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PATH DEPENDENCE IN ACTION: THE ADOPTION AND PERSISTENCE OF THE KOREAN MODEL OF ECONOMIC DEVELOPMENT

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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.

As Table 6.1 shows, Korea’s economic performance over the three decades before the 1997 Asian economic crisis was truly exceptional. Although the Korean model of economic development has come under heavy criticism since the 1997 crisis, no such criticism would seem convincing without some explanation for its apparent success in the past.

Table 6.1
Comparative growth experience, 1960–1990
(percent per year)

<i>Regions and Countries^a</i>	<i>Output</i>		<i>Labor: Number of Workers</i>	<i>Physical Capital</i>		<i>Human Capital</i>	
	<i>GDP</i>	<i>per Worker</i>		<i>Total</i>	<i>Physical</i>	<i>Labor</i>	<i>Years of</i>
			<i>Physical Capital</i>	<i>Capital per Worker</i>	<i>Quality^b</i>		
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).

^aRegional averages are weighted by each country's average GDP between 1960 and 1990.

^bThe 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 (primary, secondary, and tertiary).

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. 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. 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 reassignment 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 path-dependence mechanism that led to the economic crisis of 1997 in Korea. After a brief analysis of the consolidation of Korea’s government-business risk partnership, this section examines how the installed base of economic actors interested in preserving this system prevented Korea from adopting fundamental reforms.

2. THE QWERTY PARADIGM AND COMPETING ECONOMIC SYSTEMS

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. When the adoption probabilities depend positively on the current market shares, the allocation process exhibits increasing returns. Because the expected network size of such an increasing-returns system is positively influenced by 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. 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 (David 1985, 2000; Arthur 1994).

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. 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. Depending on the level of organization and the payoff structure associated with policy choices, these economic players exert varying degrees of influence on the decision-making process.

The objective function of policymakers may not be efficiency maximization, just as the typewriter manufacturers’ objective function is not. 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. 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.

3. THE ADOPTION OF THE KOREAN MODEL OF ECONOMIC DEVELOPMENT

Korea achieved national unity and established a centralized rule in the mid-seventh century, a remarkably early date by any standard. A pyramidlike structure, with the central government at the apex, characterized the social organization of Korea for more than a thousand years. 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 2000). The elite scholar-officials at the center could easily exploit mass society and engage in factional rent-seeking competition. Alternatively, "the best and the 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 a brief but brutal Japanese colonial rule (1910–45).

The end of the Japanese colonial rule meant that Korea was confronted with the crucial tasks of reassigning property rights and reestablishing 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. 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, Syngman Rhee, the first president of the Republic of Korea, took a

rather myopic and politically motivated approach. In fact, Rhee's use of policy instruments to finance elections and other party activities through a close alliance with select private firms played a dominant role in a succession of economic decisions during his presidency (1948–60).

After the outbreak of the Korean War in 1950, the United States reassessed Korea's geostrategic importance and provided generous aid and assistance.¹ 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. 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. 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 (Haggard 1990, p. 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 "enemy properties" resulted in windfall gains for favored businessmen and an undue concentration of economic power. The overvaluation of the Korean currency, designed to maximize arbitrage opportunities, had the effect of severely discouraging exports.

When a student protest in April 1960 finally put an end to the Syngman Rhee government, Korea was in a dismal state. 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. In fact, a cross-country study on economic development shows that Korea had a rather unusual economic structure in the early 1960s (Perkins 1997). 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, slightly over 10 percent of GNP, was unusually low, nearly 20 percentage points below the average. Even more remarkable was the extremely low share of exports; 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.

Coming in the wake of the Student Revolution of April 1960, which had put an end to the corruption-prone regime under Syngman Rhee, the "Military Revolution" of May 1961 provided the political background for the adoption of the Korean model of economic development. Upon seizing power through a bloodless coup, General Park Chung Hee 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 1963).

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 centralize economic policymaking, the military government established the Economic Planning Board (EPB) in July 1961. The EPB was charged with the task of formulating and implementing five-year economic development plans based on an "indicative planning" approach. The military government also took several measures to strengthen the role of the state in resource allocation. After the student revolution of April 1960, prominent businessmen were accused of having grown rich through political connections with the previous 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 forced them to turn in their equity shares in commercial banks as "fines." This drastic measure paved the way for the government to exert direct control over commercial banks, in effect renationalizing the banks that had been privatized in the late 1950s. In a little more than a year, the military government thus established various levers of control. The question remained, however, what kind of state-led system it would be.

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. 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.² 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 gain access to 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 (1962–66) released by the Supreme Council in July 1961, the government would take charge of investment in manufacturing. Korea would earn hard currency by exporting *primary* products and undertake massive investment projects in such *basic* industries as steel and machinery. 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, pp. 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. 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 United States and decisive reaction from the fiercely nationalistic Korean leaders played a critical role in this dramatic transition.

The U.S. authorities were initially 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 carrying out massive projects in heavy industries. The military government, however, pushed ahead with its program, trying to obtain capital for such ambitious projects as an integrated steel mill (Kimiya 1991).

In June 1962 the Korean government even implemented a shocking currency reform program without prior consultation with the United States. 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 antimarket 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, pp. 81–95).

The United States 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 United States 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. The U.S. officials took full advantage of this to demand major economic reforms and also to press the military leaders to honor their pledge to restore an elected regime by 1963.³ 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, pp. 196–97). In December 1962 the Korean government decided to revise the First Five-Year Plan to reflect major changes in economic policy,⁴ 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. 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 economic 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 to foreign institutions that extended loans 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 primarily 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, p. 114).

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 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. Because domestic firms at the time lacked the standing in the international capital market, however, the government decided to take up the problem of asymmetric information and allow state-owned banks to issue a repayment guarantee to foreign financial institutions that provided loans to Korean firms.

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 most 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 (SOEs) to accelerate industrialization, as in Taiwan, was not actively pursued.⁵ The government decided to use its credibility to raise capital on the 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. Through direct monitoring and a market test based on export performance, the government tried to contain the potential costs of moral hazard 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 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. The government also gave exporters various tax deductions, generous wastage allowances, tariff exemptions, and preferential policy loans.⁶ 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. 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. Aware of Korea’s comparative advantage in the 1960s, the government encouraged private firms to concentrate on labor-intensive industries.⁷

Based on export-led industrialization and state guarantees on private-sector foreign borrowing, the Korean model of economic development proved an efficient choice given Korea’s resource endowment at the time. In 1965 the primary and secondary enrollments in Korea were similar to the rates in countries with three times its per capita income (World Bank 1993, pp. 45–46).

Cheap and high-quality labor could be readily employed to produce a high rate of return on investment in physical capital, if Korea could 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. 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.

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 (Krueger 1979; Amsden 1989; Rodrik 1995). The market failure effectively addressed by the government in the 1960s was due to the imperfections in the international capital market rather than coordination failures involving nontradable goods 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 in the 1950s. 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.

In the terminology of the QWERTY paradigm, once the "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, the adoption of the Korean model of economic development was driven more by "historical accidents" than by foresight and design. 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, the economic policy of the military government was heavily influenced by those who argued for an "industrial deepening" program, in which the government

would have carried out massive investment projects in basic industries. In the second half of 1962, however, they lost their influence when the United States 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 military government accepted advice from the technocrats and businessmen advocating an export-led growth strategy and went far beyond the orthodox economic policies prescribed by the Americans. Incidentally, the new Korean economic system proved a popular choice in political economy terms as well. 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. An accidental product of strong U.S. pressure and nationalistic Korean response, the system could thus secure wide support.

4. CONSOLIDATION, DELAYED REFORM, AND CRISIS

Korea's economic development model centered on export-led industrialization and 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.⁸ 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, soared from 92.7 percent in 1965 to 328.4 percent in 1970. 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.

When a serious economic slowdown following the investment explosion of the late 1960s threatened to topple the debt-plagued corporate sector in 1972, 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. 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 an annual rate of 16.2 percent—when the prevailing market rate exceeded 40 percent. The August 3 Emergency Decree forced “usurious” curb lenders and disorganized taxpayers to share losses, but left the owners and managers of firms and banks intact.

In retrospect, the August 3 Emergency Decree of 1972 marked a watershed in the evolution of the Korean economy. When the government was forging a risk partnership with private firms in the 1960s by guaranteeing repayment on their foreign borrowing, the government issued a repayment guarantee to foreign financial institutions rather than to Korean firms. Aware of moral hazard created by insurance, the government certainly did not intend to guarantee the governance rights of the incumbent owner-managers (O 1995). The Emergency Decree of 1972, however, 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. Moreover, the Emergency Decree seemed to imply that an excessive dependence 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.

The government could have chosen a more market-oriented solution instead of strengthening the government-business alliance. In a sense, the two alternatives represented competing economic systems at the time. Under a more market-oriented approach, the government would have separated the problem of financial restructuring from that of protecting the governance

rights of incumbent owner-managers. 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. The installed base of economic players interested in preserving the government-business risk partnership, however, pushed the government away from adopting a more market-oriented solution. 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. The August 3 Emergency Decree of 1972 thus fundamentally changed the nature of state guarantees and ushered in a new era characterized by the deepening of the government-business risk partnership.

The ensuing heavy and chemical industry (HCI) drive aggravated moral hazard because the government was increasingly trapped in a vicious cycle of intervention (Stern et al. 1995). 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. The banks as well as the newly established National Investment Fund supported the HCI drive by providing policy-oriented loans at a *negative* real interest rate. In order to minimize time and exploit scale economies in establishing the capital-intensive HCI sector, the government relied on a select group of large family-based business groups and provided them with extremely generous financial support. Known as *chaebol*, they more than doubled their share of GDP during the heyday of the HCI drive from 1973 to 1978.

The HCI drive in the 1970s transformed the government-business risk partnership decidedly in favor of these family-based business groups. Unlike in the 1960s, international competitiveness (that is, "market test") no longer operated as a selection criterion. Although Park Chung Hee might have felt that he could always control the chaebol firms as "quasi-SOEs," he was in fact creating behemoths that would come to dominate the Korean economy. Having channeled massive resources into the chaebol 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 strengthened the case for a “too big to fail” argument should a crisis strike.

These developments in the 1970s had a profound impact on Korea’s development paradigm. The Emergency Decree of 1972 and the HCI drive consolidated the government-business risk partnership and exacerbated moral hazard. The installed base of business interests with a high debt burden pushed the government to provide financial relief at the expense of curb lenders. 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 consolidated the government-business risk partnership.

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 was beginning to force 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 redefined the role of the government.

In fact, as early as the beginning of the 1980s, many technocrats did advocate a transition to a more market-oriented system (Jones and SaKong 1980). They were clearly aware of the dilemma that the government faced. Since the collapse of a large chaebol 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 solution to this apparent dilemma was for the government to let market forces operate and allow a nonviable chaebol to go bankrupt while containing the fallout from its collapse. 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 redefine 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 and enforcing “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.

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 capital market. By this time, the Korean economic system had produced a coalition of economic players who were interested in consolidating and maintaining the government-business risk partnership. 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 tried to expand their influence in the financial sector through the ownership of nonbank financial institutions, and to limit the presence of foreign multinationals in the domestic market. 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.

The lack of fundamental reform proved fatal for the Korean economy. In 1995 the average debt-equity ratio of the top thirty chaebol was 347.5 percent. The lower-ranking groups (numbers eleven to thirty) had been 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 thirty chaebol 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 price 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. In 1997 the average debt-equity ratio of the top thirty chaebol reached 519.0 percent. Korea was on the brink of yet another debt crisis.

The Korean experience illustrates that 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 were 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. Only in the wake of the economic crisis has Korea begun to make substantial progress in this regard.

NOTES AND REFERENCES

Notes

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1. Foreign aid financed nearly 70 percent of total imports to Korea 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, p. 185).

2. 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 because of 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).

3. The stabilization program pushed by the United States 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.

4. 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.

5. General Park Chung Hee had once organized communist sympathizers in the Korean Army before he converted to the cause of anticommunism. Drastic nationalization and extensive reliance on SOEs probably would have raised sensitive questions about Park's past as a one-time communist sympathizer.

6. 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).

7. 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 to \$86.8 million (a 58.4 percent jump!), 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, pp. 8–9).

8. 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.

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