

Why Do Some Nations Prosper? “The Case of North and South Korea”

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Economists have debated for years why it is that some nations prosper while others do not. The Democratic People's Republic of Korea (North Korea, DPRK) and the Republic of Korea (South Korea, ROK), for example, started out as poor nations after World War II. Now, South Korea has the same wealth as Western European nations, on average, yet North Korea firmly remains at the bottom of the world's development ladder. This article suggests that institutions matter and that key institutions are fundamental to economic success.

Korea: From Kingdom to Colony

On the eve of the 20th century, Korea had been a unified state for over twelve centuries. The Choson Dynasty Kings (1392-1910), presided over a country strongly influenced by Confucianism and other Chinese traditions but home to a proud and distinctive people. Yet Korea was more isolated from the West than China or even Japan. The economy of the "Hermit Kingdom" (a Western-inspired nickname) was also more agrarian with less commerce, urbanization, and manufacturing than either of its bigger Northeast Asian neighbors or Imperial Russia. For example, unlike Japan and much of China, market towns did not have commercial infrastructure, and traveling merchants heavily laden with goods were much more common in Korea. Although the economy was monetized the medium of exchange was relatively undeveloped. One 19th Century foreign traveler in Korea reported that six men or one pony was required to carry a money chest of copper coins worth US\$50.¹

Japan's early 20th Century domination of Korea and later formal annexation of the country as a colony (1910-1945) began economic modernization through the cruel exploitation of the Koreans and by dividing northern from southern Koreans. Japanese established an electric power company, constructed a railroad from Seoul to Pusan, established an imperial branch de facto central bank, and created a land development company.

Through the command and control structure of Imperial Japan, much of Korean land, labor, and capital was mobilized and forcibly channeled into the production of goods and services targeted to support the Japanese economy and, later in the colonial period, to support its military aggressions in the Asia-Pacific region while thwarting Soviet threats. Efficiency and productivity concerns that actually benefitted Koreans, with the exceptions of Koreans who collaborated with the Japanese, were not priorities. Growth in manufacturing and industrialization, investment in capital, advances in technology, and the rise of Japanese-owned business enterprises moved forward on the Korean peninsula. Education, training, and some higher education efforts advanced and further development in infrastructure occurred as Japan fueled its domestic economy and fed its military machine through its territorial occupations. It is important to note that ordinary Koreans not favored by colonial overlords had almost no access to education of any kind. By 1945, when the colonial period ended, only 20 percent of Korean children had ever seen the inside of an elementary school.²

The Japanese Government's 1912-1918 comprehensive land survey resulted in seizure of both the former Korean government's land holdings and land owned by small Korean property owners; large landowners were usually left alone since they could more easily document

ownership. By 1930, the colonial government was by far the largest land owner in Korea possessing almost 40 percent of Korea's land area.³

By 1931, colonial land policies in large part forced 2.3 million farmers to become tenants, quasi-tenants, or to migrate to Japanese-controlled Manchuria or to Russian Siberia to work in mines or factories. Estimates from the same year indicate that 19 percent of Korea's total farm population had migrated. By 1936, more than half of the rice grown in Korea was being shipped to Japan. Although Colonial Korea's GDP per capita averaged approximately four percent per annum for the period, GDP for Koreans *decreased* because Japanese businesses, government, and their Korean collaborators expropriated massive amounts of crops, natural resources, and manufactured goods. Also there were environmental as well as economic costs; lumber clear-cut from the mountains of Korea was taken by Japanese companies, leaving behind much destruction and resulting in widespread land erosion in Korea.⁴

The Pacific War intensified Japanese exploitation of both Korea's economy and Koreans as several million men were drafted to work as slave laborers in Imperial Japan, Japanese colonies, and Japanese-occupied nations, and serve in the imperial army as prison guards and in other servile positions. Thousands of Korean "Comfort Women" were forced to service the Japanese military. In 1944 approximately four million Koreans, sixteen percent of the population, were living outside of Korea. Several million never returned to Korea.⁵

Even though by the end of World War II, Korea was, after Japan, the second most industrialized nation in Asia, the human costs of the colonial period were massive and most Koreans were poor and uneducated.⁶ However, the seeds for modernization had been planted. The self-serving human capital investment Japan made in some Koreans would eventually have positive unintended consequences. The relatively bright institutional story of the South economy and its people follows.

One Peninsula: Two Koreas

As the war with Japan was ending, in August 1945 the U.S. State Department charged two American officers with the task of dividing the peninsula into an American and a Soviet occupation zone. They chose the 38th parallel. This decision gave control of Seoul to the Americans, and to everyone's surprise, the Soviets agreed.⁷ In 1948, under a United States–Soviet trusteeship, South and North Korea officially became two countries governed by two different political systems—the Republic of Korea and the Communist Democratic Peoples' Republic of Korea, respectively.⁸

War erupted on the peninsula only two years after country separation and less than five years after being released from Japan's hostile grip. On June 28, 1950, the Communist Democratic Peoples' Republic of Korea, after assurances of Soviet and Chinese support, invaded the South. In reaction, with the Soviet member absent and unable to vote, the UN Security Council created an international force led by the U.S., to wage war against the North. At first, North Korean military forces were able to control most of the ROK, but a successful landing of U.S.-led UN forces at Inchon paved the way for a counterattack that destroyed most of the North Korean army and resulted in UN forces occupying much of North Korea. In November 1950, Communist

Chinese forces authorized by Mao intervened in the war and helped North Korea push U.S. forces south of the 38th parallel and the subsequent over two years of fighting produced no decisive victor.⁹

The Korean Armistice ended the Korean War on July 27, 1953. In an “Agreement between Commander-in-Chief of the United Nations Command, and the Supreme Commander of the Korean People’s Army and the Commander of the Chinese People’s Volunteers, the Korean Demilitarized Zone was established.”¹⁰ This agreement created a two-kilometer buffer on each side of the 38th parallel. North of the buffer zone, the use of air, ground, and sea military support would be permitted under the leadership of Kim Il-sung on behalf of communist North Korea as long as the support was not deemed hostile. Likewise, in the South, similar military efforts could advance in tandem with efforts to govern democratically.

The Korean War devastated both economies. North Korea was the target of extensive aerial bombardment, and the South was engulfed by the land war. Additionally, Seoul, the capital of the South, changed hands four times as the opposing sides took and were then forced out of the city. Over one million people in the ROK alone were killed. Though governments did not have accounting systems in place to record war-related expenses at this point in world history, some researchers estimate that devastation to the South Korean economy during the war years was almost equal to the combined value of all final goods and services produced in 1952 and 1953.¹¹

South Korea: The Bright Peninsula

After the Korean War, South Korea struggled to launch its climb up the world’s development ladder and, for the most part, failed miserably for the first decade after the Armistice. Land reform and education were two notable exceptions.

In 1945, prior industrialization notwithstanding, Korea was still a predominantly agrarian society with large land holders controlling the fortunes of peasant farmers. In the South, powerful landowners used political pressure to resist reform but the combination of sweeping land reform in the North, fears of South Korean peasant unrest, and American political pressure influenced the Syngman Rhee Government to pass land reform legislation in 1949. The land reform law was carried out during the Korean War and created a large number of entrepreneurial property owning small farmers. In 1944, 3 percent of the population in the south owned 64 percent of the land, but by 1956 the top 6 percent of land holders owned only 18 percent of the land. Inequities caused by traditional Korean feudalism and Japanese colonialism were addressed, and former and still-existing large land owners were incentivized to invest in business or education.¹²

South Korea’s human capital (education and training) levels immediately started rising after Japanese withdrawal. In 1945, only 22 percent of South Koreans aged 15 and older could read and write, and less than five percent of adults had more than an elementary school education. With the Basic Education Law of 1949 under Rhee and the compulsory education requirements under Park, literacy rates rose steadily in South Korea, reaching a striking 88 percent by 1970 and an impressive 98 percent by 2013.¹³

Nevertheless, South Korea struggled to advance in the presence of Rhee's import substitution policy. This trade and industrial policy was designed to reduce foreign dependence through the domestic production of manufactured goods. The increased production came at the expense of production in food and other basic necessities for South Koreans.

By controlling and restricting imports and forcing South Korea to primarily produce for domestic markets and selectively produce for exports, the government mandates of the Rhee regime placed South Korea at a competitive disadvantage both domestically and internationally. Import-substitution policies denied South Korea access to readily available and less expensive resources, goods, and services around the world. Simultaneously, they forced domestic manufacturers to produce even when their costs were high or virtually impossible. The Rhee regime failed to take into account that South Korea now had very restrictive access to a substitute for the capital, investment, and management expertise once provided by the Japanese. The electrical power, metal, and chemical industries were now part of North Korea. The South had to start largely from scratch. Despite massive aid from the United States, even in 1963, World Bank statistics indicate that South Korea's GDP per capita (current US\$), at less than \$142, was significantly lower than Ghana (\$211) and only moderately higher than India (\$103).¹⁴ As late as 1963, unemployment and poverty was the norm, and over 40 percent of the nation's population was in absolute poverty.¹⁵

Many people were disgusted by both South Korea's dysfunctional economy and the Rhee administration's corruption. In 1960, a student-led revolution ousted Rhee and a new "democratic" constitution and government was created. However, abysmal economic conditions including double-digit inflation fueled extensive demonstrations and societal chaos.

On May 16, 1961, General Park Chung-hee led a successful military coup d'état that silenced the unrest and ended the experiment with democracy.¹⁶ One of his most famous quotations shows the depth of his desire for economic modernization: "For such poor people like the Koreans on the verge of near starvation, economics takes precedence over politics in their daily lives and enforcing democracy is meaningless."¹⁷ Still today, many South Koreans, particularly in the older generation, believe that Park's suppression of political rights was an acceptable price to pay for the economic growth within a democratic government, given the dire poverty the country experienced after the Korean War and during Japanese occupation.

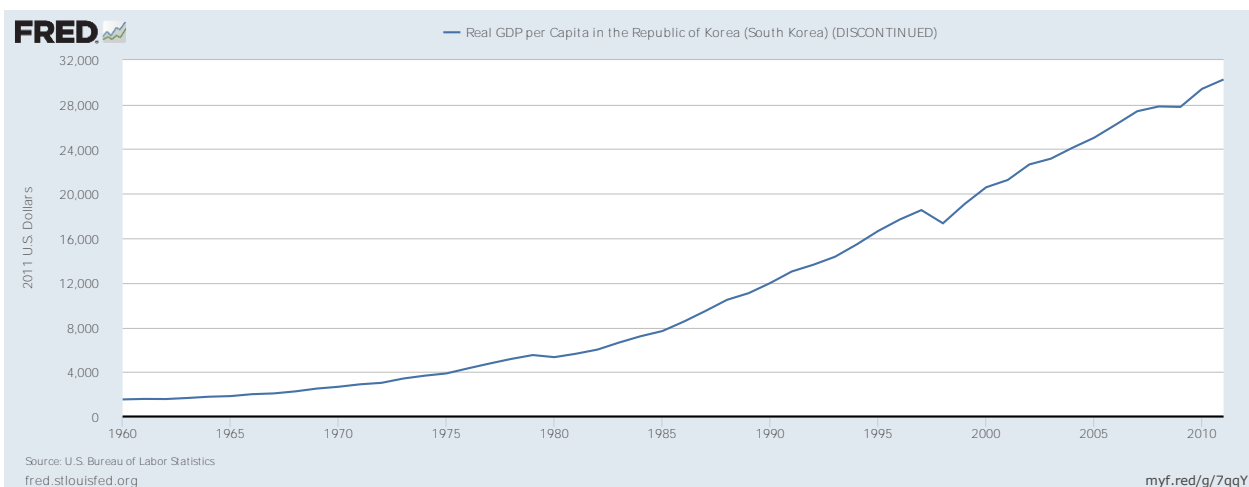
A Powerhouse Emerges: South Korea and the Global Economy

Starting in the early 1960s, South Korea expanded its economy nearly twentyfold, becoming known as an "Asian tiger" in the process. International trade played a key role in South Korea's rise.

At the beginning of the Park regime, real gross domestic product per capita was about \$1,600 per person. Growth in production started when the import substitution policies of Rhee were abandoned, and South Korea was permitted to import goods, services, and resources that were otherwise in short supply. With the advantage of relatively low cost access to waterways, South Korea successfully pursued a strategy of export-led growth fueled by the world's demand for

Korean products. In the 1960s South Korea possessed a comparative advantage in producing and exporting garments, textiles, and other items in industries requiring a relatively unskilled labor force. As the education and training landscape advanced, production and export efforts intensified in the heavy industries including, but not limited to, shipbuilding, electronics, chemicals, metal, and iron.

Increased access to the world's marketplace and Korean production of goods and services based on what South Korea could offer to its trading partners at relatively lower per unit-cost fueled economic growth and prosperity. By 1980, real GDP per capita increased five-fold to \$5,539.



More open markets helped South Korea gain access to millions of new producers and consumers. The peninsula now had more cost-effective means to secure the resources required for building the infrastructure, industries, and cities that eventually became trademarks of developed nations. Meanwhile, foreign aid from the United States and some loanable funds from Japan and other countries flowed into South Korea, boosting opportunities to build new capital and expand the industrial base. These flows helped the nation overcome traditionally low savings and investment rates.¹⁸

Park established an Economic Planning Board (EPB) in 1961. The EPB mobilized domestic labor and other production inputs by tapping into the concentrated resource and mobilization capabilities of the Korean *chaebol*.¹⁹ These family-owned businesses possessed low cost access to human and capital resources owned by families, relatives, and friends.

Since that time, the South Korean economy moved toward relatively open trade with export-led growth in key industries. Subsidies, tax breaks, low-interest loans, and political favors, though, did go to those exporters favored by the EPB. Foreign funds also flowed into Korea and toward the favored industries.²⁰ Under government directives, expressways were built to transport and distribute goods, thus lowering transaction costs throughout Korea. The net benefits from this growth were widely distributed, as evidenced by the increased GDP per capita, improved educational opportunities, and improved living standards.

In the 1970s, threats of U.S. troop withdrawals and changes in the international environment, such as President Nixon's visit to China in 1972, caused the Park administration to intensify domestic production in the heavy and chemical industries for military reasons out of fear that North Korea would invade. For example, machinery and transport equipment jumped from 3.1 percent of all exports in 1965 to 13.8 percent in 1975.²¹ Resources aided by questionable loans mandated by Park frantically shifted to the *chaebol* and caused worker unrest and demands for higher wages in other sectors of the economy. Internal political tensions escalated. Inefficiencies arose and instability spread throughout the economy. The world's oil shocks of the 1970s further pushed prices upward, causing persistent inflation. Meanwhile, Park used the possibility of North Korean attack to make himself a virtual dictator, and in 1974 outlawed all criticism of himself. In 1979, during a period of escalating political tensions, Park was assassinated by one of his own deputies. After a brief period of democratic reform, another army officer, General Chun Doo-hwan, seized power. The Korean Government backed off of intense military production efforts in the heavy and chemical industries, and took purposeful steps in moving away from favoring the large, family-owned conglomerates. In 1987, in the face of intense political pressure, the Government changed the Constitution and South Korea held its first national democratic elections.²²

During the early 1980s, partnerships between the government and the Korean *chaebol* became more transparent and government leadership advanced with market transformations on numerous levels. Specifically, deregulation occurred in the trade and financial sectors, leading to less concentration in the *chaebol*-driven industries, more business diversification across industries, and less central government involvement in production.²³ The economy rebounded, and growth in high technology industries took off. South Korea emerged as a world leader in the high-tech industry with corporations like Samsung and Hyundai becoming household names. Between 1980 and 1997, real gross domestic product per capita increased by a remarkable 248 percent from \$530 to \$18,500 in 2011 USD according to the Federal Reserve Bank of St. Louis's Economics Research Database, FRED.

The 1997-98 Asian financial crisis brought the South Korean economy to its knees. After agreeing to becoming even more open and transparent economy, South Korea accepted a \$57 billion dollar bailout from the International Monetary Fund (IMF). Special attention was given to the foreign currency market and the role of the central government in development planning.²⁴ Consequently, government officials became more involved and increasingly more localized.²⁵

The economic turmoil centering on the financial crisis sparked creative South Korean initiatives. The late President Kim Dae-jung led successful efforts to create a digital "Silk Road" cyber-infrastructure linking with Europe. Government control over domestic, export, and import markets further relaxed. South Korean popular culture in music, e-sports, and TV soap operas became internationally successful. President Park Geun-Hye (2013-2017) gave official support through tax breaks and subsidies to the rise of the "creative economy," aimed at boosting innovation and nurturing a startup-culture in the country. South Korean policymakers have long been worried that its economy is too reliant on manufacturing, and through these new strategies, the government hopes to boost innovation in industries such as software and hi-tech.²⁶ Today,

South Korea is the world's thirteenth largest economy with a per capita income of about \$30,000 (USD) and is a world leader in shipbuilding, and manufacturing consumer electronics and cars.²⁷ Not only Koreans, but also people throughout the world benefit from South Korea's economic achievements. In short, South Korea made significant progress in opening its economy to the world, and it continues to serve as a leader in helping nations successfully lift people up and out of poverty. South Korea continues to shine.

North Korea: The Dark Peninsula

Starting with a population a little more than half of that of South Korea, North Korea outperformed the south for eight years after the 1953 armistice.²⁸ With its sizable mineral resource base and an established massive industrialization program initiated under Japanese occupation, the highly-rigid dictatorship of the North marched forward. The size of the North Korean economy increased, largely thanks to aid from communist China and the Soviet Union. However, economic growth in the north was not sustainable. Close examination of the institutional structure of its economy explains why.

Since 1948, the three-generation-dictatorship of supreme rulers in the Kim dynasty has continually adhered to the tenets of a centrally planned economic system. The regime for the past few decades have given highest resources priority to military spending. North Korea, with 1.2 million active duty military and 7.7 million reserves has one of the world's largest ground forces and is aggressively developing nuclear weapons and missiles.²⁹ Command and controlled mandates, directives, and regulations direct resources to manage the government-preferred sectors of the North Korean economy. Government leaders and policy planners decide what to produce, when to produce, for whom to produce, and under what circumstances. International trade is strictly limited to that trade permitted by government. It is denied to the general populace. Most transactions among the masses are non-pecuniary.

North Korea's *Juche* (self-reliance) policy has failed dramatically. While reports indicate that per capita gross national product in North Korea initially grew at a faster rate than that of the south after the Korean War, its economy faltered and rates of growth in most industrial sectors began to fall behind those in parallel industries of the south. Economists from Adam Smith to Douglass North to Hernando de Soto can explain why.

National economies are too big and complex for central planners to exclusively manage. Central planners simply do not have the knowledge, expertise, and skills to know what works and what does not when, where, and at what price. Consider the trials and tribulations of South Korea.

Plus, ordinary people in a centrally planned economy have no incentive to assist in boosting production and mobilizing resources, especially when they do not possess any level of secure personal rights to life, liberty, and the pursuit of happiness. Knowing that any fruits from their efforts are likely be confiscated, why would they efficiently use scarce resources, readily respond to market changes, strategically invest for the future, and prudently save for tomorrow?

In the absence of a stable government that protects property rights and allows individuals to freely move in and out of markets, economic growth and prosperity are not possible over the

long run. The collapse of prior totalitarian communist economies provides corroborating evidence that help explain North Korea's abysmal economic conditions. The North Korean economy shrank as the Soviet Union crumbled. North Korea turned to China but, in the early 1990s, China scaled down aid and exports to North Korea. North Korea's health worsened. In the early 1990s, long term central planning mistakes resulted in primarily a man-made famine that claimed the lives of 600,000 to one million people.³⁰

Additionally, the continued deterioration in the overall health and wealth of the economy in North Korea gives stronger credence to the correlation between failing economic health and a shrinking communist presence. Apparently, even many North Korean soldiers suffer from malnourishment.³¹

Economic data from North Korea is famously unreliable. The government does not want its economy to be researched or indexed. With that said, a recent statistical compilation based upon multiple sources does paint a grim picture. Average individual annual incomes there are approximately a little under one-thirtieth of that of South Koreans; average height is about 5 inches shorter, and weight is 15 pounds lighter in the North than in the South; life expectancy at birth is ten years less in the North than in the South; 26.2 percent of North Korean infants die at birth compared to less than 3 percent of infants in South Korea; South Korean annual global exports and imports total well over one trillion (U.S dollars), while North Korean global exports and import totals are about 8.7 billion (U.S. dollars). The North Korean economy has depended upon significant international aid, especially food, including support from South Korea. It depends on Chinese imports of military goods, weapons, energy, nuclear reactors, and for illegal exports (counterfeit currency and drugs).³²

Sporadic reports on the situation in North Korea indicate marginal progress on the economic policy front. Overall, conditions have improved somewhat from their disastrous lows of the 1990s. The main reason provided is that some trading is being allowed in private markets. Survey studies conducted with North Korean refugees in South Korea indicate that a large majority of the population now turn to others for access to food and not the state.³³

As China advances in the world economy, its trading partners place in clear question the rationality of China's ongoing support for North Korea. China's trade with the rest of the world is increasingly brisk. In late November 2016 the United Nations Security Council, that includes China, unanimously placed sanctions on North Korea because of its continual nuclear testing and outwardly condemned the active testing of ballistic missile technologies and nuclear weapons.³⁴ China-North Korean relationships appear increasingly fragile as China claims it has stopped importing coal from North Korea in support of the UN sanctions, although there are skeptics.³⁵ Will China-North Korean relations continue to diminish?

Conclusion

Institutions matter, especially those that facilitate economic growth for any nations. Despite sharing a common culture for most of the history of the Korean Peninsula, South and North Korea could not be more different in quality of life today. South Korea's economy and society, like any nation, face significant challenges. However, people in the south benefit from a

democratic government, a market economy that they in large part created, and derive great benefit from their major role in the global economy. As long as North Korean institutions remain unchanged, most ordinary North Koreans are doomed to a life of poverty, uncertain at best personal security, and isolation from most of the rest of the world.

Teaching Resources

A plethora of teaching resources on related topics exist. These resources promise to deepen and broaden understanding on the institutional differences between North and South Korea and explain why these institutional differences matter to the people living in each country as well as to those individuals interested in the health and wealth of the Korean people. Use these resources to engage students by pointing to key primary sources, referencing high quality materials, and using teacher tested and student approved lesson plans. A few examples follow.

- *Economic Development: The Case of South Korea*. Stanford Program on International and Cross-Cultural Education (SPICE) SPICE-sales@stanford.edu

This four lesson curriculum guide with video resources is comprehensive and intended for high school classes.

- *Education About Asia*, “Focus on Korea: Economic Giant,” Association for Asian Studies volume 18, no.3, (Winter 2013) On November 17, 2016, retrieved from: <http://aas2.asian-studies.org/EAA/TOC/index.asp>

By following the above link and selecting “Volume 18:3 (Winter 2013): Central Asia” from the “Browse TOC” dropdown menu, teachers and students can access for no charge seven articles on the Korean economy that are in this special section.

- Federal Reserve Bank of Atlanta. “Lesson plan and infographic - Economic Systems: How Do Countries Organize Economic Activity?” On November 14, 2016, retrieved from: <https://frbatlanta.org/education/classroom-economist/infographics/economic-systems.aspx>

This excellent high school lesson introduces students to societal choices on how to organize economic activity and the accompanying costs and benefits.

- Federal Reserve Bank of St. Louis. “FRED: Real GDP per Capita in the Republic of Korea (South Korea).” On March 16, 2016, retrieved from: <https://fred.stlouisfed.org/series/KORRGDPC>

This site allows students to track, download, graph, and make their own calculations to determine rates of growth in real GDP per capita in South Korea during any period of interest between 1960 and 2011 (discontinued). The data series is in 2011 U.S. dollars.

- Fraser Institute's Economic Freedom of the World Map. On March 20, 2017, available at: <https://www.fraserinstitute.org/economic-freedom/map>

This interactive map allows students to track, download, graph, and make their own calculations regarding changes in a country's economic freedom index and match them against changes to freedom indicators, including the size of government, freedom to trade internationally, sound money, regulation, legal system and property rights.

- Marginal Revolution University. "The Importance of Institutions." (video) On November 16, 2016, retrieved from: <https://www.youtube.com/watch?v=wdKBfXRpNsk>

In this five-minute-seventeen-second video, economist Tyler Cowen provides an ideal introduction to the impact of differing institutions on the North Korean and South Korean economies.

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¹ Byung-Nak Song, *The Rise of the Korean Economy* (Hong Kong: Oxford University Press, 1990), 35-37.

² Donald N. Clark, *Korea in World History* (Ann Arbor, MI: Association for Asian Studies, Inc., 2012), 36.

³ Carter J. Eckert et al., *Korea Old and New: A History* (Seoul: ILCHOKAK Publishers, 1990), 266.

⁴ Byung-Nak Song, *The Rise of the Korean Economy* (Hong Kong: Oxford University Press, 1990), 37-45.

⁵ Eckert et al., *Korea Old and New*, 322.

⁶ "Korea as a Colony of Japan, 1910-1945." Asia for Educators. (New York: Columbia University). Accessed March 16, 2017, http://afe.easia.columbia.edu/main_pop/kpct/kp_koreaimperialism.htm.

⁷ Eckert et al., *Korea Old and New*, 334-335.

⁸ "US Enters the Korean Conflict," Accessed on March 16, 2017 at <https://www.archives.gov/education/lessons/korean-conflict>.

⁹ Clark, *Korea in World History*, 44-45.

¹⁰ Transcript of Armistice Agreement for the Restoration of the South Korean State (1953), accessed on March 20, 2017, <https://www.ourdocuments.gov/doc.php?doc=85&page=transcript>

¹¹ Frank Jr, Charles R., Kwang Suk Kim, and Larry E. Westphal. "Economic Growth in South Korea since World War II." In *Foreign Trade Regimes and Economic Development: South Korea*. (National Bureau of Economic Research, 1975), 11.

¹² Michael J. Seth, "An Unpromising Recovery: South Korea's Post-Korean War Economic Development: 1953-1961," *Education About Asia* 18, no. 3 (2013).

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¹⁵ Zhiqun Zhu, *Understanding East Asia's Economic "Miracles": Key Issues in Asian Studies* (Ann Arbor: Association for Asian Studies, 2016), 26.

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- ²¹ Song, *The Rise of the Korean Economy*, 104.
- ²² Clark, *Korea in World History*, 50.
- ²³ Kwangshik Shin, "Policy Agenda and Direction of Chaebol Reform," *Korean Development Institute*, Accessed October 24, 2016, http://www.kdi.re.kr/kdi_eng/publication/publication_view.jsp?pub_no=251&pg=3&tema=E4&pp=10.
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