Path Dependence in Action:
The Rise and Fall of the Korean Model of Economic Development

by

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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 its 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 implicit guarantees for loans extended to private firms on a selective basis. 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 governments 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)] 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.

This historical experience begs the following set of question: 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 early 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 by 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 made it difficult for reform-minded policymakers to introduce fundamental changes that would have placed Korea on a more sustainable, less crisis-prone development trajectory.

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 “decentralized 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 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 economic players interested in preserving this system. On the whole, a market test based on export performance and direct government monitoring contained the dangers of this risk partnership. When a major economic downturn raised the specter of massive bankruptcies, however, the government had to step in to carry out a bailout program and restructure the highly leveraged corporate sector. The government in effect provided large private firms with direction and insurance, control and protection, in this system. Section 5 examines why efforts to reduce state intervention and moral hazard were delayed, even though the Korean system became increasingly dysfunctional in an era of liberalization and democratization. The capacity 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
the principle of *de-control with de-protection*. The economic crisis of 1997 should be understood
within this context.

2. The QWERTY Paradigm and 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.\(^1\) Interpreted as
an exemplar of decentralized 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)] 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
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 sight, for the nature of decision-making involved in the adoption and evolution of economic
systems seems very different from that in the case of technological systems. Can individuals really

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\(^1\) 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.
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? Isn’t an economic system a result of 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-substitution 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 economic players in such countries are “locked in” to this dominant system. Even in such 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.

Policymakers advocating one 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 system-specific investments. Policymakers advocating different economic systems within the government may be regarded as analogous to keyboard designers championing different keyboard arrangements at typewriter manufacturers. Moreover, it is important to note that the government officials’ objective function may not be efficiency maximization, just as typewriter manufacturers’ objective function is not. The private motive of government officials, as well as “historical accidents,” may have a critical and lasting effect on the adoption and evolution of economic systems, especially when increasing returns are significant. Under such conditions, the most efficient economic system may not be adopted even if it can be identified. Furthermore, a system that was once efficient but is no longer so may persist. For example, Dertouzos et al.(1989) have argued that the previous success of America’s

\footnote{In their comparative analysis of institutions, Aoki and Okuno-Fujiiwara(1996) have identified 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}
mass production system made it difficult for Americans adapt to the new world of flexible manufacturing.

3. The Adoption of the Korean Economic System: Initial Conditions and Historical Accidents

Applying the QWERTY paradigm to the adoption of the Korean model of economic development requires an analysis of initial conditions and historical accidents that affected the subsequent decision-making process. In particular, political incentives and constraints faced by policymakers demand 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) has 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 the mass society and engage in a factional cultural beliefs.
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 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 in the Korean peninsula, however, the Americans increasingly began to support conservative forces. As a result, the socialist option was all but eliminated in the south.

Syngman Rhee, the first president 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 Liberal Party, however, he took a variety of measures to weaken his potential competitors and consolidate his power base. For instance, a land reform launched in 1949 was in part designed to reduce the political power of landowners. 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,

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3 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.
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, 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.

The sale of vested properties (“enemy properties”) provides a good example. When the Americans initially put up the Japanese industrial properties for sale, few Korean nationals could meet the qualifications and 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. Certainly, SOEs and “the mixed economy” commanded a degree of respectability around the world in the aftermath of the Great Depression and World War II,\(^4\) and many developing countries, including Taiwan, were nurturing SOEs as an integral part of their economic development program.\(^5\) Rhee’s desire to cement a close relationship with businessmen, however, precluded this type of state-led development approach. The government instead lowered the requirements for the sale of state properties to facilitate privatization, and in return for their windfall gains, businessmen made contributions to Rhee’s Liberal Party.

The privatization of banks in the 1950s illustrates this process. The government initially put up banks for sale in 1954 with a number of provisions to prevent windfall gains and to insure the separation of banking and commerce. These provisions were designed to address the concerns of

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\(^4\) For instance, Clement Attlee confidently declared: “The doctrines of abundance, of full employment, and of social security require the transfer to public ownership of certain major economic forces and the planned control in the public interest of many other economic activities.” [Harris(1982: 254)]

\(^5\) 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)]
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 the Korean War in 1950, the U.S. reassessed Korea’s geostrategic importance and began to provide generous aid and assistance. 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 repayment of the advances at a rate that significantly undervalued the dollar. His reasoning was clear: The possession of foreign exchange and aid goods at less than their market value would create arbitrage opportunities, and it would allow him to distribute favors to businessmen willing to provide kickbacks to the Liberal Party. His control over imported grains and other goods also allowed him to distribute largesse directly to government employees and others. 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)]

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6 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 to 8 percent of GNP. Net foreign savings, as measured by the current account deficit of the balance of payment, averaged 9 percent of GNP for this decade. [Mason et al.(1980: 185)]
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. Technocrats genuinely concerned with economic development received little support. The sale of vested properties resulted in windfall gains for favored businessmen and undue concentration of economic power. The overvaluation of the Korean won, designed to maximize arbitrage opportunities, had the effect of 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. Import substitution in Korea was more a result of crony capitalism than a strategy for economic development.

When a student protest in 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 was one of the lowest in the world. The savings rate 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.

In fact, in a cross-country study on economic development, Perkins(1997) has noted that Korea had a rather unusual economic structure in the early 1960s. The share of agriculture and mining in 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. Fish, silk, tungsten, and other primary products made up the bulk of Korea’s exports in the early 1960s.

(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.⁷ In the

⁷ 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.
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 takes precedence over military 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’s, 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. He also created the Economic Planning Board (EPB) in June 1961 through a merger of several policymaking functions of different ministries. 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. A super-ministry headed by a deputy prime minister, the EPB was charged with the task of formulating and implementing five-year economic development plans.8

In addition to these institutional innovations, which centralized economic policymaking, the military government took several measures to strengthen the role of the state in resource allocation. After the coup in 1961, the military government accused prominent businessmen of having grown rich through political connections with the Syngman Rhee regime. Labeling them “illicit wealth

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8 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 socialist system was not a viable option in Korea in the 1960s.
accumulators,” the government 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. 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—say, as measured by the share of government spending in GNP—remained relatively small, the power of the state was overwhelming. Park Chung Hee and his followers clearly had in mind an economic system that was dominated by the state. They did not know, however, exactly what kind of state-led system that they wanted.

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 perhaps rely on foreign capital to accelerate economic development. Given these conditions, some countries opted for the socialist system while others tinkered with market-based systems. 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. [Haggard(1990)] 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 initial steps taken by the Park government were, however, not very encouraging. Seeking to consolidate political support through populist measures, the military government expanded public works, granted pay raises to government employees, and guaranteed high prices to farmers. The first Five-Year Economic Development Plan (1962-1966) did call for export expansion in both primary products and manufactures, but exports were to be used primarily to finance the development of infrastructure and basic industries. [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. [Haggard(1990: 67-68)] U.S. authorities had been initially enthusiastic about the development-oriented Park and

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9 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. The installed base effect was apparently not strong enough to block the adoption of a more efficient economic system.

10 The installed base of protected business interests under the Syngman Rhee regime played a minimal role in
his followers, but they became increasingly alarmed after mid-1962 as the military government went on a spending spree and precipitated inflation that approached an annual rate of 30 percent. The economic situation was aggravated by poor harvests in 1962 and 1963. Faced with severe food shortages, rising prices, and dwindling foreign-exchange 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.\footnote{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.} 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)] 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.

Park Chung Hee certainly knew that it would take monumental effort to overcome aid dependence. Deploiring 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 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.

In the next few years, 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 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 insured 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 overnight the one-year time deposit rate from 15 percent to 30 percent in 1965. [Kim(1995: 114)]

These orthodox polices, designed to reduce distortions in macroeconomic variables, were accompanied by dirigist measures that deliberately introduced distortions into microeconomic incentives. The Park government knew that Korea lacked 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 direct foreign investment. 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. As domestic firms at the

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12 Cho and Kim(1997: 103) estimates 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.
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. 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 pursued. In fact, while the Park government had re-nationalized banks, it did not take over manufacturing industries and established only a handful of new state-owned enterprises. The government apparently 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 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

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13 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 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 that it was introduced in July 1962.

14 Drastic nationalization probably would have raised sensitive questions about Park’s past as a one-time communist sympathizer.
greater than their social costs created by moral hazard. 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.

In the Korean economic system, direct monitoring and a market test based on export performance generally tended to contain the costs that state-backed debt financing created. Export performance, in particular, provided the government with a relatively objective criterion to select private firms when it made its decision to extend 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 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.

Reflecting on the history of capitalism, Rosenberg (1994: 97) has 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.”

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]
Attended by leading government officials and businessmen, these meetings provided a forum to build 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 initial export pessimism (“Who would buy our products?”), the government let comparative advantage operate and encouraged private firms to concentrate on labor-intensive industries.17

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, primary and secondary enrollments in Korea were similar to the rates in countries with three times its per capita income. [World Bank(1993: 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 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.18

The Korean system also proved a popular choice in political economy terms. In this regard, it is important to note that if a nation has comparative advantage in the labor-intensive sector, as was 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 as it provided them with a great degree of control over resources. An accidental product of strong U.S. pressure and nationalistic Korean response, the system could thus secure wide support.

17 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)]

18 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.

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.\(^{19}\) 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 rose from 92.7 percent in 1965 to 328.4 percent in 1970.\(^{20}\) [Kim(1991)] While encouraging investment necessary for 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 increased systemic risks as manifest in the higher leverage of private firms. Apparently successful firms kept borrowing to expand their business under government debt guarantees, 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 recession threatened to topple highly leveraged firms, the government had to intervene in the restructuring effort as it had intervened in the prior financial resource allocation process. 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— even though the government might not have been involved in their business decisions

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\(^{19}\) 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.

\(^{20}\) During the same period, the net profit to net sales ratio of manufacturing firms declined from 7.9 percent to 3.3 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.
at all. 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 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. [Kim(1995: 256)] Concerned with moral hazard implications of a blanket bailout exercise, the government thus took a principled stance against

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21 Moreover, the incumbent management may be replaced even if the firm is rescued in such a bailout.
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 conditional on the acceptance of the IMF program. 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 in 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 the end of 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 faced with a systemic crisis. Business leaders urged the government to take extraordinary measures, and unlike in 1969, the government felt that it could no longer take a principled stance against insolvent firms. [Kim(1994: 66-70)]
### Economic Trends in Korea Before and After the 1972 Emergency Decree (1964-1978)

(Percent Per Annum, Percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth Rate of Investment</th>
<th>Growth Rate of Exports</th>
<th>Rate of Inflation</th>
<th>Interest Rate on Bank Loans</th>
<th>Interest Rate On Curb Loans</th>
<th>Debt/Equity Ratio (a)</th>
<th>Net Profit/Net Sales Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964</td>
<td>13.3</td>
<td>37.2</td>
<td>30.0</td>
<td>16.5</td>
<td>61.80</td>
<td>100.5</td>
<td>8.6</td>
</tr>
<tr>
<td>1965</td>
<td>19.3</td>
<td>47.0</td>
<td>5.8</td>
<td>18.5</td>
<td>58.92</td>
<td>92.7</td>
<td>7.9</td>
</tr>
<tr>
<td>1966</td>
<td>84.0</td>
<td>42.9</td>
<td>14.6</td>
<td>26.0</td>
<td>58.68</td>
<td>117.7</td>
<td>7.7</td>
</tr>
<tr>
<td>1967</td>
<td>25.2</td>
<td>27.9</td>
<td>15.9</td>
<td>26.0</td>
<td>56.52</td>
<td>151.2</td>
<td>6.7</td>
</tr>
<tr>
<td>1968</td>
<td>52.3</td>
<td>42.2</td>
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<td>25.8</td>
<td>56.04</td>
<td>201.3</td>
<td>6.0</td>
</tr>
<tr>
<td>1969</td>
<td>45.1</td>
<td>36.7</td>
<td>15.5</td>
<td>24.5</td>
<td>51.36</td>
<td>270.0</td>
<td>4.3</td>
</tr>
<tr>
<td>1970</td>
<td>11.3</td>
<td>34.2</td>
<td>15.5</td>
<td>24.0</td>
<td>50.16</td>
<td>328.4</td>
<td>3.3</td>
</tr>
<tr>
<td>1971</td>
<td>24.9</td>
<td>27.8</td>
<td>12.5</td>
<td>23.0</td>
<td>46.44</td>
<td>394.2</td>
<td>1.2</td>
</tr>
<tr>
<td>1972</td>
<td>3.7</td>
<td>52.1</td>
<td>16.7</td>
<td>17.7</td>
<td>39.00</td>
<td>313.4</td>
<td>3.9</td>
</tr>
<tr>
<td>1973</td>
<td>40.7</td>
<td>98.6</td>
<td>13.6</td>
<td>15.5</td>
<td>33.24</td>
<td>272.7</td>
<td>7.5</td>
</tr>
<tr>
<td>1974</td>
<td>30.2</td>
<td>38.3</td>
<td>30.5</td>
<td>15.5</td>
<td>40.56</td>
<td>316.0</td>
<td>4.8</td>
</tr>
<tr>
<td>1975</td>
<td>24.9</td>
<td>13.9</td>
<td>25.2</td>
<td>15.5</td>
<td>47.88</td>
<td>339.5</td>
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<tr>
<td>1977</td>
<td>43.1</td>
<td>30.2</td>
<td>16.6</td>
<td>15.0</td>
<td>38.07</td>
<td>350.7</td>
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<tr>
<td>1978</td>
<td>45.1</td>
<td>26.5</td>
<td>22.8</td>
<td>17.1</td>
<td>41.70</td>
<td>366.8</td>
<td>4.0</td>
</tr>
</tbody>
</table>

Note: (a) total liabilities/net worth of manufacturing 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 the maximum annual interest rate of 16.2 percent—when the prevailing market rate exceeded 40 percent.\(^{22}\) 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 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. [Cho and Kim(1997: 84)]

\(^{22}\) When, after the moratorium, 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.
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 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 Measure forced curb lenders and ordinary citizens to share losses, but left the owners and managers of firms and banks intact. Furthermore, no government officials took responsibility for the macroeconomic mismanagement of the late 1960s, which served as the background for the crisis in 1972. Major players in the government-business risk partnership thus all escaped blame.

After the economy recovered, the government did try to improve the corporate governance and financial structure of major private firms by pressing them to go public. 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. From 1973 to 1979, more than 300 companies went public. [Kim(1994: 73-74)] In spite of this apparent success, the public listing of

23 Note that the August 3 Measure, in a way, did hold the curb lenders accountable for their previous lending decisions by imposing heavy losses on them. 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 taken over the control of bankrupt firms as a quid pro quo for their losses. The governance rights of the incumbent owner-managers would not be protected.

24 Excessive speculation had brought about several national bond market and stock market crashes in Korea.
firms failed to produce 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.
Moreover, 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. 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.

In retrospect, the August 3 Measure was a watershed event in the evolution of the Korean
economic system. It established a 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
Measure also ushered in a new era characterized by the deepening of the government-business risk
partnership.\textsuperscript{25} 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 had already
started making plans to develop the intermediate goods sector as a part of its “industrial upgrading”
program. Newly established state-owned enterprises began construction of a petrochemicals
complex and an integrated steel mill in the late 1960s. A new urgency was added in the early 1970s

\textsuperscript{25} In fact, the Emergency Decree itself could be interpreted as a product of the deepening government-business
coalition. In a meeting with Park Chung Hee in June 1971, the president of the Federation of Korean
Industrialists, 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 firms. [Kim(1995: 263)]
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 is to have the ability to manufacture its own weapons. The Park government officially launched the HCI drive in 1973. 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. Known as chaebol, these large family-based conglomerates would drastically increase their share of GDP thanks to government support.

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

The chaebol, which literally means “a financial clique,” may be defined as “a large conglomerate 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 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 (e.g., 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.
imbalances and political problems forced it to adopt a comprehensive stabilization package in April 1979. 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.\[28\] [Stern et al.(1995)]

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 almost seemed *firm-specific*. During the heydays of the HCI drive from 1974 to 1978, it was not uncommon for chaebol groups to triple the number of their affiliates with new acquisitions in heavy and chemical industries. In fact, the share of top 10 business groups in GDP *quadrupled* from 5.1 percent in 1973 to 20.4 percent in 1981. [SaKong(1993)] 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 enterprise 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.” [Kim(1994: 122-123)]

Ironically, it was Park’s ambitious HCI drive itself that enabled these firms to borrow heavily

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\[28\] In October 1972, Park 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. Popular disenchantedment with political oppression, inflation, and a newly introduced the value added tax produced an electoral upset in February 1979, in which the opposition received a greater percentage of votes than the ruling party in National Assembly elections.
from the banks and expand their empires in the first place.  

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 risk analysis of their own. Although Park might have felt that he could always control the chaebol firms much like he did state-owned enterprises, he was in fact creating behemoths that would 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.

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. 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 a 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 provided to the

29 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.

30 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 debt obligations, the government had to bail it out.
chaebol firms transformed the government-business risk partnership in favor of these large family-based conglomerates.

5. Delayed Reform and Crisis

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, a shocking figure for the nation that had become used to the annual growth rate of around 8 percent. A new military regime, led by General Chun Doo Hwan, came into power and drastic measures to control inflation. The government devalued the won, imposed an IMF-backed austerity package, and cut subsidies to 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 driven the economy on the verge of a debt crisis and produced serious moral hazard.31

These 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. State intervention in the economy also invited corruption.

31 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 is more or less obliged to guarantee the chaebol’s stability. This implicit guarantee, however, encourages chaebol groups to undertake excessive investment. Expecting to be bailed out should a crisis strike, they would discount downside risks and invest wildly—unless restrained by the government. In order to maintain the stability of the economy, the government thus finds itself having to intervene in the investment decisions of private firms. The solution to this apparent dilemma would require that the government let market forces operate and allow a nonviable chaebol to go bankrupt while containing the fallout from its collapse. The government would also 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. This would serve as a credible signal that the regime has indeed changed.
The reform-minded technocrats felt that “the Korean economic system” had served its purpose and should be replaced by a more market-oriented system. Under the new system, autonomous financial institutions, rather than the government, would evaluate and manage investment risks and allocate resources accordingly. Entrepreneurs would have to identify investment opportunities on their own and take full responsibility for the consequences of their decisions. The government would no longer provide direction and insurance to private firms, but limit its role to setting “the rules of the game” and providing a social safety net. In short, the concept of “de-control with de-protection” would form the core of the reform program.

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 control, especially in the area of financial resource allocation. Business leaders wanted the government to continue to provide loan guarantees and other supports. 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 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 Korean economic system was no longer efficient, it would persist until the crisis of 1997. August Dvorak, the keyboard designer who fought in vain against QWERTY, would have understood.

(1) Partial Liberalization and the Politicization of the Risk Partnership

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 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 second-best strategy to introduce more 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 to overhaul the government-business risk partnership. Korea passed a fair trade law in 1980, but the government concentrated on placing behavioral restrictions on chaebol groups instead of relaxing restrictions on M&As and promoting competition in the product market. The government preferred to rely on direct controls rather than market forces in addressing the chaebol problem. 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.

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 blocked the import of Japanese consumer goods. Nationalist sentiment against foreign direct 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 foreign direct investment.

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 NBFIs gave these firms much greater freedom than in the 1970s. At the same time, as the Korean market remained more or less closed to foreign multinationals, chaebol groups were spared from tough competition in the domestic market.

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. Chaebol groups made contributions to politicians and came to expect favors in return. At the least, they seem to have believed that political connections nurtured through contributions would certainly protect them from bankruptcy.32

(2) The Crisis: Deja 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. Chaebol groups, in turn, exploited the residual influence of the government to extract favors and

32 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.
carried 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 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 from 1993. Halla, Jinro, and Sammi, in particular, had a debt-equity ratio of over 2,000 percent as they piled up losses.\textsuperscript{33} Financial institutions, however, continued to provide credit to these companies. In 1996, the average debt-equity ratio of 30 top chaebol groups climbed to 386.5 percent. Yet 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 top 30 chaebol groups reached 519.0 percent.\textsuperscript{34} Korea was on the brink of yet another debt crisis.\textsuperscript{35}

\textsuperscript{33} They were three of the major chaebol firms that would go bankrupt in 1997.

\textsuperscript{34} 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.

\textsuperscript{35} Some scholars contend that the Korean economic crisis of 1997 was one of 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 crisis, 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 would still have had to face a serious nonperforming loans problem.
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