

PART 6

TRADE POLICIES AND  
TRADE SYSTEM

20. Import Restriction and Import Liberalization

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## IMPORT RESTRICTION AND LIBERALIZATION

### 1. THE “PROTECTIONIST,” EXPORT-ORIENTED ECONOMY

Unless exorbitant costs will result from their adoption, economic theory favors general taxes and subsidies over tariff protection. Whatever its objects, tariff protection is bound to generate by-product distortions in factor intensity, in consumption, and toward home-market bias (see Corden, 1971). Furthermore, quantitative restrictions on imports are considered even more distorting than tariff protection.<sup>1</sup> Despite this knowledge, however, many countries relying on export promotion, such as Korea, have maintained fairly severe import-restraining systems in the form of both tariff protection and quantitative restrictions, partly because of political considerations of vested interest groups (as in the case of agricultural protection) and partly because import restriction is believed by many policymakers—regardless of trade theorists’ statements to the contrary—to be the best available policy measure at an early phase of economic development. Import restriction is thought to promote infant industries (and rapidly convert them into exporters) and also to maximize the foreign sales of currently exporting industries (at the expense of domestic consumers’ surplus).<sup>2</sup>

<sup>1</sup>Tariff protection (TP) implies perfect competition at tariff-inclusive prices. Under a quantitative restriction (QR) system, however, firms’ output levels are often determined by the imports of intermediate goods directly allocated to them. If licenses for imports of intermediate goods are allocated in proportion to each firm’s capacity, the associated quota premium encourages the development of excess capacity in the economy. Furthermore, when firm-specific allocation of intermediate imports determines market shares, there is little competition among firms, ensuring the growth of inefficient firms. Under the QR system, government officials may also deny imports of certain products whose roles in production processes they do not understand, and thereby inflict unwarranted hardships on the related industrial activities. It is believed that private-sector response to unintended incentives created by QR systems has led to the frustration of many of the goals of import-substitution (IS) regimes. See Bhagwati and Krueger 1973 and Keesing 1967.

<sup>2</sup>Export promotion (EP) and QR do not necessarily make an inconsistent policy set. For instance, an export industry can maintain a monopolistic domestic market structure because of QR. It is well known that an industry exports more with a domestic monopoly and price discrimination than with a perfectly free trade regime. See Davies and McGuinness 1982.

Countries such as Hong Kong and Singapore have pursued export-oriented growth strategies while maintaining free-trading regimes almost from the beginning. Countries such as Korea, Taiwan, and Japan, on the other hand, maintained fairly protectionist import regimes for long periods of time. It was not until the 1960s that Japan eliminated the bulk of its formal quantitative restrictions: the nominal import liberalization ratio (by items) expanded from less than 70 percent in 1960 to about 93 percent in 1964, and to 97 percent by 1976. Similarly, Taiwan did not eliminate the bulk of its formal quantitative restrictions until the early 1970s: the nominal import-liberalization ratio increased from 61.5 percent in 1970 to 96.5 percent in 1973.<sup>3</sup> As a result, in both Japan and Taiwan, quantitative import restrictions are now essentially limited to special laws and other invisible unofficial means. Korea is scheduled to eliminate the bulk of its quantitative restrictions during the period of 1984-88.<sup>4</sup>

This chapter analyzes the efficiency and welfare implications of import restriction and import liberalization in an export-oriented developing economy. In light of the Korean experience, it addresses the question of whether extensive import liberalization is always a necessary condition for the successful growth performance of an export-oriented economy. If not, it asks, when does it become a necessary condition?<sup>5</sup>

<sup>3</sup>Data from Young et al. 1982, 78.

<sup>4</sup>Economists seem to agree that a prudent policy should be based on liberalization of the current account first of all, and that whenever possible, the QR system should be removed before tackling the TP system. The capital account of the balance of payments should only be opened after the domestic capital market is freed, and this can happen only after the fiscal deficits, if any, have been substantially reduced. See Edwards 1984. This suggestion is consistent with the well-known immiserizing growth that can result from the free inflow of foreign capital in the presence of domestic distortions. See Brecher and Diaz-Alejandro 1977 and Brecher and Findlay 1983. Moreover, if one postulates that the supply price of foreign capital is an increasing function of the magnitude of its supply, then one can argue for restricting the inflow of foreign capital on the basis of monopsony power. First, there may be significantly diminishing returns on foreign capital owing to limited absorptive entrepreneurial capacities, and the international financial market not supplying larger amounts of capital without raising the risk premium. Second, if the government acts as a monopsonistic agent in importing foreign capital and allocating it competitively among domestic entrepreneurs, the difference between the average rate of return on investment and the average interest rate on foreign borrowing will accrue to the government as monopsonistic profits, which in turn may be used as subsidy funds.

<sup>5</sup>The TP and QR systems are often identified with IS regimes, but it is one of the main emphases of this chapter that an EP regime such as Korea's is never free from

In order to give the complete picture, section 2 discusses the unified analytical framework. Section 3 examines the experience of Korea in its early phase of export-oriented growth and analyzes the effect of its import policy on economic growth. Section 4 examines the Korean experience in the later stage of growth, when Korea's comparative advantage started to shift away from the simple labor-intensive consumption goods toward more capital-intensive intermediate and investment goods. The effect of sustained protectionist import policy and the need for more extensive import liberalization are analyzed. Section 5 delineates the liberalization effort of the Korean government during the period 1983-86. Emphasis is given to the politics of protection versus liberalization. The chapter concludes that in order to initiate export-oriented growth, a developing economy must undertake some minimum level of import liberalization, because an extremely protectionist regime would simply frustrate any kind of incentives given to the export sector. However, extensive import liberalization is not a necessary condition for initiating and sustaining successful export-oriented growth. Only at a later stage of development, when the economy starts shifting into the intermediate and investment-goods sectors, might extensive import liberalization become a necessary condition for maintaining production efficiency and maximizing consumer welfare.

## 2. ANALYTIC FRAMEWORK

### *2.1 Earning versus Saving Foreign Exchange: Export Promotion versus Imports Substitution*

This section summarizes the analysis of Keesing (1967) and Bhagwati and Krueger (1973). They argue for the promotion of exports (earning foreign exchange) and against the substitution of imports (saving foreign exchange).

First of all, the argument is made that the most important source of economic growth is the upgrading of human resources and production technology rather than the simple accumulation of physical capital. It is persuasively argued that under an export-promotion regime, entrepreneurs are mainly concerned with cutting costs, keeping production facilities and techniques up to date, and improving product quality and marketing to suit consumer taste (both at home and abroad), whereas workers are subject to great pressure to perform and train others. Under an import-substitution regime, on the other hand, entrepreneurs presumably spend most of their

tariff or nontariff import restrictions and IS biases.

energy manipulating government officials (who have mastered the finer arts of lobbying, corruption, and graft), in order to improve their protection, while workers learn lackadaisical ways, as they are not pressed to raise their quality and productivity performances. A developing country should therefore gain higher-quality industrial experience and undergo greater pressure for quality and efficiency performance by selling the same value of output abroad under competitive conditions than at home with protection. In short, an export-promotion regime is believed to create human resources more suitable for sustained growth than is an import-substitution regime, which, by encouraging the wrong skills and habits, casts a long shadow over the future of the economy.

It follows, then, that one of the important gains to be made from trade is rapid technical progress arising from innovative imitation. Adam Smith long ago emphasized the “educative effect” of “mutual communication of knowledge of all sort of improvements which an extensive commerce to all countries naturally, or rather necessarily, carries along with it” (Cannan ed., 1950, 125). Exporting firms must face both price and quality competition in international markets, and consequently the survival and success of each exporter depends on adaptive innovations and active absorption of available production techniques.<sup>6</sup> The export-promotion strategy also enables an economy to take full advantage of economies of scale. Even when the initial markets are found at home, the physical layout of manufactures permits a ready exploitation of scale economies and an easy transition into export markets.

Both export-promotion and import-substitution regimes may be characterized by a mistrust of laissez-faire and free trade. However, foreign governments respond to the extreme abuse of export subsidies not tolerated by international trade conventions. Hence the potential for arbitrary government intervention is more restricted under an export-promotion regime than it is under an import-substitution one. Furthermore, it is believed that in an effort to make local prices and wages appear cheap, less inflationary policies are pursued under export-promotion regimes. This, in turn, restricts the size of subsidies and tax exemptions a country can afford, providing a

<sup>6</sup>International competition enhances communication, and entrepreneurs pay close attention to the possibilities of innovation and speeding up learning processes because survival, advancement, and success depend on these. On the other hand, in an IS regime, protection is accepted as a legitimate major instrument for promoting industrialization. Every industry is thus spurred to demonstrate its need for shelter from the cruelties of foreign competition, and eventually the country ends up allowing each industry protection according to its inefficiency.

built-in check on excessive intervention.<sup>7</sup>

For a developing economy, foreign products may mostly reflect locally unattainable natural resources, skills, and technology. Most likely there will be a lack of substitutability between local resources and foreign-supplied resources. The ability to pay for needed imports may, then, severely limit economic growth. An export-promotion regime is believed to relieve the foreign-exchange constraint on growth more readily than is an import-substitution regime.

Another advantage of export-promotion regimes is that they naturally tend to rapidly expand the volume of exports and consequently also the volume of imports, while import substitution regimes tend to reduce (or increase less rapidly) the volume of a country's trade. According to Corden (1971), the opening up of an economy to trade (which may be measured in terms of the export/GNP ratio) generates a "static" efficiency gain that is very similar to a "once-and-for-all" technical advance that raises the absorption-possibility frontier of a country at a given factor-supply level. Furthermore, with a given constant propensity to save, the static efficiency gain may itself induce the rate of capital accumulation to rise. Consequently, it will raise the growth rate of the economy. This can be described as the "induced-growth gain" from trade. If investment goods are mostly imported, then this induced-growth gain will also include the effect of reduced prices of investment goods. Moreover, it is possible that the opening up of trade (or the rising trade-volume/GNP ratio) will also raise the rate of growth of an economy by directly increasing the country's propensity to save.

## *2.2 Protection, Offsetting Policy Measures, and Growth*

In a typical developing economy, with typical political power balances, import restrictions—in the form of both tariffs and quotas—have to be accepted as a fact of life. However, as shown by Johnson (1967) and Bhagwati (1968), when industrial promotion and growth are by and large biased in favor of the production of commodities in which the country has a

<sup>7</sup>Assuming realistic exchange rates, EP can be sustained mostly by subsidies. Since the costs of excess subsidies are quite visible, there are built-in forces against excessive EP. The equivalent costs of IS are borne by firms and consumers; hence opposing pressures do not emerge as rapidly. Under IS, government officials have the power to remove or enhance the domestic monopoly positions of firms, and consequently the firms can be subject to intolerable interventions into their decision-making processes. Under an EP regime, with firms engaged primarily in the export market, officials simply do not have the same degree of power.

comparative advantage, the adverse efficiency and welfare effects of the protection (which is attuned to the sectors with comparative disadvantage) are alleviated as the economy grows and as policy measures promoting industry are enforced.

Figure 7.1 illustrates such an economy. With free trade the country produces  $x$  and  $y$  at  $f$ . In order to highlight only the aspect of “protection-cum-second-best-policy,” we now postulate a small open economy in which all kinds of external economies are completely taken care of by a set of ideal taxes and subsidies. Consequently, the production-possibility curves represent the “true” ones and, in the absence of tariff protection, production and consumption are determined at the welfare-maximizing optimal points.

With a tariff-distorted domestic price ratio  $p^*$ , however, the country finds itself producing output at  $q$ , adversely affecting the production of the exportable,  $y$ . Consumption is at  $c$  where an international price line,  $p$ , passing through  $q$  intersects the Engel line corresponding to the domestic price ratio  $p^*$ . Postulating a set of well-behaving homothetic social indifference curves, we have drawn a linear Engel line that represents the income-consumption path corresponding to the given commodity price ratio;  $bq$  of  $y$  is exported, and  $bc$  of  $x$  is imported, but an amount equivalent to  $tc$  of  $x$  is taken away as government tariff revenue. To avoid cluttering the geometry, the diagram omits the social indifference curves, one of which passes through  $c$  with a slope equal to that of  $p^*$ . It is assumed that tariff revenue is not redistributed to the private sector as an income subsidy, but instead is spent by the government.<sup>8</sup>

When imports restrictions are a fact of life, there are always second-best policies to consider: in the presence of irremovable import-substitution-biased commodity-market distortions, a country can adopt certain offsetting policy measures to promote production and exports of the unprotected sector. At the given factor-supply level, and holding the distorted domestic price ratio unaltered at  $p^*$ , the government can try to shift the output pattern in the direction of  $f$  by introducing a second-best policy measure such as subsidized credit rationing in favor of  $y$ . This will necessarily result in by-product efficiency losses in production, and place the economy inside the given production-possibility curve. In figure 7.1 such a policy leads the output pattern to move along a path like “Offsetting Distortion” (OD) line 1 (ODL 1).<sup>9</sup> This implies that the stronger the offsetting factor-market distortions, the

<sup>8</sup>Figure 7.2 elaborates this aspect: tariff revenue is equivalent to  $d^*d$  units of  $x$  which is spent on  $gc$  of  $x$  and  $gc^*$  of  $y$  by the government, resulting in exports of  $bq$  of  $y$  and imports of  $bc$  of  $x$  for the country as a whole.

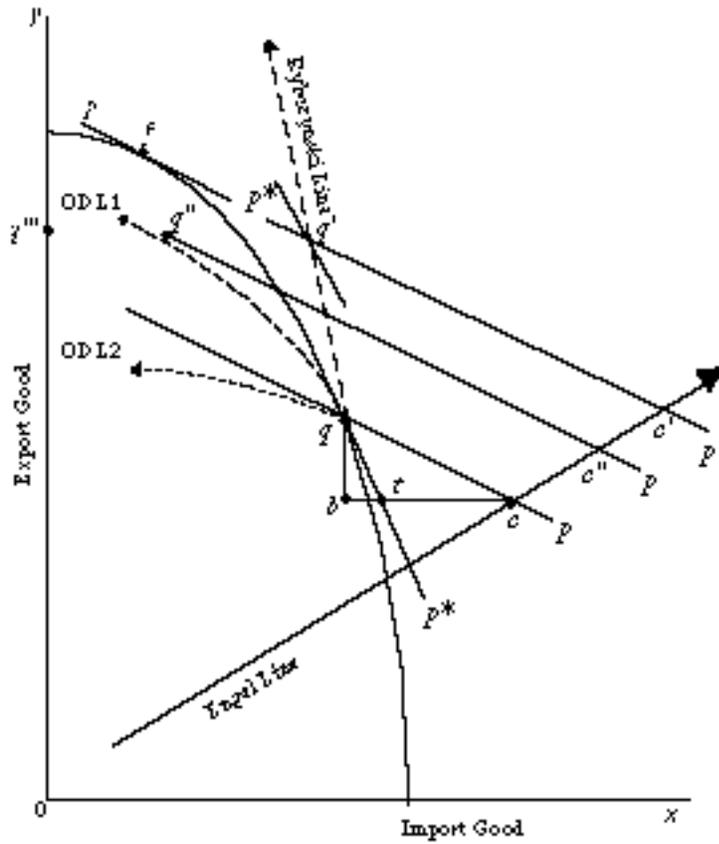


Fig. 7.1 Tariff Protection and Second-Best Policies

larger the domestic production and exports of  $y$  at the expense of  $x$  will be.

In a two-factor (capital and labor) framework, we may let  $y$  represent the consumption good, which is capital-intensive, and  $x$  the agricultural product, which is labor-intensive, completely ignoring the existence of any other raw

<sup>9</sup>When the policy measure takes the form of, say, factor-market distortions, the feasible production-possibility curve will shrink in, and there will be no tangency between the commodity price ratio and the feasible production-possibility curve. The Offsetting Distortion lines in figure 7.1 represent the locus of distorted domestic commodity price ratios ( $p^*$ ) intersecting the various shrunk-in feasible production-possibility curves.



accumulation of capital. Both movements will imply an increase in real income and a rise in export/GNP ratio.

As mentioned earlier, such second-best promotion policies will inevitably create efficiency losses. These losses, if large enough, could cause real national income to become smaller than it was in the absence of offsetting intervention—even though there may be substantial shifts in the output pattern and an increase in the export/GNP ratio. Offsetting Distortion line 2 (ODL 2) in figure 7.1 shows the immiserizing path of declining real national income.

In a dynamic context, there will be continual increases in factor supplies and technical progress that shift out the production-possibility curve. In figure 7.1 growth (or capital accumulation) is biased in favor of the unprotected export industry and hence is not immiserizing. So long as import-restriction-induced distortions in commodity markets are maintained, the need for continuous policy-induced structural adjustments through offsetting government policy measures, though perhaps reduced with growth, will never disappear—even in the absence of external economies. The trade triangle may, for instance, shift along the Rybczynski line from the one with the hypotenuse  $qc$  to the one with the hypotenuse  $q c'$ , or shift along the ODL 1 from the triangle with the hypotenuse  $qc$  to the one with the hypotenuse  $q c'$ . In a real economy, a combination of both movements will be present.

### 2.3. Protection, Reinforcing Distortion, and Growth

Just as policies favoring the comparatively advantaged (nonprotected) industries can offset some of the adverse effects of protection, this section illustrates how industrial promotion of the protected (comparatively disadvantaged) industries aggravates, or reinforces, these effects.

In figure 7.3  $y$  represents the intermediate and capital goods sector, which is capital-intensive, and  $x$  represents the consumer goods sector, which is labor-intensive. Output and consumption are at  $q$  and  $c$ , respectively, with tariff protection of the now import-competing  $y$  sector. Tariff revenue is equivalent to  $ct$  of  $y$ . Since the international price line  $p$  has been drawn steeper than the Rybczynski line, capital accumulation results in immiserization. We further postulate that the government promotes the import-competing  $y$  sector by, say, maintaining a credit-rationing system. The capital-intensive sector is now not only protected by tariffs, but is also promoted by other policy measures. Hence figure 7.3 presents the case in which the government nontariff policy measure induces the immiserizing structural adjustments along RDL (the Reinforcing Distortion line). In the



### *2.4 Protection of Monopolistic Export Industries*

In figure 7.3 growth by capital accumulation will (with or without the reinforcing distortions) eventually lead the output point to reach the Engel line, beyond which  $y$  becomes exported. With a perfectly competitive market structure, protection of the  $y$  sector beyond the Engel line is meaningless. However, Robinson (1969) shows that when the export sector consists of a monopolistic producer, import restriction of export goods can have the effect of expanding the proportion of export sales to total sales (at the expense of consumers' surplus) without resulting in allocative inefficiency. Monopolistic profit maximization through price discrimination in the domestic market does not cause the total output of the good to differ from that of free trade; it only expands the proportion of the export sales out of a given quantity of total output. That is, protection of the monopolistic export sector raises the export/GNP ratio, results in a redistribution of income in favor of the monopolist and against the domestic consumer, and may even cause a premature exportation of the import good, but it does not affect allocative efficiency.

## 3. PROTECTION AND LIBERALIZATION IN THE EARLY PHASE OF KOREA'S GROWTH

### *3.1 1961-67: Import Liberalization and an Export-Promotion Regime*

As a result of the heavy bias toward import substitution in the 1950s, Korea's commodity markets were significantly distorted. As a result, the labor-abundant Korean economy had not actively taken advantage of the gains to be made from trade à la Heckscher-Ohlin, and maintained an only half-open economy. With the initiation of the export-promotion strategy in 1961, the Korean government replaced its multiple exchange-rate system with a unitary one, made a series of exchange-rate adjustments to rectify the extremely overvalued domestic currency, and above all tried to prevent the direct impact of its own extremely protectionist import-restriction regime from negating the newly created incentives for export activities.<sup>10</sup>

Four principal policy measures were adopted in Korea in order to pursue this new export-oriented growth strategy: vigorous administrative support for export promotion, a preferential tax system, a subsidy allocation for export

<sup>10</sup>For details of the shifts in trade policies during 1961-67, see Frank, Kim, and Westphal 1975, chap. 4 and Hong 1979, chap. 5.

activities, and, finally, a reduction of the import-substitution biases of the economy. This last was especially important, because extreme import restrictions may well more than offset any kind of incentives given to export activities. For example, both tariffs and quotas are equivalent to taxes on imports, which, in turn, can become taxes on exports. Also, when direct import restraints are used as the instrument for correcting balance-of-payments deficits, exports will suffer—the exchange rate will be overvalued, and hence the competitive power of the export industries will be reduced.

In other words, a country cannot launch an export-promotion strategy while maintaining extreme forms of import restriction. Thus, when it was decided that this was the policy to be followed, the Korean government had to free export producers from the negative effects of tariff protection and quantitative restraints at the outset, by allowing tariff-exempt imports of the raw materials and investment goods that were directly used in the export-production process. Furthermore, the government tried to reduce the general level of quantitative import restrictions, culminating in the introduction of the negative list system in the second half of 1967.

In the period 1961-63, the number of items positively listed as importables (subject to government import licensing, quotas, foreign-exchange allocation ceilings, linkages to exports, and other regulations) fluctuated in the range of 1,000 to 1,600. Feeling the pressure of balance-of-payments deficits, the government reduced the number of importable items to fewer than 500 in late 1964, but then restored the 1961-63 level in 1965; the number of importable items was increased from 1,778 to 2,491 in 1966, and 3,852 by July 1967, when the switch to the negative list system occurred. Now just the “prohibited” or “restricted” import items were recorded.

Under the negative list system, only a handful of the manufactured goods belonging to SITC (Standard International Trade Classification) code numbers 6 and 8, as well as certain food products, got classified as “Automatic Approval,” import items. Most finished consumption goods were either classified as “Restricted Import” items or as “Prohibited Import” items.<sup>11</sup> The government effectively controlled the import of these restricted items by imposing annual import ceilings. Furthermore, there were numerous special laws for selected industries that, purely incidentally or with expressly

<sup>11</sup>From 1967 to 1981 the Ministry of Trade and Industry (MTI) announced the semiannual or annual lists of “Prohibited Import” items separately from the list of restricted items. Since 1982, however, the prohibited items have been listed together with the restricted ones, noting that such items may be imported subject to procedures as may be separately announced by the MTI, but without actually making such separate announcements.

protectionist intentions, restricted the import of related “automatically approved” commodities. In principle, restricted imports that competed with domestic production were allowed only to fill the estimated gap between domestic supply and demand. Quantitative import controls of noncompetitive raw materials and intermediate and capital goods (which were classified as restricted items and were not directly related to export activities) seem to have been influenced entirely by the overall balance-of-payments situation.

Imports of raw materials and intermediate inputs and investment goods for foreign exchange-earning activities, on the other hand, were approved automatically, irrespective of their classification.<sup>12</sup> Furthermore, imports financed by government-contracted foreign loans were permitted after consultation with the Trade Committee, irrespective of classification.<sup>13</sup> All in all, according to Frank, Kim, and Westphal (1975, 58), out of 30,000 SITC commodities, the number of “automatic approval” items expanded from 2,760 in the first half of 1967 to 17,128 in the second half, while the number of “prohibited import” items was reduced from 26,148 to 2,617.<sup>14</sup>

Since the old system of commodity classification (used prior to the second half of 1967) was significantly different from the more systematic classification (into 30,000 items based on the UN’s SITC manual), these numbers can only serve as a crude first approximation of the degree of liberalization. Nonetheless, we still conclude that the minimum requirements of import liberalization were satisfied in Korea, and that the remaining import-substitution biases could have been more than offset in the 1960s and 1970s by various policy measures to promote exports of manufactures.

### *3.2 1967-78: Protection Regime*

This section gives a rough description of Korea’s protectionist regime during the period 1967-78, and shows that little progress in import liberalization was made after 1967.

Following the introduction of the negative list system, the average basic legal tariff rate (weighted by import value of each commodity) was raised

<sup>12</sup>Until 1977 imports of plant facilities for export production were permitted after consultation with the Trade Committee.

<sup>13</sup>Since the second half of 1975 imports financed by foreign loan funds have been permitted according to special procedures set by the MTI. The clause on imports financed by government-contracted loans disappeared in the first half of 1977.

<sup>14</sup>Even the negative list system in principle, allowed the import of restricted items when the prices of competing domestic products were extremely high or their quality extremely poor.

from about 17 percent in 1963-67 to about 26 percent in 1968-72. From 1964 to 1972 there was also a special tariff law that empowered the Ministry of Finance to collect additional special tariffs (up to 90 percent of the differential between the estimated wholesale value and the imports cost) on nonessential imports.<sup>15</sup>

It was only after the 1973 tariff reform (which abolished the special tariff system) that the tariff rate was reduced to a 20 percent level (the average legal tariff rate for all commodities amounted to 20 percent in 1973-74 and 1976) and to 19 percent in 1978.<sup>16</sup> However, because of the tariff exemptions or reductions that were granted on the imports of raw materials directly used for export production and on the capital goods imported for foreign direct investment projects, export production and other important industries, the actual tariff rate (the amount of tariff revenue collected divided by the total c.i.f. value of imports) amounted to only about 9 percent on average during 1962-71, and about 7 percent throughout the period 1972-83.<sup>17</sup> The average tariff rate actually collected, then, does not seem to have been extremely high in Korea—but since those tariffs collected were mostly from the commodities whose imports were “approved,” they do not tell the magnitude of the import premium, or the effective rates of protection, generated by the quota system (see tables 7.1 and 7.2).

When the government changed from the positive list of quantitative restrictions to the negative list system in 1967, the nominal import liberalization ratio by item (on the basis of 1,312 SITC 5-digit classification) amounted to nearly 60 percent. However, as mentioned above, there was no

<sup>15</sup>There was another important form of import restriction that had tariff equivalent effect: since 1961 importers have had to make advance deposits of varying amounts as specified for each category of commodities.

<sup>16</sup>Data from Hong 1979, 322-49, and Republic of Korea 1983b, 8. According to Frank, Kim, and Westphal (1975, 61 and 63), the simple arithmetic average tariff rate amounted to about 42 percent in 1966-68, about 39 percent in 1972 (including the special tariffs), and about 31 percent after the 1973 tariff reform.

<sup>17</sup>For instance, in 1982, 25 percent of commodity imports constituted materials for export production that were tariff exempt, another 25 percent was crude oil, which was subject to a zero tariff rate, 3.7 percent were minerals that paid no tariffs, and 5.3 percent of imports were exempt from tariffs by various provisions. As a result, about 59 percent of imports were duty-free. The average actual tariff rate for raw material and intermediate inputs (which amounted to 14 percent of total imports) was 17.6 percent, the rate for capital goods (17 percent of total imports) was 13.1 percent, and that for grains (8 percent of total imports) was 2.3 percent. The actual tariff rate for consumption goods (3 percent of total imports) was 32.1 percent. See Republic of Korea 1983a, 10.

further movement toward liberalization after 1967, and in fact the import-liberalization ratio rather steadily declined thereafter to become about 50 percent by the first half of 1978. According to table 7.3, the number of restricted import items, as well as their share in total value of imports, was substantially larger in 1978 than it had been in 1967. There were significant increases in import restrictions (both in terms of number of items and value of imports) of machinery, chemicals, and other manufactures (except textiles) during 1967-78. Even raw materials were subject to increased import restrictions. It was only after the second half of 1978 that the import-liberalization ratio (both by items and by value) began to increase.

Between 1970 and 1975, out of Korea's total commodity imports the share of consumption goods amounted to only about 5 percent. The share of foodstuffs amounted to about 16.6 percent in 1970 and 14.3 percent in 1975. Consequently, about 80 percent of Korea's imports during this period consisted of raw materials, intermediate-input materials, and capital goods.<sup>18</sup> On the basis of this observed composition of trade, Korea's protectionist regime may be characterized as follows: imports of agricultural products were restrained to the minimum necessary levels, while preferential treatment was given to the import of capital goods (in order to accelerate investment activities) and to raw materials and intermediate goods (in order to raise the utilization rate of existing production capacity). As a result, at least until the mid 1970s, the quantitative import restrictions were essentially set against agricultural products and finished consumption goods. This is important; it means that the import restrictions did not directly affect the production of other (export) goods.

### *3.3 Growth Performance of the Korean Economy*

In the 1950s Korea's imports were mostly financed by foreign grants-in-aid. The opening up of the Korean economy to trade (through the switch to an export-oriented growth strategy) occurred over an extended period of time, spanning the 1960s and 1970s. The efficiency gains from this action materialized in the form of both rapidly increasing real wage rates and rising

<sup>18</sup>Owing to the drastic jump in the price of crude oil, the share of raw materials in total commodity imports rose from about 18 percent in 1970 to about 27 percent in 1975, while the share of capital goods fell from 28 percent in 1970 to 22.5 percent in 1975. However, the share of intermediate-input materials did not change much, amounting to about 32 percent of Korea's total commodity imports through 1970-75. The import data were obtained from material provided by the Bank of Korea Input-Output Tables.

rates of return on investment. The average gross rates of return on investment in the Korean manufacturing sector increased from about 12 percent in 1954-61 to about 23 percent in 1972-79 (see table 7.4). Over the period 1962-79, there were also rapid increases in domestic savings, which, together with the productivity gains from trade, allowed nearly 10 percent average annual growth rates of GNP. The average annual growth rate of GNP rose from about 4 percent in 1953-61 to about 8 percent in 1962-66 and to almost 10 percent in 1967-79 (see table 7.5).

During the 1953-61 period of import substitution, Korea was insignificant as an exporter of primary products, and the export/GNP ratio amounted to only about 0.01. By pursuing the export-promotion strategy, Korea became an exporter of manufactures, and the export/GNP ratio rose rapidly from about 0.04 in 1962-66 to about 0.26 in 1977-79. Commodity exports expanded from a mere \$33 million in 1960 to about \$15 billion in 1979, and the proportion of manufactures out of total commodity exports increased from about 15 percent in 1960 to more than 90 percent by 1979.

As the case of Korea proves, an export-oriented economy can achieve both high growth performance in output and export expansion with just a minimum (but necessary) degree of import liberalization. Obviously, the fairly extensive quota and tariff systems that Korea maintained throughout the period 1967-79 did not prevent it from achieving high rates of growth in either of these areas. Hence it is fair to say that the export-promotion policy measures more than offset any possible adverse effects from the tariffs and quotas. In fact, the system of tariff protection may even have contributed positively to Korea's growth. Real GNP grew about 9 percent per annum during 1962-84, and domestic savings expanded from about 4 percent of GNP in 1953-61 to about 25 percent in 1976-85. Government saving was negative prior to 1964, and negligible in 1964-66. However, it amounted to an average of about 5.5 percent of GNP during 1967-85, and about 40 percent of this was financed by tariff revenue—in spite of the fact that the actual rate of tariffs was reduced from about 9.1 percent in 1967-71 to about 6.2 percent in 1980-85. Because the Korean government has been directly involved in various productive investment activities, the static negative effects of the tariff system have to be weighed against its positive contributions of reducing consumption, enhancing domestic savings, and increasing productive investment. (This possibility has been indicated in figure 7.2.)

Owing to the fact that prior to the mid 1970s imports of intermediate and capital goods were subject to less severe quantitative controls than were consumption goods, imports substitution of these products had not been as profitable as it had been for consumption goods, and hence was relatively

slow. It might sound paradoxical, but Korea's early failure to extensively promote the intermediate and capital-goods industries seems to have contributed positively to rapid export expansion. That is, manufacturers of export goods were relatively free to use low-cost imported intermediate and capital goods rather than having to use high-cost domestic products—even when these products were classified as restricted import items. This factor, combined with the low cost of labor, seems to have helped Korea achieve an extremely rapid export expansion.

#### 4. PROTECTIONIST POLICIES IN THE LATER STAGES OF GROWTH

##### *4.1 The Mid 1970: Protection of Intermediate and Investment Goods Sectors*

As noted, until the mid 1970s, both Korea's industrial production and its exports were dominated by final-consumption goods, whose production was labor intensive and depended heavily on imported intermediate and investment goods. Import restrictions were mostly on consumption goods, at the expense of Korea consumers. This apparently was not fatal to the growth performance of the economy. However, with the beginning of the third five-year economic development plan (1972-76), the Korean government began to promote "heavy and chemical" industries, and actually implemented various tax-cum-financial incentives for these industries<sup>19</sup> (see Hong 1979, chap. 4). As a result, there was extensive domestic production of hitherto imported intermediate and investment goods by the late 1970s. Unfortunately, many of the so-called heavy and chemical industries promoted by the government were excessively capital-intensive, and Korea did not have the comparative advantage necessary to successfully compete against foreign products. As a result, promotion came to imply somewhat extensive import restrictions on these capital-intensive intermediate and investment goods, and both the growth rate of exports and of GNP would be affected.

As early as 1972 when the first petrochemical factories began operation, MTI changed ten petrochemical products from "automatically approved" to

<sup>19</sup>The Korean government had already established a legal foundation for promoting the so-called heavy and chemical industries. During the second five-year economic development plan period (1967-71), "promotion laws" were introduced for the machine industry and shipbuilding (1967), for electronics (1969), and for steel and petrochemicals (1970). Each of these laws specified various tax-cum-financial supports for the respective industry.

“restricted import” items. Such practices intensified and became more frequent in the late 1970s. Since 1976 those wishing to import machinery worth more \$1 million, and financed either by foreign loans or foreign-currency loans from domestic banks have had to report in advance to MTI (and after 1985 to the Korea Machine Industry Promotion Association). As a condition for approving the import of the domestically unproducible portion of the machinery, MTI specified a certain portion that must be produced domestically. MTI also specified the required domestic-content ratios for selected plant facilities that cost more than \$3 million and were financed by foreign loans or foreign-currency loans.<sup>20</sup>

According to table 7.3, the proportion of restricted import items in the machinery sector (in value terms) amounted to about 46 percent of total machinery imports in 1967, rising to about 79 percent in 1978, and to 80 percent in 1981. In the chemicals sector, the share of restricted items increased from about 23 percent in 1967 to about 60 percent in 1978, and was 58 percent in 1981. As shown in table 7.6 chemicals imports have been restricted mostly by special laws rather than by MTI classification notices.

#### *4.2 Impact on Export Production and Trade Pattern*

The Korean government’s decision to change its emphasis and promote the “infant” intermediate and investment-goods industries was not simply for the sake of self-sufficiency in these sectors, but also so that they would eventually become the new generation of leading exports. The government believed that tariff protection and quantitative restraints were indispensable policy measures for initiating the domestic production of these products. Unfortunately, such policies could not help but generate the familiar efficiency-reducing effects associated with import substitution, and they immediately affected the production costs of related downstream domestic industries. Eventually, the adverse effects were passed on to export-production activities. Unlike in the earlier period, this time government promotion activities did not offset the efficiency losses of protection, but rather encouraged them.

Until early 1971 any intermediate input that was needed for export

<sup>20</sup>Selected plant facilities have included cement, fertilizer, ethanol, thermal and hydro power generation, oil refinery, formalin (since 1976); polyethylene, synthetic rubber, polyester, steel (since 1977); ethylene, PVC, polypropylene, caustic soda (since 1978); caprolactam, paper, paperboard, atomic power generation (since 1979); radial tire, liquid gas, naphtha cracking (since 1980); VCM, EDC, soda ash (since 1981); and so on.

production could be freely imported, even if it were classified as a restricted import item. However, in October 1971 MTI made 41 intermediate input materials for export production (including even important textile fibers) subject to pre-import approval. In 1975, 12 more items were added to the list, and by 1982, 61 intermediate input items (based on the 4-digit CCCN classification) were subject to the prior-to-import approval system. Moreover, the import of selected plant facilities for eight industries was completely prohibited, even when they were to be used for export production. In 1985, 54 intermediate input materials for export production were subject to the requirement of a prior recommendation. Among them, about 20 items (mostly petrochemical products) could obtain the recommendation when domestic supply prices exceeded c.i.f. import prices by more than 3 to 10 percent.

By 1974 the tariff exemption on capital equipment for export production had also been changed—to tariff “payments on an installment basis,” and in 1975 the tariff exemption on raw material imports for export production was changed to a “tariff drawback” or refund, after making initial payments to the government. In late 1977 the Korean government introduced the “limited tariff drawback” system on materials imported for export production. Out of the 117 items subject to this system, 87 were given zero percent drawback (no tariff exemption at all) and the other 30 were allowed between 2 and 97 percent drawbacks of the tariffs that been paid at the time of customs clearance.<sup>21</sup>

The number of items subject to the limited tariff drawback system was reduced to 62 in early 1980, and then expanded to 128 by mid 1981, to 212 by early 1982, and to 266 by mid 1983.<sup>22</sup> By the end of 1984, 170 items were subject to zero percent drawback, and 84 items were subject to between 2 and 90 percent drawback. In principle, the tariff drawbacks on these items are allowed only on the portion that cannot be satisfied by domestic supply, regardless of domestic price. This has generated continuous conflicts between the users (export producers) and the suppliers (domestic import-competing producers) of the specific intermediate inputs.

According to Young et al. (1982, 49), in 1978 the average effective rate of

<sup>21</sup>These items consisted mostly of (petro) chemical products such as naphtha, methanol, urea, polyester resin, PVC tube, film and resin, viscose rayon F yarn, PP filament yarn, polypropylene staple fiber, polyester staple fiber, acrylic fiber, ammonium chloride nitrobenzene, etc.

<sup>22</sup>After 1981 many nonferrous metal products such as lead ingot, zinc ingot, aluminium ingot, brass bar, tin ingot, copper wire, etc., became subject to limited tariff drawbacks.

protection for heavy and chemical industries amounted to 71.2 percent, while that for light industries amounted to -2.3 percent. According to the input-output table data, the share of raw materials (excluding crude oil) in Korea's total commodity imports increased from 9.4 percent in 1975 to 11.3 percent in 1980, but the share of intermediate-input materials decreased from about 32 percent in 1975 to about 29 percent in 1980. Presumably, the protection and promotion of heavy and chemical industries was responsible for the declining share of intermediate-input materials in Korea's total commodity imports.

The labor-intensive consumption-goods sector had dominated Korea's commodity exports in the early phase of export-oriented growth. By the late 1970s, however, a new group of leading exports (including machinery, transport equipment, and iron and steel products) had emerged. These belonged to relatively capital-intensive sectors, making Korea's overall commodity composition of exports shift toward a more capital-intensive one. Hong (1987) shows that the value of capital per worker directly and indirectly employed in the Korean manufacturing sector for the production of commodity exports rose from \$3,000 in 1966 to \$8,900 in 1980 (in constant 1980 dollar prices). At the same time, owing to the promotion of capital-intensive import-substituting sectors (that included various petrochemical products), the value of capital per worker that was employed in replacing competitive imports rose from \$4,800 in 1966 to \$12,200 in 1980. The average capital intensity of Korea's manufacturing sector itself rose from \$3,800 in 1966 to \$10,400 in 1980.

With capital accumulation in a country, one naturally expects to observe a rising wage/rental ratio, and a rising capita/labor ratio in both production and exports. Unfortunately in Korea many of those intermediate and investment-goods sectors promoted by the government in the 1970s turned out to be excessively capital-intensive (for that particular stage of growth), and these sectors ended up having to be protected by tariff and quotas, which in turn raised the production costs of down-stream industries.

During the period 1965-76, Korea had maintained an average annual growth rate of real exports as high as about 34 percent. However, the growth rate of real exports started to decline in 1977, making the average growth rate of real exports only 12 percent per annum for the period 1977-85.<sup>23</sup> Furthermore, Korea's performance in GNP growth began to look less impressive after 1980. The growth rate of GNP fell from nearly 10 percent per annum on

<sup>23</sup>The growth rate of real exports represents the growth rate of the export quantum index (1980 = 100) estimated by the Bank of Korea.

average in 1967-79 to around 7.5 percent in 1981-85. The significantly reduced rates of export expansion and GNP growth may at least partly be related to tariff protection and quantitative restrictions. Consequently pressure arose for the government to search for more efficient policy measures with which to promote the intermediate and investment-goods sectors.

#### *4.3 The Late 1970s: Abortive Import-Liberalization Attempts*

In an early stage of export-promotion-based development, complete import liberalization is obviously not a necessary condition for successful growth performance. In the later stages of export-oriented development, however, an extensive import liberalization may become a necessary condition, not only for maximization of hitherto much neglected consumer welfare,<sup>24</sup> but also for efficiency maximization. Efficient domestic production is clearly important if exports are to be internationally competitive. Indeed, in Korea, by the end of 1970s nationwide pressure to initiate further import liberalization seems to have appeared.

In 1977 Korea's current account of the balance of payments registered a small surplus for the first time since 1966. This was followed by an import-liberalization effort. In February 1978 the Korean government established the Committee for Import Liberalization to formulate the direction of liberalization and then to determine the items to be liberalized. The import-liberalization ratio by item jumped from about 54 percent in the first half of 1978 to about 65 percent in the second half.<sup>25</sup> However, MTI seems to have assumed the task of import liberalization in 1978 with reluctance and skepticism.

According to MTI, the items to be liberalized were those that did not compete with domestic production, those for which there were no plans for domestic production and those that already enjoyed strong international

<sup>24</sup>The share of consumption goods in Korea's commodity imports had declined from 4.5 percent in 1970-75 to 3.8 percent by 1980. The share of foodstuffs declined from 16.6 percent in 1970 to 14.3 percent in 1975, and to 9.3 percent in 1980. According to Young et al. (1982, 92), the high prices that Korean consumers paid because of protection amounted to about 13 percent of the national income in 1978. This indicates that the dividends to consumers also became large enough to generate strong pressure for an extensive import liberalization.

<sup>25</sup>Based on 1,097 4-digit CCCN classification. In order to maintain consistency with the 1967 import liberalization ratio, the number of RI items in table 7.3 was counted on the basis of 1,312 5-digit SITC classification.

competitive power. The items *not* to be liberalized were those produced by heavy and chemical industries and other strategically promoted industries, those produced by small- and medium-sized industries, those produced by infant industries that still had to expand further in order to enjoy scale economies, those produced by industries that had substantial forward and backward linkage effects, those produced by industries that supplied necessary intermediate inputs and basic materials to the heavy and chemical industries, agricultural products, and luxury goods.<sup>26</sup> In other words, MTI wanted to liberalize the import of only those items that would have minimal impact on the domestic economy. The number of restricted import items did substantially decrease in the second half of 1978, but most of the newly import-liberalized items were either economically unimportant ones or were classified as “import surveillance” items that could be reclassified as “restricted” should a surge of imports follow.<sup>27</sup> When the balance on the current account deteriorated seriously in 1979, the halfhearted liberalization movement was brought to a halt in 1980.

## 5. IMPORT LIBERALIZATION IN THE 1980s

### *5.1 The Protectionist Regime as of the Early 1980s*

During the second half of 1981 and the first half of 1982, the import-liberalization ratio by item (or the share of automatically approved items in the 7,915 8-digit level CCCN classification) amounted to about 75 percent. However, if those items whose imports were subject to special laws are excluded, then the import-liberalization ratio amounted to only about 55 percent (see table 7.2). In value terms, as estimated by Luedde-Neurath (1984, chap. 8), the import-liberalization ratio for the first half of 1982 amounted to 58.7 percent (not taking into account the special laws), and to only about 22.7 percent if imports subject to special laws are excluded. Since many of the special laws controlled imports of related commodities purely incidentally, and since many of the import items that were only partly controlled were counted as full “restricted import” items, these figures may

<sup>26</sup>Data from Republic of Korea 1978.

<sup>27</sup>According to Young et al. (1982) the effective rates of protection for durable and nondurable consumption goods and machinery and transport equipment declined substantially during 1978-82. However, the effective rates of protection for construction materials and intermediate-input materials rather significantly increased during the same period (see table 7.2).

represent a significant underestimation of the actual degree of import liberalization in Korea in the early 1980s.

A study by Kim and Hong (1982) shows that there were steady decreases in the effective rate of protection for the manufacturing sector as a whole throughout 1963-78. During the first half of the period (1963-70), the decreases in the effective rates of protection occurred most drastically in the export sectors, while the rates of protection for import-competing sectors rather significantly increased. During the period 1970-78, however, the drastic decreases in effective rates of protection occurred in import-competing sectors and in sectors that both exported and imported, while there was a significant increase in nominal, as well as effective, rates of protection for export (manufacturing) sectors (see table 7.1). The implications of this somewhat paradoxical phenomenon were examined in section 2. As of 1983 only 38.9 percent of Korea's major import commodities were classified as "automatic approval" items, but the average liberalization ratio by item reached 80.4 percent.<sup>28</sup>

### *5.2 Import Liberalization as a Long-Term Policy Goal*

The liberalization movement that was halted in 1980 was resumed in 1981 despite the enormous current account deficit, but was again halted in 1982. The current account situation substantially improved in 1983, and a renewed movement toward import liberalization followed. This time, however, it was approached as a long-term policy goal with a definite annual liberalization timetable. According to the schedule, Korea will reach the OECD level of import liberalization by 1988.

The simple arithmetic average tariff rate was reduced from about 36 percent in 1977-78 to about 25 percent in 1979-81. The weighted average tariff rate also fell steadily from about 19 percent in 1978 to about 12 percent in 1981. In early 1983 the Ministry of Finance (MOF) took decisive initiative in the import-liberalization movement and presented a long-term (1983-88) tariff reduction scheme: the simple arithmetic average tariff rate was scheduled to fall from 23.7 percent in 1982 to 20.6 in 1984 and to 16.9 percent in 1988.

Following the MOF initiative, MTI presented its own schedule of import liberalization: the share of "automatic approval" items was to increase from 76.6 percent in 1982 to 80.4 percent in 1983, to 91.6 percent in 1986 and 95.2 percent in 1988. MTI also presented a list of the "restricted import" items

<sup>28</sup>Republic of Korea 1983a, 2.

that would be liberalized during 1984-86.

Theory suggests that it is desirable to eliminate quantitative restrictions first, even if this means raising the rate of tariff protection. Since MOF took the initiative, MTI had to follow, and faced the difficult task of selecting a large number of new automatically approved items all at once. Many of the items produced by politically influential monopolistic firms escaped the early round of liberalization, and most of the items scheduled to be liberalized first were produced by less influential small firms. The former included many heavy industrial and chemical products, and the latter included many finished consumption goods. Owing to the existing political power balances, the consumers' surplus problem was, quite unintentionally, significantly taken care of in the early phase of import liberalization.<sup>29</sup> Furthermore, the government officials seem to have pursued import liberalization indiscriminately, with no clear idea of priority between consumers' surplus and efficiency enhancement at the beginning stage.

### *5.3 Progress in Import Liberalization*

In accordance with MTI's long-term import liberalization schedule, out of the total importable items the proportion of restricted imports declined from about 25 percent to about 12 percent during 1981-85, and the proportion of "special law" items declined from about 19 percent to about 16.6 percent. According to the 1982 Luedde-Neurath data and the table 7.6 data of 1984, the import-liberalization ratio by value (the share of commodities imported as "automatic approval" items out of the total value of commodity imports) increased from about 59 percent to 78 percent during 1982-84 without taking into account special laws, and increased from about 23 percent to about 40 percent excluding the special law items.

Among primary products, imports of raw foodstuffs and mineral fuels were mostly subject to special laws. Among manufactures, the import of chemicals was largely subject to special laws. Not only did the absolute number of restricted items in the chemicals sector decrease in 1981-85, but the proportion of chemical imports subject to special laws also declined (from

<sup>29</sup>In order to cope with the possibly severely damaging effects of import liberalization on the competing domestic industries, an adjustment tariff was introduced in early 1984 that enables the government to raise the tariff rate up to 100 percentage points on a commodity whose import has been liberalized within the past three-year period. The application of this adjustment tariff rate cannot exceed three years. There have also been anti-dumping tariffs, countervailing tariffs, and retaliatory tariff systems, but none of them has even been actually enforced.

about 60 percent to 47 percent of total importable items). In the case of machinery and other manufactures (SITC 6, 7, and 8, excluding textiles and electronics products), the number of restricted import items has substantially decreased, but the proportion of imports subject to special laws has significantly increased.<sup>30</sup> Apparently, in certain sectors there has been a tendency to replace a "restricted" classification with special laws.<sup>31</sup> On the whole, however, not only did the number of restricted import items decline significantly during 1981-85, but the proportion of items subject to special laws did too (see table 7.7).

As of 1984, imports of electronics and telecommunication equipment, road vehicles, ships, and other machinery and equipment were heavily restricted. In value terms, nonferrous metal products were also significantly restricted (see table 7.6). However, if we examine table 7.3, we can see that imports of textiles have been steadily liberalized since 1967. Import restrictions on raw materials and iron and steel products very much expanded during 1967-78, but then were substantially liberalized after 1978. About 46.5 percent of raw materials were classified as restricted import items in 1978, but this has been reduced to about 10.4 percent by 1984. As of 1978, about 75 percent of iron and steel products were subject to import restriction in the form of a restricted-import classification, and more than 90 percent of total iron and steel imports were imported subject to some restriction. By 1984, however, less than 10 percent of iron and steel product imports (either by item or by value) were subject to restriction either in the form of restricted-import classification or special laws. Furthermore, as the growth rate of commodity exports slowed down in 1985, the government reduced the number of items subject to the limited tariff drawback system from 254 to 79.

<sup>30</sup>During 1981-84 the proportion of RI items in the machinery sector (SITC 7) was reduced from about 45 percent of total importable items to about 28 percent, while in value terms the share was reduced from about 72 percent to 54 percent. In the chemicals sector the proportion of RI items was reduced from about 6 percent to about 4 percent during this period, while the share in value terms was reduced from about 58 percent to about 35 percent. In the meantime, the proportion of chemicals out of total imports increased from 8 percent to about 9 percent, and that of machinery from about 22 percent to about 25 percent. Ship repair, which amounted to \$418 million in 1981 and \$2,445 million in 1984, was excluded from the percentage estimations for the machinery sector. See Korean Traders Association, 1984.

<sup>31</sup>In the cases of textiles and electronics, the number of restricted items decreased substantially, but there was no change in the number of special law items. In the case of mineral fuels, the proportion of special law items increased from about 37 percent to 50 percent.

In 1983 the simple arithmetic average tariff rates for raw materials, intermediate inputs, and finished goods were 11.9 percent, 21.5 percent, and 26.4 percent respectively.<sup>32</sup> By this time, increasingly fierce resistance to import liberalization by the big monopolistic business groups could be detected. The following guiding principles on import liberalization set out by MTI in 1984 reflect this reality:

[Monopolistically produced] commodities will be subject to early liberalization in principle. Although import liberalization should lead to increased competition among firms, it should not be pursued to such an extent as to bankrupt firms. The import liberalization program should also allow for preservation of basic material industries even if they are not internationally competitive and also for the need to protect economies of scale industries and those industries in which we are still acquiring technology. Thus, while the petrochemical, steel and metal products, automobile, and electronic product industries are oligopolistic, they are also the basic materials and strategic industries (translated from the Koran by Young [1984, 79]).<sup>33</sup>

Nevertheless, import liberalization did progress more or less on schedule in 1983-85. The import liberalization ratio by item increased from 76.6 percent in 1982 to 87.7 percent in 1985, and is scheduled to reach 95.4 percent by 1988. The government also reduced the number of so-called "automatic approval" items whose imports were subject to special laws, and intends to keep reducing it in the future. Moreover, the simple arithmetic average of legal tariff rates for all commodities, which amounted to 22.6 percent in 1983, kept falling. It reached 16.9 percent by 1988. It is true that most of the important agricultural products were not included in the 1984-88 import-liberalization scheme, but as far as manufactures are concerned, if everything goes as presently scheduled, Korea will have the most liberal import regime of all the Third World countries in its income class.

<sup>32</sup>Data from Republic of Korea 1983a, 2.

<sup>33</sup>The ministerial guidelines laid down for import liberalization for the one-year period starting in mid 1983 included statements to the effect that the manufactured commodities whose import was to be liberalized should be those for which there were no competing domestic substitutes and in whose case liberalization was unlikely to produce an import surge. Should there be an import surge, such commodities would be put on a surveillance list, and their imports could be restricted again. Furthermore, newly developed commodities may be entitled to temporary protection by being classified as new restricted import items. See Young et al. 1982, 22-23.

#### *5.4 The Political Economy of Import Liberalization*

It is also important to consider the political economy of import liberalization in an export-oriented economy. It is well known that consumers are one of the least organized groups in any economy. Hence, they cannot exert concentrated pressure against the protection accorded to the domestic producers of final-consumption goods. Therefore, in the early phase of growth, when domestic outputs as well as exports are dominated by labor-intensive consumption goods, there is usually little pressure for the government to undertake extensive import liberalization. Only a certain minimum level of import liberalization, enough to facilitate industrial growth and exports expansion, has to be enforced.

In a later phase of growth, however, a large number of intermediate and investment-goods producers emerge. They sell substantial portions of their products to domestic industries. These buyers, or so-called end-users, are better organized than consumers in general to mobilize a concerted effort against the protection accorded to the producers of intermediate and investment goods. Sellers' domination and uncontested protection rents tend to disappear in these sectors there finally exists an equally powerful group who stand to benefit by eliminating import restrictions. Often, end-users are themselves producers of other intermediate and investment goods. When this happens, their stance on import liberalization becomes very complicated.

Since it sounds more noble for end-users to insist on import liberalization in general, rather than for just those intermediate and investment goods that are directly related to their production activities, it sometimes happens that imports of consumption goods also tend to be liberalized. This may, however, be regarded as rather unintended. The government is under pressure to liberalize imports, but it is also subject to opposing pressure from the strong vested interest group of intermediate and investment-goods producers. Consumption-goods producers are comparatively weaker in political influence. What happens, then, is that the preannounced target of import liberalization is partly met by liberalizing the import of some final-consumption goods. The purpose is not to enhance consumers' surpluses per se, but simply to give the impression that the government is liberalizing imports on schedule.

The question faced by the protected industries in Korea, however, was simply whether they were to be liberalized during 1984-86 or during 1987-88. Imports of almost all manufactured products, regardless of whether they are consumption goods, intermediate goods, or investment goods, had been liberalized by the end of 1988.

Under the import-liberalization schedule for 1987-88 that was announced on October 30, 1985, a 100 percent import liberalization was achieved for metals and iron and steel products by 1987, and for electronics goods and both electrical and nonelectrical machinery by 1988. The imports of pulp and paper, ceramics, and chemicals were liberalized up to 99.6 percent, and textiles imports up to 97.8 percent, by 1988. Among textile products, only those related to sericulture (such as raw silk, silk yarn, and silk fabrics) will continue to be subject to import control. Among chemicals, only ethyl alcohol and some toxic insecticides (8 items altogether) will continue to be subject to import controls.

As of 1986, 56 monopolistically produced manufactured commodities (out of 254) were subject to import restrictions. However, by 1988, only 3 monopolistically produced commodities (milk powder, fruit juice, and fermented lactic bacteria) continued to be subject to import controls. Out of 7,915 importable items, 369 remained "restricted" in 1989, and of those, only 32 were manufactured products. The other 337 items consisted almost entirely of agricultural products and certain special items, such as precious stones.

## 6. SUMMARY AND CONCLUSIONS

When the "growth" or "promoted" industries are mostly in the export sector, the harmful effects of protecting other import-competing sectors are alleviated as time passes. However, if the growth or promoted industries are in the major import-substituting sectors, then the harmful effects of protecting these industries can be very much exaggerated as capital is accumulated and sector-specific industrial promotion policies are enforced.

In Korea the consumption-goods sector was promoted as the leading export sector in the 1960s and early 1970s, and it also constituted the major growth sector (as compared to agriculture or intermediate and investment goods). Until the mid 1970s, therefore, capital accumulation and export promotion in Korea did not seem to seriously aggravate the harmful effects of protecting the import-substituting sectors. Even the severe restriction of imports of consumption goods did not by itself seriously reduce allocative efficiency, though there apparently were substantial losses of consumers' surplus.

Since the mid 1970s, though, a host of highly capital-intensive heavy and chemical industries began, as a promising new generation of infant industries, to be protected by severe import restrictions and, at the same time, were promoted as export industries. These newly promoted industries began

supplying increasing amounts of intermediate and investment goods to domestic producers, but in many cases at excessively high costs, because Korea still did not have comparative advantages in many of these products. The adverse efficiency effects of both tariff and quantitative protection of capital-intensive heavy and chemical industries were then inevitably amplified as capital was accumulated and sector-specific promotion policies were enforced. Since Korea was not expected to gain a comparative advantage in the production of many of these intermediate and investment goods for a long time, pressure arose for import liberalization—not so much to enhance consumer welfare as to enhance the production efficiency and the international competitive power of Korean industries in general. That is, by the beginning of the 1980s, pressure arose for the Korean government to search for better measures than tariff protection and quotas to promote infant (intermediate and investment-goods) industries. At the same time, by pure coincidence, the United States also dramatically increased pressure for import liberalization, which could by no means be ignored by the Korean government.

On the basis of the Korean experience, we can conclude that, in the initial phase of export-oriented growth, extensive import liberalization does not constitute a necessary condition for high growth performance. In a later phase, however, it is more likely to become a necessary condition for maintaining the competitive power of domestic industries in the international market and the high growth performance of the domestic economy. Infant intermediate and investment-goods industries with reasonable changes of becoming internationally competitive have to be promoted, but by more efficient means than tariff protection and quantitative restriction.

The evolution of Korea's import-restriction policy suggests that an export-promotion regime is much more conducive to early import *liberalization* than is an import-substitution regime. Owing to enhanced ability to earn foreign exchange, once low domestic saving ceases to constrain growth, an export-promotion regime can afford to reduce or eliminate its import-restriction system much more rapidly than could an import-substitution one.

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