for power, Park reshuffled the cabinet and – whether by luck or by design – brought in key reformers who would change the direction of economic policy. On May 9, 1964, less than a week after the devaluation, Park offered the position of Deputy Prime Minister and Minister of the Economic Planning Board to Chang Ki-Young. The chief executive officer of the newspaper *Hankook Ilbo* and a former director of research and deputy governor of the Bank of Korea, Chang had just led the delegation that had been negotiating with Japan. Although he lacked any formal training in economics, Chang was a highly effective administrator who was known as “The Bulldozer” for his ability to get things done.⁴⁶

In offering him the position, President Park asked: “What are the problems of the Korean economy now and how should they be resolved?” Chang replied: “Give

a severe food shortage following below-normal rice and barley crops. Gilbert Brown, on consultation from USAID/Washington, and Bob Klein, program director in Seoul, had supported his tough stance.”

⁴³The Korean statement to the IMF noted: “Although recognizing as the ultimate goal, the establishment of a realistic fixed unitary exchange rate, we believe that Korea’s present circumstances require a flexible rate system for the time being. These circumstances represent the need to substantially increase our export and other external earnings in order to maintain the necessary imports for a reasonable level of economic growth and to adjust to a gradually declining volume of foreign assistance.” IMF EBS/64/73, April 30, 1964.

⁴⁴U.S. Department of State *Bulletin*, 50, May 25, 1964, p.809.

⁴⁵As Kim (1991, p.107) reports: “when the exchange rate reform was announced in 1964, some in the business community, particularly powerful, large business groups, expressed opposition to the reform. Although both export and import-substitute industries could gain by the devaluation, large business groups opposed it because they preferred to operate under extensive controls rather than under a realistic exchange rate and relatively free-market situation.” Some highly dependent on imported raw materials also opposed.

⁴⁶For example, in 1963, when food shortages pushed domestic prices up, Chang managed to import 100,000 tons of wheat from Japan and use some of the profits to fund Park’s presidential campaign (KDI, 2016, p.180). Chang had also worked to turn the Bank of Joseon into the Bank of Korea, the nation’s central bank, working with Professor Arthur Bloomfield from the University of Pennsylvania on the transition.

me one night to think about it.”⁴⁷ Chang immediately reached out to Kim Chung-Yum, an economist and a former Vice Minister of Finance (1962-63) who had worked with him on the March-April mission to Japan.⁴⁸ At one point during the Japan trip, Chang suggested that Kim prepare a report on the future of the Korean economy. Kim wrote a paper arguing that Korea needed to “promote export-led industrialization, like Japan, in order for our economy to survive.”⁴⁹

After meeting the president, Chang called Kim and asked him the same question that Park had asked. Kim promised to prepare a brief memo and meet him at 6am the next morning to discuss it. In the memo, Kim repeated his view that Korea needed to stimulate export growth and adopt market liberalization policies to receive IMF support and other foreign loans.⁵⁰ As Kim recalled,

“...the problems with the Korean economy at the time and the proposed solutions were identified quite clearly in the IMF report. ... The IMF’s policy recommendations for Korea included rationalizing exchange rates and interest rates, trade liberalization, and lowering tariffs. In other words, it recommended an economic restructuring that suited the market. Even though the policy changes were needed, the ministries were too afraid to drive them forward. Because of opposition by businessmen and the media, the Ministers could not carry out any of the IMF’s recommendations” (KDI, 2016, p.181).

Here, Chang was referring to the previously discussed IMF staff report from October of 1963 that called on Korea to scrap its complex system of import controls and export subsidies and adopt a unified exchange rate.

In essence, Kim believed that the government would have to get rid of “the three lows” – the low exchange rate, the low interest rate, and low grain prices – as well as reform the foreign exchange system. The first had already been partially accomplished with the devaluation but the others would be deeply unpopular. Kim

⁴⁷Many of these details come from Korea Development Institute (2016, p.181). Chang told him: “I am only willing to join the President’s cabinet as Deputy Prime Minister, not as a minister. I am also not willing to join the cabinet unless certain conditions are met. I need to be given full control over economic policy matters, and allowed to pursue my economic policy agenda. If I am given unfettered authority, I am sure that I will successfully implement the market liberalization policies you suggested” (Kim, 2011, p.125).

⁴⁸Kim began his career at the Bank of Korea, where he helped set up the bank’s New York office. He received training at the Federal Reserve Bank of New York and later earned a masters’ degree in economics from Clark University in Worcester, Massachusetts.

⁴⁹KDI, 2016, p.430. As Kim (2011, pp.122-23) recalled: “While I was in Tokyo for a month during the negotiations, I met Chang Ki-Young nearly every day to talk about the ongoing negotiations. Between our meetings, we talked about Japan’s economy, and the future of Korea’s economy. During one of our conversations, Chang thought that it would be a good idea if I prepared a report on the future of Korea’s economy, which he would cite during a meeting with President Park. In thinking about the report, I reflected on the economies of the US and Japan as models ... Korea was like Japan, having economic characteristics similar to those of Japan. It only made sense that Korea’s economy should go the way of Japan’s. It was not enough to develop industries through import substitution: Korea had to pursue an export-oriented industrialization policy, focused on the development of its own heavy and chemical industries to foster high-tech industries.”

⁵⁰As Kim (2011, p.124) wrote: “At the time, the IMF was pushing for market liberalization policies that sought to lower trade barriers, liberalize foreign exchange and interest rates, and deregulate trade. However, the government pushed back, as it knew the economic impact of such policies would be widely felt, leading to a backlash from business. But I believed market liberalization policies were necessary despite the challenges to improve the industrial base, to promote export-oriented industrialization, to enhance global competitiveness, and ultimately, to drive economic development. So I prepared a report focused on liberalization policies.”

warned Chang about the political challenges of implementing such policies: "Raising interest rates will anger firms that borrow a lot, raising the exchange rate will anger importers, and lowering tariffs will anger domestic manufacturers," Kim warned. "Eventually, the entire business world will protest the policies. Plus, the National Assemblymen will join them and intelligent media editorialists will criticize the policies ... it will be very difficult." Chang replied, "Mr. Kim, I will do it. I will be sure to get it done."

Chang then briefed President Park on the importance of promoting exports and implementing market liberalization policies that were "urgently needed but also were difficult to implement due to the possible adverse effects of liberalization on protected domestic industries." Chang also warned the president, "It is imperative that you do not change your mind about the policies after we embark on this process. If you stop the reform because business and industry protest it, it will be better not to have started at all." Park is reported to have replied: "Absolutely. I will do as you say to the end."⁵¹

Chang accepted the position as Deputy Prime Minister and head of the Economic Planning Board (EPB) and dominated economic policymaking over the next three years.⁵² His ability, charisma, and self-confidence won the strong support of President Park and made the EPB the powerful epicenter of economic policymaking. Chang reported directly to the president and controlled all major appointments to the economic agencies, most importantly the Ministry of Commerce and Industry, where export policy and import policy would be developed and implemented. Chang recruited an economic reform team to help introduce sweeping policy changes. Two key members of the team were Park Chong-Hoon and Kim Chung-Yum, who were appointed correspondingly Minister and Deputy Minister of Commerce and Industry.⁵³

A. Export Promotion

The country's top economic officials at this point all agreed on the overriding importance of promoting exports. They all had experience working in Japan and saw that country's export success as a model to emulate.⁵⁴ Once in office, Park Chong-Hoon, who became known as "the Export Minister," began speaking of an "export first" strategy and in June personally urged President Park to lead the nation in an export drive.⁵⁵

⁵¹The last two paragraphs are based on KDI, 2016, p.182.

⁵²According to Cole and Lyman (1971, p.46), Chang was given "practically given *carte blanche* in shaping and directing economic policies over the next few years."

⁵³After returning to Korea from Japan, Kim Chung-Yum became a professor at Yonsei University and was scheduled to teach courses on foreign exchange and international trade in the spring semester of 1964. "On June 12, while I was busy preparing my lecture for my new teaching post at Yonsei University, I was unexpectedly appointed as the Vice Minister of Commerce and Industry without any prior information or notice," Kim (2011, p.127) recalled.

⁵⁴"Watching Japan, one of our closest neighbors, achieve remarkable growth through exports, we referred to its export promotion policies a lot. The fact that Japan was right next to us, and became a model of growth from the ashes of war, was helpful to us," notes Hong Sung-Jua, a former Deputy Minister of Commerce and Industry and one of the main figures who helped implement the export-led strategy (KDI, 2016, p.432).

⁵⁵As he reportedly pleaded with President Park: "Exports are the only means to save us. I believe, from now on, we as a nation must strive to implement the export-first policy by designating it as the supreme priority of the nation. And, I urge you, Mr. President, that you lead us as the Supreme Commander. I also urge you to encourage us

The reform team immediately went to work to sustain the growth of exports. In June of 1964, the Ministry of Commerce and Industry announced a “Comprehensive Export Promotion Program” to help exporters sell more in foreign markets. Of course, what really helped boost the competitive position of exports was the May 1964 devaluation. The Park government had set the goal of reaching \$100 million in exports in 1964, up from \$87 million in 1963. Within government circles, however, the actual target was \$120 million, which seemed an unbelievable goal to reach. Government clerks worked feverishly with abacuses tabulating the closely monitored incoming data on export sales to see if the target might be met.

On November 30, 1964, South Korea’s exports hit the \$100 million mark. The next day, the commerce minister reported the news to the President Park, who shed tears at the achievement. (Ever since, November 30th has been commemorated as “Export Day,” although it was renamed “Trade Day” in 1986 to acknowledge the importance of imports.) A month later, late in the evening of December 31, Chang called the president to report that the goal of \$120 million in exports had been reached.

This achievement convinced President Park that an export promotion strategy could work and henceforth he committed himself to that strategy. In a January 1965 address, he announced that the three highest national priorities were increasing production, increasing exports, and increasing construction. He urged the nation to take exports to a new level, not only for their economic importance in generating foreign exchange but as the best way to secure political and economic independence. The government began promoting slogans such as “exports alone promise a way to economic self-reliance” and “exports as the yardstick to measure the sum of our national strength” (KDI, 2016, p.432).

On Commerce Minister Park Chong-Hoon’s recommendation, a longstanding export promotion committee was upgraded to a high-level Export Promotion and Expansion Committee to be chaired by President Park himself. The first meeting of the new committee was held in February of 1965 and every month thereafter until his assassination in October 1979, President Park presided over the two-hour export promotion meeting held at the Blue House. The meeting included representatives from government agencies (including the economic ministries, the central bank, the Korea Trade Promotion Agency) and executives from major businesses (industrial firms, chambers of commerce, and banks and financial institutions). The key purpose of the meetings was to exchange information about the current state of exports. Businesses would report the problems and difficulties they had in exporting, and government officials were expected to solve them. Officials would discuss various export promotion policies, including reducing red tape and improving the

as well to eradicate bottlenecks [to facilitate exports].” Quoted in Kim (2004, p.115). As Kim (2011, p.130) recalled: “When I was appointed the Vice-Minister of Commerce and Industry in early June 1964, export-oriented industrialization policies were needed to compete in the global economy. It was imperative for countries to overcome the limits of small and saturated domestic markets. The implementation of import-substitution-based protectionist measures such as an overvalued exchange rate policy, restrictions on foreign trade or foreign exchange, differential duties, and subsidized interest rates, made import-substituting industries more profitable than export industries. This was the main reason for the weakness of export industries. Therefore, market liberalization policies including exchange rate and interest rate liberalization, import liberalization, and lower tariffs, were required to increase exports by selecting the technologies and production methods appropriate for the economic conditions characterized by abundant labor and inadequate capital, thereby securing a comparative advantage in labor-intensive products.”

infrastructure to facilitate exports, and would provide feedback about whether export targets were being met or not.

President Park's participation in these monthly meetings demonstrated the importance and urgency of the export drive as a national goal. His presence sent a strong signal to other government officials and top business leaders about the overriding importance of increasing exports. The government set up "indicative targets" to encourage and pressure exporters to perform better and sell more. High export achievers received prestigious awards presented by the president himself. "The Korean government was successful in creating a social atmosphere in which contributions to exports were considered to be something good for society and even patriotic," SaKong (1993, p.39) notes.⁵⁶

Of course, official targets and presidential exhortations to "export more" could only go so far without concrete measures to support that objective.⁵⁷ The government unveiled a series of export incentives between January and March of 1965 that gave a concerted push to the export drive. The most important policy was a special credit for exporters at a discounted interest rate. At the time, the commercial lending rate was 16.5 percent and that for exports was 6.5 percent, a spread that later grew.⁵⁸ The government also introduced "wastage allowances" – allowing exporters to import more raw materials and intermediate goods than needed for those exports so they could be resold at a premium in the domestic market – as another way to increase the profitability of exports. These incentives were not selective but provided in a neutral matter across all exporting industries. All exports were considered good as policymakers adhered to what Anne Krueger has called an "export theory of value."

The United States, which had always wanted Korea to export enough to pay for its imports and end its dependence on American aid, strongly encouraged these efforts. The relationship between the Korean government and U.S. economic advisers improved dramatically after the May 1964 devaluation and cabinet shakeup. Policy changes in Korea, and personnel changes on both sides, helped create a new atmosphere of collaboration and the relationship shifted from antagonism and

⁵⁶Cole and Lyman (1971, pp.190-91): "... all parts of the Korean government apparatus that could be of any help work recruited for the export drive. Political leadership made it clear that performance would be judged, as would what an individual or an agency had contributed to the growth of exports. In a relatively authoritarian, achievement-centered bureaucracy such as Korea's, these can be powerful stimuli." "Not only are the Korean exporters always receiving the immediate and close attention of the president, but the successful ones are regularly honored with merit medals. As a result, anyone who has accumulated wealth via export activities is almost considered a patriot and is assured that he has the blessings of the government. This has an immense psychological impact in a society which still carries the remnants of traditional Confucianism. This honor and encouragement bestowed on exporters has undoubtedly helped channel the best of the entrepreneurial class in Korea into export activities."

⁵⁷As Krueger (1979, p.98) notes: "The targets were implemented in a variety of ways. In the first instance, fulfillment was the responsibility of the Ministry of Commerce and Industry, and an 'export situation room' was established to monitor export performance. Targets were assigned to industrial associations and firms, and in regions where exports were at or above their target levels, few changes were initiated. If, however, exports begin lagging for a particular sector, efforts were initiated to rectify the situation. Such measures extended all the way from the threat (and presumably implementation) of sanctions to the provision of additional incentives and government measures to remove bottlenecks."

⁵⁸As KDI (2016, p.107) reports: "An almost unlimited supply of short-term credit to exporters at such a preferential interest rate was an enormous incentive for exporters in the economy in which credit was tightly controlled by the government and access to banking institutions was not easy."

criticism to cooperation and encouragement. On the Korean side, the cabinet reshuffle that brought Chang Ki-Young to power also led to the replacement of military officials with civilian technocrats in economic positions, many of whom had been educated in the United States.⁵⁹ On the U.S. side, the USOM director James Killen left his post in August of 1964 and was replaced by Joel Bernstein, who had earned a Ph.D. in economics from the University of Chicago in 1956. The new U.S. team was less concerned about stabilization, such as meeting inflation targets, and more interested in longer-term structural reforms.⁶⁰ With Korea having devalued its currency and focused on exports, the two sides were now in basic agreement about the direction of Korean policy. As a result, the U.S. stance changed from one of withholding aid to force Korea to change its policy to offering additional aid when Korea moved in a direction that the USOM team approved.⁶¹ The U.S. advisers and Korean officials forged a close partnership and worked closely with each other.⁶²

In particular, the United States welcomed the government's efforts to promote exports. Amicus Most, an American consultant hired by USOM, worked for three years on export promotion. Most (1966, p.1) believed with the U.S. team that "correcting the balance of payments situation is of such paramount importance that a major effort to increase exports is essential."⁶³ The U.S. advisers did not even object to some unorthodox policies, such as the low interest loans to exporters.⁶⁴

Thus, President Park and his top economic leadership were united in their

⁵⁹Cole and Lyman (1971, p.86). Brazinsky (2007, p.132) reports that, "Under intense pressure from the United States, the Park government replaced many of its more nationalistic economic advisers who came from military backgrounds with civilian economists, many of whom were Western trained and who worked well with American advisers in Seoul."

⁶⁰The USOM built up a strong team of advisers to work with their Korean counterparts in formulating economic policies. They brought in leading American academic economists as short-term consultants, including Edward Shaw and John Gurley from Stanford and Hugh Patrick from Yale on financial sector development. Others included Richard Musgrave on tax policy, Peggy Musgrave on trade policy, Ronald McKinnon on tariff policy, Robert Aliber on exchange rate policy, and Gustav Ranis and John Fey on labor market policies.

⁶¹"Instead of berating them for their incompetence, we began to encourage their best efforts and praise their accomplishments. Instead of insisting on better performance on their part so that U.S. assistance could be reduced, we said that 'if you will do more we will try to do more and get others, such as the Japanese and Europeans, to contribute more also.'" David Cole, U.S. House of Representatives, Committee on International Relations, "Investigation of Korean-American Relations," Part 6, July 19, 1978, p.45. See also Cole (2014, pp.145-67).

⁶²"The EPB's building was next door to the USOM in downtown Seoul, and the geographic proximity of the two institutions facilitated interaction between their personnel," Brazinsky (2007, p.142). "The assistant director of the EPB credited American advisers with introducing concepts such as present value and the floating exchange system 'to the extent that we were adept and skilled with it from the beginning because we were next to our family teacher the USOM.' One American called them 'blood brothers.'"

⁶³He found that Korean businesses simply had no experience in exporting and knew almost nothing about the demands of foreign markets. "Korean businessmen had little or no contact with the outside world, and were unfamiliar with markets, market research, and methods of doing business abroad," Most (1966, p.5) reported. "Korean industry, with some exceptions, was inexperienced in the requirements of quality, design, packaging, specifications and price that would enable them to compete internationally." He introduced Korean exporters to potential foreign buyers and helped educate them about how to produce products at the higher quality level in demand in foreign markets.

⁶⁴According to Cole (2014, p.157), Bernstein invited his friend Amicus (Mickey) Most to advise the Koreans on export promotion. "Mickey worked with the Ministry of Commerce and industry to formulate a program that called for quickly available low-interest bank loans and easy access to raw materials for exporters as a stimulus especially to manufactured exports. When I went over to the Ministry of Finance to meet with the minister and senior staff to discuss the proposed program, I asked if they had any problems with it they indicated that they did not. ... I later learned that the Ministry of Finance was surprised that we had approved to low-interest loan aspect. They had counted on us to reject it, as the previous USOM leadership would have done, and so rather than taking a position that might be unpopular with the president or the DPM they have not indicated their opposition to me... I personally believe that an all-out program to promote exports was a good thing for their next few years and that credit and raw material provisions were key components of its success."

determination to promote exports. While the United States had long supported such an effort, the Korean authorities made the decision themselves to take that route. Along with U.S. advice and assistance, they formulated the policies to see this plan through.⁶⁵ The growth of exports after the 1960-61 and 1964 devaluations gave Korean officials confidence that sustained export growth was possible. At least in the beginning, as Yoo (2020, p.23) suggests, export growth led to the adoption of the export promotion policy, not the other way around.

B. Foreign Exchange and Import Liberalization

If the export drive was relatively uncontroversial, the process of opening up the foreign exchange market and easing import restrictions was much more politically sensitive and therefore more contentious. This process was drawn out over four years from 1964 to 67.

In his memoirs, Kim (1994, p.39) explained how he, as Deputy Minister of Commerce and Industry, helped simplify the foreign exchange allocation system:

“I started by canceling the export-import link system that was in effect at the end of 1964. Next, I increased the number of automatically approved import items, which stood at zero in June of 1964, to 8.0 percent of total items approved for import during July-December of 1964 and to 62.7 percent in December of 1965. I delegated the administration of import approval to the Bank of Korea. In November of 1964 I eliminated many import quota items to lay a foundation for the single floating exchange rate. Finally, in January of 1965, as a preliminary measure for the implementation of the floating exchange rate, I eliminated outdated policies, including export subsidies, the import-export link system, and the barter system with the exception of barter specified in trade treaties. The floating exchange rate was finally implemented on March 22, 1965, when the conditions were deemed right.”

In essence, a slew of ad hoc policies and regulations and previous policies of import repression, all motivated by the need to conserve foreign exchange, were swept away or relaxed in moving toward a more open (if still restricted) system related to foreign exchange.

Even so, U.S. officials believed that Korea was moving too slowly toward a flexible exchange rate after the devaluation (Joo, 2017). The IMF provided technical assistance to facilitate the transition and approved \$9.3 million in standby credit at the time of the devaluation.

⁶⁵“Rather than a product of foreign technical advice, the national export promotion drive was a result of internal Korean perceptions of their need to become economically independent and to avoid too much reliance on the United States,” as Steinberg (1982, p.99) notes. After discussing the U.S. contribution to Korea's economic success, Bernstein emphasized the following point: “Lest there be any misunderstanding of what I have been saying about events in Korea, I would like to stress that no one but Koreans could or did do the job – from the establishment of policies and programs through their execution. The United States did, however, provide financial, technical, and moral support that was a critical factor in encouraging and supporting Korean actions. Such supportive action by a foreign agency can only succeed in its purposes if there is a wide measure of common understanding and support for the operational goals involved and also adequate levels of mutual confidence.” U.S. House of Representatives, Committee on International Relations, “Investigation of Korean-American Relations,” Part 6, July 19, 1978, pp.41-42.

In March of 1965, the government unveiled an open market for foreign exchange certificates and the adoption of a flexible exchange rate, which had been promised a year earlier. Under the system, exporters would turn over their foreign exchange earnings to the Bank of Korea and receive a certificate of equivalent value that was fully tradeable at a market-determined exchange rate.

The market price for exchange certificates immediately depreciated from 255 won per dollar to 272 won per dollar. The black-market premium on the won completely disappeared, as shown in Figure 1. The government announced that the won could depreciate further but would not be permitted to appreciate (i.e., fall below 255 won per dollar). However, the government never really accepted a pure floating rate and soon intervened to stabilize the exchange rate at 270 won per dollar. However, the government did not return to a hard peg and allowed the won to depreciate steadily in line with higher Korean inflation.

Under the new system, exporters could retain or sell all of their foreign exchange earnings at a competitive exchange rate. This marked a major change from the export-import linkage in which only exporters had access to a limited amount of foreign exchange at an overvalued exchange rate. Exports were to be promoted by indirect policies, including easy access to credit, duty-free imported raw materials, and tax exemptions, rather than export subsidies or preferential access to foreign exchange, both of which were abolished.

As a result, the government no longer regulated imports by controlling the allocation of foreign exchange. The quarterly foreign exchange budgets, which made allocations to particular importers for particular products and amounted to specific quantitative restriction on imports, were no longer necessary.⁶⁶ Jones and SaKong (1980, p.96) argue that the change in incentives that came with ending privileged access to foreign exchange was an important factor behind the surge in economic growth:

“If you can make 100 percent in a few months with little risk, through privileged access to foreign exchange, there is little point in devoting effort to the difficult and complicated task of exploring export markets and putting together internationally competitive productive combinations. The exchange rate reforms closed out the zero-sum sources of rent, reduced opportunity costs, and drove rent-seekers into productive positive-sum activity.”⁶⁷

As Cole and Lyman (1971, 89) put it, the simplification of the foreign exchange regime “signaled the government’s willingness to provide incentives and opportunities for the private sector as a whole and to dismantle the complex set of controls and licensing system that had played such an important part in the corruption

⁶⁶“Given that import control by QRs had tightened severely during the previous two foreign exchange crisis years, the initial loosening in 1965 was not much more than a return to the pre-1963 level of import control,” notes Kwang Suk Kim (1991a, p.46).

⁶⁷The new policies changed the rules of the game zero-sum game under the Rhee government “with the elite seeking access to the limited foreign exchange that would allow them to become wealthy,” whereas under Park “it was a positive-sum game, because there was a virtually unlimited supply of investment opportunities” (Steinberg, 1982, p.98).

of government and business under the Rhee regime.”⁶⁸ As a result, the incentives for business activity shifted from securing rents to earning profits. These seemingly administrative policy changes had large incentive effects for exports.

The exchange rate reform was initially denounced by major businesses. “When the exchange rate reform was announced in 1964, some in the business community, particularly powerful, large business groups, expressed opposition to the reform,” Kwang Suk Kim (1991b, p.107) notes. “Although both export and import-substitute industries could gain by the devaluation, the large business groups opposed it because they preferred to operate under extensive controls rather than under a realistic exchange rate and relatively free-market situation.”

Under normal circumstances, the Ministry of Commerce and Industry might be expected to resist reform due to its close ties to businesses that benefited from the status quo and feared import liberalization. Yet the top economic officials rarely consulted business in making key decisions and largely ignored their concerns.⁶⁹ The obstacles were more within the bureaucracy. Kim recalled his efforts to explain the rationale for the more open policies and change attitudes to those in the Ministry of Commerce and Industry. “I was filled with a sense of accomplishment practicing those policies I believed in,” Kim (1994, p.40) wrote. “To solve the inherent conflicts [within the Ministry] I held directors’ meetings every morning, explaining to them the background theories for trade liberalization as well as the founding motives, goals, and functions of the International Monetary Fund and the General Agreement on Tariffs and Trade. I emphasized that we needed to take a step toward liberalization despite the uproar within the business sector.”

The 1965 initiatives – the depreciation of the won and the more open foreign exchange market – helped push exports from \$120 million in 1964 to \$175 million in 1965.⁷⁰ Of course, it is difficult to quantify the impact of each specific policy change on exports.⁷¹ Nonetheless, much of what was done in 1964-65 was simply improving the incentive to export, whether that came through the more favorable exchange rate or the access to cheap credit. “The export success of the 1960s and 1970s was basically due to the removal of impediments to trade, specifically the complicated foreign exchange system and the negative effects on export of the protectionist import policy,” Yoo (2020, p.27) concludes. “Once the impediments were removed, the economy began realizing its huge export potential, which had

⁶⁸“The main source of incentives for exports thereafter shifted to more indirect means, that is, to the exchange rate, favored access to credit and imported raw materials, and almost complete tax exemption on export production. Although the cost of imported capital and intermediate goods went up as a result of devaluation, the expanded and easy availability of such imports for the export producers and the credit to buy them were much more than offsetting compensations,” Cole and Lyman note (1971, p.190).

⁶⁹As Brazinsky (2007, p.142) notes, “U.S. and Korean economists made crucial decisions about economic policies with little or no popular input.”

⁷⁰The range and destination of Korean goods sent around the world also expanded. For example, in 1960, South Korea exported 65 products to 20 countries. Five years later, it exported 621 products to 76 countries. In those five years, the share of manufactured exports in total exports rose from 18 percent to 62 percent (Most, 1969, p.11).

⁷¹Cole and Lyman (1971, p.191): “It is difficult to estimate the real value of the various export incentives and even more so the significance of direct government efforts to promote exports. The combination of low interest rates, easily obtained loans, no restriction in imported inputs, tax exemptions and reduced public utility rates, which are available to the exporter producer, would all have to be compared with the actual or imputed costs incurred by non-exporters. These are not accurately measurable. Any result would most likely be misleading and less useful than a simple suggestion that the incentives and encouragement given to exports were sizable and effective.”

been left unexploited until then.”

Two other major policy changes in 1965 supported the export drive: the normalization of relations with Japan and the liberalization of interest rates. Both were unpopular at home but were supported by U.S. advisers and ultimately proved beneficial to the Korean economy. First, in June of 1965, Korea concluded an agreement with Japan to normalize diplomatic relations. As a result, bilateral trade grew rapidly and Japanese loans and investments gave Korea access to more foreign exchange. Second, in September of 1965, Korea lifted interest rate controls that had depressed savings and financial development. The cap on deposit rates was lifted from 15 percent to 30 percent and that on loan rates was raised from 16 percent to 26 percent, although the rate on export credit remained 6.5 percent. The result was a dramatic increase in private savings that was channeled through the banking system and produced an astonishing increase in investment that further propelled exports.⁷²

Further trade policy changes came in 1966. In January, Kim became Minister of Finance, where he sought to reduce tariffs and gain Korea's admission to the General Agreement on Tariffs and Trade (GATT). Korea's tariff code had not been revised since the 1950s because import duties had not been an important source of revenue or a means of protecting domestic industries. However, as the quantitative controls on imports were eased, tariffs became more important. Here, U.S. advice ran up against strong domestic opposition and was not ultimately taken. Ronald McKinnon of Stanford University, on contract from USAID, proposed a uniform across the board tariff of 20 percent with a limited number of industries protected at 90 percent. Domestic industries, particularly in agriculture, protested that such a step would bring irreparable harm, while exporters did not push for tariff reductions because they already had duty-free access to inputs. Opposition by business groups led to a stalemate in the inter-agency tariff-setting process and duties were reduced only slightly.⁷³

Korea also gained admission to GATT, ensuring that it had nondiscriminatory, most-favored nation (MFN) trading status in other markets. The decision to seek admission encountered strong resistance from the Agriculture-Fishery Committee in the National Assembly, but the cabinet approved the application in May of 1966

⁷²Gross domestic investment rose from 15 percent of GDP prior to the reform to more than 25 percent of GDP after, reaching nearly 30 percent by 1969; see Kwang Suk Kim (1991c, p.152). Westphal and Kim (1982, p.215) argue that “these reforms were instrumental in financing the higher investment rates required to accelerate GNP growth.” The financial reform originated from a report from three leading US academics – Edward Shaw, John Gurley and Hugh Patrick. Their June 1965 report recommended raising interest rates and relaxing credit controls. A meeting between Edward Shaw and Chang Ki-Young in late September of 1965 helped convince him to endorse the recommendations. Chang then sold these ideas to President Park and the National Assembly and the reforms were implemented by the end of the month; see Cole and Park (1983, pp.201ff).

⁷³The duties on non-durable consumer goods fell somewhat, from 74.2 percent in 1966 to 43.2 percent in 1967 (Kwang Suk Kim, 1991a, p.40). As a result of this political pressure, the tariff decline that the government was able to undertake was very modest. The tariff on consumer goods was 66% and that on capital goods was 43 percent in 1967 (Kim, 2011, p.132). However, because so many importers were exempt from paying tariffs, the formal rates give a misleading indication of the tax burden on those purchasing imported goods. The average tariff collected on imports fell from 46 percent in 1960 to 9 percent in 1966, mainly due to the elimination of a foreign exchange tax and tariff exemptions and rebates. Imported intermediate goods for export production were also exempt. The statutory tariff weighted average was 43 percent in 1966, but duties collected were just 10 percent (Frank *et al.*, 1975, p.61). “There was a clear distinction between imports for export production and imports for domestic use. The former were allowed freely so as to ensure the ability of domestic exporters to compete in the international market. The latter were strictly controlled, prioritized, and frequently made conditional upon a contribution to the national export drive” Luedde-Neurath (1986, p.87).

(Shim, 2010, p.23). It then took nearly a year to win approval from other countries. Although questions were raised about Korea's import restrictions, the contracting parties of GATT did not require any specific changes in Korea's trade regime as a condition of entry, and the country officially joined in May of 1967.⁷⁴

After serving as Finance Minister from January to September 1966, Kim was subsequently appointed Minister of Commerce and Industry from March of 1967 until October of 1969, during which time he oversaw an incremental liberalization of imports. In July of 1967, the Ministry shifted from a "positive list" system of import control – in which most imports were restricted or prohibited unless specifically allowed – to a "negative list" – under which most imports were allowed unless specifically restricted or prohibited. The number of automatically approved imports had progressively increased from 1965 to 1967 leading up to the adoption of the negative list (Kwang Suk Kim 1991a, 36). The number of commodities under the automatic licensing category was increased from 1,450 items to 2,259 items in July of 1966. This action reduced the scope of restricted imports, and the number of automatically licensed goods rose from about 30 percent in 1964 to 79 percent in 1965, and then to 84 percent in the 1966 program. The positive list consisted mainly of essential raw materials, energy products, capital and intermediate goods.

Figure 3 shows the discrete jump in the share of imports subject to automatic approval in 1966-67, along with the relatively unchanged level of import duties. However, the shift to a negative list did not constitute a radical change in import policy, only increasing imports by about 5 percent, \$27 million in the final five months of 1967 and \$68 million in 1968 (Brown 1973, 156). Yet the decision encountered stiff domestic opposition. "Large parts of Korea's business community and bureaucracy came out strongly against the liberalization plan," Brown (1973, 156) recounts. "No one wanted protection for his industry lowered, of course, and those businessmen benefiting most from protection banded together to oppose any extensive liberalization." There was extensive public debate about how quickly Korea should expose protected industries to foreign competition.

To conclude, Korea completely changed the direction of its commercial policy in 1964-67 from trade controls to export promotion. The specific policy changes included establishing a realistic exchange rate and a market in foreign exchange, which enabled the government to sweep away the old system based on an overvalued exchange rate and associated policies of foreign exchange rationing, export subsidies, import repression, and so forth. The process was described by Joel Bernstein, director of the U.S. economic mission in Korea from 1964 to 1967, as "a radical shift from a typical 'closed economy' characterized by pervasive market shortages; tight import, licensing and quantitative restrictions; tight credit rationing;

⁷⁴ A delegation was sent to Geneva, Switzerland, to negotiate with other countries over admission. The delegation stayed in a very inexpensive hotel for five months, but the Korean government was so poor that the task force team did not even have enough money to buy three meals a day, and it was not possible to approach GATT members freely to establish networks without any money. Finally, the task force team asked the Korean government to send them money to develop social connections with the GATT members. After President Park heard this request from his aides, he told them to advance his salary and send it to the task. Shim (2010, 23-24).

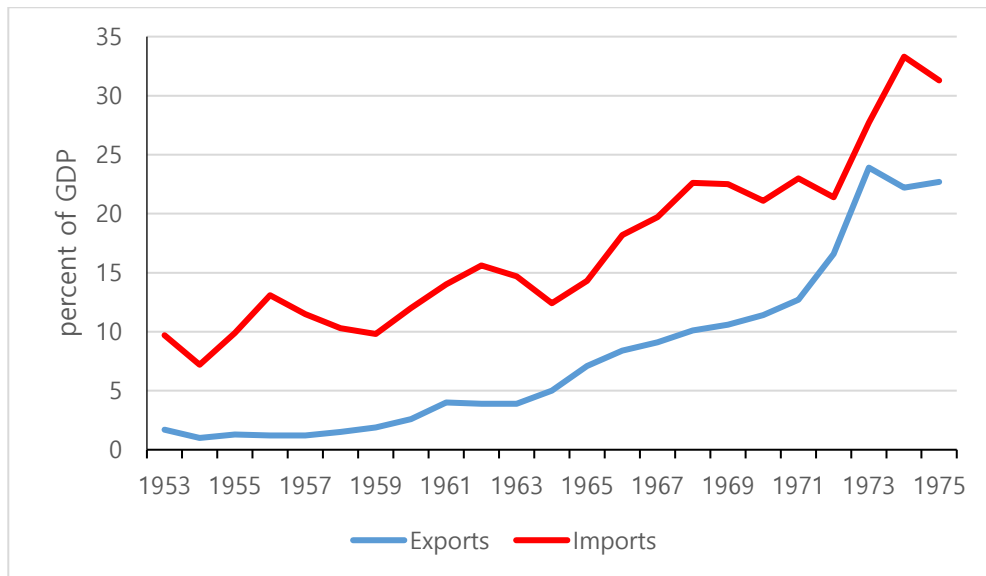


FIGURE 3. SOUTH KOREA'S EXPORTS AND IMPORTS AS A SHARE OF GDP, 1953-1975

Source: Bank of Korea, Economics Statistics System, available at <http://ecos.bok.or.kr/>.

and various other direct economic controls – to a relatively open economy in which most of these direct controls were swept away.”⁷⁵ At the same time, the government provided abundant credit to exporters and enforced export discipline.

Nevertheless, the shift toward export orientation involved more the unshackling of exports rather than the liberalization of imports, at least imports that were not used for exports. Korea did not significantly open its domestic market to foreign competition. While there were few restrictions on the importation of raw materials, intermediate goods, and capital goods and equipment for domestic producers and exporters, other products for the domestic market – particularly finished consumer goods – were not threatened by imports.⁷⁶ The liberalization process was a managed one in which importation was often linked to export performance. As Westphal (1990a, p.58) notes: “...import liberalization was not an important element of the reforms that put Korea on the path of export-led development. But the rules of the importing game were nonetheless radically changed. Prior to the reforms, rent-seeking in relation to import licensing and tariff exemptions had provided a major

⁷⁵“This was essential for a number of reasons, which included the need to allocate limited productive resources more efficiently; to provide greater opportunities for small businessmen to gain access to raw materials and credit; to reduce the corruption and sapping of morale and initiative that is typically associated with large scale licensing; to strengthen competitive pressures for increasing productivity and pursuing imports rather than concentrating entrepreneurial attention on getting licenses needed to operate; and to help control inflation.” U.S. House of Representatives, Committee on International Relations, “Investigation of Korean-American Relations,” Part 6, July 19, 1978, pp.41-42.

⁷⁶As Westphal (1990a, p.44) notes, export promotion was not achieved “by the conventionally prescribed approach, which is to reduce greatly (if not eliminate) the domestic market’s insulation from import competition. Instead, they accomplished it by insulating export activity from the otherwise adverse consequences of policies motivated by other concerns. A virtual free trade regime for export activity was established, so that capital and intermediate inputs used in export production could be imported without tariffs and outside the quotas which applied to imports for other purposes; regardless of their source, tradeable inputs were exempt from indirect taxes.”

source of revenue for businessmen and government officials alike.” With the reforms of the mid-1960s, the import regime that was rife with rent-seeking was gone and exporting was a rewarded activity.

VI. The End of Reforms

The reforms of 1964-65 began a remarkable transformation of the Korean economy, including rapid export growth and industrial development, particularly in labor-intensive manufactured goods. By 1967, in stark contrast to the despair of 1963-64, the Korean economy was growing rapidly. The country's economic success translated into political success for President Park, who was overwhelmingly reelected president in May of 1967.⁷⁷

The foreign exchange situation improved dramatically and shortages were no longer a constraint on growth or a concern for policymakers. Foreign exchange reserves rose due to the rapid growth in exports, an increase in remittances from Korean workers in Japan, and increased inflows of foreign capital. The percentage of imports financed with Korean foreign exchange had risen from 30 percent in 1964 to 79 percent in 1965 and to 84 percent in 1966.⁷⁸ This gave the Korean government to freedom to operate without dependence on U.S. aid or the advice that came with it.

Partly for this reason, the year 1967 also marked the end of economic reform. The reform team, which had been assembled three years earlier, fell apart when Chang Ki-Young was dismissed as Deputy Prime Minister in October. The driving force behind the reforms, Chang alienated many groups inside and outside government and eventually fell out with President Park.⁷⁹ Still, Chang had lasted more than three years in that crucial position, providing continuity at a time when the norm was a rapid turnover of officials. On the U.S. side, the Bernstein USOM team also dissolved as personnel were assigned to other countries. With Korea no longer as dependent on the United States, the influence of U.S. advisers also became much weaker.

An explosion of imports also contributed to the end of reform. Although exports were growing rapidly, imports grew even more rapidly – soaring from 10 percent of GDP in 1965 to 20 percent of GDP in 1968.⁸⁰ By the late 1960s, as shown in Figure 4, the merchandise trade deficit had grown to almost 15 percent of GDP. The gap was no longer financed by American aid but by massive foreign loans, which Korea

⁷⁷“Park had staked his political legitimacy on economic growth, and by producing it he created a compelling reason for the public to support him,” Brazinsky (2007, p.148) writes.

⁷⁸International Monetary Fund, 1966, I, p.12.

⁷⁹“Chang’s authoritative and unusual leadership style and his disregard for the internal order of the public service gave many public officials a hard time. Consequently, sentiment against Chang grew.” KDI, 2016, p.182. His colleagues gave him a plaque that read: “The EPB men will remember your 1,241 days of hard work and no rest.” President Park intervened twice, in 1965 and 1966, to stop “no confidence” votes against him in the National Assembly. When he began to fight with the president, however, he was let go. KDI (2016, p.224).

⁸⁰On Export Day in 1969, President Park announced that “the government will achieve at any cost the \$1 billion export goal” in 1970 (Kim, 2004, p.117). The \$1 billion target was reached, an incredible achievement given that just six years earlier the goal had been \$100 million. By 1970, exports reached \$1 billion, of which amounts of \$341 million were in textiles, \$92 million in plywood, and \$90 million in wigs (KDI, 2016, p.433). Import value was approximately 40 percent of the total value of commodity exports (Hong, 1979, p.67). Moreover, domestic content accounted for 60 percent. New export items accounted for less than 0.1 percent of exports in 1961 but 42 percent by 1970, according to Yoo (2020, p.15).

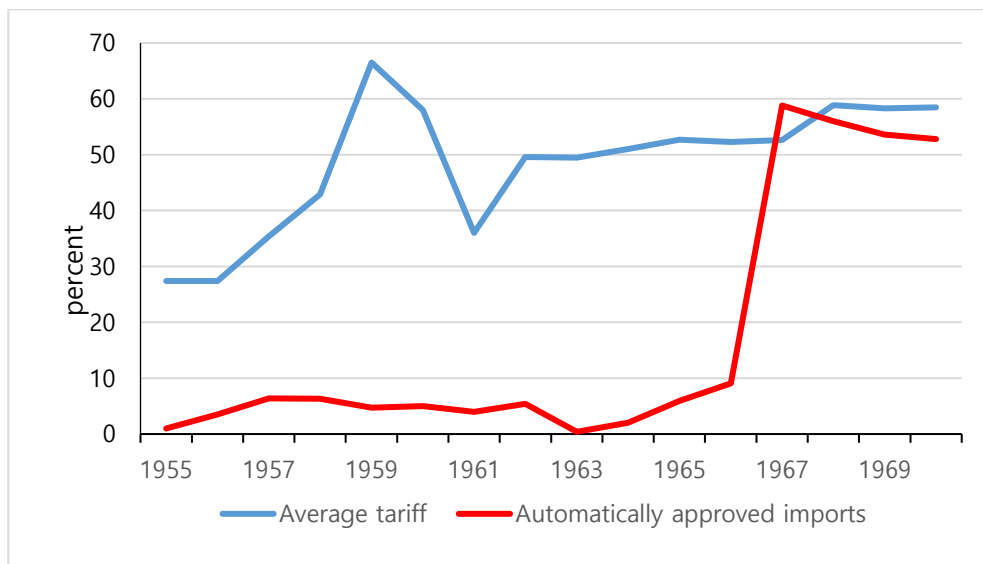


FIGURE 4. SOUTH KOREA, AVERAGE IMPORT TARIFF AND AUTOMATICALLY APPROVED IMPORTS, 1955-1970

Source: Yoo (2017, p.21).

now found easy to raise. (Korea did not record a trade surplus until 1986.) The capital inflows led to an expansion in domestic credit, which led to more inflation. With the government adjusting the value of the won at less than the rate of inflation, Korea's currency strengthened in real terms and, by one estimate, was overvalued by about 9 percent in 1968 (Westphal and Kim, 1982, p.270).

Some segments of the business community pointed to the rapid growth in imports and opposed any further steps to open the domestic market.⁸¹ The government's failure to maintain a competitive exchange rate was another factor preventing additional import liberalization. Resistance to a depreciation of the won also remained strong, not based on the old argument that it would increase inflation but on the new grounds that it would make it difficult for firms and banks to service their burgeoning foreign debts.⁸²

In the 1964-65 transition period, the key policy changes appear to have been the devaluation, the intensification of export incentives (particularly through the provision of credit), the creation of an open foreign exchange market, the partial liberalization of imports, and the liberalization of interest rates. Yet not everyone believes that these policies were important. In her well-known 1989 book, *Asia's Next Giant: South Korea and Late Industrialization*, Alice Amsden argues that government intervention and "getting prices wrong" (through protectionism, subsidies, and coercion) were critical factors behind Korea's industrialization. "In or around 1965, the Korean won was devalued, interest rates were raised, tariffs were

⁸¹USAID official Gilbert Brown (1973, p.145) thought that the monthly export meeting "increased the exposure of the president to special pleading by business groups ... and may partly explain why Korea moved away from liberalization and a realistic exchange rate from late 1967 until mid-1969."

⁸²"This failure to make progress in import liberalization was at least partly attributable to the unsatisfactory performance of exchange-rate management by the government," according to Kim (1991a, p.132).

lowered, and taxes were increased," Amsden (1989, p.141) notes, but she argues that to say that growth followed liberalization is "a fallacy" because "the logic driving Korean industrialization was not the freeing of markets." In the end, she views these policy changes as being unimportant: "In all, liberalization amounted to nothing more than a footnote to the basic text of Korean expansion."⁸³

This controversial statement prompted Larry Westphal (1990b, p.1736), a leading U.S. expert on Korea who was sympathetic to the idea that industrial policy promoted economic growth, to respond: "My knowledge of the Korean economy does not in any way support this interpretation."⁸⁴ For example, in concluding that government coercion and support were the key factors behind the country's industrialization, Amsden believes that exchange rates were unimportant. "In Korea, exchange rates were not grossly distorted, but they did succeed in stimulating exports only when they operated in conjunction with other policies," Amsden (1989, p.144) asserts. "Exports have been heavily subsidized and coerced, so inside the range of reasonableness, the relative price of foreign exchange has been altogether irrelevant." The statement that the exchange rate was not grossly distorted must refer to the periods after the 1961 and 1964-65 devaluations, not before 1961 or in 1963, when Figure 1 suggests that they were highly distorted. Her book does not discuss the period prior to 1961 when the overvalued won posed an insurmountable obstacle to most exports.⁸⁵ The assertion that the exchange rate was unimportant is contradicted by Westphal (1990a, p.45), who argues that "the most important incentive [for exports] *apart from the exchange rate* was the virtual free trade regime [for exporters], which accounted for more than two-thirds of total export incentives in 1968" (emphasis added).

The reform era of 1964-67 was also not a period in which industrial policy was an important feature of Korea's approach to trade. That term is more associated with the launching of the Heavy and Chemical Industry (HCI) drive in 1973. This initiative channeled capital investment into the production of iron and steel, non-

⁸³ "If one believes that Korea began to grow rapidly in the 1960s as a result of 'liberalization,' then its adoption of relatively freer prices must be attributed to an embrace of market theory by Korean policymakers, coached by foreign experts. Yet an examination of cotton textiles suggested that the policy regime that Korea eventually adopted evolved out of a complex process in which the interests of opposing groups were reconciled, not out of theoretical conviction," Amsden (1989, p.78) writes. "Therefore, it may be said that growth has been faster in Korea not because markets have been allowed to operate more freely but because the subsidization process has been qualitatively superior." In her view, "To attribute Korea's growth and industrialization to these market-policies rather than the 'government's dual policy of discipline and support is to misrepresent a fundamental property of the most successful cases of late industrialization.'"

⁸⁴ In personal correspondence to me, David Cole writes: "During this high export growth period many market constraints were removed, but the many incentives for exporters that were provided in many cases automatically without any bureaucratic intervention more than offset the temporary overvaluation of the exchange rate or other disincentives. The automatic incentives for exporters that were tied to the presentation of export letters of credit overcompensated for any negative elements. The government was responsible for designing the hyper-incentive system but not involved in administering it on a day-to-day basis. It was not a free-market system but rather a range of market-based incentives including the interest rates, tax rates and wastage allowances. But the incentives were all linked to export performance. Any exporter who was found to have abused the letter of credit system was severely punished. I do not believe there was much coercion but rather encouragement through the various incentives. This was not an industrial policy in the sense of promoting specific industries - that came later - but a purely export promotion policy that took many forms and achieved remarkable successes."

⁸⁵ As Westphal (1990b, p.1736) points out in his review, "the book has many more perceptive things to say about what drove Korea's industrialization in the 1970s and 1980s than it does about what caused its takeoff in the early 1960s, when neither the *chaebol* nor heavy industry were prominent."

ferrous metals, ship-building, machinery, electronics, fertilizers, oil refining, and cement. These industries were much more capital-intensive than the labor-intensive industries that had emerged as Korea's main exports in the 1960s and 1970s. President Park may have wanted to promote heavy industries ever since he attempted to do so in 1961-63, but he had the opportunity to do so in the early 1970s without American interference, ostensibly on grounds of national security (Horikane, 2005).

VII. Conclusions

This paper has revisited the story of Korea's historic shift from import substitution to export promotion in the mid-1960s. Korea was one of the first developing countries to focus on exports as a means by which to resolve balance of payments problems and foreign exchange shortages.⁸⁶ What policy lessons or generalizations can be derived from Korea's reform process? Three key features of Korea's experience stand out and are similar to those of other developing countries that decided to open up to trade in the 1980s and 1990s (Irwin, 2025).

The first point concerns the centrality of the exchange rate for balance of payments adjustments and export-oriented development. In the 1950s, South Korea's exports were suppressed by an overvalued exchange rate and the country's imports were propped up by massive U.S. foreign aid. During this period, the prevailing view in Korea and elsewhere was that import controls were necessary to deal with foreign exchange shortages and devaluations were to be avoided. Such controls may have saved foreign exchange in the short run but did nothing to generate more foreign exchange for the future.

As a result of U.S. pressure, Korea opted for devaluations that stimulated export growth and relieved foreign exchange shortages. Partly because of Korea's experience, exchange rate adjustments came to be appreciated as a better means of dealing with balance of payments problems than trade controls. This lesson helped other countries make similar choices when undertaking trade reforms in the 1980s and 1990s.

The second point concerns the role of balance of payments crises and extreme foreign exchange shortages in triggering reform. Foreign exchange makes essential imports possible and can be (i) earned through exports, (ii) received from foreign lending, or (iii) granted via foreign aid. When a country faces a sudden decline in foreign exchange reserves, either due to the adverse terms of a trade shock, a reduction in foreign lending, or a cutback in foreign aid, it is often forced to adjust. In Korea's case, the government finally ended the overvaluation of the won under duress when it faced a potential famine in 1963-64 and the U.S. government threatened to withhold aid.⁸⁷ In later cases, countries have also been forced to reform after foreign aid has been withdrawn, such as Vietnam when the Soviet Union

⁸⁶Taiwan moved in this direction a few years before Korea did (Irwin, 2023).

⁸⁷As David Cole later stated: "It is my belief that this experience in 1963-64 convinced the Koreans they should broaden their sources of support and reduce their overwhelming dependence on the United States." U.S. House of Representatives, Committee on International Relations, "Investigation of Korean-American Relations," Part 6, July 19, 1978, p.45.

reduced assistance in the late 1980s, or when foreign lending to India dropped sharply in 1990-91.

The third point concerns the political economy of trade policy reform. Economists usually focus on the role played by interest groups in driving policy changes. Yet trade policy is shaped as much by exchange rate policy and balance of payments considerations as by domestic producer interests. The policy changes that marked a historic turning point in Korea's economic development were bitterly opposed at the time, despite the rapid growth that later ensued. "The reform and redirection of economic policy were carried out amidst strife and opposition, over the often loud cries of special interest groups, and in the face of continuing and widespread pessimism and mistrust," Cole and Lyman (1971, pp.92-93) recall. "Almost every major economic reform of this period encountered doubt and skepticism at the outset."⁸⁸

Economic policymakers who wanted to change the direction of policy, not interest groups, were responsible for initiating the reforms. In May of 1964, Chang Ki-Young led a team of technocrats who seized upon the newly emergent possibilities for export growth and pushed forcefully for a broad range of export promotion and import liberalization measures. President Park Chung-Hee's support was crucial to the government's strong commitment to the policy.⁸⁹ In other countries as well, government officials and not producer interests have been behind economic policy reforms, and the key battles over reform are often between different agencies within the government rather than between the government and private interests.⁹⁰

⁸⁸"The restrictive system of import quotas and the manipulation and control of scarce banking resources had together formed the backbone of a mutually corrupting and mutually profiting system of cooperation between a limited number of businessmen and government officials," Cole and Lyman (1971, 93) pointed out. "In the reforms of 1964 and 1965, both of these systems collapsed, to the vain cries and behind-the-scenes maneuvering of those who had long lived by them."

⁸⁹In evaluating the reasons for the success of Korea's export-oriented policy, Hong (1979, 58) argued, "one should not fail to note that the single most important factor has been the leadership, determination, and devotion of President Park to the cause of 'nation-building by export.'"

⁹⁰As Bates and Krueger (1993, 455) conclude from a series of case studies on policy reform: "One of the most surprising findings ... is the degree to which interest groups fail to account for the initiation" of policy reform. Instead, at some times and in some circumstances, the changing ideas of government officials can explain the evolution of policy.

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