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Research Report

The Origin and Evolution of the Korean Economic System

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The Origin and Evolution of the Korean Economic System

November 2000

Wonhyuk Lim

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Foreword

The economic crisis of 1997 was a watershed event in the evolution of the Korean economic system. The crisis made it clear that the old system based on the public management of private risks could not be sustained in a new economic environment characterized by liberalization and democratization. In the post-crisis era, it remains to be seen how Korea will reconcile old legacies with the central task of *privatizing private risks*.

Against this background, this work by Wonhyuk Lim makes an important contribution in a very timely fashion. Unlike the typical arguments that try to explain the economic crisis by simply dismissing even the very existence of Korea's economic success in the past, this work provides an alternative explanation that accounts for both the success and the recent failure using the concept of path dependence. In particular, the author addresses the question of the origin and evolution of moral hazard, and traces how the balance of the benefits and costs of Korea's government-business risk partnership has changed over time.

I hope that this work will appeal to scholars and policymakers interested in the success and failure of the Korean economy.

Jin-Soon Lee
President
Korea Development Institute

빈 면

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1. Introduction

Developing countries typically face three interrelated policy challenges: investment, conflict management, and engagement with the outside world. They must formulate effective strategies to accumulate both physical and human capital, cope with social conflicts, and maximize the benefits of “openness” while containing the risks [Rodrik(1999)]. In the early 1960s, the Republic of Korea (South Korea) addressed these developmental challenges by combining state-led financial resource allocation with export market orientation. The government nationalized banks and assumed a dominant role in financial resource allocation, providing selective guarantees on private-sector foreign borrowing. The government in effect formed a risk partnership with large private firms. Replacing the import substitution bias of the 1950s with outward orientation, the government, for the most part, used the performance of firms in competitive export markets as a selection criterion. As for conflict management, successive authoritarian regimes used both the carrot of improving living standards and the stick of ruthless suppression— before Korea was democratized in the late 1980s.

Since the outbreak of an economic crisis in 1997, this Korean model of economic development has come under heavy criticism. In fact, many critics have argued that the risk partnership between the government and big business had resulted in an inefficient financial sector and a highly leveraged corporate sector fraught with moral hazard. Some, predominantly Western, commentators have even contended that the Korean system was nothing more than a hotbed of corruption and cronyism.

What is conspicuously missing in this barrage of criticism, however, is the recognition that the *same* system served as the backbone of “rapid, shared growth” which catapulted Korea from one of the poorest countries in the world to the ranks of OECD countries in thirty years [World Bank(1993)]. As Table 1 shows, Korea’s economic performance from 1960 to 1990 was truly exceptional. In fact, before the 1997 crisis, Korea seemed an unqualified success story, a model of modernization for the rest of the

developing world. No criticism of the Korean economic system would seem convincing without some explanation for its apparent success in the past.

Table 1. Comparative Growth Experience, 1960-1990

(percent per annum)

Regions and Countries	Output		Labor	Physical Capital		Human Capital	
	GDP	GDP per Worker	Number of Workers	Total Physical Capital	Physical Capital per Worker	Labor Quality	Years of Schooling
East Asia	7.46	4.71	2.75	10.89	8.14	1.33	1.94
Latin America	3.27	0.85	2.42	4.51	2.09	0.98	1.57
Middle East	5.14	2.71	2.43	6.43	4.00	1.36	2.93
South Asia	4.10	2.02	2.08	5.38	3.30	1.51	3.39
Sub-Saharan Africa	3.42	0.81	2.61	3.64	1.03	0.77	1.83
Developed Countries	3.56	2.38	1.17	4.62	3.44	0.63	0.90
Malaysia	6.86	3.71	3.14	9.43	6.29	1.52	2.47
Indonesia	5.92	3.74	2.18	7.91	5.73	1.75	3.62
Philippines	4.11	1.59	2.52	6.10	3.58	1.40	1.64
Singapore	8.17	5.27	2.90	12.93	10.03	0.69	1.03
Korea	8.49	5.93	2.56	11.90	9.34	2.18	2.83
Taiwan	8.31	5.66	2.66	11.87	9.22	1.83	2.41
Thailand	6.97	4.26	2.72	9.75	7.03	0.39	0.89
Japan	6.17	5.03	1.14	9.35	8.22	0.10	0.48

Source: Hahn and Kim(2000).

Note: Regional averages are weighted by each country's average GDP between 1960 and 1990.

The labor quality index is constructed as the weighted average of educational attainment for workers, where the weights are based on the (diminishing) rate of return from each additional level of schooling (i.e., primary, secondary, and tertiary level).

This historical experience begs the following set of questions: Why did Korean policymakers in the 1960s adopt a development strategy combining state-led financial

resource allocation with export market orientation? How did such a state-dominant and market-complemented system provide incentives and manage risks? What accounted for its past success and recent breakdown?

It is the objective of this paper to shed light on the adoption and evolution of the Korean model of economic development using the concept of path dependence. In order to show how “history mattered” in the evolution of the Korean economic system, this paper will focus on historical accidents and installed base effects that affected the process. In particular, this paper will argue that the very success of the system created a coalition of economic players interested in preserving the system, even when it became increasingly dysfunctional in a changed environment. The installed base of players with system-specific interests made it difficult for policymakers to introduce fundamental reforms that would have placed Korea on a more sustainable, less crisis-prone development trajectory.

Unlike the typically ahistorical arguments that take the evolution of Korea’s policy choices as given and focus on either positive or negative aspects of the Korean economy, this paper looks at the political economy context of policy choices and attempts to provide an alternative explanation that accounts for both the success and the recent failure of the Korean economic system within a consistent analytical framework. The dynamic concept of path dependence is used in a political economy context to overcome the limitations of neoclassical, dependency, and statist perspectives on economic development.¹

This paper is organized as follows. Invoking the concept of path dependence, Section 2 briefly reviews “the QWERTY paradigm” and discusses how this exemplar of decision-making in a network context can be applied to the adoption of economic systems [David(1985); David(1989); Arthur(1994)]. This section emphasizes the importance of

¹ Neoclassical studies typically claim that liberal, market-oriented policies are conducive to economic development, but they remain largely silent on the conditions under which these supposedly superior policies are adopted; implicitly, policymakers are assumed to be “free to choose.” Dependency perspectives suffer from an opposite flaw and tend to emphasize international, structural constraints that are presumed to have an almost deterministic influence on policymakers. Statist perspectives tend to reify the state and overlook the political process. On the limitations of these theoretical perspectives, see Haggard(1990) and Kimiya(1991).

historical accidents in the adoption of systems characterized by increasing returns. Section 3 examines the set of initial conditions that affected the choice of economic systems in Korea in the early stages of development. After Korea was liberated from the Japanese colonial rule in 1945, the re-assignment of property rights and the realignment of political forces provided the background of subsequent economic decisions, but what later came to be known as “the Korean model” was not the initial choice. A series of “historical accidents” that led to its adoption in the early 1960s is highlighted.

Section 4 looks at the evolution of this system. The government’s decision to forge a risk partnership with large private firms not only encouraged rapid capital accumulation, but it also created a coalition of political and economic actors interested in preserving this system. In the 1960s, the government tried to contain the potential dangers of this risk partnership by making government support contingent on market performance. When a major economic downturn raised the specter of massive bankruptcies in the early 1970s, however, the government resorted to an emergency decree to bail out the highly leveraged corporate sector. The governance rights of the incumbent shareholders and managers were protected. Exacerbating moral hazard, the government extended extremely generous financial support to large private firms during a subsequent heavy and chemical industry (HCI) drive. The government provided these firms with direction and insurance— control and protection— in the 1970s. The complementarities among the various types of bureaucratic controls over the economy, as well as political economy considerations, led the government to adopt distortionary policies.

Section 5 examines why efforts to reduce state intervention and moral hazard were only partially implemented, even though the Korean system became increasingly dysfunctional. The ability of the government to control international capital flows and domestic private firms was significantly weakened after the late 1980s, but the installed base of politicians, bureaucrats, and businessmen blocked fundamental reforms centered on removing bureaucratic controls, terminating implicit protection, and drastically re-defining the role of the government. The economic crisis of 1997 should be understood within this context.

2. The QWERTY Paradigm and Competing Economic Systems

What does the tale of QWERTY have to do with economic systems? Very little if it is simply regarded as a cute story about the persistence of an inefficient typewriter keyboard.² Interpreted as an exemplar of decision-making in a network context, however, the QWERTY story can provide insights into the adoption of competing systems characterized by increasing returns [David(1985); David(1989); David(2000)]. Whether these competing systems are technological systems or economic systems makes little difference; what is crucial is the presence of increasing returns or network externalities that can cause the collection of individual choices to tip toward one extreme or another. For such a system, its expected network size as well as its stand-alone qualities affect the adoption decisions of potential users. As the expected network size of such a system depends in part on the size of the installed base, “historical accidents” in the early stages of the system competition are likely to have a significant effect on the eventual outcome. Consequently, in the presence of increasing returns, a seemingly extraneous event can have more than a transitory effect. Moreover, if the adjustment cost is sufficiently high, a local optimum is the best that can be hoped for, and the global optimum may not be obtained [Arthur(1994)].

Applying this QWERTY paradigm to the adoption of economic systems may appear problematic at first, for the nature of decision-making involved in the adoption and evolution of economic systems seems very different from the case of technological systems. Can individuals really decide to adopt an Anglo-Saxon economic system or a Japanese system in the same manner as they choose a QWERTY keyboard or a Dvorak keyboard?

² Note that the QWERTY keyboard was initially an *efficient* arrangement given the constraints of typebar technologies: The QWERTY keyboard reduced jamming and quickly gained popularity among typists. The later development of non-typebar technologies meant that, on the basis of stand-alone qualities, the QWERTY keyboard *became* inferior to alternative key arrangements. Network externalities arising from the large installed base of QWERTY typists, however, more than made up for this shortcoming and apparently exerted an overwhelming influence on keyboard adoption decisions at typewriter manufacturers.

Is an economic system not the result of a long evolution beyond the control of any individuals? Such points are well taken, but when all is said and done, the difference between economic systems and technological systems actually seems to be one of degree.

Economic systems “compete” for adoption in policymaking circles. Developing countries in the 1950s and 1960s, for instance, faced a wide range of import-substituting or export-oriented economic systems, and adopted a collection of policies that in effect amounted to “choosing” one system or another. If an economic system appears to be beyond the control of any individuals, especially in advanced industrial countries, it is primarily because the economic players in such countries are “locked in” to this dominant system due to high fixed costs. Even in these countries, however, efforts to improve the existing system or search for a radical alternative continue, particularly in times of economic stagnation. In fact, the evolution of an economic system may be conceptually redefined as the adoption of a new system based on modifications to the existing one.

Although it is beyond the scope of this paper to specify a structural model of the QWERTY paradigm as applied to the adoption of economic systems, it may be useful to sketch the contours of such a model. The essence of the QWERTY paradigm is that the adoption probabilities associated with competing systems depend on their current market shares (network sizes) as well as their stand-alone qualities and extraneous factors. In general, an allocation process based on such an adoption scheme converges to fixed points of this probability function. The adoption probabilities may be an arbitrary function of the current market shares. When the adoption probabilities depend positively on the current market shares, the allocation process exhibits increasing returns.³

³ This kind of allocation process can be pictured by imagining an urn into which balls of different colors are added one at a time according to probabilistic adoption rules. Two simple examples may be useful here. Start with given numbers of black and white balls in the urn. (1) In the Polya urn scheme, a ball is randomly drawn from the urn and put back with a new ball of the same color from the outside. In this case, the probability of adding a color always equals its current proportion (“market share”), and two equilibrium points exist: one at which almost all balls in the urn are black; the other at which very few are black. In this increasing returns process, the initial distribution of the colors and the drawing results in the early rounds significantly affect the ultimate outcome. (2) In the Bernard Friedman urn scheme, a ball is randomly drawn from the urn and

For competing economic systems, the current “market share” associated with a particular economic system would refer to the “influence proportion” of economic players in support of that system, and the parameters of the adoption probability function would reflect the given political economy setting. If this kind of adoption game is imagined as being played within policymaking circles, the influence proportion of policymakers representing the interests of economic players may be more relevant.

In such a situation, policymakers advocating one economic system or another must take into account its stand-alone qualities as well as its compatibility with the interests of economic players who have made specific investments. These economic players may be grouped into peasants, workers, landowners, bankers, industrial capitalists, politicians, bureaucrats, military, foreign governments, and multinationals. Depending on the level of organization and the payoff structure associated with policy choices, these actors exert varying degrees of influence on the decision-making process.⁴

The objective function of policymakers may not be efficiency maximization, just as the typewriter manufacturers’ objective function is not. For profit-maximizing typewriter manufacturers, designing a keyboard arrangement that maximizes typing speed may not be a good idea if existing typists are unwilling to incur adjustment costs to learn the new keyboard. Similarly, politicians and bureaucrats may be more interested in maximizing their private payoffs from policy choices than introducing economic reforms designed to improve the general welfare. Although it is extremely difficult to specify the objective function of policymakers, its arguments may include material gain, power and control over

replaced by a new ball of the opposite color from the outside. In this decreasing returns case, the probability of adding a color equals one minus its current proportion, and the limiting proportion of black as well as white balls is equal to one-half. See Arthur(1994).

⁴ Unlike an adoption game involving *decentralized* decision-making by users in a network context (for example, VHS vs. Beta in the VCR market), the individual preferences of policymakers are channeled into the ultimate *centralized* decision-making process within the government. As a result, there is only one economic system at a given moment within a nation, even through individual policymakers may be attracted to different economic systems. An analogy may be drawn to the decision-making process at a typewriter manufacturer. Within the firm, individual keyboard designers may promote different keyboard arrangements (for example, QWERTY vs. Dvorak), but the firm as a whole typically adopts only one keyboard arrangement at a given time.

others, as well as the satisfaction from turning ideological and other beliefs into concrete policies— whether or not these policies actually improve public welfare.⁵ Whatever the ultimate objective function of policymakers may be, however, winning the next election is an important *intermediate* objective in a democracy, and making political economy calculations may be regarded as an integral part of the policymaking process. In effect, the interests of economic players are reflected in the objective function of policymakers, who may also have private motives of their own.

Under such conditions, the most efficient economic system may not be adopted even if it can be identified. Furthermore, especially when increasing returns are significant, a system that was once efficient but is no longer so may persist.⁶ For example, Dertouzos et al.(1989) argued that the previous success of America's mass production system made it difficult for Americans to adapt to the new world of flexible manufacturing.

⁵ It is perhaps impossible to specify a general objective function that accounts for the behavior of politicians ranging from Lincoln to Mobutu. On an individual basis, however, it may be possible to construct a revealed objective function by looking at institutional constraints designed to limit politicians' use of the public office for private gain. In particular, if a politician does not engage in corruption even in the absence of institutional constraints, it is safe to conclude that his or her objective function includes something besides private material gain.

⁶ In their comparative analysis of institutions, Aoki and Okuno-Fujiwara(1996) identify positive feedback forces in economic systems as follows: (1) "strategic complementarity" between institutional arrangements and individual behavior and (2) "institutional complementarity," or internal consistency (coherence) of institutional arrangements within an economic system. See also Greif(1994) on the role of cultural beliefs.

3. The Origin of the Korean Economic System: The Formation of the Government-Business Risk Partnership

Applying the QWERTY paradigm to the adoption of the Korean model of economic development requires an analysis of the initial conditions and historical accidents that affected the subsequent decision-making process. In particular, the political incentives and constraints faced by policymakers demand close attention.

(1) Traditional Context: Centralist Tendencies and Mass Society

Korea achieved national unity and established a centralized rule in the mid-seventh century, a remarkably early date by any standard. Characterizing Korea's centralist tendencies as "the politics of the vortex," Henderson(1968: 2) noted: "Few if any traditions affecting an entity of this size have operated in so uniform an environment of race, culture, and language, within geographic boundaries so stable or a political framework so enduring. Few states eliminated local power so soon or so completely and sustained centralized rule in such unchallenged form so long." In this regard, Korea's traditional political and social structure was very different from that of Japan, which operated in a feudal system. A pyramid-like structure, with the central government at the apex, characterized the social organization of Korea for more than a thousand years. The absence of independent power centers and pluralistic institutions resulted in a mass society consisting of atomized individuals.

In the economic sphere, the central government traditionally allowed little room for merchants or other groups to pursue moneymaking ventures on their own. Thus, in the Korean context, both economic stagnation and economic development had to be state-led [Cha and Lim(1997)]. The elite scholar-officials at the center could easily exploit mass society and engage in factional rent-seeking competition.⁷ Alternatively, "the best and the

⁷ While the state maintained centralized rule in traditional Korea, the monarch typically shared power with influential aristocrats or scholar-officials. What Henderson(1968) calls "centralized oligarchy" rather than absolutist rule characterized the political structure of traditional Korea.

brightest” could take advantage of Korea’s homogeneity and centralization to mobilize resources for development. To a large degree, these contrasting possibilities were realized after Korea was liberated from the Japanese colonial rule (1910-1945).

(2) Post-1945 Chaos and Crony Capitalism in the 1950s

The end of the Japanese rule was followed by the *de facto* partition of the Korean peninsula by the American and Soviet forces. The Americans, occupying the southern half, initially backed a group of moderate political leaders intent on forming a unified Korean government through negotiation. As the Cold War intensified and friction with the Soviets escalated on the Korean peninsula, however, the Americans increasingly began to support conservative forces, and the socialist option was all but eliminated in the south.

Syngman Rhee, the first president of the Republic of Korea, rose to power within this political context. A Princeton Ph.D. and longtime exile in the U.S., Rhee had solid pro-independence credentials but lacked a domestic power base. A staunch anti-communist, he initially allied himself with the Korea Democratic Party created by wealthy landowners and businessmen, some of whom were tainted with collaboration with the Japanese colonial regime. After he formed his own political organization, however, he took a variety of measures to weaken his potential competitors and consolidate his power base. For instance, the land reform launched in 1949 was designed in part to reduce the political power of landowners [J. Kim(1975)]. In fact, Rhee’s use of policy instruments to gain political support played a dominant role in a succession of economic decisions during his presidency (1948-1960).

The end of the Japanese colonial rule meant that Korea was confronted with the crucial tasks of re-assigning property rights and re-establishing the external trade and foreign exchange regime. The “enemy properties” of the Japanese and their collaborators had to be either nationalized or sold off, and the rules governing trade and foreign exchange had to be modified to deal with the vacuum created by the severing of economic

relations with Japan.⁸ Furthermore, given the lack of domestic capital and technology, policies designed to attract investment had to be implemented. In this regard, Korea's economic situation after liberation was similar to that of Central and Eastern European countries after the collapse of the Socialist Bloc. In addressing these policy challenges, however, Rhee took a rather myopic and politically motivated approach. Instead of formulating an economic development program designed to improve living standards, he chose to use the discretionary allocation of state-controlled resources to secure and sustain his political supporters. His political strategy was essentially based on mobilizing funds to finance elections and other party activities through a close alliance with select private firms.

The sale of vested properties (“enemy properties”) provides a good example. When the Americans initially put the formerly Japanese-owned industrial properties up for sale, few Korean nationals could meet the qualifications, and, as a result, the properties ended up in the hands of the new Korean government. Syngman Rhee could have used these new state-owned enterprises (SOEs) as vehicles for economic development. In the aftermath of the Great Depression and World War II, SOEs and “the mixed economy” commanded a degree of respectability around the world such that many developing countries, including Taiwan, were nurturing SOEs as an integral part of their economic development program.⁹ Alternatively, the industrial properties could have been privatized

⁸ Under the Japanese colonial rule, Korea— North and South combined—heavily depended on trade. Korea's trade volume as a share of national income steadily increased from 16.6 percent in 1912 to 65.1 percent in 1938 [Ahn(1997: 32)]. Most of Korea's trade during the colonial period was with Japan. From 1910 to 1944, Japan accounted for 83.8 percent of Korea's exports and 81.7 percent of its imports. In the 1930s, Japan accounted for 84.5 percent of Korea's total trade volume and Manchuria under Japanese occupation, another 10.5 percent [National Statistical Office(1995: 76)]. The collapse of the Japanese colonial empire in 1945 delivered a serious shock to the Korean economy, and the division of the Korean peninsula made matters worse. Although the U.S. tried to persuade Syngman Rhee to normalize relations with Japan, he refused on nationalistic grounds.

⁹ A “historical accident” played a critical role in the development of SOEs in Taiwan. Conservatives in the Kuomintang supported the state control of the commanding heights of the economy in part due to their concern about the potential ethnic conflict between the mainlanders and the native Taiwanese. They feared that an economic development strategy based solely on the growth of the private sector would strengthen the native Taiwanese, who could then use their economic power to challenge the political dominance of the mainlanders [Tien(1989)].

through a competitive bidding process.¹⁰ Rhee's political interest in cementing a close relationship with businessmen, however, precluded either approach. The government instead lowered the requirements for the sale of state properties to facilitate privatization in favor of the interim plant managers as well as the politically well-connected, and in return for their windfall gains, businessmen made contributions to Rhee's Liberal Party.¹¹

The privatization of banks in the 1950s is another case in point. The government initially put banks up for sale in 1954, with a number of provisions to prevent windfall gains and to ensure the separation of banking and commerce. These provisions were designed to address the concerns of economic experts who feared that ill-conceived bank privatization would distort resource allocation and place these financial institutions under the control of industrial capitalists. When it turned out that no bids satisfied these provisions, however, the government drastically relaxed the requirements. The result was exactly what the experts had feared. Using political connections, top industrial capitalists borrowed money from banks to make a bid for the ownership of these banks. When bank privatization was completed in 1957, all major commercial banks were under the control of industrial capitalists. According to one study, the share of loans subsequently extended to the controlling shareholder of these privatized banks exceeded 50 percent [Ahn(1993: 272)]. Each of these formerly state-owned financial institutions had thus become "the piggy bank" of an industrial capitalist. It goes without saying that the beneficiaries of bank privatization were major contributors to Syngman Rhee's Liberal Party.

Rhee also used the discretionary allocation of aid goods, import licenses, and government contracts as instruments to consolidate his power base. After the outbreak of

¹⁰ The government's decision to privatize SOEs by itself can hardly be a subject of criticism. The real problem was that Rhee's privatization policy was driven more by political calculations than efficiency considerations.

¹¹ Seol Kyung-dong, treasurer of the Liberal Party, was a beneficiary of one of these privatization deals and took over a textile mill in Taegu. Kang Jik-sun, a businessman who picked up Samcheok Cement Co., donated to the Liberal Party a 30-percent equity share in the company. The Rhee government typically set the assessed value of the vested industrial properties at 25-30 percent of the market value. Moreover, it offered the new owners of these properties generous installment plans when the annual rate of inflation hovered around 30 percent [K. Kim(1990: 170-174)].

the Korean War in 1950, the U.S. reassessed Korea's geostrategic importance and provided generous aid and assistance.¹² The Korean government deposited the local currency equivalent of all U.S. aid into a counterpart fund whose use would be jointly determined by the Americans and the Koreans. The exchange rate became a contentious issue, however, as Rhee insisted on repaying the advances at a rate that significantly undervalued the dollar. As Table 2 shows, the market exchange rate (as approximated by the rate applied to UN soldiers stationed in Korea) was at times nearly three times as high as the official rate.¹³ Rhee's reasoning was clear: the possession of foreign exchange and aid goods at less than their market value would create arbitrage opportunities, and would allow him to distribute favors to businessmen willing to provide kickbacks to the Liberal Party.

Table 2. Exchange Rates in the 1950s

(Korean hwan/US dollar)

Effective Date	Official Rate	Counterpart Fund Rate	Rate to UN Soldiers
Mar. 1951	25	40	60
Nov. 1951	60	60	60
Jun. 1953	60	60	180
Dec. 1953	180	180	180
Nov. 1954	180	180	500
Aug. 1955	500	500	500

Source: Bank of Korea, *Economic Statistics Yearbook 1960*, p.233.

Note: The hwan was converted to the won at the rate of 10 to 1 in June 1962.

¹² Foreign aid financed nearly 70 percent of total imports from 1953 through 1962. It was equal to nearly 80 percent of total fixed capital formation and 8 percent of GNP. Net foreign savings, as measured by the current account deficit of the balance of payments, averaged 9 percent of GNP for this decade [Mason et al.(1980: 185)].

¹³ The official exchange rate typically lagged adjustments in the rate applied to UN soldiers. Between December 1954 and August 1955, US Army held dollar auctions to obtain required hwan. The exchange rate at these auctions fluctuated between 430 and 510 hwan to the dollar.

Rhee's control over imported grains and other goods also allowed him to distribute largesse directly to government employees and others.¹⁴ The selective allocation of loans and import licenses and the noncompetitive award of government contracts were additional means of favoring supporters. As long as the U.S. policy toward Korea was dictated by geostrategic imperatives, Syngman Rhee could rely on the continued flow of U.S. aid to sustain his regime [Haggard(1990: 57)].

In the end, what passed for an economic system in Korea in the 1950s was primarily shaped by Rhee's use of policy instruments to secure and sustain his power base. The sale of vested properties resulted in windfall gains for favored businessmen and an undue concentration of economic power. The overvaluation of the Korean won, designed to maximize arbitrage opportunities, had the effect of severely discouraging exports. On a superficial level, the economic system in Korea in the 1950s resembled that of developing countries pursuing import-substituting industrialization, particularly in Latin America. Unlike these countries, however, there was little conscious effort on the part of the government to formulate economic policies from a strategic perspective. Technocrats genuinely concerned with economic development received little support [H. Kim(1999)]. Import substitution in Korea in the 1950s was more a result of crony capitalism than a strategy for economic development.¹⁵

When a student protest in April 1960 finally put an end to the Syngman Rhee government, Korea was in a dismal state. It was an aid-dependent country whose per capita income was one of the lowest in the world. As Table 3 shows, Korea's per capita GDP in 1960 was lower than such Sub-Saharan African countries as Mozambique and Senegal— to say nothing of most countries in Asia and Latin America. The savings rate

¹⁴ U.S. aid goods provided raw materials for the famous “three-white” industries of the 1950s in Korea: sugar, cotton yarn, and wheat flour. Rhee's politically motivated “industrial policy” created huge profit opportunities. The cost of producing a sack of wheat flour was estimated at 350 hwan, but a select group of domestic manufacturers were able to charge 1,200 hwan per sack, and shortages sometimes pushed prices to 5,000 hwan [S. Kim (1965: 27-30)].

¹⁵ In 1960, Lee Ki-bung, vice presidential candidate of the Liberal Party, was alleged to have a major equity stake in 29 firms. Overall, the Liberal Party was believed to have at least a 50-percent stake in all of the private firms receiving U.S. aid goods [J. Kim(1975)].

was less than 10 percent of GNP. The government derived over half of its revenue from U.S. aid; tax collection was less than 10 percent of GNP, which was low even by the standards of developing countries. Manufacturing constituted only slightly over 10 percent of GNP. The unemployment rate was around 8 percent.

Table 3. Comparative Economic Development, 1960-1990

Country	Per Capita GDP In 1960 (1985 Dollars)	Per Capita GDP In 1990 (1985 Dollars)	Average Annual Growth Rate(%)
Ghana	894	902	0.27
Mozambique	1153	760	-1.17
Senegal	1047	1145	0.39
Korea	904	6673	6.98
Malaysia	1420	5124	4.49
Philippines	1133	1763	1.55
Taiwan	1256	8063	6.43
Thailand	943	3580	4.61
Argentina	4462	4706	0.31
Brazil	1784	4042	2.87
Mexico	2836	5827	2.52
U.S.A.	9895	18054	2.05

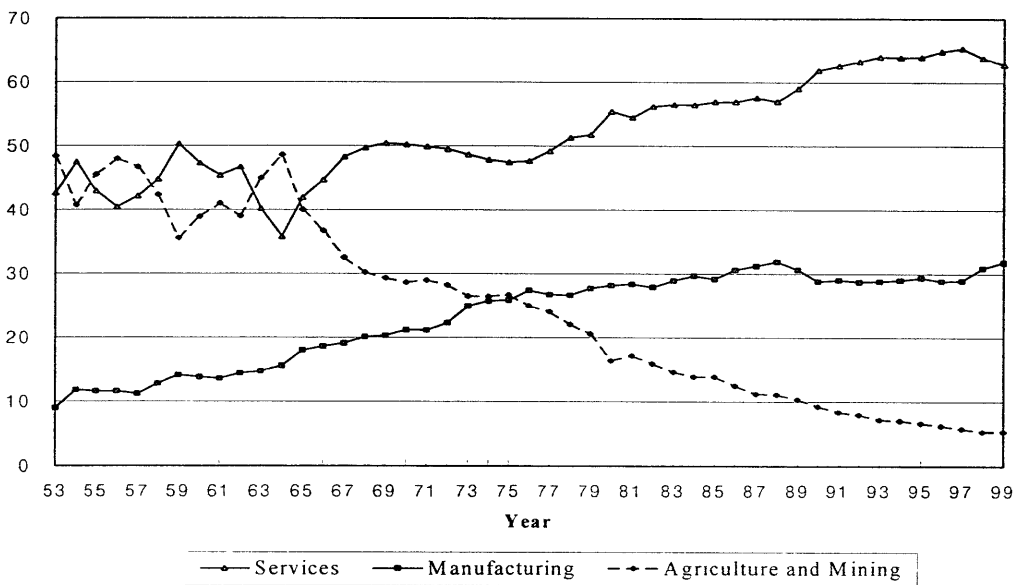
Source: Penn World Table 5.6.

In fact, in a cross-country study on economic development, Perkins(1997) noted that Korea had a rather unusual economic structure in the early 1960s. The share of agriculture and mining in the Korean GNP was close to 50 percent, nearly 15 percentage points higher than the average of other countries of comparable size and per capita income. The share of manufacturing was unusually low, nearly 20 percentage points below the average. Even more remarkable was the extremely low share of exports, as it amounted to only 3 percent of GNP when the average was about 15 percent. This was a dramatic departure from the 1930s and the early 1940s when Korea's exports amounted to about 30 percent of GNP. The Rhee government's myopic policy was largely responsible for turning a trading nation into an aid-dependent near-autarky. Overall, it seemed that the

Korean economy faced bleak prospects.¹⁶

Few, if any, expected the spectacular transformation that the Korean economy would undergo over the next thirty years. As Figure 1 shows, the share of manufacturing in Korea's GDP more than doubled as Korea was able to reallocate underemployed workers from the primary sector. Also, Korea's exports as a share of GDP dramatically increased over the same period so that by the early 1990s the export-to-GDP ratio resembled that of countries that are much smaller than Korea [Perkins(1997)]. Moreover, as Figure 2 shows, Korea's exports and imports rose in step with investment, suggesting that incentives for these activities were strengthened in a similar manner. What triggered this dramatic transformation is the subject of the next section.

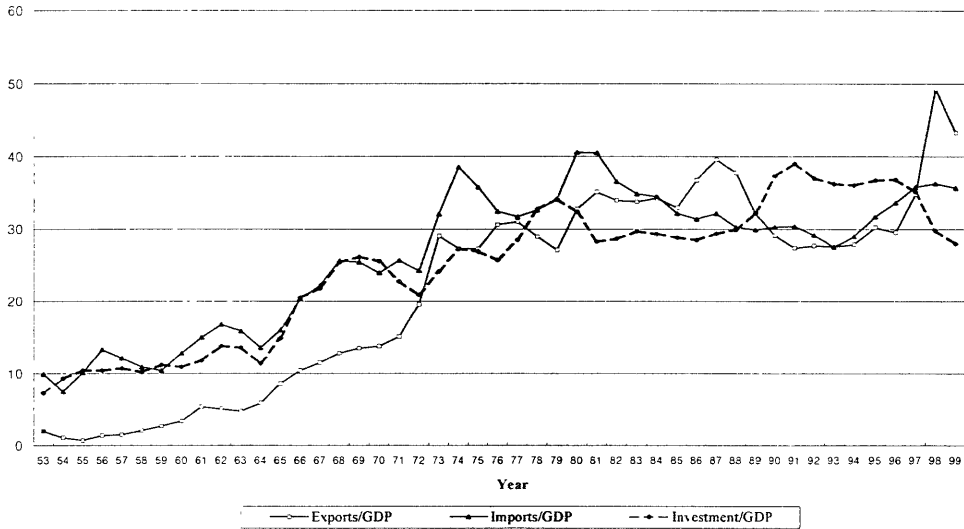
Figure 1. Sectoral Composition of Korea's GDP



Source: Bank of Korea, *National Accounts*, various issues.

¹⁶ One bright spot was improved education. With the introduction of compulsory education after Korea's Liberation, the primary enrollment rate increased from around 30 percent under the Japanese colonial rule to more than 95 percent in 1959. The high-school enrollment rate increased from around 3 percent in 1951 to 20 percent in 1959.

Figure 2. Korea's Exports, Imports and Investment as a Share of GDP



Source: Bank of Korea, *National Accounts*, various issues.
 Note: Investment here refers to gross fixed capital formation.

(3) The 1961 Coup and the Adoption of the Korean Model of Economic Development

On May 16, 1961, General Park Chung Hee seized power through a bloodless coup.¹⁷ In the Revolutionary Pledges of May 16, Park and his followers declared that they were determined to “focus all energy into developing capability to confront communism, in order to realize the people’s long-standing wish for national unification.” Park’s overriding concern was the communist regime in North Korea, which had successfully carried out a series of reconstruction and economic development programs after the Korean War. Park acknowledged that South Korea was facing a formidable adversary who was winning the economic war, which he felt took precedence over military

¹⁷ A complex figure, Park had served as a Japanese army officer and, after Korea’s liberation, he organized communist sympathizers in the Korean Army before he converted to the cause of anti-communism. His coup d’état put an end to the democratically elected Chang Myun government, which had tried to cope with various political demands following the April 1960 Revolution as well as to formulate a coherent economic development program [Y. Lee(1999)].

or political war [Park(1963: 29)]. In the early 1960s, the North's per capita income was estimated to be double that of the South, and it was feared that the income gap was growing between the two sides.

Park wanted to beat communism and build a prosperous nation. In pursuing these objectives, he took a strategic approach, setting firm policy priorities. He thought that rapid economic growth and improved living standards would provide the best antidote for communism and decided to channel all national energy into economic modernization. Other policy issues, such as political liberalization and national unification, were placed on the back burner.

Although Park and his followers had only rudimentary knowledge of economics, they believed that the state should take a leading role in economic development. In order to monitor the economy on a daily basis, Park established an economic secretariat in the presidential mansion. Implementing an idea that had been around for some time, he also created the Economic Planning Board (EPB) in July 1961 through a merger of several policymaking functions of different ministries.¹⁸ The EPB took over the budgetary function from the Ministry of Finance and the collection and evaluation of national statistics from the Ministry of International Affairs. The EPB was charged with the task of formulating and implementing five-year economic development plans,¹⁹ and in 1963, it became a *bona fide* super-ministry headed by a deputy prime minister. [H. Kim(1999)]

¹⁸ The short-lived Chang Myun government (Aug. 1960-May 1961) had the blueprint to establish a senior ministry in charge of economic development that would have planning and budgetary functions as well as coordinate economic policy. The coup leaders basically implemented this blueprint and established the Ministry of Development on May 26, 1961, which was reorganized as the EPB two months later [H. Kim(1999: 31-43)]. The Chang Myun government also established the practice of recruiting civil servants through examination. Under the previous Rhee government, civil service recruitment had been based on political and personal connections [Y. Lee(1999: 23-24)] The Chang Myun government perhaps should receive more credit than is usually given for institutional reforms that facilitated Korea's economic development.

¹⁹ Although the talk of "five-year plans" initially raised some eyebrows, the Korean version was based on the idea of indicative planning and bore little resemblance to the Stalinist model. The

In addition to these institutional innovations that centralized economic policymaking, the military government took several measures to strengthen the role of the state in resource allocation. After the April 1960 Revolution, prominent businessmen were accused of having grown rich through political connections with the Syngman Rhee regime. Taking over the task of dealing with these “illicit wealth accumulators,” the military government accused them of tax evasion and other illegal business practices, and confiscated their equity shares in commercial banks. This drastic measure paved the way for the government to exert direct control over commercial banks, in effect re-nationalizing the banks that had been privatized in the late 1950s. Moreover, an amendment to the Bank of Korea (BOK) Act in 1962 transferred monetary policy authority to the Ministry of Finance (MOF). Under the amended act, the MOF also took control of foreign exchange from the central bank and assumed the administrative power to supervise its operation and to control its budget and expenses. This step turned out to be crucial to the government’s financing strategy for development projects, as it came to depend on the BOK’s monetary expansion to a certain degree [Cho and Kim(1997: 34)].

The government also created a number of “quasi-governmental organizations” in order to facilitate communications with business and labor. Various business associations were used as channels for government-business interaction and were granted special favors such as the right to allocate quotas among member firms. Membership in these business associations was mandatory. As for labor, all labor unions were disbanded following the 1961 coup, and the restructured Federation of Korean Trade Unions (FKTU) was forced to take a moderate stance.

In a little more than a year, the military government thus established various levers of control. Although the size of the state—as measured by the share of government spending in GNP— remained relatively small, the power of the state was overwhelming. Park and his followers clearly had in mind an economic system that was dominated by the state. The question remained as to what kind of state-led system it would be.

socialist system was not a viable option in Korea in the 1960s.

Developing countries around the world at this time were faced with a variety of competing economic systems. The dearth of private entrepreneurs and lack of domestic capital in these countries seemed to imply that the state would have to take the initiative and rely on foreign capital or forced domestic savings to accelerate economic development. Given these conditions, some countries opted for the socialist system while others tinkered with market-based ones. Many Latin American countries pursued import-substituting industrialization supplemented by foreign direct investment, expressing skepticism about the benefits of free trade as primary producers [Bruton(1998)]. In Asia, Taiwan was making a transition from import substitution to export-oriented industrialization, promoting state-owned enterprises in intermediate goods industries and private enterprises in the labor-intensive sector.²⁰ Singapore was about to adopt a state-led development model of its own, relying on state-owned enterprises (“government-linked companies”) in infrastructure-related industries and foreign multinationals in the manufacturing sector as twin engines of growth [Low(1991)].

Like these developing countries, Korea had to define the role of the state and the market, set the terms of engagement with the outside world, and find a way to access foreign resources to make up for the lack of domestic capital. The military government initially tried to pursue inward-looking industrialization under the principle of “guided capitalism.” According to the First Five-Year Plan (1962-1966) released by the Supreme Council in July 1961, the government would take charge of investment in manufacturing.²¹

²⁰ From the perspective of path dependence, it may be worthwhile to elaborate on the reaction of economic players who had vested interests in the import-substitution regime. When import-substitution policies became increasingly ineffective due to market saturation and slowed growth, Taiwanese firms appealed to the Ministry of Economic Affairs to permit them to organize cartels. Technocrats, however, were acutely aware of the limits of import-substituting industrialization given the small market size of Taiwan. Also, the growing problem of corruption under the import-substitution regime reminded political leaders of their past mistakes on the mainland. Overcoming the resistance of protected business interests, the Taiwanese government adopted an export-oriented strategy in the late 1950s [Haggard(1990)]. The installed base effect was apparently not strong enough to block the adoption of a more efficient economic system.

²¹ Although a five-year economic development plan drafted by the Chang Myun government provided the basis for the Supreme Council’s First Five-Year Plan, there was a critical difference. While the Chang Myun government basically advocated market principles, the military government

Korea would earn hard currency by exporting *primary* products and undertake massive investment projects in such *basic* industries as steel and machinery.²² The Plan insisted that such a development strategy based on the idea of “industrial deepening” was the only way to achieve economic self-reliance [Kimiya(1991)]. Seeking to consolidate political support through populist measures, the military government also expanded public works, granted pay raises to government employees, and guaranteed high prices to farmers [Haggard(1990: 67-68)].

Intended or not, these economic policies bore a striking resemblance to those adopted by Latin American countries. In the 1950s, Korea had operated a *de facto* import-substitution regime, marked more by cronyism than developmentalism. Now, it seemed that Korea was about to adopt a development-oriented import-substitution regime. Park and his followers apparently gave little consideration to the differences in resource endowments between Korea and Latin America.

A series of “historical accidents,” however, prevented this outcome and led the military government to switch to an export-oriented system. Strong economic pressure from the U.S. and decisive reaction from the fiercely nationalistic Korean leaders played a critical role in this dramatic transition.

Once the U.S. had recognized the new military government in Korea, the U.S. authorities were supportive of the development-oriented Park and his followers, but they became increasingly alarmed as the military government pursued an ambitious program of “industrial deepening.” The American experts advised the Korean government to invest in infrastructure and make the most of human capital and existing factories instead of

insisted on a capitalist system under the guidance of the state.

²² In the 1950s, an American economic advisory team to the United Nations Korean Reconstruction Agency (UNKRA) prescribed a somewhat similar strategy. This group argued for a program of infrastructure investment and import-substitution that would make Korea “self-sufficient” in five years, to be financed by large infusions of development assistance and greatly expanded primary exports [Haggard, Kim, and Moon(1991: 852)]. With the benefit of hindsight, it is rather interesting that both the military government and the American experts called for export expansion in primary products.

carrying out massive projects in heavy industries. The military government, however, pushed ahead with its industrial deepening program, trying to obtain capital for such projects as an integrated steel mill. Col. Ryu Won-sik and Prof. Park Hui-beom of Seoul National University, in particular, advocated this approach [Kimiya(1991)].

In June 1962, the Korean government even implemented a shocking currency reform program without prior consultation with the U.S. Through a compulsory deposit-for-equity swap measure, a certain portion of existing deposits was to be converted into equity shares in a new Industrial Development Corporation, which would then use these captured domestic savings to invest in heavy industries. The military government would guarantee an annual dividend return of 15 percent on these shares. The Americans were not amused. Critical of the anti-market nature of this measure and insulted by the lack of consultation, the U.S. government forced the Park government to lift the freeze on deposits by threatening to postpone economic assistance [C. Kim(1995: 81-95)].

The U.S. also insisted on an economic stabilization program. The military government had precipitated inflation that approached an annual rate of 30 percent in 1962, and the U.S. was apparently determined to prevent the military government from carrying out inflation-financed investment projects in heavy industries. The U.S. aid leverage was strengthened by a poor harvest and a foreign-exchange crisis in Korea in the second half of 1962. Faced with severe food shortages, rising prices, and dwindling foreign reserves, the military government was caught in a vulnerable position. The U.S. officials took full advantage of this to demand major economic reforms and also to press the military leaders to stick to their commitment to restore an elected regime by 1963.²³ In order to secure an adequate supply of grain for the coming months, the Korean government had little choice but to acquiesce to these demands [Mason et al.(1980: 196-197)]. In December 1962, the Korean government decided to revise the First Five-Year Plan to reflect major changes in

²³ The stabilization program pushed by the U.S. called for curtailing the budget deficit and limiting growth of the money supply to 5 percent in 1963. The following year similar restrictions plus a 50-percent devaluation were imposed as conditions for continued aid.

economic policy,²⁴ but the lessons were not lost on the Korean policymakers. Reassessing the import-substituting industrialization strategy that they had initially favored, Park and his followers began to search for radically different policies that would save them from ever being trapped in such a vulnerable position again.²⁵

Park Chung Hee certainly knew that it would take a monumental effort to overcome aid dependence. Deploring that Korea had to depend on U.S. aid for 52 percent of the supplemental budget in 1961, Park(1963: 28) noted: “Though nominally independent, the real worth of the Republic of Korea, from the statistical point of view, was only 48%. In other words, the U.S. had a 52% majority vote with regard to Korea, and we were dependent to that extent.... It showed, dramatically, that our government would have to instantly close down if the U.S. aid were withheld or withdrawn.” Park(1963: 172-173) added: “From 1956 to 1962, we have received, on the average, some 280 million dollars of economic aid each year and some 220 million in military aid. In addition, we have run a current account deficit of 50 million dollars. In other words, excluding our military sector, 330 million dollars should be earned annually to keep the Korean economy on a self-sufficient footing. Then, there is the additional problem of feeding the growing population, increasing at an annual rate of 2.88% or 720,000 newborns.” In 1962, Korea’s total exports were only 54.8 million dollars. Thus, in order to secure a sufficient

²⁴ The revised Plan advocated a free market economy, scrapping “guided capitalism” as the basic principle of economic policy. It also emphasized the importance of stabilization policy, scaled down GNP growth targets, and crossed out such investment projects as an integrated steel mill. Last but not least, the revised Plan called for a shift in export priorities from primary products to labor-intensive manufactured goods.

²⁵ In an otherwise excellent study on the transition to the export-led growth strategy in Korea, Kimiya(1991: iii) concludes that “the adoption of the export-led industrialization policy was the only choice left available” for the military government. It seems clear, however, that a regime less concerned with national economic development and economic independence could easily have settled for a “muddling-through” strategy. The objective function of the Korean government must be taken into account. Determined to reduce its dependence on U.S. aid, the Korean government actively searched for an alternative strategy for national economic development. As Kimiya himself notes, the U.S. blocked the Korean government from pursuing inward-looking industrialization, but it did not positively dictate the export-led growth strategy. The choice was far from “residual” also in the sense that the particular form of the export-led industrialization strategy adopted by the Korean government reserved a minimal role for foreign direct investment.

level of hard currency, Korea would somehow have to find a way to increase exports by more than six times. In the end, the Park government would go far beyond the orthodox economic policies prescribed by the Americans, and adopt drastic measures to promote exports and increase economic independence.

The Park government implemented three interrelated sets of economic policies that came to define the Korean model of development. First, the government accommodated the U.S. demands and instituted a set of macroeconomic reforms designed to “get the prices right” and stabilize the economy. Second, the government adopted drastic measures to share the investment risks of the private sector, providing, in particular, explicit repayment guarantees for foreign loans extended to private firms. Third, Park himself spearheaded the effort to boost exports, offering various incentives based on market performance. The resulting government-business risk partnership, for which the export market performance of private firms was used as a selection criterion, defined the core of what later came to be known as “the Korean model.”

The macroeconomic reforms ensured that Korea’s state-led development model would be a market-based one. Building on the stabilization policies of 1963-64, the government devalued the Korean won from 130 to the dollar to 255 to the dollar in May 1964. Also, in order to protect depositors from inflation and to encourage domestic savings, the government raised the ceiling on the one-year time deposit rate from 15 percent to 30 percent on September 30, 1965 [C. Kim(1995: 114)].²⁶

These orthodox policies, designed to reduce distortions in macroeconomic variables, were accompanied by dirigist measures that deliberately introduced distortions into the microeconomic incentives. The Park government knew that Korea lacked the domestic

²⁶ The actual rate applied to one-year time deposits by the banks was 26.4 percent. Ironically, this “market-oriented” policy measure had the effect of increasing the government influence in financial resource allocation because the banks were state-owned. During the three-month period from July to September 1965, fixed-term money deposits had increased by 2 billion won; whereas, from October to December, deposits soared by 12.5 billion won. For maximizing the amount of financial resources under state control, an attractive real interest rate turned out to be much more effective than forced savings measures.

resources to carry out its ambitious economic development program, but unlike Latin American countries at the time (or Southeast Asian countries in the 1980s), it was not willing to depend on foreign direct investment (FDI). Seeking to tap into foreign capital while limiting the influence of foreign multinationals, the fiercely nationalistic Korean government decided to rely heavily on foreign loans.²⁷ As domestic firms at the time lacked the credit in the international market to raise capital on their own, however, the government decided to allow state-owned banks to guarantee private-sector foreign borrowing.²⁸ All foreign loans had to be authorized by the government, and were allocated according to the policy priority of investment projects.

In taking this measure, the Park government signaled that it was willing to form a risk partnership with business leaders. Although Park Chung Hee and his followers had initially condemned some of these businessmen as “illicit wealth accumulators,” they apparently concluded that combining state monitoring with private entrepreneurship would be the most effective means of carrying out the economic development plans. The alternative of using state-owned enterprises to accelerate industrialization, as in Taiwan, was not actively pursued. In fact, while the Park government had re-nationalized the banks, it did not take over the manufacturing industries.²⁹ Although it did establish a number of new SOEs, the public enterprise sector was not viewed as a main engine of growth, especially after the row with the U.S. in 1962 over the direction of economic policy.³⁰ The government apparently decided to use its credibility to raise capital on the

²⁷ Cho and Kim(1997: 103) estimate that had investment been financed exclusively by domestic savings, the average economic growth rate during 1962-82 might have been only 4.9 percent per annum, well below the actual growth rate of 8.2 percent which was achieved with the injection of foreign capital.

²⁸ The government thus took it upon itself to resolve the information asymmetry problem for international financial institutions, which, at the time, were certainly not willing to spend the time and energy on examining the credit worthiness of private firms in Korea. In his memoir, Oh(1995: 67) recalls that the government was clearly aware of the potential moral hazard created by this arrangement from the moment it was introduced in July 1962.

²⁹ Drastic nationalization probably would have raised sensitive questions about Park’s past as a one-time communist sympathizer.

³⁰ The share of SOEs in Korea’s non-agricultural GDP increased slightly from 12.70 percent in 1963

international market and allocate financial resources to private firms, in effect *contracting out* the provision of goods and services to the private sector under a system of government monitoring as well as a guarantee on loans. In other words, private firms became agents of the state in carrying out its economic development plans, and engaged in a government-monitored contest to secure loans guaranteed by the state.

This system greatly reduced the risks of private firms in the sense that they no longer had to bear the full consequences of their actions. While it certainly encouraged investment, it had the potential of creating moral hazard. On this point, Chang(1999) argues that “the socialization of risk” may not be necessarily bad. He notes that such risk-reducing institutions as limited liability, lender-of-last-resort facilities, and state guarantees can be justified when their social benefits are greater than the social costs created by moral hazard.³¹ The benefits of risk-reducing institutions should not be overstated, however. Unless accompanied by monitoring and evaluating mechanisms designed to contain the costs of moral hazard, such institutions may actually cause more harm than good. For example, unless independent financial institutions can effectively evaluate the risks of investment projects and reduce information asymmetry for investors, the institution of limited liability may create serious problems.

Through direct monitoring and a market test based on export performance, the government tried to contain the potential costs that state-backed debt financing created. Export performance, in particular, provided the government with a relatively objective criterion for selecting private firms when it made its decision on repayment guarantees.

In order to increase economic independence through export promotion, the government also introduced a number of export incentives. The short-term export credit

to 13.14 percent in 1972 [Jones(1976: 73-74)].

³¹ Reflecting on the history of capitalism, Rosenberg(1994: 97) noted: “The willingness to undertake experiments in both the social and technological spheres depends upon some sort of limitation upon the negative consequences for the individual if the risky enterprise should fail, as it frequently did. The great technological dynamism of capitalism has been inseparable from the system’s success in reducing risk to more tolerable levels while, at the same time, offering the prospect of huge financial rewards if the risky enterprise should succeed.”

system was streamlined as early as 1961. The essence of the new system was the automatic approval of loans by commercial banks to those with an export letter of credit (L/C). In order to provide institutional support in the area of foreign marketing and technology imports, the government established the Korea Trade Promotion Corporation (KOTRA) in 1962 while an elaborate network of exporters' associations provided more industry-specific services. A nearly 50-percent devaluation of the Korean won in 1964 gave a tremendous boost to exports, and partial import liberalization, designed to allow Korean firms to purchase intermediate goods at world prices, gave an additional impetus. The government also gave exporters various tax deductions, generous wastage allowances, tariff exemptions, and concessional credits [Yoo(1996: 10-11)].³² In order to monitor export performance according to indicative targets set at the beginning of each year, the president himself chaired monthly export promotion meetings. Attended by leading government officials and businessmen, these meetings provided a forum to build a consensus on solutions to emerging problems. Strong export performers even received medals and national recognition on Export Day, which was established in 1964 to commemorate the day when Korea's annual exports exceeded 100 million dollars for the first time. Overcoming the initial export pessimism ("Who would buy our products?"), the government let comparative advantage operate and encouraged private firms to concentrate on labor-intensive industries.³³

Although the adoption of "the Korean economic system" in the 1960s was dictated more by "historical accidents" than foresight and design, it proved an efficient choice given Korea's resource endowment at the time. In 1965, the primary and secondary enrollments

³² The interest rate on export loans was subsidized heavily from the mid-1960s to the beginning of the 1980s. When the 1965 interest rate reform was implemented, the interest rate on export credit was left untouched. Consequently, the rate differential between export loans and general ordinary loans widened sharply, approaching nearly 20 percentage points [Cho and Kim(1997), pp.36-37].

³³ In 1962, labor-intensive manufactures accounted for less than 15 percent of Korea's total exports of \$54.8 million. In 1963, exports increased by \$32 million (58.4% jump!) to reach \$86.8 million, and labor-intensive manufactures such as textiles and footwear accounted for more than 80 percent of this increase. Overall, exports increased at an average annual rate of 35 percent in real terms from 1963 to 1969 [Yoo(1996: 8-9)].

in Korea were similar to the rates in countries with three times its per capita income [World Bank(1993: 45-46)].³⁴ Cheap and high-quality labor could be readily employed to produce a high rate of return on investment in physical capital, if Korea could only tap into foreign capital and technology to compensate for the shortage of domestic resources and exploit its comparative advantage. The government's decision to issue a selective guarantee on the foreign borrowing of private firms and promote exports was a solution to this developmental challenge.³⁵ The Korean government thus corrected for capital market imperfections and removed the constraints that had made it very difficult for firms to exploit profitable investment opportunities in the 1950s.

Although there is a great deal of debate on what the East Asian governments did "right" to promote economic growth, it seems clear that, at least in the Korean case, correcting for coordination failure was *not* the primary accomplishment of the government in the "take-off" stage.³⁶ As Stiglitz(1996: 160) and others have noted, coordination failure could easily be addressed through trade: it is possible to develop industries that use steel simply by importing steel without developing a steel-producing industry— and without the government having to intervene to coordinate investment in "a big push."³⁷ In

³⁴ The quality of human capital in other East Asian countries was also high relative to the level of their per capita income in the early 1960s. In fact, the real mystery of East Asia's growth experience may be why it was so poor in the early 1960s given its quality of human capital— rather than why it grew so fast over the subsequent decades. After all, the theory of conditional convergence can largely account for its rapid catch-up. Although much empirical work needs to be done, the colonial experience of East Asian countries as well as the abrupt breakdown of trading relations after World War II may explain the initially poor performance of these countries.

³⁵ For Korean firms, "learning by exporting" served as an important source of productivity improvement. Export orientation exposed Korean firms to the discipline of international competition and encouraged them to adopt advanced technology and managerial know-how.

³⁶ For a discussion on the problem of investment coordination failure in economic development, see Rosenstein-Rodan(1943) and Murphy, Shleifer, and Vishny(1989). Building on case studies in Amsden(1989) and Wade(1990), Rodrik(1994) uses the concept of coordination failure to explain the nature of government intervention in East Asia.

³⁷ Rodrik(1994) and others acknowledge the possibility of mitigating the coordination failure problem through trade, but argue that there exist some essential intermediate inputs that are not tradable. It is, however, not clear from their exposition exactly what these essential, nontradable intermediate inputs are— especially in the "take-off" stage in East Asia when labor-intensive manufactures (for example, textiles and footwear) accounted for much of the output increase.

fact, East Asian countries including Korea typically relied on imported capital goods until the size of the domestic market could justify developing an intermediate goods sector of their own. Efforts to develop heavy industries prematurely often led to serious inefficiencies. What the Korean government did in the 1960s was to correct for market failures in the international capital market as well as the *government* failures of the past, which had made it virtually impossible for firms to exploit comparative advantage. With the government addressing financing problems as well as macroeconomic imbalances, private firms could now invest and export to take advantage of unexplored profit opportunities.

The adoption of the new economic system based on export-led industrialization encountered little resistance. In the terminology of the QWERTY paradigm, the influence proportion or “market share” of policymakers attached to Syngman Rhee’s corruption-prone system was drastically reduced in the wake of the 1960 student protest and the 1961 coup. The politicians associated with Syngman Rhee’s regime were thrown out of office and put on trial. The entrenched business interests favored by the Rhee government were widely discredited. The military government, while not totally free from corruption, certainly could not advocate a return to crony capitalism and had to formulate a coherent program of economic development to shore up its legitimacy. Initially, some members of the military government argued for an “industrial deepening” strategy, but they were removed from the top posts after the U.S. raised strong objections. In the end, the technocrats and businessmen advocating an export-led growth strategy had few competitors in policymaking circles in the Park Chung Hee government.

The new Korean economic system proved a popular choice in political economy terms. In this regard, it is important to note that if a nation has a comparative advantage in the labor-intensive sector, as in the case of Korea in the 1960s, export orientation can improve the welfare of workers. In addition, politicians, bureaucrats, and business leaders naturally favored the government-business risk partnership because it provided them with a large degree of control over resources. An accidental product of strong U.S. pressure and nationalistic Korean response, the system could thus secure wide support.

4. The Evolution of the Korean Economic System: The Consolidation of the Risk Partnership

The Korean economic system centered on the government-business risk partnership encouraged rapid capital accumulation and produced spectacular economic growth. Reassured by government guarantees and subsequent economic growth, foreign financial institutions expanded loans to Korean firms and provided the lion's share of necessary capital for investment projects.³⁸ As a result, Korea's external debt skyrocketed from \$206 million (6.9 percent of GNP) in 1965 to \$2,277 million (23.7 percent of GNP) in 1970 [Cho and Kim(1997)]. Korean firms, for their part, dramatically increased their leverage while their profitability actually *declined*: the debt-equity ratio of manufacturing firms, as measured by their total liabilities divided by net worth, rose from 92.7 percent in 1965 to 328.4 percent in 1970.³⁹ While encouraging investment conducive to rapid economic growth, the Korean system thus led to a highly leveraged corporate sector that became extremely vulnerable to shocks.

Although the Korean system was designed to contain idiosyncratic moral hazard by making government support contingent on market performance, it was not prepared to deal with the increased *systemic* risks as manifested in the higher leverage of private firms. Apparently successful firms kept borrowing to expand their business under government guarantees on foreign debt, and neither the government nor the private sector stopped to think seriously about the potential toll that a major economic downturn would take on heavily indebted firms.

³⁸ In the First and Second Five-Year Economic Development Plan periods (1962-71), foreign savings accounted for 52.8 percent and 39.4 percent of total investment, respectively. The share of foreign savings in investment remained significant through the 1970s, hovering around 20 percent.

³⁹ During the same period, the net profit-to-net worth ratio of manufacturing firms declined from 15 percent to 11 percent. Normally, a firm with a high debt-equity ratio would be expected to have a high return on average in order to compensate for the high risk of default. From 1970 to 1997, the debt-equity ratio of Korean manufacturing firms generally exceeded 300 percent while their profitability barely improved.

When a recession threatened to topple the debt-plagued corporate sector, the government had to intervene to contain the systemic risks it had helped to build up through its repayment guarantees. The rationale for such intervention thus involved something more than a simple “too big to fail” bailout, where the government rescues large firms because it fears the potential fallout from their bankruptcies (for example, Chrysler)—even though the government might not have been involved in their business decisions at all.⁴⁰ In the Korean case, the source of the *ex post* government intervention was the *ex ante* government intervention: as the government exercised a great deal of influence in the resource allocation decisions of financial institutions, the government had to bear responsibility for the consequences of these decisions. The logic of the Korean economic system demanded that the government be trapped in a vicious cycle of intervention. The state-led heavy and chemical industry (HCI) drive in the 1970s reinforced these tendencies, as the government adopted an industrial targeting approach and channeled a tremendous amount of resources to large business groups. By the end of the 1970s, it seemed that the government provided an implicit guarantee on the governance rights of the incumbent owner-managers of large conglomerates as well as the repayment of their debt.

(1) The Investment Boom in the 1960s and the Emergency Decree of 1972

The government-business risk partnership and high economic growth fueled what may be characterized as an investment explosion in the second half of the 1960s. In particular, in 1968 and 1969, investment increased at an average rate of nearly 50 percent per annum and domestic credit expanded at over 60 percent. Inflation as measured by the GNP deflator exceeded an annual rate of 15 percent. The current account deficit ballooned from \$191.9 million (4.5 percent of GNP) in 1967 to \$440.3 million (8.5 percent of GNP) in 1968 and \$548.6 million (8.3 percent of GNP) in 1969.

The reckless investment boom inevitably produced a number of firms that could not meet their foreign debt obligations. Fearing that the uncontrolled bankruptcy of these

⁴⁰ Moreover, the incumbent management may be replaced even if the firm is rescued in such a bailout.

firms would adversely affect Korea's credit ratings, the government took over the managerial control of 30 such firms in May 1969. The government decided to seize and dispose of the assets of the owner-managers of these companies while providing relief to the state-owned banks that had issued repayment guarantees. Companies whose going-concern value was believed to be greater than the liquidation value were restructured under government leadership [C. Kim(1995: 256)]. Concerned with the moral hazard implications of a blanket bailout exercise, the government thus took a principled stance against insolvent firms and held the management of these firms accountable for their previous business decisions. After all, the government had guaranteed only the repayment of private-sector foreign debt to the foreign lenders. It had never guaranteed the protection of governance rights to the incumbent owner-managers.

As the Korean economy showed signs of overheating near the end of the 1960s, the International Monetary Fund (IMF) stepped in to prescribe a stabilization package. The government initially resisted, but had to accept the package in 1970, when the United States made the consideration of additional developmental loans contingent upon the acceptance of the IMF program [Cho and Kim(1997: 81)]. The Park government clearly had yet to secure the level of economic independence that it sought, and the U.S. pressure again served as a stabilizing force for the Korean economy.

Consequently, monetary expansion slowed from 52 percent in 1968 and 45 percent in 1969 to 11 percent in 1970, and under tight credit control, the commercial banks could not provide much relief to firms with a heavy debt burden. Financially strapped firms had to turn to the last available resort: the curb market. A part of the dualistic financial system in Korea, the informal curb market served as an alternative source of capital for households and firms as the officially sanctioned financial institutions channeled most of their resources to high-priority investment projects. The curb market interest rate hovered around 50 percent in 1970, when the nominal interest on general bank loans was around 24 percent [Cho and Kim(1997: 82)].

A currency devaluation of 18 percent in 1971 and an additional 7 percent in the following year aggravated the foreign debt burden of firms. A worldwide economic slowdown made things worse. Tight credit control, devaluation, and worldwide recession took a heavy toll on Korean firms. The debt-equity ratio of manufacturing firms climbed to 394.2 percent in 1971 as many of them had to borrow money to make interest payments. The interest expenses-to-net sales ratio, which had been around 5 percent in the mid-1960s, reached as high as 9.9 percent in 1971. By 1971, hundreds of firms could not meet their debt obligations, and the heavily leveraged corporate sector was on the verge of a collapse. Korea was now with a systemic crisis [C. Kim(1994: 66-70)]. Business leaders urged the government to take extraordinary measures. In a meeting with Park Chung Hee in June 1971, the president of the Federation of Korean Industrialists (FKI), representing big business interests, urged the government to reduce taxes, expand money, supply, and have the banks take over the “usurious” curb loans to relieve the debt burden of “hard-working entrepreneurs” [C. Kim(1995: 263)]. Unlike in 1969, the government felt that it could no longer take a principled stance against insolvent firms.

In the end, the Park government decided to bail out the debt-plagued corporate sector and issued the Presidential Emergency Decree for Economic Stability and Growth on August 3, 1972. Commonly referred to simply as “the August 3 Measure,” the Emergency Decree placed an immediate moratorium on the payment of all corporate debt to the curb lenders and called for an extensive rescheduling of bank loans at a reduced interest rate. The moratorium was to last three years, after which all curb funds had to be turned into five-year loans at a 1.35% monthly interest rate, or an annual rate of 16.2 percent— when the prevailing market rate exceeded 40 percent.⁴¹ Furthermore, approximately 30 percent of the short-term high-interest commercial bank loans to firms were converted into long-term loans on concessional terms. The debt restructuring was ultimately backed by the central bank, which accepted special debentures issued by the

⁴¹ After the declaration of the moratorium, when all curb lenders and debtors were ordered to register with the government, the amount of informal curb loans turned out to be equal to 42 percent of total bank loans in the formal financial sector. It showed the extent to which the corporate sector had become dependent on the curb market.

commercial banks. These measures shifted the crushing debt burden of the corporate sector to curb lenders and ordinary citizens, who wound up paying an inflation tax [Bank of Korea(1973); Cho and Kim(1997: 84)].

Table 3. Economic Trends in Korea Before and After the 1972 Emergency Decree (1964-1978)

(Percent Per Annum, Percent)

	Growth Rate of Investment	Rate of Inflation	Interest Rate on Bank Loans	Interest Rate On Curb Loans	Total Liabilities/ Net Worth	Net Profit/ Net Worth
1964	13.3	30.0	16.5	61.80	100.5	15
1965	19.3	5.8	18.5	58.92	92.7	15
1966	84.0	14.6	26.0	58.68	117.7	17
1967	25.2	15.9	26.0	56.52	151.2	17
1968	52.3	16.1	25.8	56.04	201.3	16
1969	45.1	15.5	24.5	51.36	270.0	14
1970	11.3	15.5	24.0	50.16	328.4	11
1971	24.9	12.5	23.0	46.44	394.2	4
1972	3.7	16.7	17.7	39.00	313.4	17
1973	40.7	13.6	15.5	33.24	272.7	30
1974	30.2	30.5	15.5	40.56	316.0	23
1975	24.9	25.2	15.5	47.88	339.5	17
1976	77.1	21.3	16.1	40.47	364.6	22
1977	43.1	16.6	15.0	38.07	350.7	21
1978	45.1	22.8	17.1	41.70	366.8	23

Source: Bank of Korea, *Economic Statistics Yearbook and Financial Statements Analysis*, various issues; Cho and Kim(1997).

Note: The last two columns are the average figures for manufacturing firms (weighted by net worth).

What would have happened had the government not intervened? Massive business failures would have ensued. The owner-managers of bankrupt firms would have lost their ownership and control stakes, banks and curb lenders would have suffered huge losses, and many ordinary citizens would have become the victims of unemployment. For those firms whose going-concern value was deemed to be greater than the liquidation value, creditors would have used a combination of debt forgiveness, debt rescheduling, and debt-equity swaps. These firms would have survived after restructuring, but their owner-managers would have been replaced. Some combination of a tax increase and inflation would have been necessary in the ensuing financial restructuring process.

The August 3 Decree forced “usurious” curb lenders and disorganized taxpayers to share losses, but left the owners and managers of firms and banks intact.⁴² Furthermore, no government officials took responsibility for the macroeconomic mismanagement of the late 1960s, which served as the background for the crisis in 1972. The major players in the government-business risk partnership thus all escaped blame.⁴³ Violating the property rights of the creditors in the informal curb market, the government relieved the debt burden of the private firms it had come to rely on as agents to carry out its ambitious economic development plans.

After the economy recovered, the government did try to make up for the excesses of the Emergency Decree by attempting to improve the corporate governance and financial structure of major private firms. The government believed that opening up family-owned enterprises to public shareholding would lead to the emergence of modern corporations characterized by dispersed ownership and professional management. The government also felt that public listing would allow firms to issue equity to finance their long-term investment and reduce their dangerous dependence on debt. Until 1972, the year before the introduction of the Law on Facilitating the Opening Up of Corporations, only 66 firms had gone public since the opening of the stock exchange in 1956.⁴⁴ From 1973 to 1979,

⁴² In his statement on the August 3 Decree, President Park declared: “Many enterprises are burdened with usurious loans while some other businesses camouflage themselves as if they were burdened with these loans in an attempt to evade taxes. The situation should be redressed not only for the protection of conscientious businesses but also for social purification.” Camouflaged curb loans for tax evasion and other purposes turned out to be one-third of the total amount.

⁴³ Note that the August 3 Decree, in a way, held the curb lenders accountable for their previous lending decisions. Recall that the rate differential between the curb market rate and the interest rate on general bank loans was around 25 percentage points prior to the declaration of the moratorium. This differential in part reflected a risk premium as the curb market took into account the insolvency risks of financially strapped firms. Although the moratorium on curb loans was imposed in an arbitrary manner, the losses suffered by the curb lenders could be justified as a consequence of their “high risk, high return” lending strategy. In a more market-oriented resolution of insolvency, however, the curb lenders would have assumed control of the bankrupt firms as a quid pro quo for their losses. The governance rights of the incumbent owner-managers would not have been protected.

⁴⁴ Excessive speculation, combined with the absence of an appropriate regulatory mechanism, had brought about several national bond market and stock market crashes in Korea.

more than 300 companies went public [C. Kim(1994: 73-74)]. In spite of this apparent success, the public listing of firms failed to produce the intended results. Because the government neglected to introduce institutions designed to reduce agency problems and protect the property rights of minority shareholders, the separation of ownership and control actually worsened the corporate governance of Korean firms. Also, entrepreneurs continued to prefer debt to equity as a means of raising capital. Although equity financing could reduce leverage, the owner-managers were not willing to share ownership and control with people outside the family. Moreover, the Emergency Decree of 1972 had shown that an excessive reliance on debt would not only go unpunished but might actually be rewarded by the government— as long as other companies also depended heavily on debt.⁴⁵

In retrospect, the August 3 Decree was a watershed event in the evolution of the Korean economic system. It established the precedent that the government would take extraordinary measures to relieve financial distress when necessary— *without* holding the management of firms and banks accountable for their previous investment and lending decisions. The government gave a strong impression that it would not only guarantee repayment on private-sector foreign borrowing but also protect the governance rights of the incumbent owner-managers in a crisis situation. The August 3 Decree thus ushered in a new era characterized by the deepening of the government-business risk partnership. The tough stance that the government took against the incumbent owner-managers of insolvent firms in 1969 was a distant memory.

(2) The HCI Drive in the 1970s and Its Aftermath

The heavy and chemical industry (HCI) drive in the 1970s further consolidated the government-business risk partnership. In the second half of the 1960s, the government

⁴⁵ In other words, there may be *isolated* cases of bankruptcies— especially for firms without a close relationship with the government. In fact, the government did let prominent business groups such as Kaepung, Yulsan, Dongmyung, and Kukje go bankrupt. When a large number of business groups were on the verge of a collapse, however, firms could reasonably expect a rather different response from the government based on their experience with the Emergency Decree of 1972.

had already started making plans to develop the intermediate goods sector as a part of its “industrial upgrading” program. The newly established state-owned enterprises began construction of a petrochemical complex and an integrated steel mill in the late 1960s. A new urgency was added in the early 1970s as the U.S. announced that it would reduce its forward-deployed troops in Asia in the wake of the Vietnam War. One of the two U.S. infantry divisions stationed in Korea since the end of the Korean War departed in 1971, forcing the Korean government to embark on a crash program of military modernization. The government felt that Korea must develop the heavy and chemical industries if it was to have the ability to manufacture its own weapons. The Park government officially launched the HCI drive in 1973 [Oh(1995); C. Kim(1995)].⁴⁶

In order to minimize time and exploit scale economies in establishing the capital-intensive intermediate goods sector, the government decided to rely on a select group of large conglomerates and provide them with extremely generous financial support. The idea of setting up a public-sector holding company in the heavy and chemical industries was briefly discussed in policymaking circles, but was rejected in favor of using established private firms with government financial support.⁴⁷ Known as chaebol, these large family-based conglomerates would drastically increase their share of GDP thanks primarily to government support.⁴⁸

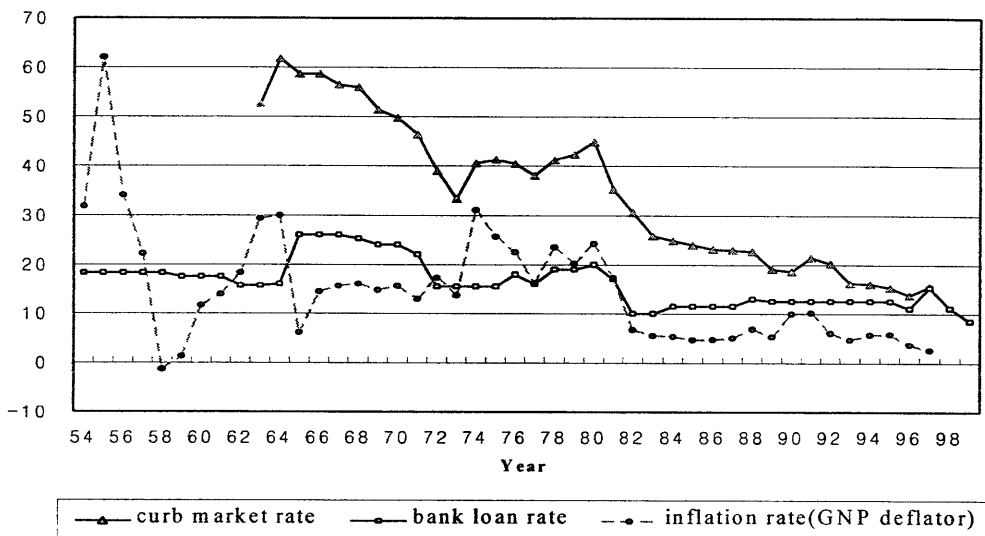
⁴⁶ Meanwhile, in October 1972, Park Chung Hee declared a state of national emergency and adopted a new constitution that gave dictatorial powers to the president, eliminated term limits, and abolished direct presidential elections. Under the new Yushin Constitution, Park had the power to appoint one-third of the members of the National Assembly. Through a series of emergency decrees, he also banned discussion on the constitution. Thus, in a span of less than six months, Park Chung Hee introduced a series of measures that seemed more compatible with a totalitarian system than a democratic one: the Emergency Decree for Economic Stability and Growth in August, the Yushin Constitution in October, and the HCI drive in January 1973. A constitutional amendment in 1969 that allowed a third term for Park had laid the foundation for the move toward increasing authoritarianism.

⁴⁷ In contrast, the state-owned enterprises in Taiwan carried out the bulk of investment projects in the heavy and chemical industries.

⁴⁸ The chaebol, which literally means “a wealth clique,” may be defined as “a large business group that owes a significant portion of its growth to state support and is disproportionately controlled by a family with partial ownership.” Although the chaebol has become notorious for its large size and

In December 1973, the government established the National Investment Fund (NIF) to finance long-term investment in the heavy and chemical industries. In 1974, the NIF interest rate was set at 9.0 percent when the prevailing three-year interest rate on bank loans was 15.5 percent. In real terms, the NIF provided loans at a significantly negative rate. The banks also supported the HCI drive by providing policy-oriented loans on favorable terms.

Figure 3. Interest Rates and Inflation



Source: Bank of Korea, *Economic Statistics Yearbook*, various issues; KDI internal data.

Note: The curb market rate is the interest rate applied to “Grade A” firms.

For the 1954-1995 period, the bank loan rate is the interest rate at the end of each year on general loans with a maturity of one year or less for general enterprises. Effective July 1996, the monthly bank loan rate is calculated as the weighted average of the interest rates on new loans incurred in that month. The annual bank loan rate is equal to the December rate.

high degree of diversification into unrelated fields, these characteristics are primarily the *consequences* of the chaebol’s competitiveness as well as distortions in capital and product markets (due to state intervention in financial resource allocation and weak domestic competition). The *essence* of the chaebol has much more to do with its corporate governance (i.e. partial ownership and complete control by a family dynasty) and its political power which influences the state in economic decisions. Given these defining features, the chaebol may behave more like a rule-setter than a rule-taker, and may have an objective function that diverges significantly from profit maximization for the firm as a whole.

As Figure 3 shows, this was a dramatic departure from the second half of the 1960s. The interest rate could no longer operate as an effective price signal in the resource allocation process.⁴⁹

During the late 1970s, HCIs accounted for almost 80 percent of all fixed investment in the manufacturing sector when their share in the manufacturing sector’s output was around 40 percent. As a result, a myriad of small- and medium-sized enterprises in the light manufacturing industries were in effect pushed aside by a select group of chaebol firms that expanded their business empires thanks to generous government support. The Park government’s relentless drive for the HCIs was called off only when serious macroeconomic imbalances and political problems forced it to adopt a comprehensive stabilization package in April 1979 [Stern et al.(1995)]. Prices were rising at an annual rate of more than 20 percent, and the external debt was approaching almost 50 percent of GNP. The expansion of the large conglomerates at the expense of smaller enterprises was also eroding political support for Park Chung Hee’s increasingly dictatorial regime.⁵⁰

Table 4. Chaebol’s Value Added as a Share of GDP

	1973	1974	1975	1976	1977	1978	1979	1980	1981
Top 5	3.5	3.8	4.7	5.1	8.2	8.1	-	-	-
Top 10	5.1	5.6	7.1	7.2	10.6	10.9	-	-	-
Top 20	7.1	7.8	9.8	9.4	13.3	14.0	-	-	-
Top 46	9.8	10.3	12.3	12.3	16.3	17.1	16.6	19.5	24.0

Source: SaKong(1993).

⁴⁹ An important side effect of this distortionary policy was a real estate boom, as people tried to protect themselves against inflation. Firms that had access to low-interest loans even used a portion of these funds to purchase land. Starting from the level of 100 in 1975, the land price index soared to 328.1 by 1980, while the consumer price index increased to 220.9.

⁵⁰ Popular disenchantment with political oppression, inflation, and a newly introduced value-added tax produced an electoral upset in 1979, in which the opposition received a greater percentage of popular votes than the ruling party in National Assembly elections.

The HCI drive in the 1970s transformed the government-business risk partnership decidedly in favor of large conglomerates. Unlike in the 1960s, government support during the HCI drive was not contingent on export market performance and had a strong industry-specific bias. As only a select group of large conglomerates were favored, the bias seemed almost *firm-specific*. During the heyday of the HCI drive from 1974 to 1978, it was not uncommon for chaebol groups to triple their number of affiliates with new acquisitions in the heavy and chemical industries. As Table 4 shows, the share of top chaebol groups in GDP greatly increased in this period. This increase in economic concentration was primarily a result of extremely generous financial support provided by the government rather than a by-product of market-based resource allocation.

Park Chung Hee apparently felt serious misgivings about these developments. He expressed displeasure whenever he heard people refer to a family-based conglomerate as a “group,” which carried a connotation of empire-building. He pointed out that some family-owned conglomerates had an excessive number of affiliates and concentrated wealth in the hands of a few people. When the firms that greatly benefited from the Emergency Decree of 1972 were slow to go public, Park instructed the cabinet in May 1974 to speed up the public listing of these companies, “warning family-owned conglomerates against their incessant expansion efforts via borrowing from the banks” [C. Kim(1994: 122-123)].

Ironically, it was Park’s ambitious HCI drive itself that enabled these firms to borrow heavily from the banks and expand their empires in the first place.⁵¹ Pressed by government officials for whom security concerns overrode economic calculus in the 1970s, financial institutions kept lending to the favored large conglomerates without carrying out a

⁵¹ Haggard(1980: 132) argues that in addition to the HCI drive, restrictive rules toward foreign investors and the creation of general trading companies (GTCs) suggested an explicit policy of promoting industrial concentration. Qualifying as a GTC led to numerous financial privileges, but the government imposed steadily rising capital and export requirements that limited the GTC club to the largest ten to twelve Korean firms. In spite of the reservations that Park Chung Hee might have expressed about the large conglomerates, his policy in the 1970s greatly increased economic concentration.

risk analysis of their own. Although Park might have felt that he could always control the chaebol firms like “quasi-SOEs,” he was in fact creating behemoths that would come to dominate the Korean economy and change the government-business risk partnership in their favor. Having channeled massive resources into the chaebol firms to carry out high-priority investment projects— sometimes over the initial objection of their owner-managers, the government had to take responsibility should these projects turn sour. Moreover, the gigantic size and high leverage of the chaebol firms strengthened the case for a “too big to fail” argument should a crisis strike.⁵²

These developments had a profound impact on the Korean economic system. When the government was forging a risk partnership with private firms in the 1960s by guaranteeing repayment on their foreign borrowing, it certainly did not intend to guarantee the governance rights of the incumbent owner-managers. Nor did it necessarily favor the chaebol firms.⁵³ The Emergency Decree of 1972 and the HCI drive, however, transformed the nature of the government-business risk partnership and exacerbated moral hazard. The Emergency Decree set the precedent that the government would take extraordinary measures to deal with a systemic crisis *without* holding the incumbent management of firms and banks accountable for their previous business decisions. The installed base of business interests with a high debt burden pushed the government to move in this direction. Subsequently, the industrial targeting approach adopted during the HCI drive trapped the government in a vicious cycle of intervention, and the massive financial support extended to the top chaebol firms transformed the government-business risk partnership in favor of these family-based conglomerates.

⁵² The Daewoo experience in the 1970s provides an example. During the HCI drive, the Park government asked Daewoo, a textile and trading company, to take over a machine-tool manufacturer and a shipyard, as well as enter the automobile industry. In the process of complying with the government’s wishes, Daewoo’s debt-equity ratio climbed to 900 percent. When Daewoo could not meet its debt obligations, the government had to bail it out.

⁵³ Some may argue that the government’s guarantee on private-sector foreign borrowing naturally favored larger firms. Although this point is well taken, access to credit in the 1960s did not guarantee success— or even survival as in the case of insolvent firms in 1969. In contrast, the government support during the HCI drive had a built-in large firm bias and also provided implicit protection from bankruptcy, because the government had a greater role in investment decisions.

5. Delayed Reform and Crisis: The Politicization of the Risk Partnership

Although the government called off its ambitious HCI drive in April 1979 to stabilize the economy, the second oil shock and the assassination of Park Chung Hee in October 1979 made things worse. In 1980, the Korean economy registered a negative 3.7 percent growth rate, a shocking figure for a nation that had become used to an annual growth rate of around 8 percent. A new military regime, led by General Chun Doo Hwan, came into power and introduced drastic measures to control inflation. The government devalued the won, imposed an IMF-backed austerity package, and cut subsidies to the HCIs. In addition, the technocrats who were entrusted by Chun to run the economy advocated a transition to a more market-oriented system. They felt that excessive state intervention had produced serious moral hazard and had driven the economy to the verge of a debt crisis.

The technocrats were aware of the dilemma that the government faced. Since the collapse of a large chaebol group would bury the financial system in nonperforming loans, the government was more or less obliged to guarantee the chaebol's stability. This implicit guarantee, however, encouraged the chaebol to undertake excessive investment. Expecting to be bailed out should a crisis strike, they would discount the downside risks and invest wildly— unless restrained by the government. In order to maintain economic stability, the government thus found itself having to intervene in the investment decisions of private firms.

The technocrats believed that the solution to this apparent dilemma required the government to let market forces operate and allow a nonviable chaebol to go bankrupt while containing the fallout from its collapse. The technocrats also thought that the government would have to hold the incumbent owner-managers accountable for their previous decisions and refrain from intervening in the investment decisions of private firms in the future. Moreover, autonomous financial institutions, free from the control of the

government *and* industrial capitalists, would have to be allowed to make decisions on their own and bear the full consequences of their actions. The government would have to re-define its role and focus on competition policy and prudential regulation rather than allocate financial resources according to its industrial policy objectives. In other words, the government would have to stop providing direction and insurance to private firms, but limit its role to setting “the rules of the game” and providing a social safety net. This series of decisive measures would serve as a credible signal that the regime had indeed changed.

The technocrats believed that the government no longer had any excuse to intervene in the investment decisions of private firms. Much had changed since the 1960s. The domestic savings rate had more than doubled, and Korea could now finance most of its investment needs by itself— unless, of course, the state orchestrated an investment binge like the HCI drive. Successful Korean firms no longer needed the government’s repayment guarantee on their foreign debt as they could now raise capital on their own. Moreover, as the economy became more complex, it became increasingly difficult for the government to identify profitable investment opportunities and monitor the performance of individual firms.⁵⁴ State intervention in the economy also invited corruption. The reform-minded technocrats felt that “the Korean economic system” had served its purpose and should be replaced by a more market-oriented system.

By this time, however, the Korean economic system had produced a coalition of economic players who were interested in consolidating and maintaining the government-business risk partnership. Politicians and bureaucrats wanted to hold on to the levers of

⁵⁴ According to Jones and SaKong(1980: xxxv), “the more than fivefold expansion of the economy from 1961 to 1979, plus equally dramatic alterations in structure, make control techniques appropriate to the simple environment of the 1960s inappropriate for the 1980s.” They added: “Decentralization of decision-making, reduced reliance on command, increased use of field manipulation and the market, and reduced discretion of civil servants all become increasingly desirable in a more complicated environment where the information available to a small number of civil servants is a decreasing share of the total needed to run the economy.” They were also clearly aware that demand for equity and social justice would rise with income and that the rapid increase in the level of business concentration would pose a serious problem. SaKong later served as Chief Economic Advisor to Chun Doo Hwan in the 1980s.

control, especially in the area of financial resource allocation. Business leaders wanted the government to continue providing loan guarantees and other support. Although ordinary citizens periodically had to bear the brunt of restructuring costs when a recession produced massive nonperforming loans and the government decided to socialize the losses, they were disorganized and, on balance, might have been satisfied with the economic growth that the system produced. Certainly, as evidenced by the experience of Taiwan and Singapore among others, the Korean economic system was not the only system that could produce rapid growth. Whenever some reform-minded policymakers advocated a transition to a more market-oriented system, however, the installed base of economic players with system-specific interests would impede reforms. In the end, reform-minded policymakers would be pushed aside by bureaucrats who were more willing to accommodate the wishes of the entrenched interests. Although the system was no longer efficient, it would persist until the crisis of 1997.

(1) Partial Liberalization and Democratization in the 1980s

The technocrats who initiated policy reforms in the early 1980s believed that distortions in the financial sector had to be removed if Korea was to move toward a more market-oriented system. The interest rate gap between policy loans and general loans was almost completely eliminated in 1982. In addition, the government reoriented its policy away from industry targeting toward functional support, such as for R&D.

In 1983, the government privatized the major commercial banks while placing ceilings on the equity share of industrial capitalists so as not to repeat the mistakes of the 1950s. Had this round of bank privatization resulted in the effective transfer of control to the private sector, it would have marked the beginning of a transition to a more market-oriented system. While relinquishing its holdings in the banks, however, the government retained its governance rights by basically requiring the appointment of bank managers to be approved by the Ministry of Finance. Apparently, the reform-minded technocrats could not overcome the resistance of politicians and bureaucrats who were interested in retaining their control over the allocation of financial resources. Instead of carrying out a

comprehensive bank privatization program, the government relaxed entry barriers for non-bank financial institutions (NBFIs) and expanded their business boundaries as a means of promoting competition in the financial sector. As the government allowed industrial capitalists to own NBFIs, however, this policy introduced a new source of distortion into financial resource allocation.

In fact, a series of liberalization packages adopted by the government proved to be less than adequate for overhauling the government-business risk partnership. Korea passed a fair trade law in 1980, but the government concentrated on placing behavioral restrictions on the chaebol groups instead of relaxing restrictions on M&As and promoting competition in the product market.⁵⁵ In addressing the chaebol problem, the government preferred to rely on direct controls rather than allow market forces to operate in both the product and M&A markets. Behavioral restrictions were employed as the main instruments of competition policy. Structural remedies, such as divestiture, were never used. The government also neglected to introduce institutions designed to provide private remedy. Bureaucrats took it upon themselves to discipline firms through *ad hoc* regulations instead of allowing private citizens to address their problems through legal channels. Firms only had to take care of the bureaucrats as they faced almost no threat of private litigation.

Also, although a large bilateral trade surplus that began to surface in the second half of the 1980s led to increased U.S. pressure for the liberalization of trade and foreign investment, significant barriers remained. For instance, an import diversification policy, justified on the grounds of Korea's bilateral trade deficit with Japan, effectively limited the import of Japanese consumer goods. Nationalist sentiment against foreign direct

⁵⁵ In fact, the formal title of this fair trade law itself, the Monopoly *Regulation* and Fair Trade Act, reflected a preoccupation with bureaucratic controls. Established antitrust practices in other countries typically regard monopolies as something to be busted or broken up rather than administratively regulated. For firms that *legally* monopolized the market through superior skills or historical accidents, such a drastic structural remedy may not be warranted, but even in this case, a sensible policy response is competition promotion rather than regulation. A notable exception to this rule is natural monopolies.

investment remained strong, and the government as well as business leaders did little to change the closed mindset of ordinary citizens. Although Korea's exports amounted to nearly 30 percent of its GDP in the 1980s, it remained hostile to FDI.

On the whole, partial liberalization in the 1980s improved the position of chaebol groups in the Korean economy. Although the government managed to retain some levers of control, deregulation and control over the NBFIs gave these firms much greater financial freedom than in the 1970s. At the same time, as the Korean market remained more or less closed to foreign multinationals, the chaebol groups were spared from tough competition.

Unfortunately, progress in de-protection failed to match this partial progress in de-control. In fact, the 1980s saw an increasing politicization of the government-business risk partnership as political connections rather than economic fundamentals appeared to play a more important role in the survival of firms. These tendencies were reinforced after Korea's democratization in 1987, as competitive elections were held without adequate checks on campaign financing and spending.⁵⁶ The chaebol groups made contributions to politicians, and at least, they seem to have believed that political connections nurtured through contributions would protect them from bankruptcy.⁵⁷

⁵⁶ After Korea was democratized in 1987, it seemed inevitable that the economic system associated with a succession of authoritarian regimes was due for fundamental reform. The actual changes were, however, less than overwhelming. Workers made up for the wage suppression of the first half of the 1980s and began to raise equity issues. The government accommodated their demands and took various measures to improve income distribution. On the matter of establishing a more market-oriented economic system, however, politicians and bureaucrats made little progress. Most of them were unwilling to let go of the benefits that they enjoyed by intervening in the resource allocation process.

⁵⁷ These expectations were reflected in their investment patterns. A firm that expects the government to provide protection against bankruptcy would have a higher rate of investment and tend to increase investment when uncertainty rises because it discounts downside risks. Hahn(2000) shows that compared with other firms, top-ranking chaebol groups indeed maintained higher investment rates and tended to increase investment when uncertainty rose.

(2) The Crisis: Déjà Vu All Over Again

As the mid-1990s approached, most of the problems in the Korean economic system remained unresolved. Although the government no longer pursued traditional industrial policy, it retained some important levers of control. In particular, it continued to control the banks and market entry through licensing decisions. The government also appeared to provide implicit guarantees on loans. The chaebol groups, in turn, exploited the residual influence of the government to extract favors and carry out ambitious investment projects with little concern for insolvency risks. They provided political donations in return. The government-business risk partnership was becoming increasingly dysfunctional in an era of liberalization and democratization.

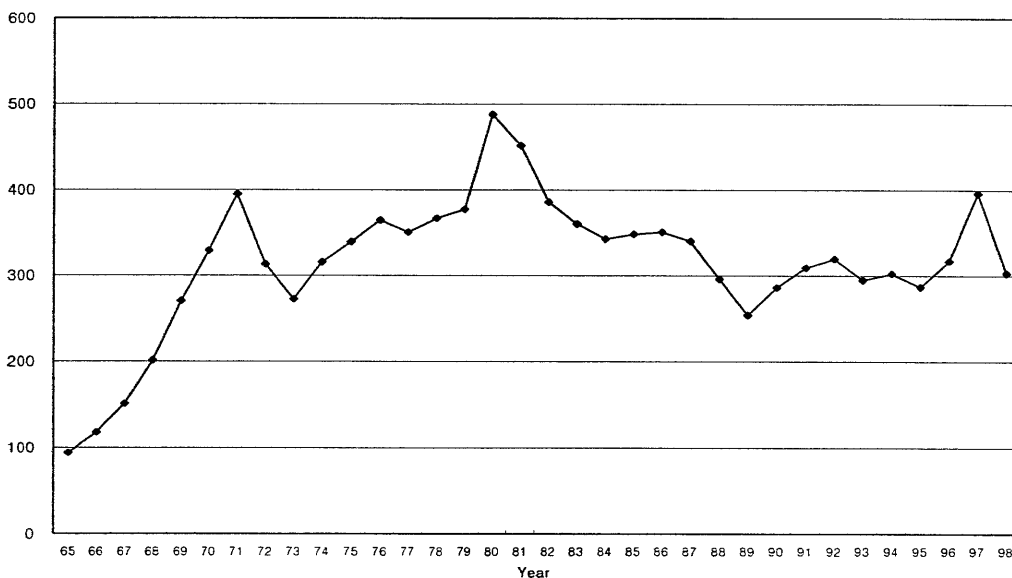
In 1995, the average debt-equity ratio of the top 30 chaebol groups was 347.5 percent. The lower-ranking firms (No. 11 to No. 30) were earning a negative average return on assets since 1993. Halla, Jinro, and Sammi, in particular, had a debt-equity ratio of over 2,000 percent as they piled up losses. Financial institutions, however, continued to provide credit to these companies. In 1996, the average debt-equity ratio of the top 30 chaebol groups climbed to 386.5 percent, but the financial institutions still propped up the debt-plagued conglomerates. In April 1996, Korea's terms of trade began to decline sharply as the prices of semiconductors collapsed. The decline in the terms of trade reached 20 percent by the end of the year, and it turned out to be Korea's biggest terms-of-trade shock since the oil shock [Shin and Hahm(1998)]. In 1997, the average debt-equity ratio of the top 30 chaebol groups reached 519.0 percent.⁵⁸ Korea was on the brink of yet another debt crisis.⁵⁹

⁵⁸ In 1997, the average debt-equity ratio for the Korean manufacturing sector as a whole was 396 percent. Comparable figures for the U.S., Japan, and Taiwan were 154 percent, 193 percent, and 86 percent, respectively.

⁵⁹ On December 1, 1997, three major political parties proposed that the government allow firms to defer their debt service obligations and freeze wages. Recall that back in 1971, it was the Federation of Korean Industrialists that urged the government to take similar measures.

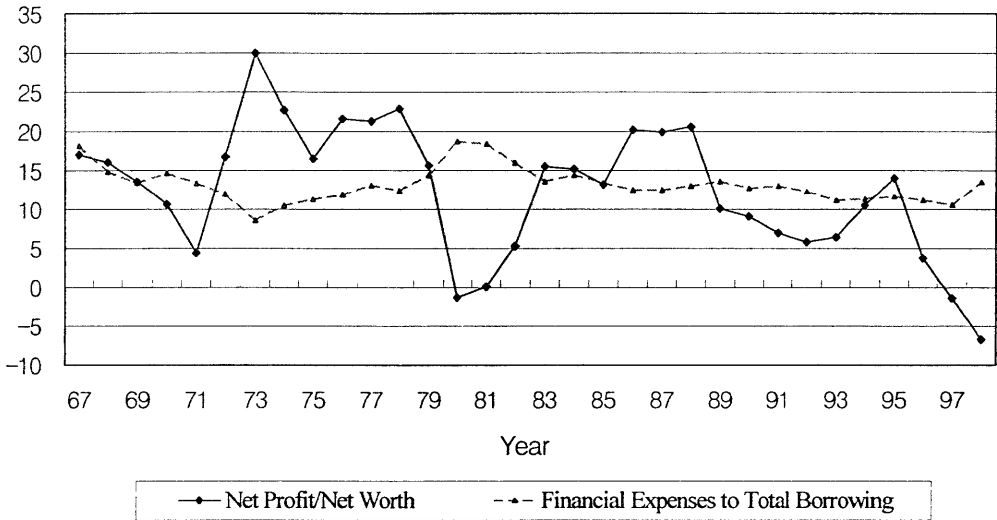
The evolution of the Korean economic system over the past four decades indicates that the crisis of 1997 was not really a unique event— as compared to the crises of the early 1970s and 1980s. On the surface, the economic crisis of 1997 had some features of a liquidity crisis due to Korea’s low foreign reserves, heavy reliance on short-term foreign debt, and loss of confidence by foreign investors. It must be recalled, however, that the series of chaebol bankruptcies led to the loss of confidence and triggered the international bank run on Korea, not the other way around. If Korea had secured a sufficient level of reserves, it might have been able to avoid a currency crisis, but it still would have had to face a serious problem with nonperforming loans.

Figure 4. Average Debt-Equity Ratio of the Korean Manufacturing Sector



Source: Bank of Korea, *Financial Statements Analysis*, various issues.

Figure 5. Profitability and Opportunity Cost of Capital



Source: Bank of Korea, *Financial Statements Analysis*, various issues.

Note: Total borrowing does not include non-interest-bearing IOUs.

Figures 4 and 5 illustrate the basic nature of the problem with the Korean corporate sector. Korean firms have relied excessively on debt financing, even when carrying out massive investment projects with a long gestation period. Figure 4 shows that Korean firms dramatically increased their leverage in the second half of the 1960s after the government decided to provide explicit repayment guarantees on private-sector foreign borrowing. This trend was reversed in 1972 due to the August 3 Emergency Decree, but the average debt-equity ratio remained above 300 percent for most of the pre-crisis period.

It would be one thing if Korean firms had a sufficiently high profit rate to cover interest expenses, but their rate of return on net worth has been below the opportunity cost of capital for much of the past two decades. In fact, Figure 5 shows that prior to the economic crisis of 1997, there were only two sub-periods during which the profitability of Korean manufacturing firms was significantly above the opportunity cost of capital: (1) 1972-1978, when the corporate sector's debt burden was artificially reduced by the Emergency Decree of 1972 and the low-interest rate policy during the ensuing HCI drive;

and (2) 1986-1988, when the Korean economy enjoyed the so-called “three-low” boom characterized by low oil prices, low international interest rates, and a low value of the won relative to the Japanese yen after the Plaza Accord of 1985.⁶⁰

How could Korean firms operate on such a thin margin of error when they certainly knew that they were extremely vulnerable to shocks? How could they be so cavalier in discounting the downside risks? The answers to these questions can be found in the way the nature of the government-business risk partnership has evolved in Korea.

⁶⁰ The semiconductor boom of the mid-1990s had only a temporary effect on the profitability of Korean firms.

6. Conclusion

Unlike the typically ahistorical arguments that try to explain the 1997 economic crisis by simply dismissing even the very existence of Korea's economic success in the past, this paper has attempted to provide an alternative explanation using the concept of path dependence within a political economy context. Applying the QWERTY paradigm to the evolution of the Korean economic system, the paper has argued that the very success of the system created a coalition of economic players interested in preserving the system, even when it became increasingly dysfunctional in a changed environment. The paper has covered four main topics: (1) the adoption of the Korean economic system, (2) the initial success of the system, (3) the seeds of failure in the system, and (4) the persistence of the system. The main arguments of the paper are summarized in the remaining pages.

■ Why the Korean Model of Economic Development Was Adopted

In the terminology of the QWERTY paradigm, the influence proportion or “market share” of policymakers attached to Syngman Rhee's crony capitalism was drastically reduced in the wake of the 1960 student protest and the 1961 coup. Although the evolution of economic systems is typically marked by path dependence due to the influence of the entrenched interests, the corruption-prone system under the Rhee government lost its supporters in the changed political environment, and this provided an opening for competition among alternative economic systems.

Initially, Park Chung Hee's military government pursued an “industrial deepening” program, in which the government would have carried out massive investment projects in basic industries financed by increased primary exports, foreign loans, and forced domestic savings plus inflation. In the second half of 1962, however, the Park government was forced to abandon this strategy when the U.S. used its aid leverage to demand stabilization measures and also to press the military leaders to stick to their commitment to restore an elected regime by 1963. Determined to avoid being trapped in such a vulnerable position again, the Park government went far beyond the orthodox economic policies prescribed by

the Americans, and adopted drastic measures to promote exports and increase economic independence.

First, the Park government accommodated the U.S. demands and instituted a set of reforms designed to reduce distortions in such macroeconomic variables as the exchange rate and the interest rate. Second, the government took unprecedented steps to share the investment risks of the private sector. In particular, the state-owned banks provided explicit repayment guarantees to foreign financial institutions on loans extended to Korean firms. Third, Park Chung Hee himself spearheaded the effort to boost exports, offering various incentives based on market performance. The resulting government-business risk partnership, combining state-led financial resource allocation with export market orientation, defined the core of the Korean economic system.

■ Why the Korean Economic System Was Successful

The Korean model of development proved an efficient choice given the country's resource endowment at the time. In the early 1960s, the primary and secondary enrollments in Korea were similar to the rates in countries with three times its per capita income. Cheap and high-quality labor could be readily employed to produce a high rate of return on investment in physical capital, if Korea could only tap into foreign capital and technology to compensate for the shortage of domestic resources and exploit its comparative advantage. The government's decision to issue a selective guarantee on private-sector foreign borrowing and promote exports was a solution to this developmental challenge.

What the Korean government did "right" in the take-off stage was of a different nature than is usually pointed out in the existing literature.⁶¹ The market failure

⁶¹ Neoclassical perspectives typically trace Korea's economic success to a set of market-oriented macroeconomic reforms in 1964 and 1965 [Krueger(1979)]. These measures by themselves, however, would not have been very effective in correcting for the imperfections in the international capital market. It was basically impossible for then-little-known Korean firms to tap into foreign resources. Statist perspectives, by contrast, point to the pervasive distortion of microeconomic incentives ("getting the prices wrong") by the Korean government, and argue that such government intervention promoted rapid economic growth [Amsden(1989)]. It is unclear, however, whether

effectively addressed by the government in the 1960s was due to the imperfections in the international capital market rather than coordination failures in the domestic manufacturing sector. Far more important for Korea's economic growth, however, was the Park government's effort to correct for the *government failures* of the past: the policies designed to generate arbitrage opportunities that had made it virtually impossible for firms to exploit Korea's comparative advantage. With the government addressing financing problems as well as macroeconomic imbalances, private firms could now invest and export to take advantage of unexplored profit opportunities. Rapid capital accumulation, combined with learning by exporting, was the key to Korea's economic success.

■ Why the System Became Increasingly Dysfunctional

Changes in the nature of state guarantees as well as changes in the economic environment led to serious problems in the Korean economy. Driven by internal logic, the nature of state guarantees changed in the direction of exacerbating moral hazard. Moreover, government intervention itself became increasingly ineffective as Korea was liberalized and democratized.

Although the Korean system was initially designed to contain idiosyncratic moral hazard by making government support contingent on market performance, it was increasingly exposed to systemic risks as apparently successful firms kept borrowing to expand their business under government guarantees on foreign debt. When an economic slowdown threatened to topple the debt-plagued corporate sector in 1972, the government decided to issue an emergency decree to relieve the debt burden of the firms. This drastic measure fundamentally changed the nature of state guarantees: the government gave a strong impression that it would not only guarantee repayment on private-sector foreign borrowing but also protect the governance rights of the incumbent owner-managers in a crisis situation. The state-led heavy and chemical industry (HCI) drive aggravated the

the Korean economy grew thanks to or in spite of government intervention. Although more sophisticated statist studies advance "coordination failure" arguments, they are less than convincing in showing the existence of essential, nontradable intermediate inputs in the "take-off" stage *and* demonstrating the role of the government in coordinating the production of these goods.

problem as the government was increasingly trapped in a vicious cycle of intervention. The politicization of the government-business risk partnership in the 1980s exacerbated moral hazard as firms making political donations came to expect the government to protect them from downside risks.

By the 1980s, it had become possible for successful Korean firms to raise capital on their own. It had also become increasingly difficult for the government to identify profitable investment opportunities and monitor the performance of individual firms. Moreover, increased domestic and foreign pressure for liberalization and democratization forced the government to relinquish some important policy instruments that it had used to motivate and discipline private firms. Given the reduced desirability and effectiveness of government intervention in the economy, policymakers should have fundamentally re-defined the role of the government. The lack of such reform, combined with increased moral hazard, proved fatal for the Korean economy.

■ Why Fundamental Reforms Were Delayed

By the beginning of the 1980s, the Korean economic system had produced a coalition of economic players who were interested in consolidating and maintaining the government-business risk partnership. In the terminology of the QWERTY paradigm, these players commanded a large “market share” in policymaking circles. Although domestic and foreign pressure for liberalization and democratization did lead to the adoption of some market-oriented reforms, the government-business risk partnership continued to dominate and blocked fundamental reforms.

As early as the beginning of the 1980s, many technocrats advocated a transition to a more market-oriented system. Backed by a new political leadership determined to arrest the inflationary spiral in the wake of the second oil shock, the technocrats were able to impose tough stabilization measures and to reorient economic policy away from the industry targeting approach of the HCI drive. They were, however, far less successful in introducing policies designed to enhance the autonomy of the financial sector and to promote competition in the product and M&A market. The politicians and bureaucrats

were certainly unwilling to relinquish the levers of control. The state control of the banks continued, and the government took a decidedly bureaucratic approach to competition policy. The chaebol groups tried to expand their influence in the financial sector through the ownership of non-bank financial institutions, and limit the presence of foreign multinationals in the domestic market. In short, the economic players interested in preserving the existing economic system were empowered to make policy decisions.

In general, once an economic system is well-established, it is very difficult to introduce fundamental changes because the economic players interested in preserving the existing system tend to be the ones who wield a great deal of influence in the policymaking process. The Korean model of economic development itself was adopted only when the entrenched interests associated with the old corruption-prone system were wiped out in the wake of a student revolution and a military coup. As for the new economic system based on the government-business risk partnership, the chances for fundamental change were smaller than in the case of the old system. It was not just because the new system was far more successful than the old one. In the case of the old system, which was based on crony capitalism, a political upheaval throwing out the entrenched interests would do the trick— if it is followed by an institutional reform designed to reduce rent-seeking in the economy. In the new system, however, a political upheaval replacing one set of policymakers with another would not result in a fundamental change— unless the new politicians and bureaucrats were willing or forced to relinquish their control over the economy. Even in the wake of the economic crisis, Korea has made little progress in this regard.

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