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“Export Promotion Policies, Export Composition and Economic  
Development of Korea”

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## I. Introduction

South Korea, Korea hereafter, has shown rapid economic growth since the 1960s. The government has provided various incentives to promote exports, expecting export-led economic growth. Export values increased from US\$87 million in 1963 to US\$17.5 billion in 1980, and then to US\$363.5 billion in 2009. Although import values were more than 6 (2.3) times larger than export values in 1963 (1971), trade surpluses have been recorded since 1998. The trade dependence ratio defined as (export values + import values)/GNP increased from 46.6 percent in 1972 to 78.9 percent in 1980, to 76.6 percent in 2001 and then to 98.6 percent in 2009. Thus, the Korean economy is regarded as one showing very high trade dependence ratio. In the meantime, per capita GNP increased from less than US\$100 in 1960 to US\$1,688 in 1980, to US\$12,581 in 1996 and then to US\$17,085 in 2009. Export expansion has been believed to be possible by aggressive export promotion (EP) policies, in particular in the early stage of economic development. The Korean government provided tax and financial incentives in addition to incentives such as establishment of organizations to promote exports. Thus, the experience of economic growth of Korea has been regarded as an example of pursuing the export-led economic growth strategy.

Although the Korean government provided many types of export incentives in its rapid economic growth, the World Trade Organization (WTO) system strictly regulates most such incentives to promote exports. Therefore, developing countries trying to pursue export-led economic growth strategy are not free to take many EP measures that were provided by the Korean government during the period of very rapid economic growth. The current paper explains the EP measures taken by the Korean government, points out their contributions and problems, and provides developing countries pursuing economic growth with the implications under the WTO system drawn from the experience of Korea.

The structure of the paper is as follows. Section II explains the effect of EP policies on exports and economic growth. Section III shows the overall patterns of the EP policies of Korea during the 1960s – 2000s. Section IV explains various export incentives that have been provided by the Korean government. Section V evaluates the EP policies pursued by the Korean government and draw implications for economic development of developing countries. Section VI provides conclusions.

## II. The Effect of Export Promotion on Economic Growth

### A. Benefits and Costs of Export Promotion Policies

The outward-oriented economic development strategy has often been compared with the inward-orientation strategy. Chris Milner emphasizes that outward orientation (OO) and government intervention are separate issues. For EP, the role of government is essential.<sup>1</sup> If financial benefits are conferred by the government to exports

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<sup>1</sup> Milner, Chris, ed., *Export Promotion Strategies: Theory and Evidence from Developing Countries*, Harvester Wheatsheaf: N.Y., 1990 (1990a), p. 2.

conditional on export performance, they would be regarded as export subsidies.

For economic growth and welfare improvement of a national economy, OO is expected to dominate inward orientation or import substitution (IS) in the following manner. First, assuming economies of scale, expanded sales opportunities due to participation in international trade would lead to lower average production cost and higher profit level. Second, due to severer competition in the international market, productivity improvement can be expected from OO. There may be potential economy-wide benefits from “intensifying competitive pressures and managerial efficiency, accelerating technical progress by greater contact with foreign institutions and ideas”.<sup>2</sup> Third, the rapid economic growth performance of the East Asian countries show that the OO strategy is superior to the IS strategy.

In addition to the benefits of OO, we can also expect the rationale for EP by the government. First, as Falvey and Gemmell notice, EP measures may be justified, first, to remedy anti-export bias made by import protection. That is, import protection harms exports through two channels: it reduces domestic exporters’ competitiveness in international markets by raising the cost of imported inputs in production of exportables; and it reduces the incentives for the production of exportables relative to importables. EP policies might be justified as an attempt to compensate for the effects of such anti-export bias.<sup>3</sup> Second, infant-exporter argument for temporary assistance has been suggested, based on the idea that entering the new export markets is a difficult and costly activity with the cumulative volume of exports having a favorable effect on the unit cost of exports.<sup>4</sup> Third, we can think of the strategic trade policy argument. According to it, exports subsidized by the government may pre-empt the international market and the domestic company can get the monopoly profit, as the foreign competitor is driven out.<sup>5</sup> The above-explained rationale for EP can be summarized as the role of government regarding policies to transfer resources from less productive toward more productive uses.<sup>6</sup>

One can also think of the costs of those. First, as certain amount of government expenditure is directed to EP, it sacrifices its allocation to the other sectors such as social welfare or the non-export related production activities. Second, the resource allocational inefficiencies may arise from government intervention in the market.<sup>7</sup> Therefore, whether budget allocation to EP is more efficient in terms of welfare improvement of the national economy as a whole may be doubtful. Third, provision of tax incentives means loss of tax revenue. Given the fact that lots of developing

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<sup>2</sup> Findlay, “Growth and development in trade models”, in Jones, Ronald and Peter Kenen, eds., *Handbook of International Economics*, Vol. 1, 1984, p. 11.

<sup>3</sup> Falvey, Rodney E. and Norman Gemmell, “Compensatory financial and fiscal incentives to exports”, in Milner (1990a), p. 10, 110.

<sup>4</sup> Findlay, *op. cit.*, p. 12.

<sup>5</sup> Brander, J. A. and B. J. Spencer, “Export Subsidies and International Market Share Rivalry”, *Journal of International Economics*, 1985, Vol. 18, No. 1/2.

<sup>6</sup> Wade, Robert Hunter, *Governing the Market*, 2004 (2<sup>nd</sup> edition), Princeton University Press: Princeton and Oxford, 2004, p. xviii.

<sup>7</sup> Barcelo, J. J., “Subsidies and Countervailing Duties – Analysis and a Proposal”, *Law and Policy in International Business*, 1977, Vol. 9.

countries do not have sufficient tax base, it can be a big loss with respect to tax collection. Fourth, if financial incentives are provided to the private companies via government control of the banking sector, it may lead to lending to inefficient projects and, consequently, increasing debt-equity ratio of the concerned banking sector. In the long run, development of the financial sector would be retarded. Fifth, pursuing EP may influence the income distribution of a concerned economy. It may benefit the exporters, but harm the producers in non-exportables and the taxpayers in general.

## B. Empirical Evidence

Although it is a common sense that export expansion leads to economic growth, there have been empirical works testing it. The empirical literature started from regression analyses examining correlation. Beginning from the mid-1980s, the Granger causality tests were applied to the relationship between export growth and economic growth. Threshold effect has also been studied in the literature. According to it, export-led growth does not hold until certain level of economic development, while it holds after the threshold level. Conclusions of such empirical works have been mixed. That is, export-led growth has not been supported unanimously by empirical works. Hans Singer expressed the view that the positive effect of OO became not so evident since the mid-1970s even in the Newly Industrializing Countries.<sup>8</sup>

Reflecting the popularity of non-stationarity and cointegration tests in empirical economic analysis, export-economic growth causality tests have been performed using cointegration tests and error-correction models since the 1990s. Awokuse uses Johansen cointegration test and Granger causality tests based on the error correction models applied to Argentina, Colombia and Peru. Awokuse shows that there is some empirical evidence supporting the export-led growth hypothesis.<sup>9</sup> Iyer, Rambadi and Tang (2009) use a cointegrated vector autoregressive model, complemented by a Granger causality test and show that exports are shown to be not significant in explaining economic growth of Australia.<sup>10</sup> Thus, the empirical evidence appears to be mixed. Amin Guitierrez de Pineres and Cantavella-Jorda (2007) use data for sixteen Latin American countries and conclude that the results for the export-led growth hypothesis differ depending on the selection of data and test methodologies.

As an extension of the causality between export expansion and economic growth, a group of works has tested the hypothesis that changes in export product composition cause economic growth. The empirical evidence has shown support of the hypothesis in general. Ghatak *et al.* used cointegration and causality tests to examine the export-led growth hypothesis for Malaysia and found that economic growth of Malaysia was driven by manufacturing exports rather than exports of primary goods.<sup>11</sup> Koh and Mah

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<sup>8</sup> Singer, Hans W., "The World Development Report 1987 on the blessings of outward orientation: a necessary correction", *Journal of Development Studies*, 1988, Vol. 24, p. 232.

<sup>9</sup> Awokuse, Titus, "Traee Openness and Economic Growth: Is Growth Export-led or Import-led?", *Applied Economics*, Vol. 40, No. 2, 2008:.

<sup>10</sup> Iyer, Krishina, Alicia Rambaldi, and Kam Ki Tang, "How trade and foreign investment affect the growth of a small but not so open economy: Australia", *Applied Economics*, Vol. 41, No. 12, May 2009.

<sup>11</sup> Ghatak, S., Milner, C. and Utkulu, U., "Exports, export composition and growth: cointegration and causality evidence for Malaysia," *Applied Economics*, Vol. 29, No. 2, 1997.

apply cointegration test and error correction models to Korea. Their results show that the increasing ratio of non-textile, i.e. heavy and chemical industries, exports to textile exports has led to higher economic growth and *vice versa*. Trade liberalization is shown to have a positive effect on economic growth of Korea.<sup>12</sup>

Unlike the works examining the causality between export growth and economic growth, some authors have tested whether EP measures actually lead to export expansion significantly. Jung and Lee (1986) investigated the effects of various types of export promotion policies on the amount of manufactured export in Korea. They establish an aggregate export supply function where relative prices, subsidy and capacity utilization ratio as the domestic demand pressure variable are used as the explanatory variables. Subsidies comprise preferential export finance, tariff reduction and exchange rate changes. Using data for the period 1964 – 1980, they show that a 1 percent increase in subsidy would bring about 2 percent increase in export supply. Although it is the first empirical work on the effect of EP policy on export, the measure of export subsidy includes neither export insurance nor duty drawback. Mah's (2007c) cointegration test result shows that duty drawback scheme was effective in promoting export supply of Korea during 1975-2001. Lederman *et al.* (2010) used data covering 103 developing and developed countries. Their cross section analysis shows that export promotion agencies have a statistically significant effect on export expansion; meanwhile, they do not consider export incentives such as export insurance and duty drawback.

### III. Export Patterns of Korea since the 1960s<sup>13</sup>

By the early 1960s, the Korean government had pursued import substitution policy. In 1964, the government announced pursuing export promotion policies with the slogan "Export Number One", i.e. export promotion is the most important policy. The government began to increase the amount of export subsidy, placing emphasis on exports of the products of the labor intensive Light Industries (LI), in particular textile and garment industry where the Korean economy had a comparative advantage.<sup>14</sup> The government introduced 50 percent reduction of profit tax relating to exports and export finance schemes at low interest rate in 1964. Exchange rate devaluation contributed to export promotion as well. For instance, the exchange rate which was devalued from time to time, i.e. from 255 won/US\$ in 1964 to 484 won/US\$ in 1974. Under the export-import link system, the government granted the exporters the right to use foreign exchange necessary for imports, which was intended to promote exports under the situation of extreme foreign exchange shortage.<sup>15</sup> The government developed land sites

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<sup>12</sup> Koh, Sae Ran and Jai S. Mah, "The Effect of Export Composition on Economic Growth: The Case of Korea", *Journal of Developing Areas*, 2011 (forthcoming).

<sup>13</sup> For further details on export patterns of Korea until the late 1970s, refer to Mah, Jai S., "Export Promotion and Economic Development of Korea", *Journal of World Trade*, February 2006.

<sup>14</sup> Lee, Sunghoo, Sidong Kim, and Sung-Ho Han, *Industrial Policy of Korea*, KIET: Seoul, 1989 (in Korean) and Oh, Wonchul, *The Korean Model of Constructing the Economy: The Engineering Approach*, Kia Economic Research Institute: Seoul, 1996 (in Korean), Vol. 1.

<sup>15</sup> Jeong, Kap-Young, "Effects of Korean Industrial Policy on Market Concentration", p. 94 in Park, Tae-Kyu and Roy K. Wilkinson, eds., *Industrial Policy in Korea and the EU*, Yonsei University Press: Seoul, 1995.

for industrial complexes and provided them cheaply to the firms entering those.<sup>16</sup> Together with various tax and financial measures to promote exports, the government established the institutions to support EP.

In 1965, the Korean government chose the following LI products as those appropriate for export-led industrialization, i.e. raw silk, cotton fabrics, plywood, leather, craftwork, potteries, rubber products, radio and electric appliances, fisheries and mushroom cans, wool products, clothes, and miscellaneous products, which reflected the then economic development level of Korea. It provided EP measures to the manufacturers producing those selected products. As of 1967, the textile industry shared one third (a quarter) of all manufacturing sectors in terms of the number of workers (income). The Korean government began to establish Woosan Petrochemical Industrial Estates and the POSCO in the late 1960s. In 1967, Korea became a GATT contracting party and export products of Korea were accorded the most-favored-nation status in the global trading system.<sup>17</sup>

During the 1970s, the main thrust of the industrial policy of Korea shifted from the LI to developing the high value-added HCI. The rising wage level which tended to undermine the international competitiveness of the labor intensive LI also forced the government to change the engine of economic growth.<sup>18</sup> The government chose iron and steel, non-ferrous metal, shipbuilding, electronics and chemical industries as the most important HCI.<sup>19</sup> The share of the HCI in all industries increased from 23 percent in 1960 to 39 percent in 1970, and then to 54 percent in 1980.<sup>20</sup> Overall, the spectacular economic growth of Korea in the 1960s and 1970s, as shown in Table 1, was accompanied by rapid export growth. Due to over-investment in the HCI, the capacity utilization ratio of the HCI declined in the late 1970s. Structural problems such as those resulting from the government-dependent inefficient banking system began to be observed in the late 1970s and the early 1980s.<sup>21</sup> To overcome the problems arising from excess capacity of certain HCI the so-called HCI Rationalization Measures were taken during 1979 – 1981, which included the postponement or withholding of the capacity expansion schedules with respect to certain HCI such as diesel engine, tire, machinery, and shipbuilding.<sup>22</sup>

In 1981, the government began to emphasize the importance of research and development (R&D) and expressed to continue the export-led growth strategy. Consequently, since 1983, the government's attention shifted away from sector-oriented support such as the HCI Drive toward function-oriented support, support for R&D in

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<sup>16</sup> Lee, Jaymin, "Dynamic Comparative Advantage and Korea's Industrial Policy", p. 64 in Park and Wilkinson (1995).

<sup>17</sup> Kim, Jeongryum, *From a Least Developed Country to a Developed Country*, 2006 (in Korean), pp. 115-116.

<sup>18</sup> Oh, *op. cit.*, Vol. 4.

<sup>19</sup> Kim, *op. cit.*, p. 326.

<sup>20</sup> Chang, Ha-Joon, *The Political Economy of Industrial Policy*, St. Martin's Press: London, 1994, pp. 96-97.

<sup>21</sup> Lee, *et. al.*, *op. cit.*

<sup>22</sup> *Ibid.*

particular,<sup>23</sup> which means that the importance of export support granted to specific industries or firms weakened after the mid-1980s. Such an emphasis on R&D led to increase in exports of technology-based electronic products since the late 1980s.<sup>24</sup>

Table 1. Economic Growth, Exports and Exports/GDP in Korea

Years	real GDP growth rate (percent)	export values (US\$ billions)	exports/GDP (percent)
1962-1966	8.0	1	7.7
1967-1971	9.7	3	13.7
1972-1976	8.4	22	27.8
1977-1981	6.1	77	31.5
1982-1986	8.7	141	34.4
1987-1991	9.2	307	32.1
1992-1996	7.0	510	28.7
1997-2001	4.3	734	42.8
2002-2006	4.8	1,239	31.2
2007-2009	2.5	1,186	42.2

Source: IMF, *International Financial Statistics Yearbook 2004*; *The Bank of Korea, Economic Statistics Yearbook 2010*.

In the late 1990s, the government decided to promote the capital goods industry. Therefore, in 1995, it announced the Capital Goods Industries Promotion Plan, which was expected to promote the high value-added capital goods industries by supporting the development of new products and establishing them as the main export industries. Meanwhile, the government has pursued deregulation and market opening measures to strengthen the market mechanism and even right after the occurrence of the economic crisis in 1998, Korea eliminated several remaining direct export subsidies. The government currently promotes exports by supporting international marketing activities and exhibitions abroad. In addition to such indirect measures, certain export promotion measures such as provision of export insurances and duty drawback not exceeding threshold levels are provided to the exporters, since they are not prohibited by the current WTO regulations.

With the EP policies mainly targeting the HCI, export values increased by leaps and bounds. Table 1 shows the tendency of real GDP growth rate, export values and the ratio of exports/GDP since 1962. Annual average real economic growth rate reached over 8 percent until the mid-1970s. Export values increased from just US\$ 1 billion during 1962-1966 to US\$ 77 billion during 1977-1981. The share of exports in GDP increased from mere 7.7 percent during 1962-1966 to 27.8 percent during 1972-1976 and then to 42.2 percent in 2007-2009.

<sup>23</sup> *Ibid.*

<sup>24</sup> R&D promotion policy of the government contributed to development of mobile phone industry of Korea in the 1990s (Ahn, Hyeon-joo and Jai S. Mah, "R&D Policies and Development of Technology Intensive Industries of Korea", *Journal of Contemporary Asia*, 2007).

Table 2 shows the changing commodity structure of exports in Korea. Although textiles and garments shared some 42 percent of total export values in 1968, the share decreased to 29 percent in 1980, and then to less than 3 percent in 2006. The share of HCI increased from about 9 percent in 1968 to 41 percent in 1980 and then to 84 percent in 2006. Exports of products belonging to the primary industry accounted for 37 percent of the total exports in 1968, while its share is less than 1 percent nowadays. Table 2 demonstrates that the share of electronic products continued to increase from the 1970s.<sup>25</sup>

Table 2. Exports by Principal Commodity (unit: US\$ billion)

Year	total	LI	Textiles	HCI	iron & steel	electric/electro.	cars
1968 (US\$ million)	455	n.a.	193	41	1	19	0
1980	17.5	n.a.	5.2	7.2	1.7	1.9	1.2
1991	71.9	26.1	13.8	41.0	5.7	17.0	1.5
2000	172.3	30.3	15.1	127.6	11.4	62.0	11.1
2006	325.5	26.9	8.8	270.4	27.2	89.8	30.5

sources: The Bank of Korea, *Economic Statistics Yearbook 1972, 1982, 2007*

#### IV. The Export Promotion Measures of Korea

The EP measures of Korea have comprised tax incentives, financial incentives, establishment of free trade zones and the supporting organizations. The government provided huge amount of subsidy to promote export-related industries. The export subsidy ratio of Korea during the aggressive EP period, i.e. the mid-1960s to the early 1980s, differed depending on the calculation methods. Effective subsidy for exports reached the following: Korea: 31 percent; Taiwan: 12 percent; Colombia: 10 percent; Singapore: 0 percent.<sup>26</sup> Chong-Hyun Nam calculated implicit subsidies to export sales as of the year 1978 on the basis of interest-rate differentials between export loans and ordinary bank loans and reduction in direct taxes, under the assumption that other incentives were either not genuine subsidies or negligibly small in amount. For the manufacturing sector, the subsidy rate for export sales was 15.9 percent, whereas that for domestic sales was 3.5 percent. It implies that there were greater incentives to export than to sell in the domestic market.<sup>27</sup>

<sup>25</sup> See Ahn and Mah, *op. cit.* for details on the role of government in development of leading technology intensive products in Korea.

<sup>26</sup> Balassa, Bela, *et. al.*, *Development Strategies in Semi-industrial Economies*, Johns Hopkins University Press, 1982. According to Tibor Scitovsky, the value of all the readily quantifiable export incentives, expressed as a percentage of gross export receipt, was calculated as 10.7 percent over the period from 1962 to 1976 in Taiwan (Scitovsky, Tibor, "Economic Development in Taiwan and South Korea, 1965-1981", in Lawrence Lau, ed., *Models of Development: A Comparative Study of Economic Growth in South Korea and Taiwan*, San Francisco: Institute for Contemporary Studies, 1986, p. 160.

<sup>27</sup> Nam, Chong-Hyun, "Export promotion strategy and economic development in Korea", in Milner

Together with the EP policies, Korea practiced import protection policies. Protection measures targeting import substitution may have anti-export bias in the sense that the production resources are to be allocated among non-tradables, exportables and importables.<sup>28</sup> Import barriers such as tariffs or any other non-tariff barriers would tend to raise the price level of importables, thus directing production resources from exportables to importables. Therefore, the fact that the Korean government pursued export promotion as well as import protection policies during the 1960s and 1970s actually mean that some of the resources might have been directed to importables production, although the benefits to exports would have dominated the costs from high price level of importables.

#### A. Tax Incentives

##### a. tax incentives in general

In December 1961, the Tax Exemption and Reduction Control Law began to provide export firms with tax deduction measures. Since 1964, tax benefits such as 80 percent reduction of profit tax were provided to profits arising from exports. In 1967, export firms were allowed to depreciate their machinery investments 30 percent more rapidly than that normally allowed for additional tax benefits.<sup>29</sup> Since 1973, as a measure of the HCI Drive, the strategic HCI such as steel, chemical, shipbuilding and machinery industries began to be exempt from domestic taxes such as profits tax during the first three years of establishment and exemption of half of the taxes for the next two years. The Tax Exemption and Reduction Control Law amended in 1975 granted investment tax credits and accelerated depreciation to designated key industries.<sup>30</sup>

Tax benefits began to be offered on the function-oriented support schemes, i.e. support of R&D activities, since 1982.<sup>31</sup> Special rates of depreciation targeting export industries were reduced in 1988 due to the continuing trade surpluses in the latter half of the 1980s.<sup>32</sup> Meanwhile, tax benefits with respect to R&D of capital goods industries were introduced in 1995 to develop such industries.<sup>33</sup> Currently, tax benefits are based on the function-oriented support principle and are provided mainly to FDI inflows and R&D activities. For instance, as of 2005, in the case of foreign investors' investment in areas designated as the FDI region, profits and income taxes are exempt for the first

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(1990a), p. 178..

<sup>28</sup> Milner, Chris, "The role of import liberalization in export promotion", in Milner, ed., (1990a), 1990b, pp. 81-108.

<sup>29</sup> Cooper, Richard N., "Fiscal Policy in Korea", in Haggard, Stephan *et. al.*, eds., *Macroeconomic Policy and Adjustment in Korea, 1970-1990*, Harvard University Press: Cambridge, 1994, pp. 111-144.

<sup>30</sup> Lim, Joo-Young, "Tax Support System", in Choi, Kwang and Jin-Kwon Hyun, eds., *The Fifty Years History of Tax Policy in Korea*, Korea Institute for Public Finance: Seoul, 1997 (in Korean), Vol. 1 and Bae, Jin-Young, "Incentive Structure and Its Changes in the Korean Industrial Policy Regimes from 1962-1997", *Journal of the Korean Economy*, Fall 2001, Vol. 2, No. 2.

<sup>31</sup> Hyun, Jin Kwon, "Profit Tax", in Choi and Hyun, *op. cit.*

<sup>32</sup> Won, Yoonhee, "Tax Policy during the Period of Stabilization", in Choi and Hyun, *op. cit.*, p. 235.

<sup>33</sup> Lim, *op. cit.*, pp. 923-928.

ten years from establishment. Tax deductions are provided to 50 percent (40 percent in case of large firms) of the new R&D expenditure.<sup>34</sup> Tax benefits directly relating to EP are currently not available.

b. duty drawback scheme<sup>35</sup>

Duty drawback scheme can be used as a measure of EP by reducing the cost of producing exported products. Meanwhile, since the procedure of drawback may be complicated under certain circumstances, the social cost born by the government, banks and exporting firms may be too high to promote exports.<sup>36</sup> Therefore, its effect on EP would depend on the efficiency of the scheme that is actually practiced. Although most tax benefits targeting EP have been prohibited by the WTO Subsidies Code, duty drawback not exceeding the amount of duty actually levied on the imported product has been permitted.

The government began to use the duty drawback scheme to promote exports in 1975. As of the mid- to late 1980s, Korea's duty drawback system has been set more generously than that of Taiwan, its one of main competitors, so as to give more subsidy to exporters.<sup>37</sup> According to the Special Act for Duty Drawback in Korea, the imported raw materials that were used to produce export products within thirteen months from import qualified for duty drawback, which was applied to Korea until 1997. Since 1997, the Act changed the period to two years. Although duty drawbacks recognized by specific items are more difficult to administer, such types share more than four-fifths of the entire duty drawback cases in Korea.<sup>38</sup>

The drawback rate defined as the amount of duty drawback divided by export values increased from 0.3 percent in 1975 to 2.6 percent in 1990. Table 3 shows that the amount of duty drawback was as low as 0.1 trillion won, equivalent to U.S.\$ 0.2 billion, in 1975, while it continued to increase to 3.2 trillion won in 2009, equivalent to US\$ 2.7 billion. Due to continuing trade surpluses during the 2000s, it fell to 0.8 percent in 2009. The ratio of duty drawback/import tariff collection has been between 17 percent and 27 percent during 1990 – 2009. It reached 38.4 percent in 2001. In 2009, it was recorded as 21.6 percent.

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<sup>34</sup> Finance Forum, "Updating the Tax Regulations", Korea Institute for Public Finance: Seoul, 2003.

<sup>35</sup> The other East Asian economies also introduced duty drawback schemes during the 1970s – 1980s (Hill, Hal, "Indonesia: export promotion after the oil boom", in Milner (1990a), p. 194).

<sup>36</sup> Mah (2006), *op. cit.*

<sup>37</sup> Taiwan also utilized it very actively. The share of tariff refunded over total tariff collections reached about half since 1970 to the mid-1980s in Taiwan (Wade, *op. cit.*, p. 56).

<sup>38</sup> Chang, Keunho and Jinsoo Kim, *Economic Effect of Duty Drawbacks and Policy Implications for Further Reform*, Korea Institute for Public Finance: Seoul, 1997 (in Korean).

Table 3. Duty Drawback/Export Values and Duty Drawback/Tariff Collection

Years	Amount of Duty Drawback (trillion won)	Duty Drawback /Export Values	duty drawback /tariff collection
1975	0.1	0.3	n.a.
1990	1.2	2.6	24.0
2000	2.2	1.0	21.0
2009	3.2	0.8	21.6

Sources: IMF, *International Financial Statistics Yearbook 2005*; Korea Customs Office, *Customs Yearbook*, various issues; <http://mosf.go.kr>, *Performance of duty drawback*, accessed September 28, 2010

## B. Financial Incentives

The Ministry of Finance strictly controlled the commercial banks of Korea up until the early 1980s. Policy loans, i.e. lending at preferential rates due to the policy direction, were provided to specific, mostly export-related, industries. Currently, export insurance is the main financial incentive relating to EP.

### a. policy loans

The government had regulated most interest rates by the end of 1988. The government control of interest rates provided the strategic industries preferential access at subsidized interest rates. As a result of the HCI Drive in the 1970s, the HCI sector not only had better access to capital, but also faced significantly lower average borrowing costs. The export industries enjoyed preferential access to capital.<sup>39</sup> The government-owned Korea Development Bank also supported certain industries. During the 1970s, policy loans at preferential interest rates increased from less than 40 percent of total bank lending in 1971 to over 55 percent during 1976-1977 and 70 percent in 1978.<sup>40</sup> The interest rate differential between preferential and ordinary loans was abolished with the June 1982 interest-rate reform.<sup>41</sup>

The HCI sector not only enjoyed preferential access to capital, but also faced significantly lower average borrowing costs. It was favored considerably in the second half of the 1970s. Although its average borrowing cost had been about the same as that of the LI until 1974, it began to fall sharply from 1975 until the late 1970s and the borrowing cost averaged 36 percent lower for the HCI than the LI (Cho and Kim (1997)). Since *chaebols*, i.e. the large conglomerates in Korea, were mostly involved in the HCI, they were the main beneficiaries of policy loans. The share of the HCI in all manufacturing industries increased gradually from 23 percent in 1960 to 39 percent

<sup>39</sup> Bae, *op. cit.*

<sup>40</sup> Haggard, Stephan, *Pathways from the Periphery*, Ithaca: Cornell University Press, 1990.

<sup>41</sup> Nam, *op. cit.*, p. 175.

in 1970, and to 54 percent in 1980, respectively.<sup>42</sup> Policy loans at preferential lending interest rate were mainly directed to *chaebols*, which were appropriate for HCI showing the economies of scale property. Therefore, *chaebols* began to grow rapidly in Korea in particular during the 1970s.

In 1980, the government decided to reduce policy loans and restrictions on the managerial autonomy of the commercial banks, with the ultimate goal of privatizing them.<sup>43</sup> Due to the continuing trade balance surpluses in the late 1980s and the pressure of economic liberalization from abroad, the government liberalized most interest rates officially in December 1988.<sup>44</sup> Nowadays, policy loans can be found in the lending to small and medium-sized enterprises (SMEs) and are not directly related to EP.

b. export finances

Export finances have been provided to exporters in various stages of export-related activities since 1961. Exporters received huge amount of interest rate subsidies during the 1960s – 1980s. Even if the applied lending interest rate was not preferential, such guarantees of lending *per se* can be considered as beneficial to the industries of a developing country facing the liquidity constraint.<sup>45</sup> The export finance system is one of the currently used export promotion measure in Korea. The Korea EXIM Bank has lent to the export firms.<sup>46</sup> Export finance covers mainly capital goods, such as industrial plant, machinery, and ships. As of 2009, lending of up to 100 percent of contract value is available provided that the minimum foreign exchange earnings ratio is not less than 25 percent. The average interest rate applicable to export finance was three percent during 1998-1999, which was lower than the market average lending rate of 8.5–20 percent in 1999.<sup>47</sup> The ratio of exports supported by the EXIM Bank divided by total exports reached 18.6 percent in 2007. Together with the Korea Export-Import Bank, commercial banks in Korea also provide export finance to exporters; meanwhile, they charge the prevailing lending interest rates.<sup>48</sup> In 2009, the Korea Credit Guarantee Fund (KCGF) guarantees repayment of the amount of SMEs' borrowing from commercial banks, which is related to export. It guarantees up to ten billion won. The amount of guarantee provided to exporting enterprises by the KCGF reached 4.2 trillion won and 4.6 trillion won, respectively, in 2006 and 2007.<sup>49</sup>

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<sup>42</sup> Chang, (1994), *op. cit.*, pp. 96-97.

<sup>43</sup> Haggard, Stephan and Susan Collins, "The Political Adjustment in the 1980s", in Haggard, Stephan, *et. al.* eds., *Macroeconomic Policy and Adjustment in Korea, 1970-1990*, Harvard University Press: Cambridge, 1994, pp. 75-110.

<sup>44</sup> Youn, Won Bae, "Financial Liberalization", in *The Dictionary of Economics*, Pakyoungsa: Seoul, 1998 (in Korean).

<sup>45</sup> Mah (2006), *op. cit.*

<sup>46</sup> Korea Export-Import Bank, <http://www.koreaeximbank.go.kr>, 2004.

<sup>47</sup> WTO, *op. cit.*, Ch. III, para. 133.

<sup>48</sup> The Korea Exchange Bank, <http://www.keb.co.kr>, accessed May 16, 2009.

<sup>49</sup> The Korea Credit Guarantee Fund, *Annual Report 2007*, <http://www.kodit.co.kr>, accessed May 16, 2009. Total capital funds of the KCGF amounted to about 4 trillion won in 2007.

c. export insurances

The export insurance scheme was introduced into Korea in 1969 under the Export Insurance Act to help exporters increase their exports by protecting them against losses. The Export Insurance Fund (EIF) was established to support it. The amount of the EIF totaled 1.5 trillion won, i.e. about US\$1.2 billion, in 2008. During the period 1968-1972, the value of exports supported by export insurance, i.e. the utilization ratio of export insurance, had been lower than 1 percent and had remained at around 3 percent during the 1980s. The government began to emphasize the role of export incentives such as export insurances and established the KEIC in 1992 as one fully devoted to the export insurance scheme in Korea.<sup>50</sup>

With the establishment of the KEIC,<sup>51</sup> as shown in Table 4, the utilization ratio of export insurance increased abruptly to 21.7 percent on annual average during 2003-2004. It rose to 37.8 percent in 2009 and Korea is currently the heaviest user of the export insurance system. The Export Insurance Act requires the Export Insurance Fund to finance the insurance programs, if the KEIC should run budget deficits. The loss ratio, defined as claims paid divided by premium received, remained less than 100 percent in general up to 1991, implying that the preferential effect of government subsidization in the form of export insurance was not significant until the early 1990s.<sup>52</sup>

The annual average loss ratio was as high as 325 percent in 2003-2004, showing that the preferential effect of the export insurance scheme was significant, although it fell to 122 percent in 2008-2009 due to increase in recoveries.

Table 4 shows that the total amount of claims and premium revenues amounted to US\$ 0.7 billion and US\$ 0.6 billion during 2008-2009, respectively; while recoveries increased to US\$ 0.3 billion, equaling more than one third of claims payment. The number of underwriting contracts increased from 415,991 cases in 2006 to 535,864 cases in 2009.<sup>53</sup> By types, the insured amount of the Foreign Investment Insurance began to increase remarkably in 2006 and 2007. For instance, although it had not been larger than 100 billion won until 2005, it increased to 132 billion won in 2006, 482 billion won in 2007, 982 billion won in 2008 and 638 billion won in 2009,<sup>54</sup> which reflects the recent increase in Korea's foreign direct investment outflows; for instance, US\$ 8.1 billion in 2006, US\$ 15.6 billion in 2007, US\$ 18.9 billion in 2008 and US\$ 10.6 billion in 2009 due to the continuing current account surpluses and accumulating foreign exchange reserves. Since the duty drawback not exceeding the

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<sup>50</sup> For further details on evolution of the KEIC, refer to Mah, Jai S. and Yunah Song, "The Export Insurance System of Korea: Its Implications on the Trade Regulations in the Global Trading System", *Journal of World Trade*, August 2001, Vol. 35, No. 4.

<sup>51</sup> It was renamed as the Korea Trade Insurance Corporation (K-sure) in July 2010. Under the new name, K-sure will cover not only export transactions but also import transactions to secure overseas natural resources and commodities critical to the Korean economy (Korea Trade Insurance Corporation (K-sure), *K-sure Annual Report 2009*, K-sure: Seoul, 2010 (2010b)).

<sup>52</sup> Mah and Song, *op. cit.*

<sup>53</sup> K-sure (2010b), *op. cit.*

<sup>54</sup> Korea Trade Insurance Corporation (K-sure), *Export Insurance Magazine*, K-sure: Seoul, January-February 2010 (2010a), p. 73.

threshold level and export insurances complying with the OECD Arrangement on Export Credits are not prohibited, export insurance is expected to continue as an important measure of EP of Korea under the WTO system.

Table 4. Export Insurance Scheme of Korea (units: US\$ 100 million, %)

years	export values (A)	insured amount (B)	premium received (C)	claims paid (D)	recoveries (E)	utilization ratio (B/A:%)	loss ratio (D/C:%)
1974-1976	182.5	1.5	0.01	0.01	0.00	0.8	41.4
1983-1985	1,053.9	42.5	0.28	0.06	0.01	4.0	22.1
1989-1991	2,115.2	49.6	0.14	1.55	0.02	2.3	1,082.9
1992-1994	2,705.8	118.2	0.77	1.45	0.11	4.4	187.9
2003-2004	4,481.2	970.4	2.12	6.90	1.75	21.7	325.2
2008-2009	8,065.0	2,444.1	5.94	7.14	2.57	30.3	122.2

Notes: Export values (A) denote the aggregate income that result from commodity exports and from overseas construction. Claims paid (D) is based on the year paid, not the year underwritten.

Sources: KEIC, *Annual Report* and *Monthly Export Insurance*, various issues; K-sure, *Annual Report 2009, 2010* (2010b).

### C. The Other Policies and Organizations

#### a. Free Trade Zones (FTZs)

FTZs in Korea have been governed by the Law on the Free Trade Zones. FTZs are exclusive areas outside the national customs boundary, exempt from customs requirements, upon request from regional governments. Activities in the FTZs are subject to streamlined import procedures and exemption from import tariffs, and receive tax relief, e.g. value-added tax and reduced corporate tax. Foreign cargo may enter and leave freely from the FTZs. Since Korean goods entering the FTZs are treated as exports, they are entitled to duty drawback. The FTZs are located in several places.<sup>55</sup> Currently, to be qualified to enter the FTZ, more than 50 percent of total sales amount should be exported. The amount of foreign investment should be over 50 million Korean won, i.e. about US\$40 thousand, and the ratio of foreign investment should be over 10 percent.<sup>56</sup>

The Masan Free Trade Zone (FTZ), originally called the Free Export Zone, focusing on EP was established in Korea in 1970 as the first foreign exclusive industrial complex in Korea. It was expected to contribute to the national and local economy by attracting more FDI inflows. It has concentrated on manufacturing.<sup>57</sup> It is a seaside industrial complex and has offered the benefits of being in close proximity to highways, railways

<sup>55</sup> WTO, *op. cit.*, Ch. III, para. 22.

<sup>56</sup>Source: Administrative Authority of Masan Free Trade Zone, <http://www.ftz.go.kr/eng/investment/conditions.jsp>, accessed April 16, 2009.

<sup>57</sup>Source: [http://www.kishtpc.com/Free-en/free\\_korea.htm](http://www.kishtpc.com/Free-en/free_korea.htm), accessed April 16, 2009.

and, particularly, seaports. Besides, near to it, aviation, shipbuilding, automobile and machinery components have been densely populated, providing the benefits of an inter-industry relation effects.

Table 5 shows that the Masan FTZ was most lively during the second half of the 1970s – the second half of the 1980s. In 1987, the number of workers employed in the Masan FTZ reached 36,411. Some 98 percent of products produced within this zone are exported. The Masan FTZ exported about US\$50 billion and employed about 6 thousand workers in 2008, which does not share a significant proportion in the Korean economy nowadays, but shares about 2 percent of exports.<sup>58</sup> Overall, the FTZs played an important role until the 1980s, especially in EP.

Table 5. Economic Performance of Masan FTZ (unit: number, US\$ million)

Year	number of firms	number of persons employed	exports	imports of raw materials	amount of domestic capital	foreign capital inflows
1972	70	7,106	9.7	6.7	2.0	34.9 (95)
1977	99	30,719	367.9	203.5	10.5	93.5 (90)
1987	75	36,411	1,399.5	799.2	26.3	137.3 (84)
1997	75	14,682	2,201.3	1,327.0	57.0	185.5 (77)
2008	94	5,936	5,072.2	3,103.9	83.7	144.3 (63)

Source: Administration Office of the Masan Free Trade Zone, <http://www.ftz.go.kr/kor/Morgue/Total/totalyear.jsp>, accessed April 15, 2009

Note: Values within the parentheses denote the share (percent) of foreign capital in total amount of investment.

#### b. Exchange Rate

The Korean won had been pegged to US\$ until early 1980. It had been devalued from 190 won/US\$ to 255 won/US\$ in 1964, to 317 won/US\$ in 1970 and then to 399 won/US\$ in 1972. The exchange rate had been fixed at 484 won/US\$ between 1974 and 1980. Although devaluation (or depreciation) *per se* can be regarded as beneficial to EP, the fact that the Korean economy continued to show trade deficits until the first half of the 1980s imply that exchange rate did not act basically as a measure of effective EP policy. The exchange rate system was changed into the managed flexible exchange rate system in February 1980. Since then the exchange rate was determined basically by the market forces in the foreign exchange market, while the government has intervened in it from time to time to counter volatile exchange rates.

#### c. Organizations

In Korea, Korea International Trade Association (KITA) and Korea Trade Promotion

<sup>58</sup> Sources: [http://www.kishtpc.com/Free-en/free\\_korea.htm](http://www.kishtpc.com/Free-en/free_korea.htm), accessed April 16, 2009 and Administration Office of Masan FTZ, <http://www.ftz.go.kr/kor/Morgue/Total/totalInvest.jsp>, accessed April 16, 2009. Currently, as of September 2010, there are several FTZs in Korea.

Corporation (KOTRA) have worked as the institutions helping firms overcoming the export barriers such as the motivational, informational, and operational/resource barriers. KOTRA was established in 1962 as a national trade promotion organization. Since then, it has facilitated Korea's rapid export-led economic growth through various trade promotion activities such as overseas market surveys and business matchmaking. In 1995, cross-border investment promotion and support for technological and industrial cooperation projects were added to KOTRA's mandate, and it was renamed the Korea Trade-Investment Promotion Agency. As of April 2009, there are some 100 Korea Trade Centers in 73 countries.<sup>59</sup> In 2007, total such government promotional expenditure on export promotion amounted to 34 billion won; most of which financed participation in overseas trade missions and exhibitions.<sup>60</sup>

## V. Lessons of the Experience of Korea Regarding Export Promotion

The Korean government provided various tax and financial incentives to promote export until the early to mid-1980s in particular. The concerned literature shows that the EP policies contributed to the expansion of export values. Exports of manufactured products had increased significantly during the 1960s and 1970s. The share of exports of more value added capital intensive and technology intensive products has risen since the 1970s. Rapid increase of export values appears to have led to economic growth of Korea, supporting the export-led economic growth strategy.

Although such EP policies of Korea appear to have benefited economic growth of Korea in the sense of economies of scale and improvement of technologies facing fierce industrial competition from abroad, one may notice the role of changing economic structure and export composition in economic development. That is, in case of Korea, the share of exports of value-added commodities divided by that of labor intensive textiles and garment (or primary products) has increased for the past half century.<sup>61</sup> It can be compared with the experiences of the other countries showing very high trade dependence ratio. For instance, although Papua New Guinea that relies heavily on exports of primary products shows the trade dependence ratio higher than 140 percent, its economic growth rates have been mediocre since independence in 1975. It means that together with EP policies *per se*, one needs to pay attention to EP of manufactured products (and more value-added manufactured products in particular), the composition of export products and the other factors such as human capital.

Therefore, it is necessary for the policymakers of developing countries to recognize the importance of export-led growth, in particular growth led by exports of manufactured products. In addition, it would also be necessary for developing countries to enhance the administrative capacity to implement EP schemes, enhance the education level of the public in order to improve the capacity of producing value-added manufactured products, establish and maintain institutions that developing countries do not have, but allowed in the WTO system, direct official development assistance to enhancing export

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<sup>59</sup> KOTRA, "About KOTRA - History" (available at <http://english.kotra.or.kr>, accessed April 20, 2009).

<sup>60</sup> WTO, Trade Policy Review – Korea, WTO: Geneva, 2008, Ch. III, para. 125 and 126.

<sup>61</sup> See Koh and Mah, *op. cit.*

capacities, and utilize the currently existing special and differential treatment provisions in the WTO in favor of developing countries.<sup>62</sup>

EP policies may lead to economic growth via expansion of export values, as is shown in case of Korea. Meanwhile, it is noteworthy that such aggressive EP policies through strict control of commercial banks can lead to resource allocational inefficiency in some cases and distortion in the banking and corporate sector.<sup>63</sup> Therefore, the problems of EP in economic structure are to be recognized.

Since the current regulations strictly regulate developing countries with respect to EP policies, it is worthwhile to think of granting developing countries policy space. From the viewpoint of ‘distributional fairness’, one may doubt the fairness of the current WTO system, which regulates the use of EP policies regardless of extremely different level of economic development. Therefore, it would be necessary for developing countries to think of concrete ideas and put pressures on modifying the WTO regulations in favor of promoting their exports, export of manufactured products in particular.<sup>64</sup>

## VI. Conclusion

During the period of rapid economic growth, the Korean government provided tax and financial incentives and established export-promoting organizations. As a result of EP policies, export values rose significantly. Beginning from the early 1980s, the government changed the policy direction from direct subsidization of selective industries and firms toward function-oriented support such as general support for R&D activities. The transition from the LI to the HCI and then to technology-intensive industries led to the higher value-added industrial structure and contributed to economic growth. Meanwhile, the rapid economic growth was accompanied by structural problems. That is, the accumulated non-performing loans of commercial banks became one of the causes of the economic crisis in 1998.

Under the current WTO system which prohibits the direct export promotion measures, Korea does not provide export subsidies in general that are prohibited by the WTO regulations. Meanwhile, export incentives provided by the government such as duty drawback and export insurance schemes are actively utilized. The FTZs are in operation and expected to be strengthened mainly to attract FDI from abroad. Exchange rate is no longer used to promote exports. There are government-supported EP organizations. These types of EP can also be provided by other developing countries. That is, the governments of developing countries would benefit from maintaining and strengthening the appropriate institutions relating to EP such as the

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<sup>62</sup> For further details, see Mah, Jai S., “Government-led Export Promotion in Light of Distributional Fairness in the Global Trading System”, *Journal of Economic Issues*, Vol. 45, No. 4, December 2010 (forthcoming), pp. 885-887.

<sup>63</sup> See Mah (2002), *op cit*.

<sup>64</sup> For detailed ways of modifying the relevant WTO provisions, see Mah (2010), *op. cit.* pp. 887-889.

export insurance and duty drawback schemes subject to the budget constraint, which are not prohibited under the current WTO system. In addition, it would be necessary for the WTO Members to think of the concrete ways of modifying the concerned WTO regulations in favor of the developing countries' use of EP policies from the viewpoint of distributional fairness.

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