

Institutions and Economic Development: The Case of Korea⁽¹⁾

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Institution building is essential for economic development. In this regard this paper reviews how institutions were built in Korea since 1960s, how they have contributed toward Korean economic development, and reasons why some of them no longer serve their intended purposes. The paper argues that the government-led development strategy using financial repression to channel resources to the 'desirable' sectors often dominated by Chaebols, though quite successful in the earlier years, began to lose its fruitfulness from the latter of 1980s. The system is now the main hindrance to further development and the ultimate cause for the current Korean economic crisis. The paper argues that Korea needs to overhaul the entire economic management system and accompanying institutions toward more open, transparent, and rule-based systems and institutions.

1. INSTITUTION BUILDING IS ESSENTIAL FOR ECONOMIC DEVELOPMENT

The level and contents of economic activity of a country are determined by various factors. Factors of inputs such as human and physical capital and technology are commonly cited as such. Thus theories of economic growth usually point out the accumulation of human and physical capital and the progress in technology as ultimate determinants of the growth process. What is usually missing in these discussions is the role of institutions. However, institutions are, if not more, as important as the others. Likewise, institution building (destruction of outdated, improvement of existing, replace

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ment of old, and introduction of new) is equally important as the accumulation of capital and progress in technology in determining a country's growth performance.

Korea has achieved remarkable economic development and growth in a relatively short time span of 40 years. Her people, who were poor, unskilled, and illiterate with barely 50 years of life expectancy in 1960, now roam the world as professionals, businessmen, and tourists, boasting more than 75 years of life expectancy. With the rapid economic progress, Koreans have become confident, assertive, and optimistic. Once shy, pessimistic, passive, and regarded as hopeless, they now vie for the leadership role of the world in business, science, sports, music, and arts.

How has this been possible? What are the factors that have made this remarkable success possible? A variety of explanation has been given. The explanations, following the framework suggested by the neo-classical growth theories, stress the rapid accumulation of such inputs as physical capital, total number of working hours, and human capital. Indeed it has been the case that the investment ratio, which was less than 10% in 1960, has persistently risen to more than 35% in 1996. This rapid increase in investment, which had been initially financed by external borrowing, has been financed to a large extent by equally rapid increase in savings rates.

Total number of working hours has increased over time as workers from rural areas steadily migrated to urban and industrial sectors, and the participation rate of women has increased throughout the period. Not only the total number of working hours, but the efficiency of workers has also dramatically increased through education, on the job training, and learning by doing. Several educational achievement indicators clearly show how rapid the rate of accumulation in human capital has been. In 1960 the literacy rate was about 50% and the elementary school enrollment rate was about 60%. The secondary and tertiary education was at bare minimum. By 1995 enrollment ratio for the primary and secondary education has reached respectively 100% and 90% level. The enrollment rate of more than 40% for the tertiary education in 1995 is one of the highest in the world. Everyone can write and read these days and computer literacy is rapidly rising.

The role of international trade is also emphasized as an engine of Korea's growth. Here international trade is seen to have contributed toward economic growth by making

it possible for exporters to enjoy economies of scale, by intensifying the competitive pressure, and by making it possible for domestic firms to acquire new ideas, knowledge, skills, and technology through trade, learning by doing, imitation, and technological transfers. International trade has also contributed to economic growth by allowing domestic firms to have access to wider variety of intermediate goods and by making domestic firms better enjoy the benefits of product quality improvement.

The role of government has been frequently emphasized, too. As government's roles, its spending and taxation policies are seen to have been very favorable for economic growth. Combined central and local governments of Korea have never spent more than 25% of the GDP. This is quite small compared to other countries whose government spending ratios easily exceed 35% of the GDP. In this sense government in Korea has never been 'big'. Whereas in other countries governments allocated a bulk of their budget for public consumption and transfers, Korean government spent more than one third of her budget for public investment, keeping transfers to the minimum. Meanwhile tax policies were extensively used to promote saving and capital accumulation.

Many commentators argue the qualitative roles Korean government has played are equally important as her quantitative roles for economic development. For example, the two pronged strategy of outward oriented export promotion and industrialization, and judicious policies taken to implement the strategy are seen to have been crucial for rapid development of Korean economy. Here the adoption as means of industrial policies of the preferential export financing system and the promotion of heavy and chemical industries through government coordinated credit allocation are the two most important examples of successful qualitative roles suggested so far.

In these discussions, however, references to the importance of institutions for economic development have been notably lacking. There are scarcely any discussions on how exactly Korea has pulled herself out of poverty and grew to be a high income developing country, and what kind of mechanisms, systems, and institutions have been utilized. Somehow the institutions or systems are taken for granted as something already there waiting for someone to utilize them. Likewise there is little discussion on the actors who have played instrumental roles in the development process. Without leaders or planners

who have actively set up institutions and systems favorable for growth, economic development of Korea would have been impossible. Understanding who led the development process and how they set up new institutions, replaced old with new institutions, and flexibly adapted existing ones to new environments is perhaps the most important lesson one can learn from Korea's development experiences.

It is universally understood that economic performances would be most active and the resulting outcomes would be most efficient when the bulk of economic activities are organized through and coordinated by markets. Markets enable all the participants to creatively utilize their ability to the fullest extent in response to changing economic signals. Backed by this understanding, many economists advise policy makers to let the markets perform their roles as freely as possible. Thus intervention by government in the economic processes is strongly abhorred. At the same time economists realize that nothing is perfect and markets do have limitations, too. When economic activities have externalities, are public goods in nature, occur under asymmetry of information, possess characteristics of dynamic comparative advantage, and are subject to large scale economies, markets often produce sub-optimal results and coordination mechanism other than markets should be brought in. That is why the same economists who praise markets are in favor of government intervention, provided it can correct the sub-optimality of market allocations.

The qualified reliance on markets has been the main theme in the last 50 years for such multilateral institutions as the World Bank and the IMF in their development assistance activities. Undoubtedly their assistance has helped numerous countries to bring themselves out of the poverty trap and successfully climb up the growth path to become middle income developing countries. The Asian NIEs were the first to follow the path, the ASEAN countries were the second, and the Latin American countries were the next after a long hiatus. These were early reformers. The successes of early reformers have kindled new waves of growth among hitherto dormant countries. Thus India, Bangladesh, and the Philippines finally altered their development courses for the right direction and some of the formerly socialist economies now in transition to market economies show vigorous signs of growth. This is particularly evident in China and Viet Nam.

Why then are there equally numerous countries, who were given assistance from the World Bank or the IMF and followed their advice however hesitantly, whose economies are still in deep troubles? Almost all the Sub-Saharan African countries, most of the newly independent countries of Central Asia and Eastern Europe, and most of the countries in Middle East and Western Asia belong to this category. One easy answer would be to argue that these countries have in fact never earnestly heeded to the advice given to them, or to argue that the development history is too short to judge successes or failures as yet. Perhaps this is a valid argument. However, there may exist deeper answers and we should not flatly reject the hypothesis that the simple minded advice to leave everything to markets with limited government intervention is grossly inadequate and it may lead to disastrous results. Where markets do not exist, where there does not exist an able body of policy makers, and where there do not exist institutions and systems that policy makers can rely on, we can neither leave everything to markets, nor expect policy makers to successfully intervene when markets fail to correctly perform.

It is then evident that there must be a set of markets through which we can organize and coordinate economic activities, an able body of policy makers who can oversee the economic processes, and institutions and systems under which economic actors play their roles, before we can hope for a self-sustained and prolonged development process to work. These do not mean, however, that countries who do not meet the requirements cannot hope for economic development. After all most of the developing and developed countries started from a position where these requirements were not in place. What they have done was to continuously nurture markets, policy makers, and institutions along the growth paths. Thus economic development and development of systems or mechanisms went hand in hand. System or mechanism design was initially done by the conscientious efforts of forerunners and leaders. When economy reached a certain stage of development, this process of system design itself became embedded in the development process and thus became almost autonomous. In any case it is quite evident that development of markets, policy makers and policy mechanisms, and economic systems should be a joint process with economic development.

How can one start this joint process? For the countries who are contemplating to

launch development processes, the answer appears to be a simple one. They can, for example, critically survey their initial conditions and choose the best strategy available. The set of strategies may consist of implications from theoretical models and experiences of forerunners. It is necessary, therefore, to carefully study growth theories and to accumulate as much practical information as possible. This paper aims to contribute to this task through a study of how Korea has developed markets, institutions, and systems in the last 35 years. In doing so I will be selective and provide several examples of how Korea has done in the area of institution building, rather than giving comprehensive analyses.

2. AN OVERVIEW OF HOW INSTITUTIONS HAVE EVOLVED IN KOREA

2.1. From the Liberation in 1945 to 1960: How Korea Met Challenges for Nation Building

Before her economy began to take-off in the early sixties, Korea was a very poor country with less than \$100 of per capita income. When she was liberated from a long colonial oppression in 1945, she was ill prepared to build a new nation: the colonial government actively repressed the formation of leadership among Koreans. As a result the country was in turmoil and chaos. To add insult to wound, the super powers divided the country arbitrarily into north and south, where two ideologically diabolic governments were set up. This division and the ensuing ideological struggles escalated into the Korean War. The three year war destroyed almost all social infrastructure, most of the physical capital stock, and a substantial amount of human capital on the peninsular. When the War ended leaving the peninsular as divided as before, Korea was one of the poorest country in the world. In 1954 her per capita income was only \$67.

What could a country such as this hope for? The massive destruction of physical, human and social capital by the War could have easily led Koreans into abysmal despair and hopelessness. Indeed on both political and economic fronts, Korea seemed to be a hopeless case. The short run impacts of the full fledged western style democracy, which

was newly introduced in 1948 and became the basic feature of South Korean political system after the War, were to add instability and bred corruption. It was soon disintegrated into a dictatorship, even as the country became more and more unstable. The economic picture was equally bleak. South Korean economy at the conclusion of the Korean War was dominated by the traditional agriculture with almost all the industrial foundations destroyed and with extremely poor natural resource endowments. What she had was an abundance in people. Even this was more of a burden at that time than a source of productive inputs.

Faced with these seemingly insurmountable difficulties, Koreans did not remain in despair. First, they worked extremely hard to rebuild the country. Farmers, merchants, businessmen, factory workers, educators, and bureaucrats all worked close to 60 hours a week. Second, even though the income was meager, most Koreans tightened their belts to save for the future. Third, even more importantly they put the greatest emphasis on children's education. Even during the heat of the War, schools were never closed. Indeed the elementary education was already made compulsory for all. Fourth, the colonial oppression, the ensuing liberation, the struggles between left and right, and the destruction from the War had hardened in the mind of Koreans a fierce desire to build a democratic nation. This desire led to a series of demonstration against the dictatorship of President Rhee, who ruled the country from 1948 to 1960.

These efforts began to produce fruits, however meager they were. The country was able to overcome the destruction of the War and got back to the normal development path by 1960. There were several factors behind this relatively rapid recovery. First, the fierce determination of Koreans not to fall pray again to Japanese had made them work really hard. Second, the equally fierce determination of South Koreans not to fall behind of the North Koreans had made them work even harder. Third, even though the War had destroyed most of the physical capital in the country, the human capital was relatively intact. Koreans, who had more than two thousand years of written history, had the capacity to rebuild the country out of rubbles. Fourth, the bureaucracy and the education system, which were rather efficient, played important roles. Fifth, the help from the outsiders, especially from USA, had also played an essential role.

2.2. From 1960s to 1970s: Institution Building for Government-Led Development

Though the country got back to the normal development path by 1960, this normal development path was a very poor one. It was a path that an average traditional agriculture bound economy would be most likely to follow. It was evident at that time that if Korea were to follow the path, the future would be very bleak. To make matters worse, the political situation was very unstable. The dictatorial President Rhee was toppled and expelled from the country by a series of student demonstrations in 1960. Hardened with this success, students began to play larger political roles. However sincere and noble their motives might have been, it became evident that students did not have the political and administrative capability to run the country. The political instability and the resulting uncertainty for the future of the country paved the way for a military coup in 1961.

2.2.1 The 1960s: Launching new institutions

As soon as he took the power, President Park, whose slogan was to build the country strong and prosperous, began to undertake a series of institutional inventions and innovations.

First, President Park had made himself the self-proclaimed leader to revitalize the country. He was quite determined to break the vicious circle of poverty and put the country onto a sustained development path. He pledged to step down if he could not achieve the stated goal of development. He became one of the first development oriented leaders.

Second, he introduced several important administrative innovations. One was to create an inner circle of senior advisors who would assist him in national management. What was important was not the creation of the inner circle per se, but was the fact that all the senior advisors for economic affairs were technocrats. They were selected based on their expertise and ability. Another innovation was to create a new ministry which would be in charge of long-term economic planning, macroeconomic management, and policy coordination. The new ministry was the Economic Planning Board(EPB), whose minister doubled up as the deputy prime minister of the cabinet. President Park gave the EPB the authority to draw national budget, too. The budgetary power served as an effective mean

to bring other ministries in line.

Third, the meritocracy was firmly established as the only mean to select bureaucrats, judges, and other public officials. This had prevented the nepotism from playing any role and as a result most of the posts in the government were filled with the best crops in each generation.

Fourth, the financial system was extensively revamped so that it could serve for development. This was done mostly in the form of financial control and repression. Commercial banks were nationalized, specific purpose banks were newly created, and the independence of the central bank was curtailed. This financial repression was used to channel bank credits to the 'desirable' sectors. This policy was a very risky one and would have produced a great deal of undesirable results. Indeed financial repression has produced tons of ill effects. The ill effects were somewhat contained, however, because of an innovative system of credit allocation which was introduced concurrently with the imposition of severe financial controls. The innovation was to introduce the export financing system, which automatically directed the flow of credits to the export sector. Since the export sector was exposed to market forces, the export financing system made government-led credit allocation partially market conforming.

Fifth, President Park made a compact with business leaders that he would help them in every way so long as they do their parts. The parts requested for the businessmen were to do their best to build a modern manufacturing-based export economy. In addition to giving businessmen economic freedom, President Park also provided them with a comprehensive set of financial and tax incentives. This had led to creation of a multitude of general trading companies, which were forerunners of Chaebols.

Sixth, President Park, who appreciated the importance of human capital development, took pragmatic approaches to education. He emphasized the universal primary education and vocational training for teenagers. President Park sponsored the establishment of the Korea Development Institute. KDI played important roles in the transformation processes of the Korean economy.

2.2.2. The 1970s: Intensified interventions and the ensuing difficulties

The 1970s was a decade of internal inconsistency in economic management. Thanks to the phenomenal growth during the 1960s, the economy had by now become much bigger and thus was not easily amenable to control and manipulation by government. This means among others that Korean government should have begun to pull out from the markets and leave more things to markets. However, having successfully led the economic transformation process in a short span of time, government became very confident and intensified its grip on the economy.

A first such example was the special decree issued by President Park in 1972 to essentially nullify debts incurred by firms to the curb market lenders. The decree was ostensibly justified on the ground that the curb market lenders were engaged in illegal trades. The moratorium created a huge turmoil in the financial markets. Development of the market based credit allocation mechanism, which was slowly becoming more efficient, was rudely pushed back several decades.

A second example of intensified government intervention was the heavy and chemical industrialization(: HCI) drive launched in the early 1970s. The HCI drive was another manifestation of the over-confidence gained by the government after a decade of successful economic management. The policy was to promote heavy and chemical industries such as automobiles, steel, shipbuilding, electronics, machinery, and petrochemicals.

Extensive financial and tax subsidies were given to firms who moved into the designated heavy and chemical industries. A Presidential Task Force was also created to oversee the HCI drive. In addition to these, the Korea Ex-Im Bank was set up to specialize in long-term export financing, and several special funds were created to help finance the HCI drive, too. Though commercial banks were partially privatized in the early 1970s, government control on financial sector had become stronger in the 1970s as a result of the HCI drive. This left great scars on the financial industry from whose consequences the Korean economy is still suffering.

Concurrently with these economic developments, suppression of the political rights became stronger, too. President Park made himself the life-long leader of the country and

harshly punished those who opposed his dictatorship. Human rights violations became prevalent and labor movements were ruthlessly suppressed. By the end of the decade, it became evident that this system of one man dictatorship could not go on. It abruptly ended when President Park was assassinated in 1979.

2.3. The 1980s and the 1990s

2.3.1 The 1980s: Grips of government on the economy weakened

The death of President Park, which left a void in the power structure, brought with it uncertainty and instability. The problem was all the more serious since most Koreans were not used to political freedom after an 18 years of one man dictatorship. The void left by President Park was quickly captured by another set of military generals, which put Koreans once more under authoritarian rules of Presidents Chun and Rho.

Though they were political dictators President Chun and to a less extent President Rho left the business of economic management to their technocrat aids. These technocrats, who were all American trained experienced economists, were aware of the shortcomings of President Park's strongly interventionist approach to national economic management. Determined to reduce government interventions they introduced a set of plans to free the economy from the tight grips of the government.

The main element of the plan was to liberalize the markets so that competition should prevail to the widest extent. On the domestic front, the new policy stance meant to reduce government-supported entry barriers and to free firms from tight regulations. Most of all it meant to liberalize the financial markets, which had been very tightly controlled. On the external front, the policy meant to abolish import restrictions and open domestic markets for international competition. While pursuing these liberalization policies, government imposed stricter disciplines on the macroeconomic fronts. Restraints on government spending were imposed to keep the budget in balance. Non-expansionary monetary policies which were in line with the stated policy goal of curtailing the inflationary pressures were consistently implemented, too.

The macroeconomic policies were successful. Expansion in government spending was checked within reasonable bounds and inflation numbers were brought down from double digit to low single digit figures. On the liberalization fronts the results were not as

impressive. When compared with the situation in earlier decades, it was true that the economy got freer both domestically and internationally. However, this liberalization was rather half hearted. There were several reasons why this was the case.

First, the intention of the majority of the bureaucrats was not as sincere. They were enjoying the power stemming from controls and regulations and they did not want to relegate this power base.

Second, the machinery of control and intervention was kept more or less intact. That is, there were no serious attempts to change the institutional features that were designed to suit controls and interventions. Without institutional reforms, policy reforms could not be successful.

Third, the stakeholders who had benefited from interventions and controls did not want to throw away the privileges bestowed on them. They thus explicitly or implicitly opposed any serious change in existing institutional setups.

Fourth, the stakeholders who would benefit from institutional reforms were not organized and hence were still weak to bring about the desired changes.

Fifth, the external pressures to open the economy, though they were getting stronger, were not yet strong enough to overcome the resistance by the group who benefited from import restrictions.

Sixth, the technological improvements that had made widespread liberalization inevitable in the advanced economies were not strong enough to bring similar changes in Korea.

2.3.2 The 1990s: Institutional reforms in the age of liberalization and globalization

The decade marks a turning point in the evolutionary processes. It is a decade when government, retreating from the strong interventions of the past, has begun to introduce measures liberalizing the economy. The measures are essentially of two kinds.

The first group is to introduce more competition in the markets. For this various controls on entry, products, and prices are being rapidly reduced or eliminated. Likewise various public monopolies are being privatized and at the same time entry into previously monopolized state owned industries is allowed. Import liberalization measures being introduced extensively in the decade are also to promote more competition. Thus

government has begun to dismantle various trade protection measures erected in the preceding decades.

The second group has to do with establishing a new regulatory framework suitable for the liberalized market economy. The existing regulatory framework has been designed to assist extensive controls imposed by government. As government began to take extensive measures introducing more competition in the markets, it was necessary to dismantle existing regulatory frameworks. However, dismantling existing frameworks did not mean to leave everything to markets. Rather it meant to introduce a new framework that would insure better functioning of the freed markets. It also meant to introduce a framework under which unsatisfactory outcomes of free competition could be addressed.

More than three hundred different measures weakening or eliminating regulations were freshly introduced. Likewise measures were taken to externally liberalize the economy according to a comprehensive import liberalization plan introduced earlier in the decade.

On the regulatory front, the fair trade commission was completely revamped. Most of all it has become a quasi-independent unit whose most important goal is to promote fair competition. A consumer protection agency, which had first been setup in the 1980s, was also newly revamped and strengthened to improve consumer protection. This was a new development in that the concept of protecting consumers had been somewhat foreign to Koreans.

In order to make financial transactions more transparent and thus less susceptible to corruption, a real name account system was introduced in 1992. Before this measure was introduced, Koreans could open financial accounts in false and/or borrowed names, in addition to accounts in their own names. This anonymous account system had helped the financialization of the economy. It had, however, also bred a rapid growth of the unrecorded financial transactions and hence become an important aid to illegal activities. The introduction of the real name account system was a first step to correct the problem.

An extensive set of measures were drawn up to form a comprehensive financial market liberalization action plan. As these measures are being implemented, hitherto segmented financial markets are rapidly being integrated, new entries are made, government-owned financial institutions are being privatized, new products are being introduced, and interest

rates are being set freely. At the same time, domestic financial markets are becoming more and more integrated with the world markets, as the financial market-opening measures are concurrently implemented.

A new financial reform plan is currently being made. The plan aims for further liberalization of the markets, redefining the role of the central bank, and revamping the financial market regulatory framework.

Significant evolution or reforms in other institutions are being made, too. Thus the judiciary system is becoming more independent and neutral, the tax authority is becoming freer from political influences, and the education system is currently undergoing an extensive reform process. Most significantly on the political front, important measures were taken to decentralize the administrative apparatus.

On the whole, therefore, we can observe important changes are being made in Korea. The economy is becoming more market-oriented, the political system is becoming more democratic, and the society is becoming more open and freer.

However, these changes are only the beginning and there still remains an immeasurable array of reform tasks to be dealt with. The most important among them is the task of restructuring government itself. In the past the administrative apparatus of government has been chiefly developed to satisfy the need to control the citizen and the markets. Thus there exists a genuine need to reform the apparatus of government so that they can better serve the citizens and the markets in the open and free environments of the coming century.

3. AN INNOVATION IN NATIONAL ECONOMIC MANAGEMENT

Beginning with this section we are going to examine several institutional innovations Korea had made in the first stage of development. The first example we take on in this section is the role of the leadership and government in development. The second example we take on in section IV is the institutional innovations for export promotion. Then in section V, we will look at the Korea Development Institute as an example of institutional

innovation in the area of human capital development.

3.1. Development-Oriented Leadership

In the first stage of the development process it is important to have a national leader with a clear sense of direction where he wants to lead the country. The leader must be able to convince the citizens with a vision of the country ten or twenty years into the future and has the ability to implement necessary policy measures to realize the vision. This leader, whom we call the development-oriented leader, could be a single person or a succession of persons representing the core group of leaders. Mr. Lee of Singapore, Mr. Deng of China, Mr. Park of Korea, and the former leaders of the LDP in Japan are examples of such leaders.

The leadership role, though, must be replaced with a well established democratic system of government, once the development process is well underway. In fact the changes that the economic development brings with it will invariably force a fundamental shift in the leadership structure from the rule by persons to the rule by the system. That is why advanced countries in the world invariably have the political structure of the rule by the system. Likewise that is why any leaders, who succeeded in launching and sustaining the development process, but who refused to relegate his role to a set of systems, have ultimately been kicked out from the leadership position.

Of course even in the first stage the development-oriented leadership alone is not sufficient. There must be mechanisms to check whether the leader is on the right track, and if not, to bring him back and keep him on the right track. Without such mechanisms the development-oriented leaders even with the best intentions would degenerate into dictators.

Mr. Park of Korea, who was a military general, took power with the military coup in 1961. As the head of the military governing body he amassed all the political and economic powers in his hand. In this process, he oppressed the politicians who dared to object him, sometimes by putting them in prisons. Likewise he nationalized key industries and brought many business leaders to courts for alleged corruption charges. Thus Mr. Park showed all the signs of a power hungry military dictator.

However, Mr. Park was a man with a very strong desire to become a national leader

whom the posterity would remember as a man who rescued the nation from poverty and who built a prosperous and strong nation. Thus he changed his mind very quickly toward economic matters. At first he showed a leaning toward socialism. However, once he was elected to become the President in 1963, President Park made a compact among technocrats in the administration, business leaders, and himself, that he would do everything under his power to help business leaders so long as they made contributions toward economic growth. He had also made promises that he would insure political stability and would protect the country from any aggression from the North Korea. In essence he said that he would not only provide stability, predictability, and security so that citizens could freely engage in economic activities, but also actively help them in their pursuits for wealth creation and accumulation.

There were several forces that have influenced President Park's turn around. First was the domestic economic situation. The initial measures he introduced to socialize the economy produced dismal results. Output growth was minimal, unemployment worsened, prices soared, interest rates shot up, and exchange rates on the black markets depreciated very rapidly. This deterioration of the economy acted as a clear warning signal to President Park. Second, there were technocrats in the administration and academia trained in the U.S., who dared to lecture him on the virtue of market economies. Third, there was the direct influence from U.S. and Japan. President had no choice but to get help from U.S. and Japan. Both countries, which already had strong market economies, provided good examples why he should follow a market dependent development path. Fourth, multilateral institutes such as USAID, IMF, and World Bank had also influenced President Park in his step toward market-friendly development. Finally, the competition with North Korea played a role here. North Korea was already on the path of strongly socialistic development. Thus a market-dependent development path seemed to be a more logical choice for the South.

Thus partly by choice and partly by luck President Park became a strong leader who was more than willing to mobilize national resources toward a single goal: To register himself as the leader who had revitalized the country by making her strong and prosperous. As a leader who understood the importance of economic freedom he chose the

market-based development strategy as the back bone of Korean model. Under this strategy he introduced measures assuring private property and granting as much economic freedom as possible to individuals. He understood the workings of the market mechanism and thereby let markets do the majority of coordination. He was not a naive free market ideologue, though. He was rather pragmatic and used his power unsparingly to introduce new measures, institutions, and rules, if they were thought to promote productive activities.

At the same time President Park understood economic activities would be most vigorous under stable and predictable environments. To provide such environments, he made it clear that as far as economic management was concerned he would rely on technocrats and not on politicians. Thus he nominated the best available technocrats as cabinet ministers in charge of economic matters. Presidential advisors in economic matters were also selected from technocrats. Furthermore, he kept them in position for a long period to insure continuity in economic policy making.

However, President Park's idea of insuring stability and predictability was far from the ideal of stability and predictability under the rule of law. Instead he thought, to maintain stability and predictability, he had to severely curtail political freedom and if possible he should remain as the national leader for a long time. Thus on political front Korean system under Park was far from the democratic ideal, though on economic front, it was rather close to western style market system.

The authoritarian political rule of Park was inevitably reflected in his economic policies. The result was an economic system which was basically market-oriented, but at the same time strongly led and coordinated by government. This latter feature became a source of severe problems in due time.

3.2. Pro-Development Restructuring of the Government

President Park introduced quite a few innovations in the apparatus of government. Of those we will deal with three examples.

3.2.1. President's office

Being a former military general, President Park understood the importance of strategic planning and coordination. He viewed the goal of achieving economic development as

nothing more than winning a war against poverty and against North Korea. There were some indications that he also viewed Japan as an object of competition. Therefore, the first thing he did after consolidating power was to reorganize the Presidential Office toward the direction of strengthening its planning and coordination function.

He created several positions for special Presidential advisors and filled those related to economic matters with experienced technocrats. Of these the special economic advisor played the most important roles. Among others the special economic advisor was expected to assist the President by providing him with strategic policy options. In doing so the advisor would take into account the opinions of cabinet ministers, academic specialists, media, businessmen, and other opinion leaders. Of course pertinent views held by the President would be strongly reflected in the process. The special economic advisor was also expected to play an important role in building national consensus. He was expected to seek understanding from the general public by explaining government's economic policy stances to the latter.

The special advisors were nothing more than staff members. As such they did not have formal authorities given to them. This was an important difference between them and the cabinet ministers. As line managers the latter had substantial power. Nevertheless the special advisors exerted a great deal of power. The source of their power was the trust the President had bestowed upon them. The simple fact that every day they talked to President gave them authority.

President Park knew, however, the value of check and balance. Thus he made the Minister of the Economic Planning Board a Deputy Prime Minister and entrusted in latter the authority to coordinate economic policies promulgated by various ministries. In addition to this, he regularly consulted the DPM, thereby checking possible misuse of power by the special economic advisor. Needless to say the power of the DPM was checked by the presence of the special advisor.

This arrangement of keeping special advisors in the Presidential Office has been kept throughout the recent history of Korea. It still plays an important role. However, it is high time to review their roles and reassess whether Korea still needs such an arrangement. How these advisors played their roles varied depending on the personality

of the President and the advisor himself. This means that the arrangement has been more of an apparatus of a rule by person than a rule by law. This is evident in that the roles of special advisors are not specified very well. In particular their roles are not defined by a law. As a result there exists an inherent danger that this arrangement of the rule by person may get out of hand.

3.2.2. The economic planning board

President Park regarded the role of policy coordination and planning so important that he decided to create a new cabinet ministry, which would specialize in planning and coordination. Thus he created the Economic Planning Board as a full fledged cabinet ministry. He named its minister as a deputy prime minister who was second in rank in the cabinet after the prime minister. The DPM had authorities over all economy related ministries in the sense that he had the final say when there were disagreements among ministers. The DPM had also authorities over other ministries as far as the policy disputes had to do with economic issues.

EPB had several departments. They were department of planning and coordination, department of international economic cooperation, department of price regulation, and department of industry policies. In addition to these, EPB had the department of budget, which prepared annual budget for the entire government. In a sense this was the most important department of EPB, as its power over other ministries stemmed from its budgetary authority.

Since EPB emerged as the most prestigious cabinet ministry, it was able to staff its officials with the best from each cohort of new recruits. These were invariably the elite graduates of the top universities in economics or law major. Of these those who majored in economics were educated by professors who were in the neo-classical tradition. As such they were fundamentally pro-markets. In addition to this, quite a few of the new recruits, regardless whether they majored in economics or law, were regularly sent to overseas for training after a few years' stint at the ministry. They were sent mostly to U.S., the most market-oriented economy in the world, and as a result when they returned, they came back with a conviction that the market system and its associated price mechanism was possibly the best coordination mechanism available to human being. They

strongly believed that government ought to leave as much as possible to markets and to keep government interventions to the minimum. This had made EPB as the most pro-market ministry of President Park's cabinet.

From the inception EPB played important roles in national economic management. It had prepared a series of five year economic plans and had implemented various policies designed to achieve the policy goals stated in each five year plan. The five year economic plans were indicative plans. Based on available information, analyses, data, and forecasts the plan depicted a quantitative picture of the national economy for each year in the planning period. It was indicative in that the plan just set the targets that planners hoped the economy would achieve during the planning period. Whether the economy would actually achieve the targets was mostly left to the private sector. The chief role of government was envisioned as one of assisting the private sector. For this government would formulate and implement macroeconomic policies that would provide a favorable environment for the private sector. It was also expected that government would use policy tools and means to actively assist the private sector whenever it was judged that the latter was in need of such assistance.

3.2.3. Ministry of finance

One of the key reason how EPB was able to maintain a policy stance emphasizing the role of markets was the existence of its antagonist. Its antagonist has been the Ministry of Finance. Even though MOF was staffed with equally able recruits, it turned out to be very conservative in policy stance. MOF was conservative in the sense that it valued the role of government very highly, it did not mind to exert control as much as possible, it did not hesitate to intervene in the markets, and it did not want to shed this power. Staff members of MOF, unlike those of EPB, strongly believed that the private sector was inherently unstable and did not know what was good for the national economy. Thus they believed that government should guide and regulate the private sector. MOF carried out this ideology faithfully in the financial markets. That was why the financial sector had been one of the most heavily regulated industry. Thus the policy stance of MOF was diabolically opposite to the policy stance of EPB. Because of this struggle, EPB had been able to keep its pro-market policy stance and had effectively neutralized MOF's intervent-

ionist policies.

As Korean economy developed and grew mature, the need for planning function diminished very rapidly. In addition to that as the economy became more market dependent and more open to the world, a consensus emerged several years ago that Korea did not need EPB any more. In response to this new challenge, government merged the EPB with the Ministry of Finance to create a new Ministry of Finance and Economy.

However, there are indications that the merger of two ministries into a new ministry was a wrong response to the challenges Korean government faced in the 1990s. The challenge was to reorganize government so that there would be change in the balance of power from government toward markets. What Korea had a simple merger of two ministries. There were no meaningful reduction of staffs or functions. The result was a creation of a super ministry that had retained most of the powers held by EPB and MOF. Rather than shedding powers held by government, the new ministry became an apparatus of concentrating power in one ministry. The restructuring of government substantially weakened the check and balance function prevailed among ministries. Furthermore, the coordination function, which was held by EPB and which has become all the more important in the liberalized environment, was mistakenly eliminated together with the planning function in the process of the merger. Therefore, there is a genuine need to revisit the issue of restructuring government. This is all the more so because there has never been meaningful restructuring of government.

3.2.4. The meritocracy

Another important innovation President Park introduced into governing institutions was the establishment of the meritocracy in selecting candidates for all levels of public officials. Thus government employees such as officials for central and local governments, officials of the judiciary branch, and teachers for the public schools were all chosen through open written examinations. Anyone, except for teacher's position for which one must be a graduate of relevant education colleges, could apply for the position regardless of sex, age, and level of education. Among those whose exam scores were above certain minimum a fixed number of candidates were chosen from the top for each cohort of

recruits.

There were separate tracks for high ranking central government officials, low and middle ranking central government officials, and officials for local governments. The newly recruited would get on the job training and would be assigned to a ministry or a local government, where he or she was expected to serve without much rotation to another ministry or another local government. The job security for public officials was rather strong, though the pay level was somewhat lower compared to that of the comparable employees of top class business firms.

In fact the meritocracy has a long tradition in Korea. From about 1,500 years ago candidates for the top ranking government officials were regularly selected through exams held in the royal courts. Anyone from the upper class could take the exam. Fame, wealth, and high social status were bestowed upon those who passed the exam. There were numerous over night success stories of a youngster from a poor family suddenly becoming a national hero when he passed the exam. The youngsters who passed the exam could invariably marry with girls from established families or from royal families. This was one of the surest way to move up the social ladder. Often a youngster who passed the exam was able to uplift his entire family. As a result passing the exam became the most coveted feat a youngster would dream of.

The meritocracy has served its purposes rather well. The system has enabled government to recruits some of the best college or high school graduates. They were able, highly motivated, and had the sense of responsibility for the well-being of the nation. These public officials, especially the high ranking central government employees in economy-related ministries, formed a core group of elite. They had led Korean development, especially in the 1960s and 1970s.

The system has also served as an important means to narrow social inequality. As it was in the old days, those who passed the exams to become high ranking government officials (or judges and prosecutors) could marry with girls from wealthy or politically powerful families. Many of the former were from financially poor families from the rural areas. Upon passing the exams, these youngsters from poor families suddenly become very eligible candidates in the marriage market. Through such interclass marriages and

through a utilization of the prestigious position of being a high ranking government official, he could easily transform himself from a nobody to a somebody.

Another byproduct of the system was the aspiration it had instilled in young men and women of Korea. The observation that once one passed the coveted exams one could have both fame, beauty, and wealth has instilled in youngsters a strong motivation to succeed. Since success was possible only when one studied very hard, the motivation has naturally led them to study extremely hard.

The meritocracy now shows some signs of strain. As the society becomes more open and diverse, there is a real question whether selecting government employees entirely through exams is the best system. The exams are only exams and there are clearly limitations to them. After several decades of practice it became evident that those who passed the exams in recent years were mostly those who could take exams well, not necessarily those who could become good public officials. It is very hard to select genuinely creative individuals through written exams. Currently there exists a danger of Korean bureaucracy becoming too monotone.

4. INSTITUTIONAL INNOVATIONS TO PROMOTE EXPORTS: THE EXPORT FINANCING SYSTEM

By now it is well understood by Korea watchers that one of the secret behind the success of Korean economy in the last 35 years is her steadfast adherence to the export-oriented strategy. Many economists believe the phenomenal and persistent export growth has been one of the main forces that have led Korea to grow so rapidly in such a prolonged period. How has then the phenomenal export growth been possible? Economists give us many different answers to this question. Still there is a common thread among the reasons given. The common thread is the belief that judicious policy making has been crucial for the export-led growth of Korean economy.

Various policies were used to promote exports. First, using fiscal and/or financial measures direct subsidies were given to the exporters. Second, import restrictions were imposed to shield the export sector from foreign competitors. Third, new institutions such

as the Korea Trade Promotion Agency and the Korea Ex-Im Bank were set up to assist exporters with information gathering and financing. Fourth, general trading companies were encouraged to set up in order to facilitate the export and import businesses. Fifth, the transfer of technology from the advanced countries was encouraged.

How have the policies worked? Have they been effective? Have there been any ill effects? In order to deal with these issues, we will closely examine the export financing system in this section. The goals are to understand how the system has worked and whether the system has been successful.

4.1. The System Described

The export financing system was an arrangement whereby banks provided preferential credits to the exporters. Under the system banks would automatically extend credits to exporters with the understanding that the central bank would extend credits to the lending bank when there was shortage in loanable funds. The system works in the following manner.

Exporters typically fulfill orders on credit. When an exporter wants to sell products to an overseas buyer, he demands to receive a letter of credit (L/C) from the importer's bank. Only when he can secure an L/C, he begins to prepare the export items. An L/C is a promissory note issued by the importer's bank. The importer's bank promises to pay the amount indicated on the L/C when its due date arrives. Upon receiving an L/C, the exporter brings it to his bank to finance his export activities. After a careful evaluation of the creditworthiness of the L/C, the bank would buy the latter. When a bank purchases an L/C from an exporter, it is effectively giving a loan to the exporter. Up to this point this is an entirely routine transaction and no special favor is given to an exporter. Bank lending to an exporter would be of the same kind as any other bank lending. When there is a financial control, however, the situation would be different.

Korean government introduced an important twist into the export financing business in the 1960s. First of all it introduced an interest rate regulation on banking transactions. The regulation required banks not to charge interest rates higher than a level set by government. The ceiling rates were typically set at a level well below the rates at which markets clear. This practice of setting regulated interest rates below the market clearing

rates naturally created a huge excess demand for loanable funds. Suddenly a fierce competition among borrowers for the limited available amount of bank credits emerged.

The simple fact that bank lending rates were set at a level much below the market clearing rates meant nothing more than a creation of huge economic rents. Suppose the interest rate ceiling was set at 10% level, when market clearing rates were at around 15% level before the interest rate regulation was introduced. This itself meant a 5% point subsidy to those who could borrow from banks at the controlled rate. The actual subsidy, however, turned out to be greater than this. This was so because the post-regulation market rates rose higher than the pre-regulation market rates with the introduction of interest rate control. Though borrowers all scrambled to secure a loan from banks, naturally not all the demands could be fulfilled. Those who could not borrow from banks, then turned to other sources of funds. This competition would invariably push non-regulated interest rates higher. The result was a post-regulation market clearing rate that was higher than the pre-regulation market clearing rate. For example, when the pre-regulation rate was at 15% level, the post-regulation rate could be at 20% level. But this meant an interest rate subsidy of 10% point.

Securing a loan at 10% borrowing rate from a bank in the case just described amounted to receiving a 10% point subsidy for each dollar borrowed, a fat 100% subsidy! In this situation everyone would try very hard to borrow from the banks. When he could secure a 100% profit rate by simply relending the borrowed amount in the open market, why would anyone not to borrow from a bank? Indeed there emerged a huge excess demand as expected. Of course government also foresaw this and made provisions to tackle the problem.

In order to expedite the allocation of the available funds, when demand for funds greatly exceeded the supply of funds, government issued guidelines for the banks. The guidelines specified to whom, how much, and at what interest rates the banks were allowed to lend. The guidelines were usually set so that funds could be channeled into sectors deemed to be desirable by government. One of the priority sector was the export sector. The system in itself was prone to misuses by bankers, borrowers, and bureaucrats.

However, government set the guidelines so that the bulk of the available credits would

be automatically allocated to exporters. This was done by a simple measure which required the banks to extend credits to exporters, whenever the latter brought valid L/Cs to the former. The rule was simple, transparent, and non-discretionary. From a banker's viewpoint, all that was involved was to check the creditworthiness of an L/C, subtract a correct amount of interest prepayment from the amount of the loan, and lend the relevant sum to the exporter. This was a rather simple banking business. Since the loan was granted taking an L/C as a collateral and since anyone could verify the validity of the L/C, the business was transparent, too. It was also non-discretionary, because export loans were granted solely on the basis of an L/C.

This was the essence of the export financing system. To repeat, it was a system under which banks automatically gave credits to exporters at rates substantially lower than the going rates, whenever exporters brought valid letters of credit to the bankers. This was a system under which government created a substantial amount of rent through interest rate controls and then allocated the rents to the exporters using a simple, transparent, and non-discretionary rule.

4.2. How the System Worked

The export financing system had provided crucial assistance to the exporters. When it was extremely difficult to secure loans from banks, the system guaranteed bank credits to exporters, thereby eliminating a big chunk of uncertainties from their business environment. Furthermore, through interest rate subsidy, the system provided important financial assistance to the exporters. In sum, the system helped exporters a great deal and with the help exporters were able to grow very rapidly. This rapid growth of exports had undoubtedly contributed toward the overall economic growth of Korea.

There were two key features of the system that had made it successful. First, the fact that the system was simple, transparent, and non-discretionary had made it nearly immune to misuses. This had prevented widespread rent seeking behavior from occurring. Without this feature, it was highly likely that system would have degenerated into a corrupt system of allocating favors according to personal or political whims. Second, the fact that the system was effectively tied to market signals played a key role. Under this system those who benefited from it were those who succeeded in international markets, not those

whom bankers or bureaucrats personally favored. The system had provided right incentives for exporters to improve efficiency.

The incentives provided by the system were for both static and dynamic efficiency. Statically it provided incentives for producers to reallocate resources into sectors that were more productive. Dynamically the system pushed firms into sectors that markets themselves deemed to be dynamically efficient. The system helped those exporters who were successful in international markets. Old exporters who did not do well on international markets were ruthlessly fell off from the favored list and new exporters who found niches in international markets were given extra pushes. When domestic markets were not well developed, this signaling function of the overseas markets played an especially important role.

4.3. Costs of Financial Controls

As Korean economy grew, the value of the export financing system steadily diminished. Most of all it became clear that promoting a particular sector of the economy at the expense of others could not be justified indefinitely. The harmful effects of the export financing system were rather limited, though, because the system relied on market signals in the distribution of rents. What had made matters worse were financial controls other than the export financing system.

Beside the export sector, there were numerous sectors that Korean government deemed desirable to support. The agricultural sector, the construction sector, the heavy and chemical industries, and the small and medium sized firms are only a handful of examples. These sectors were selected as strategic areas into which subsidized bank credits would flow. Indeed massive financial resources were channeled into those sectors. However, financial controls used to promote so called strategic industries were fundamentally different in nature from the export financing system.

The difference lied in the manner how the targeted sectors were selected. In the case of the export financing system, there was a simple, objective, and transparent guideline: offer financial assistance automatically to those who passed the market tests by being able to bring in valid letter of credits issued by the overseas importer's bank. In other cases, however, there was neither a transparent nor a simple rule to distribute credits: the

rule was to distribute credits to those industries or firms that government deemed important. But how could government officials know which industries or firms were important? Even though the bureaucrats in charge of credit allocation tried to rely upon market signals, the selection process remained mostly discretionary. The results were unavoidable misuses of the system. In numerous cases financial resources were misallocated and wasted.

Even in the cases where the subsidized credit allocation had promoted rapid development of industries, the policy had inevitably induced most Korean firms to be overly dependent on bank credits. It has substantially weakened the financial health of Korean firms. More importantly it became clear that the system was imposing a heavy burden on the financial system. The facts that interest rates and other terms of credit were tightly controlled by government meant that banks were not able to pursue normal paths of development. This had impeded growth of the banking sector which still remains as the most retarded industry in Korea.

Recognizing these ill effects, government began to phase out the subsidy component from the export financing system from the middle of 1980s. Thus interest rates began to be deregulated. With the weakening or elimination of interest rate control, excess demand for bank credits rapidly disappeared. The result was no longer a need for government-mediated credit allocation. Here pressures exerted by trading partners or multilateral institutes such as OECD or GATT (WTO) also influenced government's decision to stop meddling in the financial markets.

The shift in the policy stance toward financial markets proves as yet only half-hearted. Entry barriers still remain and the industry is segmented. Because of the severe controls on the ownership structure of banks, major banks do not have controlling shareholders. The result is a lack of effective governance mechanism with which the bank management can be disciplined. On top of these woes, most banks are burdened with huge amount of non-performing assets. To make matters worse, many industrial firms that have borrowed heavily from the banks are now in big troubles. Some of them already went bankrupt as many banks were either unable or unwilling to extend further credits. This bankruptcy made banks even more vulnerable.

5. WHAT CAN WE LEARN FROM THE KOREAN EXPERIENCES?

The history of institutional development and innovations in Korea over the last 35 years provides us with interesting insights into the nature of economic development and into the role of government in economic development.

It is evident that institution building must be an essential part of the development process. Without proper institutional setup it is very difficult to launch a development process. Even if it could be launched, it cannot be sustained due to the lack of mechanisms under which difficulties that would inevitably arise can be dealt with. When institutions in the form of basic rules of the game, leadership, policy making mechanisms, relevant apparatus to carry out policies, well functioning markets, and market-supporting organizations are not in place, therefore, efforts should be made to develop them, before we can hope for growth processes to move along smoothly.

Institutions are key component of social capital, which in turn constitutes one of the most important ingredients to the aggregate production process of an economy. The importance of private capital such as human and physical capital held by individuals is well understood. However, economists often neglect the importance of social capital, though the importance of social physical capital in the form of infrastructure is well understood. Social non-physical capital in the form of law, customs, history, systems, markets, and institutions is equally important as social infrastructure. They could be even more important for development.

As institutions constitute an important part of social capital, they should be subject to new inventions, innovations, and improvements like any other capital stock. These are nothing more than the accumulation processes of social capital. When social capital is inadequate, the resulting economic activities would be grossly inadequate. Likewise when the accumulation of social capital is inadequate, the growth of economic activities would be retarded, too. Hence the importance of institution building for any sustained development processes.

It is equally evident that institutions could be stumbling blocks for development. Here it would be pointless to stress why wrong institutions would hamper economic activities. What is more important is the observation that once adequate institutions could become grossly inadequate in a new environment. Not only inadequate, they may positively retard proper development.

A good example for the case in point is the various governing apparatus of Korea built in the 1960s and 1970s. They were created to assist government in implementing its strongly interventionist policies. Though they played important positive roles in the initial stages of development, they became important stumbling blocks when Korean economy grew and mature. For the latter environment what was needed were institutions that would promote markets, not the existing ones that were designed for a stage when markets were not yet sufficiently developed. Korea was somewhat slow in addressing this problem. It is only in the last few years that this problem is being earnestly dealt with.

Another example along the line is the Korean education system. Even though the education system of Korea has been very successful in supplying human resources needed for rapid economic growth, it is no longer suitable for the new global environment. In the past the regimented system of mass education contributed toward economic development by supplying a steady stream of productive hard-working workers. However, the current system is very inadequate in nurturing creative and original minds. If the latter is needed for the new environment in which knowledge and information would become increasingly more important, then it is clear that the current Korean education system should be reformed from its roots. This is one of the challenges Korea now faces. How she deals with it would determine whether she can renew the sustained development processes of the past.

A third example is the financial system of Korea. Financial industry is one of the least developed sector in Korea. The main reason for this backwardness lies in the fact that it has been the most strongly regulated industry. Government used financial controls to allocate credits to policy-designated industries. This policy was based on the belief on the part of the policy makers that the financial markets, if left alone, would allocate scarce resources to 'wrong' borrowers. That is, the policy was based on the belief that in an

underdeveloped country financial markets would be more likely to fail than to succeed. At the initial stage of development, this observation could be correct. In this case judicious intervention by government in the financial sector could be justified as an activity to correct the market imperfections. However, by the middle of 1980s it became evident that such heavy intervention in the financial markets were creating more ill effects than benefits. Policy makers themselves recognized this glaring problem and began to deal with it by introducing a series of reform measures.

The financial market reform measures just mentioned are not yet fully implemented. One of the main reason why such reform measures are not easily implemented is because of the strong resistance put forward by the beneficiaries of the existing setup. This is in fact one of the key difficulty every institutional reform activity inevitably faces with. When the forces that demand institutional changes are strong enough, they can overcome the resistance and bring about the needed changes. Otherwise, reforms would be slow and incomplete.

For the case of Korea, the two most important forces that make institutional reforms urgent are the rapid pace of domestic liberalization and the equally rapid progress in globalization in the economy.

First, globalization demands Koreans to change her institutions so that they would conform better to international standards and practices. Since these demands are usually exerted by advanced countries, whose economies are much more market-dependent and whose governments play much smaller roles, globalization forces Korea to reform her institutions so that they would be more market-friendly and less dependent on government.

Second, the rapid pace of domestic liberalization, which is propelled by rapid technological changes, also requires changes in existing institutions so that they would become more market-friendly and less dependent on government.

What Korea needs at this stage of development is to revise the basic rules of the game so that they can fit better to a developed market economy. Concurrent with the changes in the rules, institutions to implement the rules should also be reformed. Among others this calls for institutional reforms in the direction of reducing government interventions

and promoting the self regulating function of markets. In the past government has played the dominant role on Korean economic scene. It is high time now to bring markets to the front and relegate government to the back stage. This requires fundamental shifts in the balance between government and markets, away from government toward markets.

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