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| 著者 | Yanagihara Toru |
| 出版者 | Institute of Comparative Economic Studies, Hosei University |
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# Structural Reform as Precondition for Economic Growth: Analytical Framework and the Case of South Korea

**Toru Yanagihara**
*Takushoku University*

## Abstract

High and sustained growth in East Asia, and particularly in Northeast Asia, after the Second World War stands out as exceptional experience in the economic history of the world. This article aims to provide a new perspective on this unique growth experience in Northeast Asia by presenting an analytical framework for the understanding of the critical role of *structural reform* as precondition for the start and continuation of economic growth. The analytical framework will be illustrated in discussing the case of South Korea. The article undertakes the following tasks: provide a methodological examination on the key concept of *precondition*, adopted to place growth experiences in the perspective of economic history; trace the growth trajectories of three Northeast Asian economies (Japan, Taiwan, and Korea) in a long-term perspective and post-WWII growth performances in some detail; identify both regional commonalities and differences across individual economies; present an analytical approach to *precondition* of economic growth from the standpoint of *developmentalism;* provide conceptual articulation of and analytical framework for *structural reform*; illustrate the conceptual and analytical approaches by applying them to the examination of the experiences of Korea. The article concludes with the recapitulation of the central messages of the paper and the indication of tasks for further study on the relationship between stages of economic development and economic system evolution.

## 1. Introduction

The record of high and sustained growth in East Asia, and particularly in Northeast Asia, after the Second World War stands out as exceptional experience in the economic history of the world. This paper aims to provide a new perspective on this unique growth experience in Northeast Asia by presenting a *developmentalist* analytical framework for the understanding of the critical role of structural reform as precondition for the start and continuation of economic growth. The analytical framework will be illustrated in discussing the case of South Korea (Korea, hereafter). The paper is organized as follows: Section 2 provides a methodological examination on the key concept of *precondition*, adopted to place growth experiences in the perspective of economic history. Section 3 traces the growth trajectories of three Northeast Asian economies (Japan, Taiwan, and Korea) in a long-term perspective and describes post-WWII growth performances in some detail. Here both regional commonalities and differences across individual economies are identified. The selection of Korea for case study will be justified. Section 4 presents an analytical approach to *precondition* of economic growth from the standpoint of *developmentalism*, and provides conceptual articulation of and analytical framework for *structural reform*. Section 5 applies the conceptual and analytical approaches to the examination of the experiences of Korea, illustrating main thrusts of the argument of this article. Section 6 concludes with the recapitulation of the central messages of the paper and the indication of tasks for further study on the relationship between stages of economic development and economic system evolution.

## 2. Economic history approaches to economic growth

Most economic studies on the factors affecting economic growth have been based on analytical frameworks of economic growth theory and empirical formula of growth accounting or growth regression. In early years, attention was primarily directed to such factors as capital formation, education, and technical progress. Recently, a wide variety of other factors have also come to be introduced in growth studies, such as natural and geographical conditions, cultural, social, and political situations, and policy and institutional environments. At the same time, policy prescriptions by mainstream international financial institutions such as the World Bank and the International Monetary Fund (IMF) have been dominated by neoclassical economic views that claim that avoiding government interventions into markets and eliminating distortions in the price system are necessary prerequisites for economic growth. In the recent past, other policy actions and institutional factors have been added to the policy prescriptions of those organizations.

Common to those academic and policy-oriented approaches is the lack of an economic-history perspective in which economic growth experiences are viewed as historical processes. Prerequisites for economic growth are deduced as logically necessary conditions and little attention is paid to their relevance and applicability in historical processes of economic changes in particular country contexts. This applies with particular force to the structural adjustment programs of the World Bank and the IMF. The programs typically consist of a standard package of policy and institutional reforms prescribed as prerequisites for sustained economic growth. There a general causal relationship between *structural reform* and economic growth is presupposed and no effort is made to place and evaluate individual economies in their respective historical contexts.

What then will be unique contributions economic-history perspectives could possibly make to the understanding of economic growth? What sorts of viewpoints and implications do they provide regarding prerequisites for the start and continuation of economic growth? One may broadly classify contributions of economic history into three categories. First, one can note the definition and stylization of Modern Economic Growth (MEG) by Simon Kuznets and the “relative backwardness” thesis in a comparative historical framework developed by Alexander Gerschenkron. Second, one needs to recognize the formulation of “stages of economic development” by Walter Rostow. Third, Douglas North's investigation on “institutional evolution” in historical perspectives deserves attention.

Kuznets defines and places the modern period as an “epoch” in human history in which high rates of economic growth became sustainable based on advances in science and technology and shows national trajectories of Modern Economic Growth in its various statistical manifestations. He sees the historical process of propagation of Modern Economic Growth from its origin in the West to the rest of the world as driven by the dissemination of Industrialism, involving not only technological and economic changes but wholesale social transformation.

This perspective also informs the studies by Alexander Gerschenkron and others in comparative economic history, where the characteristic features of the catching-up processes of latecomer countries are examined in empirical and policy-oriented perspectives. Here, attention is mainly directed to mechanisms of the start and continuation of economic growth on the basis of introduction of modern technologies and management methods from advanced countries. In particular, Gerschenkron addressed this question in a comprehensive perspective encompassing formation of promoters of investment, establishment of financial systems, and creation and propagation of *developmentalist* ideologies for resource mobilization.

The formulation of the "stages of economic development" by Walter Rostow has won wide recognition mostly because of the naming and definition of a "take-off" as a stage in which an economy undergoes a historic change in its working, summarized in a rise in the investment ratio, enabling it to move on to the next stage of sustained growth. No less important from the economic-history perspective are his designation of the preceding stage as "preconditions for a take-off" and his wide-ranging considerations covering many aspects of social life. In its comprehensive scope, Rostow's formulation is considered as a variant of modernization theses aimed at the stylization and explication of the historical process of modernization of traditional societies. As such, his thesis, along with other modernization theses, was criticized as a simplistic linear view of history and also as an imposition of the Western ideological views of historical progress. From the economic-history perspective, however, there is no denying that Rostow's study has made important contributions in that he recognized and emphasized in his stage thesis formulation the role of productive investments in economic development and the multifarious preconditions for their realization.

The principal significance of the study on "institutional evolution" by Douglas North consists in the adoption of the concept of "*transaction costs*" as key component of his thesis on the determinant of the realization of productive investments, the central developmental question posed by Rostow. Investment projects, and especially those embodying modern technologies, are often characterized by indivisibility and irreversibility as well as by multiplicity of stakeholders, making them risky propositions for prospective investors. North clarified and articulated the concept of *transaction costs*, distinguishing ex-ante ones incurred in advance of investment decisions and ex-post ones in the operation phase of business. He saw institutions supporting the establishment and enforcement of property rights as key mechanisms for reducing *transaction costs* and organized his comparative historical studies to illustrate diverse experiences of institutional evolution and their consequences in terms of investment behavior and growth performance.

In summary, we could obtain the following viewpoints and insights from the economic-history studies reviewed above. The central determinant of economic growth is the level of realized productive investments. In latecomer economies there may exist business opportunities that promise high rates of return to investment based on the introduction of modern technology and management method from advanced countries. There are, however, preconditions for the realization of such investment opportunities: they include formation of promoters of investment, establishment of financial systems, and creation and propagation of *developmentalist* ideologies (as emphasized by Gerschenkron), and also institutional factors that contribute to reduction in *transaction costs* surrounding investment decisions (as highlighted by North), among others. This paper attempts to present an analytical perspective to the preconditions of economic growth in post-WWII Northeast Asia, informed by the important viewpoints and insights obtained from the economic history literature.

## 3. Development experiences in Northeast Asia over the past century

Let us start by reviewing the trajectories of economic growth over the hundred-year span of the twentieth century for Japan, Taiwan, and Korea. First, let us roughly trace the broad contours of the per-capita GDP growth in a long-term perspective based on the estimates by Angus Maddison (Table 1). The following two observations suggest themselves as recognizable patterns in the time-series statistics.

First, broadly stylized, there are common patterns of phase transition in long-term trends of the three Northeast Asian economies. All of them exhibited similar and characteristically high rates of growth since the 1950s. Second, comparing in more detail the levels and rank orders of growth rates among the three economies in the pre-war (1911-40) and post-war (1851-92) periods, one finds a contrast between comparatively higher growth rates of Japan in the pre-war period and of Taiwan and Korea in the post-war period. In other words, the degree of growth acceleration from the pre-war to post-war period was higher in Taiwan and Korea than in Japan.

Next, let us trace sequences over the post-war period of growth rates in some more detail (Table 2). The following four patterns are recognizable in this table. First, the decade averages of growth rate from the 1950s on exhibit a common, inverted U pattern: accelerating initially, reaching a plateau, and decelerating subsequently. Second, the timing of the phase transition mentioned above was observed at an earlier timing in Japan than in Taiwan and Korea by about 10 years. Third, Japan recorded the highest growth rates in the 1950s and 1960s, but Taiwan and Korea registered much higher rates than Japan from the 1970s on. Fourth, comparing the levels of growth rates over time between Taiwan and Korea, one can observe successive narrowing of gaps between them as they followed a broadly similar pattern of phase transition.

The historical patterns identified above may lead us to the following research agenda. One task will be to understand the mechanism of economic growth capable of explicating the pattern of sequence common to all three Northeast Asian economies. Another will be to identify the factors that enabled Korea to realize an especially rapid “catching-up” process. In addressing these two tasks, it will be necessary to have mutually consistent answers to the questions posed. Our focus in this paper will be placed on the second task. In presenting our views and conclusions on Korea, care will be taken to delimit their applicability by distinguishing factors unique to Korea from those common to Northeast Asia in general.

## 4. Analytical perspectives of *developmentalism*

This Section presents analytical perspectives to be adopted in the investigation of the central theme of this paper, i.e. “*structural reform as precondition* for economic growth”, and examines the main concepts employed in them. This paper adopts the standpoint and analytical perspectives of *developmentlism* in addressing this theme. The unit of analysis will be set at the level of a firm, since our analytical focus will be mostly placed on decision-making related to productive investments, considered to be the key determinant of growth performance at the macroeconomic level. The central analytical task of this paper will be to investigate how the (broadly defined) transaction costs incurred by the firm in its decision-making on investment may be affected by "economic structures" and, based on that understanding, to deduce the significance of "structural reform" for attaining superior growth performance. We will partly rely on the concepts and analytical frameworks of the New Institutional Economics, as spearheaded by Douglas North and Oliver Williamson in particular. In the following paragraphs we will first define and characterize *developmentalism* before we turn to the analytical tasks stated above.

### 4.1. *Developmentalism* and *developmentalist* policy system

*Developmentalism* refers to perspectives in empirical and policy discussions that emphasize the leading role of the government as both necessary and effective in realizing economic development in late-comer countries. As such it is placed in contraposition to liberalist positions on empirical and policy questions as exemplified by neoclassical development economics with its emphasis on the leading roles of the private sector and the market mechanism. *Developmentalism*, while generally placing emphasis on the role of the government, varies widely regarding the importance attached to the role of the private sector and the market mechanism. On one end of the spectrum, one could envisage the socialist command economy where major economic activities are governed under direct government control. Toward the other end, one could conceive of a mixed economy bordering on liberalism, where positive roles of the private sector and the market mechanism are pursued to their limits. *Developmentalism* in Northeast Asia (Japan, Taiwan, Korea) is of the latter variety with some intra-regional variations.

Here, we will review a schematic representation of *developmentalism* by Yasusuke Murakami (Murakami 1992) as the most systematic description of its salient features. Murakami defines *developmentalism* as follows:

> A political-economic system of the state where governmental interventions from the long-term perspective of industrialization are incorporated as essential components within the fundamental framework of capitalism (i.e., private property and market economy).

Murakami expresses his views on the factors propelling industrialization as follows:

> The most fundamental features of industrialization consist in the belief that the physical environment could be constantly remade and the efforts toward its realization. In that sense, the core constituent of industrialization is an incessant process of technical progress.

This fundamental perspective of Murakami almost completely agrees with Kuznets' historical vision of Modern Economic Growth and Rostow's formulation of stages of development in emphasizing the holistic nature of historical processes. Discussing the political-economic system aspect of industrialization, Murakami observes that "[i]n general, industrialization needs to be guided by *developmentalism*. ... It was the case even in England, even though it was an unconscious type there." He emphasizes that *developmentalist* political-economic system and policy framework could vary widely both over time and across countries.

Murakami proposes a prototype model of the *developmentalist* policy framework based on his stylization of relevant aspects of experiences in post-war Japan. The model consists of three broad categories: (1) industrial policy (capitalist market economy principle, designation and promotion of promising industries (including export-oriented manufacturing industries), support for the development of small enterprise); (2) distributive policy (amelioration of inter-sectoral income disparities, price support policy in agriculture); and (3) intangible infrastructure (education system, modern bureaucracy). Our immediate interest relates mostly to the first of the three categories above.

Murakami contends that government interventions for industrial policy in the 1950s and 60s in Japan were "specific, rule-based and indicative", that they set the parameters for "compartmentalized competition", and that they helped realize high growth of the leading heavy and chemical industries. His argumentation goes as follows: In this period each enterprise in many heavy and chemical industries anticipated growth in domestic demands and envisaged the possibility of realizing decreasing costs by means of the introduction of new technologies and the expansion of productive capacities. These conditions created constant pressures for aggressive investment behaviors characterized by "unstable equilibria" of market competition incapacitating the automatic regulating function of the market. Under such situations government interventions made important contribution in realizing more stable paths of industrial development, with government-designed investment coordination curbing excessive investment competitions during boom periods and government-sponsored cartels averting cut-throat price competitions during depressive periods.

Murakami expresses his views on the manner of government intervention in post-war Japan in the following words: The dominant mode for attaining policy goals was "spontaneous regulation" and "spontaneous coordination" administered by industry-wide business associations engineered by government through informal administrative guidance. This mode of government intervention was adopted because there were strong oppositions against government-imposed decisions among business and political circles. It was practicable because it could rely on custom of informal coordination between government ministries and business associations carried over from the war-time mobilization regimes. Murakami states: "Given that legal compulsion is not an option, the government had no other ways of attaining its policy goals but elicit autonomous cooperation from private enterprises by means of indirect mechanisms acting as intermediary and arbitrator."(Murakami 1992 Vol.2, p.47)

The relationship between the government and the private sector in post-war Japan was formed and evolved in the process of the implementation of industrial policy. There are two important questions to be addressed in this connection. One is the relation between *developmentalism* at the government level and *developmentalism* at the enterprise level. The other is the evolution of that relationship over time. On the first question Murakami states as follows: "*Developmentalism* as national policy is designed to bring about *developmentalism* in business management." (Murakami 1992 Vol.2, p.293) Conversely, "if *developmentalism* is to succeed as government policy, there need to exist a sufficiently large number of enterprises infused with *developmentalism* in the sense of being motivated to realize decreasing costs. There may be cases where government policies lead to successful fostering of such enterprises, but there is no general guarantee for such success. Alternatively, there may be cases where enterprises come to embrace *developmentalism* on their own volition when they perceive clear prospects of dc in the industries they operate in. (Murakami 1992 Vol.2, p.326, fn 26) On the second question Murakami's characterizations are as follows: "During the first phase of rapid growth up to the early 1960s there were distinctly *developmentalist* institutions that progressively shaped the practices of government-business relations and business behaviors corresponding to them. During the subsequent period, those relations and behaviors became fully established thus consolidating the operational principles of *developmentalism*." (Murakami 1992 Vol.2, p.311-312)

These characterizations and reflections by Murakami offer many useful insights and suggestions for our formulation of analytical framework and examination of the Korean case in the following parts of this article.

### 4.2 Structural reform in the *developmentalist* perspective[i]

Latecomer countries enjoy the possibility of starting and sustaining economic growth based on the introduction of modern technology as discussed in the previous section. At the micro level, this could be stated as the presence of latent investment opportunities for enterprises. Such opportunities are realized if and when they take risk and carry out investment decisions. Economic growth at the level of the national economy is achieved as a collective outcome of investment behaviors of individual enterprises.

*Developmentalism* in Northeast Asia is essentially predicated on the capitalist economic system and the realization of investment opportunities are primarily left to private enterprises. The state designs and implements varied policies and institutions in support of investment activities of private enterprises with a view to facilitating national development process. In some cases, forming and fostering private enterprises constitutes an important focus of development policy. This encompasses two aspects: on the one hand, it involves creation or expansion of business opportunities; on the other it relates to the formation of an enterprise system in its entirety, comprising technical and managerial capabilities, procurement and sales, workforce, finance.

The nature and significance of the *developmentalist* policy system may be pointed out in relation to the following varied aspects. First, existing vested interests are suppressed and their speculative and rent-seeking opportunities are eliminated. The adoption of such a policy stance presupposes the independence of the regime in power from traditional economic interests and asset holders. Second, investment activities deemed conducive to economic growth are encouraged by means of policy measures for the creation of investment opportunities, reduction of investment risks, provision of finance, and support in the formation of an enterprise system. Such a multi-faceted policy system is deemed necessary as new business enterprises are fraught with an inevitable array of uncertainties and their survival needs to be guaranteed by the state if latent investment opportunities are to be realized. This view poses a sharp contrast to the neoclassical theory of investment where investment decisions are

i This section builds on Yanagihara, T. (1997)

couched in marginal principles in terms of simple comparison between expected returns and capital costs.

In what follows, we first provide conceptual discussion on “economic structure” as prelude to our approach to the nature and significance of “*structural reform*” from the *developmentalist* perspective.

In this article, “economic structures” signify all the factors considered given and constant over a short run in relation to enterprise activities. They can be classified into four broad categories: (1) The first category refers to productive forces comprised of tangible capital (productive and infrastructural facilities), human capital, and technical and managerial capabilities. These capitals and capabilities are often specific to particular activities of individual enterprises. (2) The second is an enterprise system consisting of all the internal and external relations of an enterprise and rules and customs governing them. (3) The third relates to general environmental factors governing enterprise behaviors, consisting of formal policies and institutions defined and enforced by political and administrative authorities and informal societal norms and customs as dictated by tradition and culture. (4) The fourth consists of “intermediary factors” that contribute to the formation and reformation of enterprise systems under the general overall environment defined by formal policies and institutions and informal norms and customs. Our discussion of “*structural reforms*” will mostly relate to institutional reforms in relation to the second, third and fourth categories of “economic structures” introduced above (i.e. (2), (3), and (4)). The neoclassical approach to “*structural reforms*” is mostly limited to formal policies and institutions (i.e. part of (3) above). Since the early 1980s, as the neoclassical resurgence swept the development thinking and structural adjustment became the dominant approach of the international financial institutions, the focus of the fist generation of reforms was squarely placed on eliminating distortions in policy frameworks that perversely affect earnings and cost calculations by private economic agents. Subsequently in the 1990s, as the new institutional economics gained increased influence, attention came to be paid to “*transaction costs*” and formal institutional factors affecting them, ushering in the second generation of reforms. Finally since the late 1990s, in the wake of the East Asian economic crisis, some attention has come to be paid to “intermediary factors” or the lack thereof (i.e. (4) above) in providing diagnoses and prognoses for less than desirable corporate behaviors deemed responsible for the economic crisis. The present state of research on “intermediary factors” remains rudimentary in conceptual and analytical elaboration, leaving much to be further investigated. In what follows, we will attempt to provide an analytical framework with a view to placing and explicating their role as determinant of economic behavior and performance.

There are many ambiguities and confusions surrounding discussions on institutions. Oliver Williamson observed parallel developments at the macro and micro levels in the New Institutional Economics and proposed that conceptualization and analysis be conducted in a clearly differentiated manner categorically distinguishing the macro and micro levels. He proposes and defines the following two terms corresponding to the macro and micro levels: “The *institutional environment* is the set of fundamental political, social, and legal ground rules that establishes the basis for production, exchange and distribution... An *institutional arrangement* is an arrangement between economic units that governs the ways in which these units can cooperate and/or compete.” (Williamson 1995, p.174, italics added). Let us paraphrase the conceptual distinction between the macro and micro levels. The *institutional environment* defines the basic rules for the conduct of economic behavior in general terms at the macro (or national) level through such formal rules as the legal system, the judiciary, the election system and through informal rules embedded in societal norms and customs. In contrast, *institutional arrangements* refer to mutual understandings and agreements between economic agents and also to coordinated actions based on them, such as explicit and implicit contracts and conflict resolution procedures, agreed to ex ante or ex post. In other words, they may be understood as governance mechanisms incorporating incentives and controls over the behaviors of individual agents in specific economic relations.

The key concept in the New Institutional Economics is that of the "*transaction cost*". It comprises all the costs incurred in managing the formation and maintenance of economic relations including those of investigation, consultation and negotiation, and as such constitutes a parallel to the transformation cost incurred in the actual carrying out of economic activities. *Transaction costs* are broadly divided into ex-ante and ex-post ones, the former referring to those incurred in advance of the formation of economic relations while the latter borne for the maintenance of existing relations. The fundamental analytical hypothesis in microeconomics incorporating *transactions costs* postulates that decision-making on economic behavior by the optimizing agent is defined in terms of the comparison of expected benefits on the one hand and transformation and transaction costs on the other.

*World Development Report 1997* provided a useful analytical framework for the understanding of economic behavior and performance, linking the macro and micro levels of institutional analysis. The macro-level *institutional environment (institutional structure)* is determined both by the formal rules defined and enforced by the state and by the informal societal rules and norms determined by and embodied in historical traditions, cultural values and religious teachings. The institutional structure at the national level largely determines the incentive structure that governs the behavior of individual agents, which in turn importantly affects transaction costs in prospective economic relations, delimiting the feasibility and nature of institutional arrangements (contracts) that could be implemented by individual agents. This determines the level and composition of economic activities in the national economy, thus influencing its overall performance.

Additional examination on the role of institutions in promoting development was provided by *World Development Report 2002*, subtitled as "Building Institutions for Markets". In this Report, market-enhancing institutions were identified in relation to three essential functions they perform: reduce information asymmetries; reduce the costs of dispute resolution/contract enforcement; and enhance competition in markets. While providing some detailed discussions from these selective functional perspectives, the Report did not provide any advance in analytical framework.

Based on the conceptual clarification and analytical formulation in the existing literature reviewed above, here we will make further exploration in conceptual elaboration and analytical amplification with a view to addressing more systematically the challenge of developing institutions that support the market economy. Our exploration starts from the conceptual dichotomy between the *institutional environment* at the macro level and the *institutional arrangement* at the micro level as proposed by Oliver Williamson and the analytical framework linking the macro and micro levels as presented in World *Development Report 1997*. The key elements in our innovation consist in the concept of institutional intermediation and its insertion as additional layer in the analytical framework (Figure 1). This concept/layer relates to functions supportive of the formation and maintenance of *institutional arrangements* under the particular set of parameters defined by the *institutional environment*, such as will enable or facilitate exchange of information, analysis for decision- making, and negotiation between prospective collaborators. If and when such functions work adequately, transaction costs for economic agents will be reduced and a larger number of (and more efficient types of) institutional arrangements will be realized. *Institutional intermediation* functions may be discharged by private agents or by state organizations.

Relatively more emphasis is placed on the role of state in *institutional intermediation* in the *developmentalist* perspective. In that perspective, structural reforms are conceived as necessary preconditions for the realization of the kind of activities by private enterprises that would remain unrealized without them during early phases of industrial development. The key elements of structural reforms consist of governmental actions designed to provide *institutional intermediation* in support of the realization of investment opportunities and the formation of an enterprise system. Such governmental actions are designed to minimize uncertainties and transaction costs prevalent in all aspects of new industrial ventures and often accompanied by additional more direct support in financing and risk mitigation.

In the next section, we will review Korean experiences and place them in the conceptual and analytical framework presented above.

## 5. Structural reform as precondition for economic growth: Korean experiences[ii]

### 5.1 Establishment and evolution of the development system

In post-war Japan, private enterprises recognized ample investment opportunities and had strong desires to realize them as they had high expectations of expanding domestic demands and also sufficient technical and managerial capabilities to realize diminishing costs through the introduction of new technology and capacity expansion. Under such conditions, the main task for industrial policy was to coordinate private investment decisions to achieve orderly realization of investment opportunities.

Initial conditions were drastically different in South Korea. There was no shared vision of economic development or of promising directions for industrial development. Private enterprises were far less capable of successful realization of latent investment opportunities or even nonexistent. Under such circumstances, the *developmentalist* government faced a dual challenge of (1) establishing national goals for economic development and (2) creating and fostering industrial enterprises capable of undertaking potential investment projects. Thus the fundamental aim of structural reforms at this stage was (1) to establish a government-led system of economic development at the level of *institutional environment* and (2) to help establish an effective enterprise system for its execution at the level of *institutional arrangement*.

ii This section relies on information contained in Amsden (1962), Kim (1994), Sakong, (1997), The task of establishing an overall design of development was carried out by the newly created Economic Planning Board (EPB). The EPB was designed to be a super-powerful organization that combined planning and budgeting functions within it, with its minister accorded the rank of vice prime minister in the cabinet. It formulated a series of Five-Year Development Plans and Annual Resource Allocation Plans.

Economic management during the first decade (1961-72) of the Park administration had the following characteristics. The fundamental goal of economic development was directed at realizing a modern and self-sustaining economy and "guided capitalism" was the economic system adopted to achieve it. The administration, being a military regime, did not relay on existing economic groups for political support. It utilized them to realize its goals, while at the same time promoting new enterprises. At the time of the *coup d'etat* of May 1961, the owners of then existing business groups were arrested on account of "unlawful profiteering" and were only released on the condition that they would cooperate with the policies of the military regime in economic construction. On this occasion, private commercial banks, which were affiliated with those business groups, came to be managed as state-owned banks. These "initial conditions" clearly defined the vertical nature of relationship between the government and the private sector.

Economic management during the second half (1972-79) of the Park administration was characterized both by aspects of continuity and by new elements. The fundamental goal of economic development continued to be realizing a modern and self-sustaining economy and "guided capitalism" remained to be the economic system adopted to achieve it. New elements included the administration's strong desire to achieve industrial upgrading in the sphere of heavy and chemical industries and the existence of business groups developed during the previous decade. The vertical nature of relationship between the government and the private sector was largely maintained, although some business groups came to be considered to be "too big to fail" from a national economy perspective.

The Park administration undertook a drastic change in the institutional environment for financial activities with a view to strengthening the influence of government over them. The development finance system was designed as the central mechanism of policy intervention and consisted of the nationalization of private banks, establishment of specialized "policy finance" banks, subjugation of the central bank to government control, and the provision of governmental guarantees for external borrowings. Furthermore, mobilization of funds from informal finance ("curb markets") to the formal financial system thus established was attempted through a series of policy measures such as a currency reform (1962), a drastic increase in deposit rates at commercial banks (1965), and a major crackdown on informal finance (1972).

In what follows we will trace the process of the realization of investment opportunities by private enterprises and the formation of enterprise systems over the 1960s and 70s in Korea.

## 5.2 Role of government in the creation and realization of investment opportunities

There was a sharp contrast in the mechanisms for the creation and realization of investment opportunities between the first (1961-72) and latter (1972-79) parts of the Park administration.

Over the first decade (1961-72) of the Park administration, there was a division of labor between commercial banks and specialized “policy finance” banks, with the former extending export finance and the latter serving other policy goals. Commercial banks play a dominant role in realizing rapid expansion of export-oriented manufacturing activities and of business groups based on them. Initially investment opportunities were identified in large-scale, standardized, labor-intensive manufacturing operations based on imported technologies. As enterprises accumulated managerial capabilities in their initial lines of business, they deployed newly acquired capabilities to similar types of manufacturing operations, thereby realizing investment opportunities in the process of horizontal diversification of productive activities organized as business groups.

The main targets of economic development during the initial phase of the Park administration were infrastructure development in road, port, and energy sectors and promotion of import substitution in fertilizer, cement, chemical fibers, and iron and steel industries. Financing for these projects were secured mostly from external sources, public loans in the case of infrastructure and private ones for industrial projects. These projects provided numerous investment opportunities for existing and newly formed private enterprises. The infrastructural projects were of utmost significance for construction and related businesses and many business groups sprang from original bases there. In the next phase, over the second half of the 1960s, increasingly more attention came to be paid to export promotion as a central pillar of economic development. Initially manufactured exports mostly consisted of simple products in textiles and miscellaneous category and their share in total exports was modest. Over the second half of the 1960s, manufactured exports diversified greatly and heightened their importance in the total, spearheaded by the rapid expansion of exports of electronic products.

The main purpose of *institutional intermediation* by the government over this period was placed on the promotion of exports. Governmental policies for *institutional intermediation* comprised financial and informational intermediation. On the financial aspect, preferential financing was extended in an unlimited amount and in an indiscriminate manner solely on the basis of accomplished export earnings, enabling enterprises to realize export-oriented investment opportunities in successively larger scales and also to diversify into other industries. Similar preferential financing was also extended to "indirect exporters", or enterprises supplying inputs to final exporters, contributing the realization of investment opportunities by them. Informational intermediation mostly took the form of provision of information on promising export products and markets and dispatch of exploratory trade missions and helped prospective exporters to recognize latent investment opportunities and make relevant contacts with foreign firms.

During the latter part (1972-79) of its existence, the Park administration strongly promoted the mobilization and channeling of investible funds to government-designated priority industries for the purpose of rapidly developing heavy and chemical industries. Under this policy finance regime, private enterprises undertook large-scale investment projects in successive areas of heavy and chemical industries, realizing rapid expansion of business groups through diversification of productive activities across those industries. Ventures in heavy and chemical industries were associated with qualitatively far more demanding requirements for technical, managerial and financial capabilities, making investment opportunities much more costly and risky in the eyes of private enterprises. Government support had to be all the more extensive and preferential to solicit private investment. The government played an instrumental role in rapid and large-scale realization of investment opportunities by providing low-cost financing for eligible projects and contingent assistance for companies in difficulty thereby raising expected returns to and reducing risks for private enterprises. Under such conditions, essentially the same pattern of corporate diversification was observed during this period resulting in further expansion of business groups.

The main purpose of *institutional intermediation* by the government over this period was placed on the promotion of private investment in machinery industries. Central policy measure for that purpose was financial intermediation and concentrated fund allocation to designated industries. The government in effect created investment opportunities for private enterprises in promoted industries and enticed them to commit investment in them by means of attractive measures of institutional intermediation, without realistic examination of their technical and managerial capabilities needed for realizing decreasing costs in those industries. The consequence of such forceful policy of investment promotion was extensive generation of excess capacities and serious worsening of corporate financial positions, necessitating direct government intervention for their resolution.

### 5.3 Comparative analysis

The stylization of development experiences in post-war Japan by Murakami presented in the preceding section provides a multi-faceted and systematic understanding of factors involved in "investment opportunities and their realization", the main thematic focus of this article. In post-war Japan, private enterprises recognized ample investment opportunities and had strong desires to realize them as they had high expectations of expanding domestic demands and also sufficient technical and managerial capabilities to realize diminishing costs through the introduction of new technology and capacity expansion. Under such conditions, the main task for industrial policy was to coordinate private investment decisions to achieve orderly realization of investment opportunities. To paraphrase it within the analytical framework presented in this article, this coordination function was carried out: (1) under the *institutional environment* of the (formal) principles of the market economy and the (informal) tradition of public-private collaboration; (2) through *institutional intermediation* on the basis of close consultations between government bureaus and industry associations; and (3) by means of *institutional arrangements* that effectively restricted individual enterprises' competitive behaviors in investment and operation decisions. Here, *institutional arrangements* refer to rules effectively governing inter-firm relations with regard to investment behaviors or pricing decisions. What made those rules effective was administrative guidance to individual enterprises practiced by government bureaus in charge of particular industries. In other words, *institutional arrangements* between enterprises do not necessarily entail explicit agreements among them but could be formed and made functional if individual enterprises involved could be made confident of behaviors of others by means of understandings established between them and government bureaus in charge. In this way, *institutional intermediation* by government bureaus reduced uncertainties and *transaction costs* faced by individual enterprises in the formation and management of *institutional arrangements* among them.

In Korea, industrial policies were carried out: (1) under the *institutional environment* of the (formal) principles of "guided capitalism" with the EPB at its helm (and the lack of (informal) tradition of public-private collaboration); (2) through *institutional intermediation* by government bureaus based on the designation of promoted industries and the extensive use of "policy finance"; and (3) by means of *institutional arrangements* that promoted the formation and expansion of business groups. Here, *institutional arrangements* refer to rules effectively governing intra-group relations with regard to investment behaviors. In contrast, *institutional arrangements* governing inter-group relations with regard to investment behaviors were not established, bringing about repeated episodes of excessive competition in investment and resultant excess capacities in the 1970s.

During the first phase, investment opportunities were realized by private enterprises through the *institutional intermediation* by the government by means of strong support measures in financing and information provision for export-oriented activities. It should be noted that preferential financing for exporters were based on actual export performance of private enterprises and that it was extended in a non-discriminate manner. This resulted in gradual and successive development of technical and managerial capabilities of a large number of private enterprises and enabled them to realize decreasing costs in large-scale, labor-intensive operations in manufacturing (and construction). *Institutional arrangements* were established within individual groups formed as a result of diversification of business activities across industries, and they served the purpose of investment coordination within each group. Investment decisions by private enterprises proved mostly sound as they were based on previous successful experiences and realistic assessment of their own technical and managerial capabilities. *Institutional arrangements* for investment coordination across groups were not established, but in fact they were not needed since most dynamic industries where decreasing costs were realized were export-oriented and thus did not face demand constraints during this initial expansion phase of Korea's industrial development.

During the second phase, investment opportunities were forcefully created by government through its *institutional intermediation* by means of competitive strong support measures in financing and other preferences for projects in designated heavy and chemical industries, especially machinery industries. This resulted in simultaneous entries by competing business groups into those industries. In fact, they largely coincided with those promoted in Japan two decades earlier. Unlike in Japan then, private enterprises failed to realize decreasing costs in their operation in those new ventures, as they lacked relevant experience and technical and managerial capabilities for them. *Institutional arrangements* were established within individual groups for the purpose of investment coordination within each group, but investment decisions were seldom based on realistic assessment of their own capacities. In effect, Korean enterprises had come to behave more like Japanese ones in that they were much more aggressive in the pursuit of investment opportunities than before. Unlike in Japan, however, *Institutional arrangements* for investment coordination across groups were not established beforehand by means of governmental institutional intermediation. The upshot of such forceful policy of investment promotion was generation of excess capacities and serious worsening of corporate financial positions. This represented a manifested failure of establishing inter-group *institutional arrangements* in those industries. In the event, government resorted to direct control of the situation by ordering private enterprises involved to scale down and/or postpone investment projects and also to participate in joint ventures across different business groups by merging separate projects.

## 6. Concluding remarks

The Korean experiences reviewed and analyzed in the preceding section could be considered the most forceful application of *structural reform* informed by *developmentalism* in NEA. In attaining the start and continuation of economic growth, Korea undoubtedly represents a success story. We have focused on structural reform by means of governmental *institutional intermediation* and argued that it was instrumental in reducing transaction costs faced by prospective investors in industrial production and export activities and thus eliciting their investment decisions in the first phase of industrial development during the 1960s. We have also noted that the governmental *institutional intermediation* in Korea lacked mechanisms for coordination of investment projects ex ante or price control ex post, thus leading to wasteful excess investments in some lines of heavy and chemical industries and direct government control for industrial restructuring during the subsequent stage in the 1970s. This stood in clear contrast to the successful governmental *institutional intermediation* in Japan, whose main purpose was to avoid excessive investments and cut-throat price competitions in heavy and chemical industries. This contrast highlights the emphasis Murakami places on (1) the supply-side and demand-side conditions for realizing decreasing costs and (2) the relationship between *developmentalism* at the government level and *developmentalism* at the enterprise level.

During the first phase of industrial development in Korea, investment opportunities were realized by private enterprises through the *institutional intermediation* by the government by means of strong support measures in financing and information provision for export-oriented activities. This resulted in gradual and successive development of technical and managerial capabilities of a large number of private enterprises and enabled them to realize decreasing costs in large-scale, labor-intensive operations in manufacturing (and construction). *Institutional arrangements* were established within individual groups formed as a result of diversification of business activities across industries, and they served the purpose of investment coordination within each group. Investment decisions by private enterprises proved mostly sound as they were based on previous successful experiences and realistic assessment of their own technical and managerial capabilities. *Institutional arrangements* for investment coordination across groups were not established, but they were not needed since most dynamic industries where decreasing costs were realized were export-oriented and thus did not face demand constraints during this initial expansion phase of Korea's industrial development. To recapitulate, (1) supply-side and demand-side conditions for realizing decreasing costs were adequate and (2) the governmental *institutional intermediation* informed by *developmentalism* was effective in motivating private enterprises to embrace *developmentalism* at the enterprise level.

During the second phase, investment opportunities were forcefully created by government through its *institutional intermediation* by means of strong support measures in financing and other preferences for projects in designated heavy and chemical industries. This resulted in simultaneous entries by competing business groups into those industries. As it turned out, private enterprises failed to realize decreasing costs in their operation in those new ventures, as they lacked relevant experiences and technical and managerial capabilities for them and demand conditions were not favorable either. Korean business groups had embraced developmentalism and come to behave aggressively in the pursuit of new investment opportunities created through government *institutional intermediation*. *Institutional arrangements* for investment coordination across groups were not established beforehand by means of governmental *institutional intermediation*, however, leading to a setback in industrial upgrading. To recapitulate, (1) supply-side and demand-side conditions for realizing decreasing costs were missing and (2) the governmental *institutional intermediation* for investment promotion without attention to the need to establish *Institutional arrangements* for investment coordination across groups led to excessive degrees of developmentalist behavior at the enterprise level.

In concluding, let us attempt to place Korean experiences in the general discussion on the stages of economic development and the evolution of economic system and also to identify agenda for further research.

From the microeconomic perspective of the present article, the stages of industrial development are defined in terms of (1) the nature of investment opportunities and (2) *transaction costs* involved in the execution of investments both conceived at the level of the individual enterprise.

The nature of investment opportunities refer to the sources of rents as fundamental incentives for investment. They are broadly classified into the following categories of relative advantages: (1) nature/location; (2) labor cost; (3)scale economy; (4) technical/managerial/organizational capabilities (or innovations); and (5) policy actions. In the early phase of industrial development in latecomer countries, investment projects in manufacturing industries tend to be fraught with high degrees of uncertainties arising from the lack of relevant experiences and the absence of appropriate *institutional arrangements* and established practices within and between enterprises. The tasks involved in undertaking new ventures could be quite daunting in securing markets, seeking financing, procuring inputs, recruiting and training workforce, setting up and maintaining production facilities, establishing management systems, and obtaining necessary permits, making them relatively unattractive in comparison with alternative options for the use of funds and resources in the eyes of prospective investors.

The *Developmentalist* government could affect the balance between anticipated rents and surrounding uncertainties for private enterprises in favor of industrial investments by way of two types of policy actions. First, it could provide prospective investors with protection from imports (or domestic competitors, as case may be) and access to funds and inputs on preferential conditions, thus generating policy-based rents for them and also reducing uncertainties surrounding the sales, procurement and financing aspects of their ventures. Second, the *Developmentalist* government could engage in *institutional intermediation* by means of actions designed to facilitate the establishment of enterprise systems, or *institutional arrangements* within and across enterprises for effective functioning of their productive activities and sound investment decisions. This would contribute to reducing transaction costs involved in the managerial and organizational aspects of enterprise activities, thereby making prospective ventures less uncertain *ex ante* and less costly *ex post*.

The first type of developmentalist government actions could result in prolongation and consolidation of policy-based rents in an exclusionary political-administrative-economic system of rent generation and sharing. (Murakami sees this a likely outcome of *developmentalism* and calls it an apolia of *developmentalism* and a great challenge unique to *developmentalism*.)

Under such circumstances, enterprises are less likely to evolve their operations and systems so that they could generate rents from sources other than policy-based ones. By contrast the first type of *developmentalist* government actions designed to facilitate the establishment of enterprise systems might be expected to be conducive to stage transition in industrial development in terms of the sources of rents characterizing investment opportunities. Schematically and as an illustration of a possible pattern of transition, it could shift from the initial dependence on governmental action to labor cost advantage, and then to scale economy based on large-scale operations, and eventually to innovations based on enhanced technical/managerial/organizational capabilities accumulated through experiences and investments over the preceding phases of industrial development. I would argue that *developmentalism* contributes to the attainment of economic development over a long term when and only when it plays a positive role in the continuous enhancement of technical/managerial/organizational capabilities and thus facilitates a transition in the source of rent determining the nature of investment opportunities for private enterprises as illustrated above.

The second question of *transaction costs* involved in the execution of investment may be analyzed and related to the stages of development in the following manner. *Transaction costs* faced by prospective investors are largely influenced by both managerial/organizational capabilities internal to individual enterprises and also by ie surrounding them and *institutional intermediation* available to them. In the initial stage of industrial development, internal capabilities are minimal and the *institutional environment* and *institutional intermediation* tend to be inadequate, thus leaving prospective investors faced with high *transaction costs*, in the absence of governmental *institutional intermediation*. Government could play an honest broker/arbitrator role in providing *institutional intermediation* vis-à-vis private enterprises, and under unfavorable conditions of the prevalent absence of "contractual infrastructure"[iii], or formal *institutional environment* for property right protection and contract enforcement, government-engineered *institutional intermediation* could prove to be the only effective conduit for the formation of *institutional arrangements* among private enterprises in early stages of industrial development. Over time, reliable "contractual infrastructure" could be developed and private sector agents may come to provide effective *institutional intermediation* thus reducing transaction costs faced by prospective investors, thereby diminishing or obliterating government's role in *institutional intermediation*.

Our preliminary discussion on the themes of (1) the nature of investment opportunities and (2) *transaction costs* involved in the execution of investments should be squarely placed in historical perspectives and investigated as important analytical foci in the general discussion on the stages of economic development and the evolution of economic systems. Theoretical and empirical research is in order for more systematic formulation of stage transition from both political-economy and comparative history perspectives.

iii The notion of "contractual infrastructure" is presented and discussed in Rajan, R.G. and L. Zingales (1998, 2001).

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**Table 1 Growth rates in real per-capita GDP in a Century-long perspective**

(annual averages for periods indicated, %)

| | 1901-10 | 1911-40 | 1941-50 | 1951-92 |
|---|---|---|---|---|
| Japan | 1.0 | 2.6 | -3.9 | 5.6 |
| Taiwan | 1.4 | 1.5 | -3.9 | 6.0 |
| Korea | 0.5 | 2.0 | -6.1 | 5.8 |

Source: Hsiao and Hsiao (2003) Table 1. Original statistical series taken from Maddison (1995)

**Table 2 Growth rates in real GDP in the post-war period**

(annual averages for periods indicated, %)

| | 1950s | 1960s | 1970s | 1980s | 1990s |
|---|---|---|---|---|---|
| Japan | 8.5 | 10.4 | 5.2 | 3.8 | 1.7 |
| Taiwan | 7.6 | 9.1 | 10.8 | 8.1 | 6.2 |
| Korea | 5.1 | 7.6 | 9.3 | 8.0 | 5.8 |

Source: Economic Planning Agency, *Asian Economies 1999*

**Figure 1 Institutions at three levels**

Source: The author