THE GOVERNMENT AND FINANCIAL SYSTEM IN THE
ECONOMIC DEVELOPMENT OF KOREA

by

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ABSTRACT

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The paper investigates the main characteristics of the government-business relationship in Korea in the past three decades in order to find out how it may have contributed to Korea's economic development. It proposes that the government and large private enterprises in Korea should be viewed as constituting an internal organization, namely a quasi-internal organization. As such, extensive intervention by the government with Korea's financial system can be viewed as an internal capital market and, consequently, it could have led to a more efficient allocation of credit than possible in a free-market financial system. It is also argued that the quasi-internal organization has made it possible for the government to efficiently implement its developmental policies. It is, however, pointed out that for the quasi-internal organization to be successful in accelerating the pace of economic development the country must have a political leadership committed to the goal of economic development and adopt basically an outward-oriented development policy.
1. INTRODUCTION

What accounts for the economic success of Hong Kong, Korea, Singapore, and Taiwan in the past three decades is still a challenging question subject to various interpretations. There is, on the one hand, a widely held neoclassical view which attributes their success to an outward-oriented development strategy and its effect on allocative efficiency. This strategy is said to have promoted allocative efficiency by providing unbiased incentives to both exports and import-substitutes and by minimizing uncertainty over the structure of incentives (Balassa 1980 and 1981). Implicit in this view is the assumption that there exist well-developed markets which would function efficiently but for government intervention. Accordingly, the governments in these four Asian economies are supposed to have played only the very minimal role of providing social infrastructure and a stable political environment. Even in some cases where they have played a more active role, it was only to offset the effect of already existing price distortions.

There is, on the other hand, an alternative view which finds a much more active involvement of government in managing the economy in some of these countries (e.g., Alam 1989, Amsden 1989, Bradford, Jr. 1987, Hamilton 1989, Lee and Naya 1988, Lee and Yamazawa 1990, Whang 1987). Although they may be factually correct in their observation of the extent of government involvement, most of the authors fail to provide a satisfactory explanation of why and how government intervention has contributed to economic development. This failure is, however, understandable given that the role of government in economic development, as observed in the East Asian economies, cannot be readily accommodated in either of the two currently dominant doctrines on economic system—the doctrines of the Leninist command economy and the "Anglo-American 'free-enterprise'" economy.
Johnson finds the government-business relationship in Japan, Korea, and Taiwan rather unique, being different from that found either in the free-enterprise market economies of the West or in the planned socialist economies. He calls government intervention in these economies as "market-conforming" and singles out, in the case of Japan, the Ministry of International Trade and Industry (MITI) as the agency with the greatest influence on the development of the Japanese economy. As he sees it, the economic system in these countries is divided into two subsystems—a public system committed to developmental goals and a private system pursuing profit motives. The intent of the public system is to manipulate the decisions of private enterprises so that its developmental goals are achieved whereas the intent of the private system is to maximize profits, limit risks, and achieve stable growth. The relationship between the two subsystems is continuous and interactive.

It needs to be pointed out, however, that this economic system is different from the so-called Anglo-American free-enterprise economy less because of its dual structure but more because of the nature of the relationship between the two subsystems. Even in the latter the public system manipulates the decisions of private enterprises with the objective of achieving societal goals and its private system is no less profit-seeking than its counterpart in East Asia. Granted that in the United States societal goals may be less development-oriented, its public system nonetheless attempts to achieve its goals with various policy instruments at its disposal. Broadly speaking, in the United States policy instruments are legalistic and transparent and they are employed by the government in an arm's-length relationship with the private system. Furthermore, policy instruments by and large affect market parameters and are not
selective in their effect on market agents. In contrast, in the East Asian economies the private system is manipulated in a less transparent but more direct and discretionary manner. Thus, what differentiates the East Asian system from the free-enterprise system of the West is the way the public and private systems interact and not its dual characteristic.

In view of this controversy over the role of government in economic development we need to carefully examine the nature of the relationship between the public and the private system in Korea. Among the four high-growth developing Asian economies Korea stands out as a country where the government has intervened most actively with the private system. If such intervention leads to resource misallocation, as contended by many, Korea is a place where economic stagnation, not rapid development, should have occurred. Clearly that is not the case. At the same time, the fact that the Korean economy has developed rapidly in the presence of active government intervention cannot necessarily be taken as evidence that the intervention has led to economic development. Thus, if we are to find an explanation for Korea's rapid economic development we need to first examine the nature of its government-business relationship and then provide a theoretical rationale why and how such a relationship has contributed to economic development.¹

2. GOVERNMENT AND BUSINESS AS AN INTERNAL ORGANIZATION

In Korea large private enterprises have played a critical role in export expansion and economic growth. Since the government has influenced the decisions of these enterprises with various policy instruments but most importantly with
its control over credit allocation, finding out what the relationship has been among government, financial system, and large private enterprises is a key to understanding Korea's economic development. In Korea the financial system was used as an instrument for allocating credit and consequently the effectiveness of government policy in dealing with large enterprises depended crucially on the effectiveness of this instrument. Thus, how the government used the financial system to achieve its policy objectives and how it maintained its effectiveness as a policy instrument are important questions we must deal with in understanding the government-business relationship in Korea.

To analyze this relationship and its contribution to economic development during the 1960s and 1970s, we propose that the government and large private enterprises be regarded as constituting an internal organization. This is a hierarchical organization which handles transactions, that might otherwise be carried out in the market place, with administrative processes (Williamson 1975 and 1985). Thus, institutions such as the firm, the conglomerate, and vertical integration are all internal organizations.

In the case of Korea the relationship between government and business was hierarchical and was a nexus for a set of implicit contracts although it was not entirely in the form of administrative processes as prices were also used to influence business decisions. For instance, as long as the enterprises achieved the export targets assigned by the government, they were favored with preferential loans. The boundary of this internal organization was not, however, legal and was not clearly delineated as its constituent enterprises might change from time to time. For these reasons and to differentiate it from the private internal organization, the internal organization composed of the government and large enterprises is called the quasi-internal organization (Lee and Naya 1988).
In an economic system where this organization exists, the government is not merely an outsider to the market system controlling at most parametrically its environment but is a member of the most important internal organization inside the system. This organization thus defines the relationship between the public sector and an important subsector of the private system. In this section we will examine the components of this subsector and find out how the financial system was used to influence their decisions.

(a) Private enterprises in the quasi-internal organization

One of the salient characteristics of Korea's private sector is its dual nature: a relatively small number of large enterprises, many of them belonging to business groups called Chaebol, and a relatively large number of small and medium-sized firms. For instance, in 1982 there were 35,971 firms in the manufacturing sector, but the 271 manufacturing firms belonging to large business groups accounted for more than one third of the value of shipment, value added, and capital in the entire manufacturing sector.

The expansion of large private enterprises during the 1960s and 1970s paralleled that of the Korean economy, and given their importance in the economy the success of the Korean economy is in effect the success of these enterprises. In fact, during the 1975–78 period the sales of the largest 50 and 100 firms listed in the stock market were on average 52.9 and 73.9 percent of the total sales of all listed firms (excluding financial and insurance companies), respectively (Chong 1988).

As noted above, many of these firms are not independent entities but belong to business groups such as Daewoo, Hyundai, Samsung, and Lucky–Gold Star. At the end of 1977 there were 40 such business groups in mining, manufacturing, and
services (excluding financial, insurance, and trading industries). The top 30 business groups controlled 126 enterprises in 1970, 429 in 1979, and 402 in 1982. During the 1971-79 period, these groups made a net addition of 303 enterprises, 202 by establishing new ones and 135 through acquisition. Even during the contractionary period of 1980-82 when the groups as a whole shed 27 firms, they established 30 new units and added 25 units through acquisition.

Given this dual structure of Korea's manufacturing sector, the government relationship with large private enterprises needs be distinguished from that with numerous small and medium-sized firms.\(^2\) Even in Korea the relationship of the government with these firms has been at an arm's length with its control over market parameters as a key instrument. Its relationship with large enterprises has been, however, quite different, being more direct and intimate as in an internal organization. In fact, this relationship has been described as a partnership where the government is a senior partner and private enterprises junior partners (Jones and Sakong 1980). Such a relationship between the government and business was maintained through channels such as "deliberation councils" and "discussion groups", and it facilitated the exchange of information more direct than possible through markets.

The relationship between government and these larger enterprises has been, however, more than meetings of deliberation councils and discussion groups. In addition, the government has used various measures such as auditing the balance sheets of targeted enterprises. But, its most important instrument was its control of the financial system and the access to subsidized credit by these enterprises or, as Roh (1990) calls it, "preference and selectivity" in the allocation of financial resources. By controlling their access to credit the government controlled their decision over resource allocation and thus the
pattern of industrial development.

In standard neoclassical economics an economy with such a "repressed" financial system is not efficient and thus cannot achieve rapid economic growth (e.g., Fry 1988). Although some may argue that the presence of informal credit markets attenuated the adverse effects of such a system, it could not have completely nullified them as these markets were not a significant source of funds for fixed capital investment. Thus, how Korea has been able to develop so rapidly with a repressed financial system is a puzzle that still needs an answer.  

(b) Financial system and control over large enterprises

During the 1960s and 1970s Korea's financial system was to a large extent under the direct control of the government. With the amendment of the Bank of Korea Act in May 1962 the structure of the Monetary Board, the supreme authority overseeing monetary policies, and the management and administration of the Bank of Korea and the management and operation of the banking system as a whole, was altered drastically. The membership of the board was increased to nine by adding two appointed members to the existing seven. The power of the finance minister, the chair of the board, was expanded such that the minister could request the board to reconsider a resolution previously passed and could take the matter to a cabinet meeting if the request was turned down by the board. The expansion of the ministerial power meant that the central bank became in fact an arm of the Ministry of Finance and not an autonomous branch of the government.

The commercial banks were nationalized, immediately after the military coup of 1961, through the confiscation of wealth allegedly accumulated illicitly during the previous regime. The annual budgets of the commercial banks and appointments to top management became then subject to the approval of the finance
minister. Special banks such as the Korea Development Bank and the Small and
Medium Industry Bank were established but they were fully government-owned and-
controlled. In sum, the role of banks, both commercial and specialized, became
that of credit-rationing outlets for the government as the allocation of credit
was tightly controlled by the Ministry of Finance.

Theoretical consequences of a financial system such as the one found in
Korea until its recent liberalization are all well known. They are (1) reduced
savings resulting from low or even negative real rates of return on deposits at
financial institutions and (2) an inefficient allocation of credit as it is
allocated not by markets but by bureaucrats.

In spite of the theoretical strength of the argument against financial
repression much of the empirical work attempting to show its adverse effect on
saving has not been successful. At most it has been shown that low or negative
real rates of return on financial assets have only a marginally significant
effect on national and household savings (Dowling, Jr. 1984, Giovannini 1983, van
Wijnbergen 1982).

One of the allocative inefficiencies resulting from financial repression
is supposed to be overly capital-intensive and large-scale production techniques
as credit is allocated by the government at an artificially low rate (Fry, pp.
410-17). This inefficiency will result, however, only if the receivers of credit
use it in fact for government-designated projects. They may instead divert the
funds to the informal credit market, capturing the rent arising from the
difference between high rates in that market and the artificially low rate they
get from the government. Interest rates in the informal credit market being
rather high, such credit diversion will lead to the adoption of overly labor-
intensive production techniques by ultimate borrowers.
Cole and Park (1983) and Hong and Park (1986) argue that there probably was a high degree of credit diversion in Korea's manufacturing industries as firms in these industries could make large profits by diverting the rationed credit from designated projects to other more profitable projects. If this were true, the actual pattern of credit use would differ from the pattern of allocation directed by the government. In the extreme case of perfect credit diversion, the receivers of rationed credit would get rents accruing to their favored position but the pattern of credit use would be the same as the one under free-market allocation.

Empirical evidence on credit diversion was provided by Hong and Park who examined the association between sectoral credit rationing and the expansion of output and exports. They took the ratio of loans to value added (L/VA) in a given sector as a proxy for the amount of subsidy provided to that sector. Their results show that in spite of relatively low L/VA ratios, labor-intensive industries realized very high "gross" rates of return throughout the 1970s and the early 1980s and they achieved either significant factor substitution or significant expansion of output or both. Further, many of these sectors have become major exporting sectors in Korea. In contrast, capital-intensive manufacturing industries earned very low gross rates of return during the 1971-73 period in spite of relatively high L/VA rations, and a majority of them failed to become exporters although some have succeeded later.

Hong and Park interpret the fact that the labor-intensive industries realized high rates of return in spite of their low L/VA ratios as an indication that they would have done well without the subsidies. They thus conclude that the labor-intensive industries received a windfall wealth transfer through subsidized credit and that the credit they received had no or little effect on output and
export expansion. It should be pointed, however, that the same evidence can be interpreted to mean that subsidies were highly effective in these industries whereas they were not in several capital-intensive heavy and chemical industries.

The effect of a subsidy on output depends, other things being equal, on the elasticity of supply, the effect being greater the larger the elasticity. In a labor-abundant, developing country such as Korea there are reasons to expect that the price elasticity of supply is larger for labor-intensive manufactured goods than for technologically sophisticated, capital-intensive products. Furthermore, since the demand for the former in domestic as well as world markets is more price elastic than the demand for the latter, the same amount of subsidy would also have a larger effect on the output of the former.⁴

In Korea of the 1960s and 1970s credit diversion might have been contained within a tolerable margin because of, among others, the widely held ideology of export drive and high penalties expected in case credit diversion by favored borrowers was discovered. This cost of credit diversion may have been extremely large then because the authoritarian government had the institutions to closely monitor the flow of funds and it was ready to impose severe penalties on the infractor.

Credit diversion presents a classic example of measurement problems in the principle-agent relationship where ideology can play a role in reducing the monitoring cost. In a regime of financial repression the government may be seen as a principal and the borrowers as agents who are to carry out investment projects in accordance with government directives. By imbuing the minds of the borrowers with the importance of exports for the survival of the nation, the government legitimized the societal goal of export expansion. As North (1981) would argue, this ideology of export expansion may have checked the extent of
credit diversion by suppressing individualistic calculus of costs and benefits.⁵

If credit diversion did not circumvent the control of government over resource allocation, then how did government-led resource allocation bring about rapid economic development in Korea. Could it have mimicked a free-market allocation of resources? Or could it have been more efficient for a developing country in bringing about economic development than free-market allocation?

3. QUASI-INTERNAL ORGANIZATION AND ECONOMIC DEVELOPMENT

(a) Quasi-internal organization as an internal capital market

A developing country suffers from the underdevelopment of its capital markets, and the role that the government has played in Korea can be interpreted as a second-best solution for this problem. As pointed out by Stiglitz (1989), capital markets even in a developed country do not operate as described in "textbook models" of perfect capital markets as the problems of adverse selection, moral hazard, and contract enforcement are inherent to these markets. Consequently, "credit rationing" and "equity rationing" are innate characteristics of capital markets.

Credit rationing by banks may occur because of the asymmetry of information and because banks are risk averse (Stiglitz and Weiss 1981), and financial liberalization may thus lead to an inefficient allocation of credit in the absence of well-functioning equity markets (Cho 1986). Equity rationing occurs as the firm is reluctant to offer new equity issues to raise capital as they will result in large decreases in its market value (Stiglitz 1989). Unwilling to see its net worth decrease, the firm is reluctant to issue new shares and thus unable
to divest itself of the risks it faces. Consequently, it may rely more on internal financing for capacity expansion which may result in a less efficient allocation of resources.

There are reasons why the problems of imperfect capital market are more serious for developing countries: capital markets are less developed and the economy is subject to greater changes and uncertainty (Díaz-Alejandro 1985). Furthermore, these countries are not likely have developed private institutions capable of coping with the problems of imperfect capital markets. The effect of credit and equity rationing is more serious, as noted by Stiglitz, for developing than developed countries:

In more developed economies, large firms have developed internal capital markets, that lead to reallocation of funds among units that are the size of many firms in LDCs. The LDCs are thus at a double disadvantage: not only are there informational imperfections, leading to credit and equity rationing; not only are these informational imperfections likely to be more important within LDCs, because the process of change itself leads to greater informational problems; but more importantly, the institutional framework for dealing with these capital market imperfections are probably less effective, because of the small scale of firms within LDCs and because the institutions for collecting, evaluating, and disseminating information are likely to be less well developed. (Stiglitz, 1989, pp. 200-201).

For a developing country the message is clear: a liberal financial regime even combined with a well-functioning equity market will not necessarily bring about an efficient allocation of capital.

It should be noted here that although Stiglitz's observation regarding the double disadvantages of developing countries is generally correct it cannot be said to apply to Korea. There developed two institutions which have functioned to compensate for the disadvantages of underdeveloped capital markets and the limited size of individual enterprises. One is the quasi-internal organization and the other is Chaebol, the multiunit business group. This has an internal
capital market large enough even in comparison with that of a multiunit enterprise in the developed industrial countries and is therefore able to overcome the scope and size limitation of typical individual enterprises in a developing country.\(^6\) Discussion of Chaebol's role in the economic development of Korea will have to be, however, a subject for another paper.

It can be now readily seen that the quasi-internal organization could overcome the problems faced by the developing countries mentioned by Stiglitz. First of all, the quasi-internal organization is an internal capital market where the government allocates credit among the large enterprises. It is a well-documented fact that they were given, especially during the 1970s, large sums of preferential credit to develop certain product lines targeted by the government. Although such a practice is commonly called financial repression, it differs little from the way an internal capital market operates within the multiunit enterprise. There may be, however, a difference between the objectives of the quasi-internal organization and those of the multiunit enterprise, and this may explain whatever difference there may be in the performance of the respective internal capital markets.

The similarity between the quasi-internal organization and the modern multiunit enterprise seems further clear. Activities of their component units and transactions between them are internalized, and these units are monitored and coordinated by salaried employees (i.e., bureaucrats) instead of by market mechanism. Given this similarity and given that the modern multiunit enterprise is an efficient institution (Chandler, Jr. 1977), it follows that the quasi-internal organization can be efficient in achieving its objectives.

Stiglitz has also noted that informational imperfections which lead to credit and equity rationing are more serious for developing countries as the
developmental process itself leads to greater informational problems. Again, the quasi–internal organization can be viewed as an institutional adaptation designed to overcome these problems.

In discussing the efficiency of internal transactions relative to that of market transactions, Williamson points out two characteristics of the internal organization that make it better handle informational imperfections. Firstly, because of its hierarchical structure which allows the specialization of decision making and economizes on communication costs the internal organization is able to extend the bounds of rationality. Secondly, the internal organization is able to reduce uncertainty by coordinating the decisions of interdependent units to adapt to unforeseen contingencies.

The quasi–internal organization in Korea has had the advantages of these characteristics. Because of the direct contact maintained through channels such as deliberation councils and discussion groups the government and large private enterprises were able to share the information which would otherwise have had to be conveyed indirectly through prices. Thus, decisions over the allocation of credit could be made before price changes could signal the direction of credit allocation and private agents could respond to these signals. Also by coordinating these enterprises the quasi–internal organization could adapt to unforeseen contingencies. For example, the government established the Korea Traders Association which collects economic and trade information virtually all over the world, evaluates it and disseminates to the members of the quasi–internal organization.

It needs to be pointed out, however, that the fact the quasi–internal organization could function as an internal capital market does not necessarily mean that funds would be allocated efficiently. Even the reduction of
informational imperfections does not mean that the quasi-internal organization would utilize the improved situation for developmental goals.

Clearly, it goes without saying that the quasi-internal organization has to be committed to developmental goals for it to allocate resources toward achieving these goals. Efficiency in allocation does not necessarily mean efficient allocation in achieving developmental goals. It is in fact possible that the quasi-internal organization is efficient achieving its own narrow objectives at the expense of the rest of the economy.

Will the quasi-internal organization allocate resources efficiently if it is committed to developmental goals? In the case of a firm with its own internal capital markets, the choice of a wrong product or technique may lead to bankruptcy and thus to its dissolution. Furthermore, market competition ensures the survival of only those that on average choose right products and production techniques and thus the survival of efficient internal organizations.

The quasi-internal organization does not face the competition that private firms face in the market place as it is the only such organization in the economy. Is there then any mechanism that will correct an inefficient credit allocation it may make? Whether such a mechanism exists or not depends on the setting in which the quasi-internal organization operates. If it is committed to an outward-oriented development strategy there is such a mechanism whereas if it is committed to import-substitution policies there is none.

For a small developing county committed to an outward-oriented development strategy prices are parameters determined in the rest of the world. The government cannot thus arbitrarily change prices to cover the consequences of an inefficient allocation of credit. Because of this constraint an inefficient internal allocation of credit which supports wrong projects will result in
financial losses for the large enterprises undertaking the projects. They may be able to survive with subsidies from the government but their losses are nevertheless internal to the quasi-internal organization. Thus, whether there are subsidies or not the quasi-internal organization will be suffering financial losses, and it will be eventually forced to correct its pattern of credit allocation.

In contrast, a small developing country which has adopted an inward-oriented development strategy can alter prices to cover the consequences of a wrong internal credit allocation. Potential losses of the large enterprises can be made to disappear by changing prices with little noticeable effect on the government treasury. The quasi-internal organization can avoid making losses resulting from an inefficient allocation of credit, and there is at least in the short run little or no incentive or compulsion to correct the existing pattern of allocation.

As market competition is necessary to ensure the survival of efficient private internal organizations, so is competition necessary to ensure that the quasi-internal organization committed to economic growth make efficient allocation of credit. For the quasi-internal organization such competition exists only if it is exposed to competitive forces in world markets. For this reason it is essential that the country is committed to an outward-oriented development strategy. 7

The above discussion provides an additional reason why a developing country should adopt an outward-oriented development strategy. The standard neoclassical argument in favor of the strategy is that because of its neutrality of incentives between exports and import-substitutes it brings about allocative efficiency in resource allocation. The argument, however, fails to recognize that even with the
neutrality of incentives a developing country may not achieve allocative efficiency because of informational imperfections and the limited size of firms. The quasi-internal organization can overcome these problems of market failure and be efficient in credit allocation only when it is subject to international competition.

(b) Quasi-internal organization for efficient policy implementation

Another reason why the quasi-internal organization in Korea could have contributed to economic development is that it has made possible the efficient implementation of policies.

In a market economy of the neoclassical mold, government intervention is indirect as it is implemented through taxes and subsidies and through arm's-length regulations. Here the cost of policy implementation (ignoring the cost of policy formulation) is the cost of collecting taxes on appropriate activities, making it certain that subsidies are used for predesignated activities, and also making it certain that regulations are abided by. This method of policy implementation works essentially by controlling market parameters and thus modifying the decisions of market agents. For this reason we may call it the market mode of policy implementation.

An alternative to this market mode is what has been observed in Korea, which we may call the internal mode of policy implementation. As policies are implemented within the quasi-internal organization, policy implementation is an internal transaction and it does not rely solely on changes in market parameters. Since these transactions parallel those within a private internal organization, they would be also efficient for the reasons why private internal organizations are efficient relative to markets. That is, because of extended bounded
rationality, reduced opportunism and uncertainty, reduced small-number indeterminacies, better information, and a group-oriented atmosphere the internal organization reduces transactions costs.

Direct and continuous contact between the government and large enterprises permits sharing of information which would have to be done indirectly through prices with the market mode of policy implementation. The government possesses nonprice as well as price incentives and control techniques to be brought upon agents in a selective manner, it can coordinate interdependent enterprises to adapt to unforeseen contingencies, and it can resolve with fiat small-number bargaining indeterminacies among enterprises to the benefit of the public good. Thus, with better information and with various incentives and control techniques the government can see to it that its policies are effectively carried out by the private system.

Korea's response to the oil crises, the development of the heavy and chemical industries, and the promotion of construction service exports, to name a few, are some of the cases which clearly illustrate the way the government has implemented its policies (Cho and Kim 1991). In all of these cases the government has used discretionary as well parametric manipulation to achieve its policy objectives. It made decisions quickly often in consultation with private enterprises but changed policies when they were shown to be inappropriate. Even if one might argue that some of the policies were wrong, one would be hard pressed not to admit that they were effectively implemented.

It was noted above that credit diversion could have subverted the effective implementation of policies. It is now clear that in addition to the export ideology which may have restrained the individualistic calculus of costs and benefits the quasi-internal organization would have made credit diversion very
difficult. Since preferential loans went by and large to the enterprises constituting the quasi-internal organization, they were subject to internal scrutiny and would have found it difficult to engage in opportunistic behavior of credit diversion. In other words, because the relationship between the government and the recipients of subsided credit was that inside an internal organization and not an arm's-length relationship it would have been difficult for credit diversion to take place.

Williamson notes that the efficiency of the internal organization relative to markets is related to environmental and human factors as it is dependent on the social context within which transactions take place. For similar reasons it may be also argued that the efficiency of the internal mode of policy implementation is dependent on social and cultural factors. In the case of Korea the widely-held Confucian hierarchical ethos may be, as suggested by Herman Kahn, one of these factors:

In the Confucian hierarchial society, the emphasis is on cooperation among complementary elements, much as in the family.... There is emphasis on fairness and equity, but it is fairness and equity in the institutional context, not for the individual as an individual. Synergism—complementarity and cooperation among parts of a whole—are emphasized, not equality and interchangeability. The major identification is with one's role in the organization or other institutional structure, whether it be the family, the business firm, or a bureau in the government.

The modern Confucian ethic is superbly designed to create and foster loyalty, dedication, responsibility, and commitment and to intensify identification with the organization and one's role in the organization. All this makes the economy and society operate much more smoothly than one whose principles of identification and association tend to lead to egalitarianism, to disunity, to confrontation, and to excessive compensation or repression. (Kahn, 1979, pp. 121-122).

Perhaps one may argue that the Confucian ethos has performed the role of an ideology which, according to North, reduces the cost of monitoring in the principal-agent relationship. Thus, for Korea the quasi-internal organization may
well have been an appropriate institution for carrying out the developmental objectives of the state.

4. CONCLUSION

This paper has examined the role of government in Korea's economic development. One of the motivating factors for the paper is the author's dissatisfaction with both the standard neoclassical attempt to explain the economic success of Asia's newly industrializing economies primarily in terms of its dominant market paradigm and the institutionalist view of effective government intervention for economic development. It is the author's view that in the case of Korea the government has played a critical role in economic development and how it has played this role is different from that which has been observed in either a socialist planned economy or what Johnson calls the Anglo-American free-enterprise economy. It is proposed here that that role and its effectiveness in promoting economic development can be best understood if the government-business relationship in Korea is viewed as that within an internal organization.

Once we accept the notion that the government and large private enterprises together form an internal organization and behave as such, what is commonly regarded as a repressed financial system can be seen as an internal capital market. It then follows that such a financial system is not necessarily inefficient and in fact can be more efficient than a free-market financial system which suffers from various market imperfections.

The usefulness of the institution of the quasi-internal organization will diminish in Korea as its economy develops further. It will run into
organizational failures if it expands to stay abreast with the growing economy. If on the other hand it does not expand to remain efficient, the quasi-internal organization will become small relative to the overall economy and its importance for policy implementation will thus diminish. In addition, as the economy develops the problems of credit and equity rationing can be better handled by private enterprises and consequently the need for the government to complement the market mechanism will diminish.

Whether the quasi-internal organization can be replicated in another developing country and be used effectively to promote economic development is a difficult question to answer. For it to be successful it needs a political leadership committed to developmental goals and, probably, an ideological or cultural setting conducive to its efficient operation. The social usefulness of such an institution depends on its context which certainly varies from country to country. Nevertheless, the experience of Korea demonstrates that a developing country should adopt basically a system of market economy but it can accelerate the pace of its economic development by establishing nonmarket institutions, if they are complementary to the market system and appropriate to its culture and history.⁹
Notes

1. As Alam (1989) sees it, "[t]he central task of development economics..., is to determine the mix of government and markets that in a specific stage and context of development holds out the greatest promise of accelerating this process."

2. Although Johnson does not make this distinction in the case of Japan, logic dictates that such distinction be also made for Japan: MITI could not have dealt directly with thousands of small enterprises however eager it may have been to control and manipulate them to achieve developmental goals. What Johnson observed in the case of Japan is the relationship between the government and large private enterprises or industry organizations, and it is this relationship which sets apart the economic systems of Japan and Korea from what he calls the Anglo-American free-enterprise economies.

3. This paper does not address the recent debate between the so-called McKinnon-Shaw school for financial liberalization and the neo-structuralists represented by Taylor, van Wijnbergen, and others (Taylor 1983, van Wijnbergen 1982 and 1983). The difference in opinion regarding the effect of financial liberalization between the two schools depends crucially on the assumption they make about the efficiency or inefficiency of informal credit markets. The argument presented in this paper sides with neither of the two although one could argue that its position is opposite to that of the McKinnon-Shaw school as it points out that financial repression can lead to economic development under a certain set of conditions.

4. In another attempt to measure the degree of credit diversion, Hong and Park estimated an investment function with the amount of government-controlled credit as an argument. Their econometric work, however, suffers from a conceptual flaw
as the degree of credit diversion cannot be a parametric variable in their investment function and, consequently, their empirical results have little bearing on the issue of credit diversion. The extent of credit diversion depends on the expected gains from credit diversion—the difference between the expected rate of return from a predesignated project and that from the best alternative chosen freely by the borrower—and the expected cost of credit diversion. The expected cost includes the penalties the borrower must pay if credit diversion is discovered by the government and the future loss resulting from losing the preferred status accorded by it. The cost would in turn depend on the monitoring ability of the government and the severity of the penalty it would impose. The expected gains from credit diversion would depend, among others, on the state of the domestic as well as the world economy as it would affect the rates of return on both the predesignated project and the freely chosen best alternative investment project. For these reasons the degree of credit diversion is not stable over time and thus cannot be treated as a behavioral parameter in the investment function specified by Hong and Park.

5. In fact, a recent statistical analysis linking the number of group-member firms established in 1973–79 and the cost of credit supports the view that large business groups responded positively to government credit incentives in the 1970s by establishing new firms in targeted industries (Zeil 1989).

6. A similar organization called the Group also exists in some Latin American countries, and how it functions to overcome the disadvantages of underdeveloped capital markets has been analyzed by Leff (1976).

7. This, of course, raises a political-economy question as to why a country follows this strategy to begin with. Findlay (1989) finds his answer in the "relative autonomy" of the state although he is clearly aware that autonomy does
not guarantee that the state will commit itself to such a strategy.

8. In a highly provocative book on Japan, Van Wolferen (1989) argues that the development of Japanese culture has been deliberately manipulated by the ruling power of the country for the purpose of gaining political and social control over the population. His book clearly raises a "chicken-and-egg" question on the relationship between culture and economic development.

9. The importance of nonmarket institutions and rules for the performance of the market mechanism was pointed out Bruton (1985) in his thought-provoking paper on development economics.
References


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