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Credible Commitment South Korean Style

by

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## Introduction

The transformation that occurred in South Korea, going from a poor agricultural economy to a modern industrial one, has by many economists been termed a 'miracle'. In 1961, the country was poor, not self-sufficient and had an insecure investment climate. Adding to these gloomy characteristics was the uncertainty created by a recent military coup with the new government seen as a threat to the private property of many businesses. However, business investments increased rapidly during the 1960s and marked the take-off of the South Korean economy which has grown more or less steadily the following 40 years, becoming a modern industrialized economy and an OECD member.

South Korea had insecure property rights in 1961; and insecure property rights are the starting point for an analysis of the need for credible commitment. If a business lacks property rights, investing makes little sense because the business might not be able to keep the property, the profit or the products. Businesses, owned privately, are in danger of being expropriated (or abused otherwise) by the government in settings with inadequate protection of property rights.<sup>1</sup> If the economy lacks these secure property rights the government has to show restraint by guaranteeing it will not expropriate. These guarantees alone are, however, not sufficient; the government has to make these guarantees credible, in effect to show 'credible commitment'.

Many papers on South Korea have already mentioned the need for credible commitment following the military coup in 1961. For instance, Haggard et al. (1991) mentioned how the compromise following the 'illicit wealth' investigations was the main tool for credible commitment from the government towards business. Dewit et al. (2001), in a short note, suggested that the export promotion strategy was the main commitment mechanism. Campos and Root (1996) mentioned the role of the deliberation councils as 'commitment devices'. However, no paper, to my knowledge, has systematically explored various credible commitment mechanisms in South Korea.

The current paper attempts to provide such a systematic analysis using a game

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<sup>1</sup> Market exchange in general requires some protection of property rights as a business can steal from other businesses. In this paper only the government as an expropriator will be considered.

theoretical framework. In the first part, the rationale for focusing on investments is made and some background history is provided. In the second part, the game theoretical model, a Bayesian signaling model, is presented with some empirical implications. In the third part some clarifications are made on how to relate the model to the evidence. In the final part, four main mechanisms that affected the credible commitment of the government are analyzed.

## I - South Korean Investments

This paper attempts to answer the question ‘how was the South Korean government able to promote business investments?’ The paper is limited to look at how the government promoted business investments in an environment with low trust. This paper does not attempt to be exhaustive, but rather attempts to define several criteria for analyzing the existence for credible commitment signals and relating these to South Korea.

The background for the need for credible commitment was the 1961 coup which followed a long period with non-developmental policies.<sup>2</sup> Following the end of Korean War hostilities in 1953, South Korean policies were formulated by Syngman Rhee (hereafter Rhee), who was also the head of the united Korea 1948-50. Rhee pursued an import substitution industrialization (ISI) effort. Lim (2000 pp. 6-9) has described the policy as ‘crony capitalism’, as Rhee was more concerned with building a political power base than with economic development. Rhee was forced to resign following student protests in April 1960 which led to the first democratic government in South Korea under Chang Myŏn (hereafter Chang). However, Chang proved weak in decision making power and was seen as a puppet for the Americans. Under Chang, the national assembly was dominated by internal conflicts with little real policy being decided in 1960.<sup>3</sup> In principle, the various political parties and their supporters only agreed in their disapproval of the Rhee regime, but the alternatives provided by the

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<sup>2</sup> Developmental policies are policies that contribute to long-term economic development. Economic development is defined as the increase in living standards measured by GDP per capita and is in this paper equated with economic growth. Economic development and growth are for the sake of simplicity defined as synonyms because these concepts are not the main focus of the paper.

<sup>3</sup> Signs of improvement were apparent in 1961, for example plans to establish the forerunner of the Economic Planning Board early May 1961, shortly before the coup. Nobody knows for sure how a more institutionalized economic policy under Chang would have worked. But, Chang did not have the decision making power to change the patronage relationships between the state and the businesses.

opposition were internally incompatible. Under Chang, several political movements, including leftist groupings, were gaining in popularity.

The 1961 coup marked a clear break in economic policies, with a change in government-business relationships and development strategy. The military feared the increased leftist influence on South Korean politics and intervened when General Park Chung Hee (hereafter Park) seized power on the 26<sup>th</sup> of May 1961. Park wanted to make economic development the main priority of the government increasing the decision making power of the executive for that purpose. The government-business relationships were problematic because of business elite ties with the Rhee regime. Dismantling these ties and seizing the accumulated 'illicit wealth' of the business elite was one of the key pledges of the new government. Despite these pledges, the government needed the businesses to fuel economic development. Economic development and the political pledges therefore became contradictory. The government faced a related problem, namely which development strategy to pursue.<sup>4</sup> A capitalist ISI strategy seemed most viable, but the ownership structure had not yet been decided.<sup>5</sup> The government choice was whether to rely heavily on public enterprises as in Taiwan (by expropriating) or on large private conglomerates as in Japan (by not expropriating).

A game theoretical model will be used to assess how the government was able to credibly commit itself to economic development in such a short period. Game theory deals with strategic interactions of the type considered.<sup>6</sup> The model I will develop is not meant for empirical testing, but rather serves as an analytical framework. True testing of such a model is difficult as intentions are contingent on the actions of other players, making quantification near impossible.

Taking South Korea as a case study raises one question in specific; how representative is the country? South Korean investments increased from 12 % of GDP

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<sup>4</sup> The orthodox planned economy model, popular at the time in communist countries for instance China and the USSR, was excluded due to the geo-political situation.

<sup>5</sup> Export promotion was not a part of the original strategy but was added from 1964 and onwards.

<sup>6</sup> As in the words of Greif (1997 p.3): 'Game theory provides economic theory with an explicit theoretical framework that does not lead to the a-historical conclusion that the same preference, technology, and endowment lead to a unique economic outcome in all historical episodes... it can be used for analyzing strategic situations in a manner sensitive to their historical dimension.'

in 1961 to close to 26 % in 1970 (see table 1). Living standards (measured by GDP per capita) improved dramatically over the same period as a consequence. This remarkable outcome has had several scholars to identify specific factors rendering South Korea as ‘not representative’ as a developing country because of the high education levels given the income level, Confucian work ethics and bureaucratic traditions, low income inequality and a lack of natural resources which reduced potential rent-seeking.<sup>7</sup>

**Table 1 – Investment and GDP Figures 1961-70**

<b>Year</b>	<b>Investment growth rates</b>	<b>Investment/GDP</b>	<b>GDP growth rate</b>	<b>Growth rate GDP per capita</b>
<b>1961</b>	3.6 %	12.0 %	4.9 %	2.0 %
<b>1962</b>	28.8 %	14.3 %	2.5 %	-0.3 %
<b>1963</b>	27.3 %	14.1 %	9.5 %	6.7 %
<b>1964</b>	-9.3 %	11.7 %	7.6 %	4.9 %
<b>1965</b>	27.2 %	15.4 %	5.2 %	2.6 %
<b>1966</b>	59.6 %	21.2 %	12.7 %	10.0 %
<b>1967</b>	22.6 %	22.5 %	6.1 %	3.7 %
<b>1968</b>	37.4 %	26.2 %	11.7 %	9.2 %
<b>1969</b>	24.8 %	26.9 %	14.1 %	11.6 %
<b>1970</b>	1.0 %	25.6 %	8.3 %	6.1 %

**Source: WDI (2008)**

There is no denying that these aspects are important if not vital, but they count for nothing unless there are investments to exploit the potential imbedded in these aspects. The problem of raising initial investment levels is as fundamental no matter which additional advantages an economy is believed to have. Therefore I classify South Korea as a representative example of a developing country as the problems they had were much the same as other developing countries at the time.

Not only is the initial investment surge a problem no matter the additional benefits, in South Korea, the investment surge was most likely the reason for the growth take-off. According to Rodrik (1994 pp.5-19), investments, and not exports as is generally believed, were the most likely reason for the South Korean growth take-off. This

<sup>7</sup> See for instance Rodrik (1994) on the effect of human capital and the low income inequality; Sakong (1993) on the Confucian work ethic and bureaucratic traditions; and Sachs and Warner (1995) on the primary resource curse.

argument has been strengthened based on the Krugman-Young hypothesis emphasizing factor accumulation.<sup>8</sup> The investment-led take-off is believable based on two main arguments. First, the increase in investments coincided with the increase in economic growth; the increase in exports occurred first after the increase in economic growth. Second, exports, especially manufacturing exports, were too low in the 1960s to explain, in a pure accounting sense, how they could have driven GDP growth. Therefore, investments and not exports probably provided the take-off for the South Korean economy.<sup>9</sup>

## II – The hold-up signaling game

The game theoretical framework has the motivation to explain the dynamics between government signals, business investments and economic development. This is an ambitious undertaking, but as emphasized, the model merely functions as a framework. The model, a Bayesian signaling model, gives insights to many of the problems of attempting to promote investments from the government's point of view, and the investment decision from the business point of view. The implications are summarized and attempted to put into terms that serve as empirical criteria to be used in the empirical section.

### *Bayesian signaling hold-up game model*

It is assumed there are a large number of businesses,  $L_t$  (in period  $t$ ), altogether, with each business being denoted with  $i$ .<sup>10</sup> The model has four sequential stages:

**Period 1 Stage 1 – The government is either ‘good’ or ‘bad’.** The government type,  $t$ , can be drawn from all feasible types  $t \in T$ . For simplicity, I consider only two types of government, ‘good’ that would not expropriate even in a static one shot game; and ‘bad’ that would expropriate in the static one shot game and needs to credibly commit it. The assumption by allowing only two types does not affect the

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<sup>8</sup> The hypothesis, set forth in Young (1992, 1995) and Krugman (1994), caused a major debate regarding the ‘quality’ of the East Asian growth. The debate brought the importance of factor accumulation back to the fore.

<sup>9</sup> This is not the same as saying that exports were unimportant for South Korean growth. Exports were most likely vital for the long-term economic growth in South Korea, but to lesser degree for its growth take-off. The consensus is that exports were vital for the long-term growth of the South Korean economy, even though the importance and the mechanisms have been debated.

<sup>10</sup> Businesses are defined as preexisting private businesses and potential private businesses that have not started up yet.

analysis. The only two interesting types are the ones mentioned above, as other types would be different only in the degree of preference for expropriating.

Government pay-off is determined by political power, economic gains, and economic development. Political power is the utility people get by staying in power which often is a good in itself rather than a means to an end. Economic gains are the gains the sitting regime enjoys by being in power which includes the fiscal and other goods such as the luxurious ones. Economic development is the utility the government gets through the increase in the general living standard in the country. In simple algebra terms the utility of the government,  $U_G$ , can be expressed as:

$$U_G = U_G(\text{Ec. development}; \text{Ec. gains}; \text{Pol. power})$$

These variables are not independent and their correlation is important. Political survival and economic gains might be hard to reconcile; the shorter the regime expects to be in power, the faster the regime might want to use the resources available for personal gains, which might include expropriation. Political survival and economic development are, in theory, reconcilable. Increased living standards for people in general might legitimize the regime and reduce the probability of a regime change.<sup>11</sup> Economic gains and economic development are only reconcilable if the regime stays in power for a long period. Economic development might increase the economic gains for the regime by increasing the overall size of the economy and thereby increasing tax revenues and profits of state-owned enterprises. If the regime only expects to be in office for a short period the rewards of economic development, in terms of economic gains, are low.

**Period 1 stage 2 – The government, knowing its own type, sends a message to persuade the businesses to invest.** The government sends out a message  $m$  from the feasible set  $m \in M$ .<sup>12</sup> There are several major points that need to be mentioned. It is

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<sup>11</sup> Some theories argue that increased living standards and political survival is ambiguous for autocratic regimes. Higher living standards make people better off, but it also make people change their relative preferences from food security towards political freedom. Because I am looking at the short run, I will only look on the positive effect from economic growth on legitimacy and therefore political survival.

<sup>12</sup> The wording ‘message’ can be misleading; the only rational for using the word is simply because it is used in the literature of signaling models. In this context a ‘message’ is any kind of behavior that intends to persuade the businesses to invest. This could for instance include infrastructure investment

assumed that the government sends out several messages, the sum of these messages denoted by  $\phi_{m,t}$ .

No matter if the government is ‘good’ or ‘bad’, the best thing for the government is business investments. The asymmetry of information means that businesses do not know for certain the type of government as only messages are observable. As such, even ‘good’ governments have to send messages that normally ‘bad’ governments do. The ‘good’ government might, however, do so at a lower cost than the ‘bad’ as the forgone opportunity to not expropriate does not weigh high for the ‘good’ government.

Any message, to be credible, must affect the utility of the government and be irreversible. This is best illustrated by assuming that this is not the case. A ‘bad’ government might want to send a message pretending it to be a ‘good’ government by sending a costless, or reversible message, for instance saying ‘I will not expropriate’. If the businesses believe this message and invest, the government might reverse their decision without cost and expropriate. As the businesses know this to be the case, it will not trust the government if messages are costless and reversible.

As messages therefore imply a cost for the government, the messages must be as effective as possible. The messages must therefore generate as much investment as possible given the cost of the message. This has to be weighed up with a threshold of minimum investments,  $I_{TOT,t}^{min}$ , that needs to be achieved to increase the probability of economic growth, and thereby increased pay-offs in the long-run. Also, too much investment might generate too much excess capacity and be ‘wasteful’, therefore there is an upper limit  $I_{TOT,t}^{max}$  to investment. Expressing the utility of the government in algebra terms yields:

$$U_G = U_G^A(I_{TOT,t}) - K_{m,t}\phi_{m,t}$$

$$I_{TOT,t} = \sum_{i=1}^I I_{i,t}(\phi_{m,t})$$

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which is not a ‘message’ in everyday usage, but in game theory sends a ‘message’ that the government is willing to better the investment opportunities for businesses.



$$I_{TOT,t}^{min} \leq I_{TOT,t} \leq I_{TOT,t}^{max}$$

The first term,  $V_G^A(I_{TOT,t})$ , expresses the increase in utility the government gets by an increase in the total investment level,  $I_{TOT,t}$  at time t and this utility is generated by the above mentioned variables. The second term,  $K_{m,t}\phi_{m,t}$ , expresses the decline in utility by multiplying the cost of the government messages at time t,  $K_{m,t}$ , with the sum of the government messages at time t,  $\phi_{m,t}$ .

In the subsequent discussions, there are two strategies that will be considered. The first is based on the standard rationality assumption of maximization. The second is based on the bounded rationality assumption of satisfaction. If the government functions as a single rational actor, the government maximizes expected utility by choosing the message m:

$$\max_{\phi_{m,t}} EU_G = E[V_G^A(I_{TOT,t}) - K_{m,t}\phi_{m,t}]$$

$$\text{given } I_{TOT,t}^{min} \leq I_{TOT,t} \leq I_{TOT,t}^{max}$$

If the government has bounded rationality, the decision might be taken by many actors coming to a compromise where to solution not necessarily is maximizing but optimizing. The situation is highly uncertain due to a lack of information and at least three broad strategies can be chosen: i) Attempting to secure the minimum investments needed for economic growth; ii) Attempting to secure the ‘optimal’ level of investments; or iii) Attempting to maximize investments. The second alternative is the same as saying, ‘letting the market decide’ and it is not certain that the market level of investments will be higher than the minimum required. Therefore this alternative is excluded as the risks are too high.

Multiple criteria might be used to choose the strategy that is not based on maximization. However, in a low stage of development with scarce capital there are two extreme outcomes, one is to have too low investment to take-off and be stuck in a low level of development, second is to have too high investment and having excess capacity and ‘wasteful’ investments. There is no doubt which of the two is the lesser evil; excess investments are less feared than to remain in low development. In

addition, it is also possible for the government to take measures to reduce excess investments and take measures to make investment less ‘wasteful’ by coordinating them and setting performance criteria. This could be part of a ‘Big Push’ strategy with part of the government messages as complementary public investments to increase the likelihood for successful business investments, thereby increasing the upper bound for total investments. By increasing public investments and sending other costly messages in period 1, the government might lose in the short-run, and gain in the long-run.

**Period 1 Stage 3 – Businesses observe the message and choose whether to invest or not.** The businesses most likely have some prior belief regarding the government. The observed message will update the beliefs regarding the government and each business in turn will choose whether to invest and how much to invest.

Each business chooses the investment decision for itself and there is no representative business as there are large differences in the resources, information and the risk aversion of the businesses. The heterogeneity of the businesses means that it is unlikely that all businesses will invest in period 1.

For the businesses, I assume that the decisions are made based on long-term profits. It is important to notice the wording ‘long-term’ as short-term profits may deviate from these as business decision making as well is based on optimizing and thereby bounded rationality. One of the reasons for choosing bounded rationality is that decision making in businesses is in general not made by ‘the entrepreneur’, but involves a decision making process from several persons in a more or less set decision making pattern.<sup>13</sup> In algebra terms the utility of business  $i$ ,  $U_{B,i}$ , is determined by the sum of

the long-term profits over all conceivable periods  $\sum_{t=1}^{\infty} \pi_{it}(I_{it})$  :

$$U_{B,i} = \sum_{t=1}^{\infty} \pi_{it}(I_{it})$$

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<sup>13</sup> See Nelson and Winter (1982) on the concept of bounded rationality and how it applies to the business decision making process.

For individual businesses there are a number of factors affecting the investment decision process. The one focused on in this paper is the belief over government type, when business is in doubt of the intentions of the government. Another important factor is the general economic outlook as low income countries often face adverse economic circumstances. South Korea in 1961 is, as I mentioned earlier, no exception. The business infrastructure, which include the roads, communication, and supporting institutions are often weak in low income countries. In addition to being credible, or even to show credibility, the government has to improve the general outlook of the economy by for instance improving the business infrastructure. Another factor influencing the business investment decision is the attitude towards risk. Businesses have different degrees of risk aversion and this naturally affects their investment decision. Finally, the degree of information regarding the government is different for businesses as some businesses might be closer to the government, both geographically and in figure of speech.

There is also a potential multiplication effect of investments as one business chooses to invest as another already has revealed it will do so. If one business is planning to invest other businesses might believe that this business might have information that others do not have and choose to invest themselves as their probability of a ‘good’ government increases. If investment reaches a threshold it could unleash a ‘horde’ of investors, which might again unleash a second ‘horde’ and so on. This process will not continue all the way through as uncertainty is still high in period 1 and will mean that some groups of investors will not be persuaded by other businesses investment decisions for different reasons as for instance a high risk aversion. Also, investment opportunities and the degree of capital available might also be limited.

The investment decision of the business affects the profit and thereby the pay-off. The investment of business  $i$  in period  $t$ ,  $I_{it}$ , can be expressed as:

$$I_{it} = I_{it} [E\pi^N(I_{it}), E\pi^G(\theta_{it}, I_{it}), PrEx(\theta_{it})]$$

$$E\pi = E\pi^N + E\pi^G$$

The first term,  $E\pi^N(\theta_{it})$ , is the part of the expected long-term profit that the government cannot influence but are important for business profits for instance the state of the world economy. This term can be both negative and positive as the expected profits based on external factors outside the government control can be ambiguous. The second term,  $E\pi^G(\theta_{it}, I_{it})$ , is the part of the expected long-term profit that the government can influence by for instance bettering the country's infrastructure. The term is assumed to be ambiguous on investments for the same reasons as the first term. Messages,  $\theta_{it}$ , are assumed to be positive on investment decisions as the government attempts to increase the profitability of investments by making the expected profits higher. The final term,  $PrEx(\theta_{it})$ , is the probability of expropriating by the government. It is assumed that there exists a prior belief of the type of government and that messages,  $\theta_{it}$ , update these beliefs by decreasing the probability of expropriating.

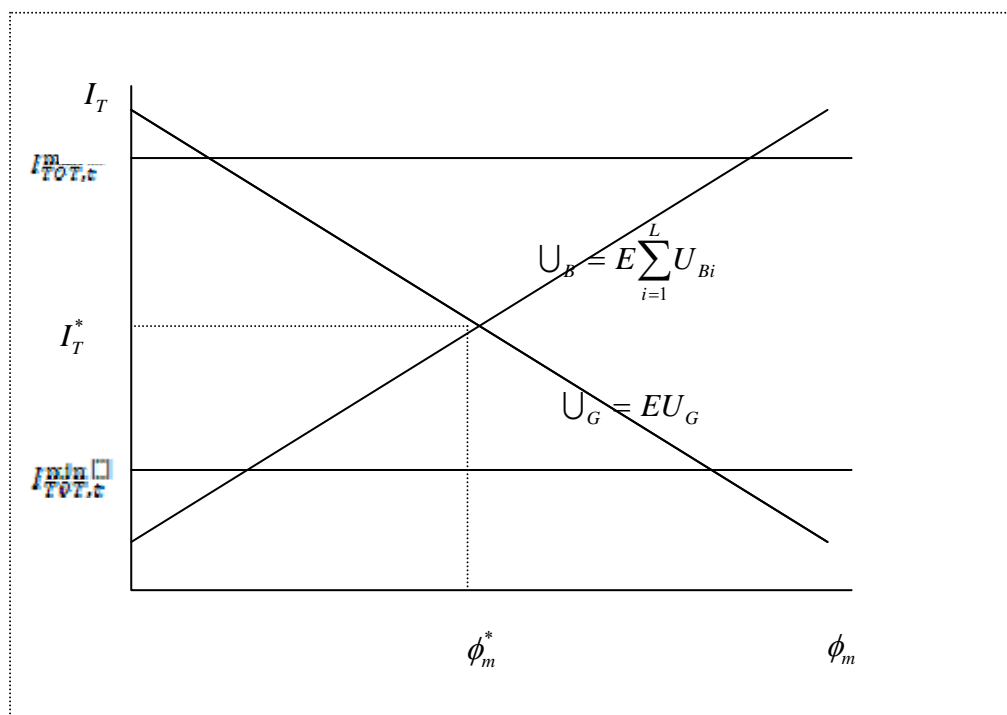
Each business attempts to maximize the long-term expected profits by choosing the investment level:

$$\max_{I_{it}} EU_{Bt,t} = E \left[ \sum_{t=1}^T \pi_{it}(I_{it}) \right]$$

**Period 1 Stage 4 – The government and the businesses receive their pay-offs.** At the end of the period, the players receive their pay-offs. An important feature is that the revealed pay-offs at the end of period 1 does not reveal the government type, only increases the probability for a government type.

If the government was a maximizing agent it will choose to increase  $I_{TOT,t}$  by choosing  $\theta_m$  to increase  $E\pi^G(\theta_{it}, I_{it})$  and decreasing  $E PrEx(\theta_{it})$  for as many businesses as possible until the FOC condition is met. The solution to the game is that the government chooses  $\theta_m^*$  which it expects maximizes its utility, while each business chooses its own  $I_{it}^*$  which determines not only whether there is an investment, but also the amount of the investment. The sum of all individual investments amounts to  $I_{TOT,t}^*$ . The solution for period 1 can be illustrated graphically:

Figure 1 – Equilibrium period 1 with government maximization



Graph 1 illustrates the outcome in terms of investment levels was above the minimum required. When the graphs cross below the minimum requirement line the government might not want to send any more messages and expropriate.

Turning to the bounded rationality example, the government would rather want to overshoot than to attain the market outcome, ‘just-to-be-safe’. If the economy is a low stage of development, the government might find it more appropriate to decrease its short term utility by more than the assumed ‘optimal level’ to signal its willingness to credibly commit.

This excessive decrease in utility in the short term is credible signal if business believes the government to be rational in the long term. The government would only be willing to decrease utility by more than the assumed optimal level if it believed that the increase in utility in the long run would be worth while.

**Period 2 (and onwards) stage 2 and 3.** The government has a choice to send a new message or not. The businesses now have prior history, and have updated their beliefs

on the basis of this assertion. The government then has to attempt to reach new thresholds for businesses to invest, which can be boosted by messages, but can also be boosted by positive prior history.

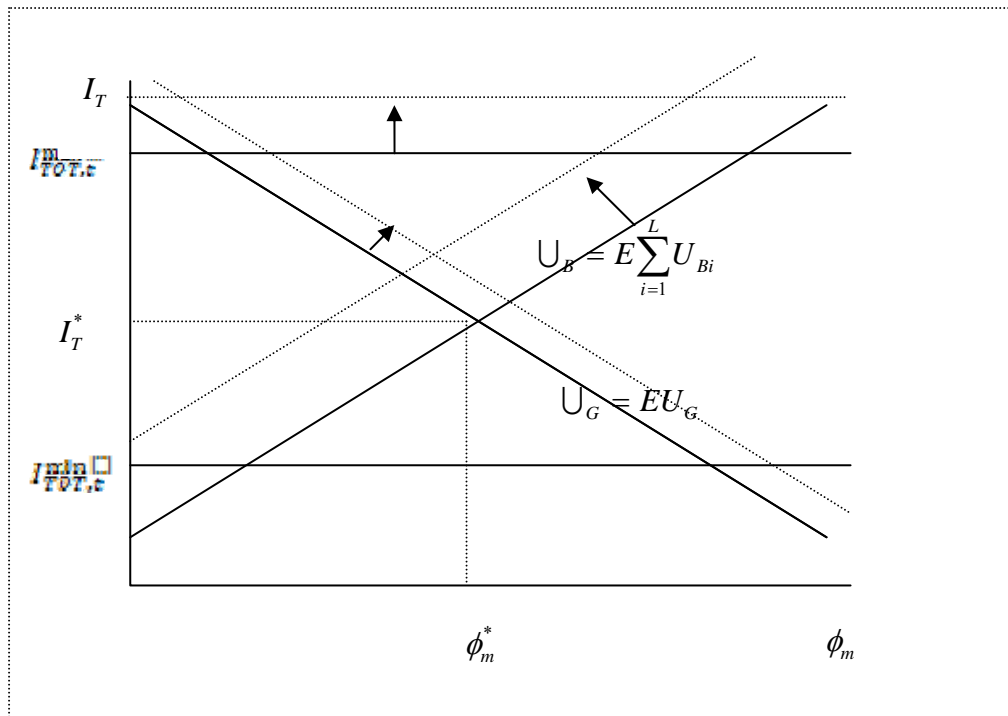
The game for period 2 and the subsequent periods is qualitative different than the one in period 1. The government now has the choice whether to send a message or not as there are feedback loops going from past decisions to past outcomes and this increases business learning. The government can build a reputation by not expropriating and delivering increased living standards which might give the businesses higher returns on their investments which in turn leads to increased investments.

The game becomes different for a different reason, namely the decreased danger of expropriation. The game in the first period is whether the government has serious incentives to expropriate, after the first period this danger is reduced. This probability will get closer and closer to zero as the periods with no expropriation increase. The messages the government sends in the latter periods to raise investments are therefore much to do with macroeconomic stability in the short term and the feasibility of economic growth in the long-run.

**Period 2 (and onwards) stage 4.** The pay-offs received and the messages send will lead to a feedback mechanism which over time increases the businesses knowledge of the type of government.

There is dynamics involved going from period 1 to period 2 and so forth. There was a high degree of pessimism in South Korea around 1961; the economic growth that did occur took even South Koreans by surprise. Both  $E\pi^N(\theta_{it})$  and  $E\pi^G(\theta_{it}, I_{it})$  were probably low for a lot of businesses and potential investors. Over time these probably increased, with  $PrEx(\theta_{it})$  decreasing as well. It is also assumed that this learning was higher for the first few periods than for the periods in the long-term. Graphically this can be illustrated by:

Figure 2 – Dynamic equilibrium



### *Empirical criteria for credible commitment*

The model illustrates the large qualitative difference between the first and the subsequent periods. As experience increases and business learn, government types are over time revealed. In an environment with high uncertainty and many decision makers, it might be safer to send out excessive messages in period 1, and gradually reduce these as there are positive feedback loops increasing the probability for a ‘good’ type of government.

Translating the model into empirical criteria means identifying some unique aspects around messages that signal credible commitment. There are three criteria that will be used in the empirical part to identify credible commitment signals. First, governments must intentionally want to raise business investment (or economic development which involves business investments). If investments are raised by some non-intended side-effect, they do not count as a message to increase investments. Second, period 1 is qualitative different from the subsequent periods and messages during the first period are therefore vital for a threshold of credible commitment to secure the economic take-off. Therefore, only credible commitment signals in period 1 as business still has a reasonably high probability assigned to expropriation and could only rely on

government messages. Third, any message to be credible must reduce government pay-off and/or be irreversible.

### III – Clarifications

Before proceeding to the empirical application of the model, a number of methodological and theoretical issues relating to the three criteria need to be addressed.

#### **Intentions and qualitative evidence – Causality and human action**

Human actions, in this case the players strategies, are causal if direct evidence exists. Pure direct evidence, objectively, would require reading the player's mind at the time of decision making, which is impossible. Therefore, the best indicators available are documentations of the player's *intended* strategy and how this strategy corresponded to *actual* actions. As in the words of Greif (1997 p.5):

Direct evidence is explicit documentary accounts reflecting the strategies utilized or intended to be utilized by the decision makers... Clearly, statements about intended courses of action can reflect "cheap talk." Yet, a confidence in the empirical relevance of a strategy can be enhanced by indirect evidence. Indirect evidence is an empirical confirmation of predictions generated under the assumption that a particular strategy was employed.

The distinction between causal and non-causal human actions in this paper is defined on the basis of *intention*. If actions were not directly (or indirectly) intended towards securing investment, but nevertheless did so through *non-intended* side-effects, is a case of a *non-causal* effect, which might be seen as a form of externality.<sup>14</sup>

Park had a strong influence on the decision making of the government, had his convictions are therefore interesting to look upon closer.<sup>15</sup> Two books written by Park

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<sup>14</sup> It becomes difficult to use this approach on economic variables. One cannot say that increased productivity *intended* to increase gross domestic product. It therefore becomes vital to differentiate between impersonal concepts and sapient beings with intentions.

<sup>15</sup> Cole and Lyman (1971 p.95) summed it up by saying: 'The strength of his (Park's) convictions were crucial, for on numerous occasions the president personally made the decision on critical economic issues which determined the margin of priority given to economic development over other political objectives. In doing so, he sometimes went against not only established interests but elements of his own supporters'.



in 1962 give an insight into his intentions at the time of decision-making and are the pillars of his policy. The first is 'Our Nation's Path'; the second is (the modestly titled) 'The Country, the Revolution and I'. There are a number of problems regarding the accuracy of the books. First, the ones I obtained were second editions from 1970 which means the books probably are somewhat revised. Second, it is not even certain that Park himself wrote the books. Finally, many of the statements might have reflected 'cheap talk', especially the passages in the books where Park is humble and states he is not interested in the role as state leader for the sake of the job alone as political survival became more and more important during his political career.

The books are nevertheless highly relevant as they are messages of how Park wanted to be perceived. The books are also relevant because Park had a high degree of decision making power, had a high involvement in the economic processes, and it gave insights to the convictions for business. In addition, the convictions over the importance of economic affairs probably do reflect his true intentions as it is backed by indirect evidence, which I will return to later.

### **'Period 1' – 1961-64**

Two different time frames will be emphasized to differentiate the period 'without prior history' and the period 'with prior history'. The distinction is made to differentiate when the businesses only had the government messages to rely on, and when the business could start to trust the government based on experience. The 'period 1' chosen is the period with the most dramatic institutional and political change from 1961 to 1964 when the return to civilian rule was completed. The 'subsequent periods' are from 1965 and onwards, where prior history exists.

There are problems with this framing; what constitutes 'no prior history' is subjective. However, there are three reasons for the division made. First, the framing of 'period 1' is a 'point of reference'. Without a point of reference, it is difficult to establish causality along the time dimension. Second, the 'period 1' metaphor also relates to the analytical framework that is set in the model structuring this period. The period chosen is not accidental, because government action, and thereby messages, were more pronounced, and partly less predictable, than after the return to civilian rule in 1964 when the institutional and political environment were more set. Finally, it also

differentiates the group of business that invested based on the messages and other business investments, and the businesses that needed experience.

The first period, 1961-64, is long, as it spans three years. This is not accidental and relates in part to the problem of the 'perception of the current economic environment' which can be misleading. People are often uncertain whether the economy is in a recession or not. The perception of the current situation is important for the general mood of the economy; the actual situation is easier to interpret in hindsight. According to Cole and Lyman (1971 pp.80-81) the general mood in South Korea from 1961 to 1966 was one of pessimism and self-doubt and 'the full commitment of the Park administration to a vigorous development program' was still in doubt until as late as the latter part of 1966. When growth statistics for 1963 and 1964 came forth, they were higher than expected with supporters of the government claiming a new sustained economic growth path, while critics, and much of the media, were critical around the lack of accuracy of growth statistics.

### **Actual government pay-off**

In the previous section I stated that the government preferences were determined by political survival, economic gains and economic development. How are these motives evident during the Park government?

The Park government had a high preference for economic development and political survival, but not so much short-term economic gains. Park (1970b) famously said 'In human life, economics precedes politics or culture'. The statement shows a high commitment to economic development. The relevancy of the statement is significant, because the statement most likely reflect Park's true motivations which are strengthened by indirect evidence (Jones and Sakong, 1980). First, Park spent a lot of his time on economic affairs, for instance participation in export promotion meetings. Second, Park created an incentive mechanism that promoted growth-oriented businesses and bureaucrats. The evidence for a high preference for political survival is overwhelming. The clearest evidence was the suspension of democracy in 1971; Park

instated himself for life when Kim Dae Jung seemed to win the elections.<sup>16</sup>

Another important aspect in the model was the differentiation between rationality and bounded rationality. It seems that bounded rationality comes closer to the mark as overshooting as optimizing seemed more in line with the real situation than maximizing. The strategy is best summarized by Cole and Lyman (1971 p.199):

Its (the Park government) tendency has been to overshoot their mark rather than to be caught short in providing incentives for such items as exports or savings. Some inefficiency probably resulted, in that policy measures may have been stronger than would necessary had there been more knowledge or analysis of the particular situation toward which the policy was directed. On the other hand, the extreme approach did produce results that have undoubtedly far exceeded their costs. More cautious measures might well have failed.

#### IV – Signaling credible commitment in South Korea

The potential mechanisms used by the South Korean government to signal credible are too numerous to look into them all. Instead, I have selected four mechanisms that affected the credible commitment in South Korea, which I will discuss in turn. The first is the institutional set-up where the government signaled that economic development was the main priority on many levels. The second are various forms of industrial policy. The third is the compromise following the ‘illicit wealth’ investigations. Finally, there are the external relationships with external actors, mainly the US, that limited and, partly dictated, the solutions the Park government choose.

##### **I. Institutional-building**

The institutional set-up in South Korea had the goal of making economic development the primary objective while making policy making effective. The policy making process has three levels, agenda setting, policy formulation and policy implementation. For the policy making process to be successful, all these three have to be effectively dealt with. In South Korea, this was the case. To highlight the institutional set-up and how it affected credible commitment I will look at three institutional innovations; the Economic Planning Board; deliberation councils; and the

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<sup>16</sup> Kim Dae Jung was subsequently hit by a truck in 1971, kidnapped in 1973 by the Korean Central Intelligence Agency and put under house arrest in 1979.

restructured financial institutions. At the end, these institutional developments will be looked at all at the same time and how it affected the economic policy making framework.

### *Economic Planning Board*

The Economic Planning Board (EPB) was established in June 1961. The EPB was actually planned by the Chang government based on the Indian model and announced in early May, 1961; the same month as the Park coup (Haggard et al., 1991 p.856). But, the EPB under Park was different from the one envisioned by Chang, resembling the Japanese Ministry of International Trade and Industry (MITI) as the budget bureau was transferred from the Ministry of Finance; the statistics and research bureau transferred from the Ministry of Home Affairs and the planning and coordination offices from the Ministry of Reconstruction (Haggard et al., 1991 p.860).

The EPB became responsible for economic policy in South Korea both under the military rule and after the return to civilian rule.<sup>17</sup> The chairman of the EPB, Chang Key-young, was given the title Deputy Prime Minister to emphasize the importance of economic planning. Chang Key-young formulated much of the economic policy in the early years and used the EPB's budgetary power to make the EPB a 'clearing house for all economic policy' (Cole and Lyman, 1971 p.87). The strong support for the chairman of the EPB by Park was also important in that respect.<sup>18</sup> One of the first tasks of the EPB was to prepare the First Five Year Development Plan (1962-66) which was officially adopted in December 1961. The plan was made rather hastily and was prepared without good statistical data or thorough analysis (Jones and Sakong, 1980 p.49).

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<sup>17</sup> Park won the 1963 presidential election and the newly established Democratic Republican Party (established by the Military government) got 110 of 175 seats in the National Assembly, despite having gotten only 34 % of the popular vote (Cole and Lyman, 1971 pp.39-50). With a pro-Park National Assembly government policy was legitimized through semi-democratic institutions.

<sup>18</sup> Chang Key-young had an aggressive development program which made him a controversial figure in the early years when the development of the country was still in doubt. Park's support proved vital in surviving votes of no-confidence from his own Democratic Republican Party in 1965 and 1966.

Table 2 – First Five Year Development Plan Planned and Actual Outcome		
	First Five Year Plan	
	Planned	Actual
Average GNP growth	7.1 %	8.3 %
Investment as share of GNP (annual average)	22.6 %	16.9 %
Industrial structure (terminal year)		
Agriculture, forestry and fisheries	34.8 %	37.9 %
Mining and manufacturing	20.6 %	19.8 %
Social overhead capital and other services	44.5 %	42.3 %
Source: Jones and Sakong (1980 p.54-55)		

The outcome in the years 1962-66 was a better than predicted growth rate. According to Jones and Sakong (1980, pp.49-50) the plan was important at the time, not so much for its ability to project the course of the economy, but as a ‘commitment device towards economic development’. It also provided a forum for dialogue for bureaucrats and businessmen. In table 2 the planned and the actual results from the First Five Year Development Plan are shown. It is interesting to note that economic growth was higher than predicted, but the investment growth lower. This could, as Jones and Sakong (1980 p.53) suggested, be as a result of better capital utilization as X-efficiency increased. It could also reflect effective government measures to decrease the dangers of ‘wasteful investments’.

Closely linked to the development of the EPB was the general development of the bureaucracy. The building of a competent bureaucracy involved three different processes (Campos and Root, 1996 pp.138-173).<sup>19</sup> The first process, making economic development the top priority for the bureaucrats, was achieved by some direct measures by Park. For instance, Park started his New Year Meetings after the first year of the First Five Year Development Plan when results were not as good as hoped. Park met each minister personally and discussed targets. The following year Park would return with the previous year targets and ministers which achieved less than 80 % of the set target were fired (Campos and Root 1996 pp.139-141).<sup>20</sup> The second process, attracting competent personnel, was achieved by filtering new

<sup>19</sup> The competence of the bureaucracy is defined according to Weberian standards of a professional bureaucracy.

<sup>20</sup> After two-three years the routine was established and ministers were becoming more skillful in setting measurable targets and developing strategies to achieve them. The ministers used the same system down the chain of responsibility as managers who did not fulfill the plan were fired.

employees by examination, performance criteria and graduate degrees (Campos and Root, 1996 pp.142-143). Financial incentives in the form of salaries were low compared to the private sector, but the bureaucracy still managed to attract some of the brightest pupils from universities. Potential reasons mentioned are the relative security of employment and the well-defined competitive career path in public services which is highly valued in Confucian values. The final process, balancing the independence of the bureaucracy with the accountability of the leadership, was achieved through monitoring the bureaucracy. Park had great responsibility in the promotion and firing of bureaucrats.<sup>21</sup> As the EPB had control of financial flows which the businesses needed; and the bureaucrats were dependent on business to meet targets; consensus building between bureaucrats and business became important which increased policy implementation.

The EPB, the First Five Year Development Plan and the increase in the quality of the bureaucracy are all potential signals for credible commitment. The EPB is a credible commitment signal as it decreased the government's political power by making the economic policy making more institutionalized; it occurred in the time frame 1961-64 and was developed to increase economic development which included raising investments. The First Five Year Development Plan was also a credible commitment signal as the plan committed the government to a specific policy; it was adopted in 1961 and among the objectives was to raise investments.

The increased bureaucratic quality did lower the government pay-off by allowing a professional rather than a political bureaucracy; and the increased bureaucratic quality was intended to increase economic development.<sup>22</sup> However, the increased bureaucratic quality was not a credible commitment signal within the timeframe 1961-64 as it took more than three years to build a high quality bureaucracy. One could possibly argue that the message to increase the quality of the bureaucracy over time is a credible commitment signal as it was an ongoing process. The problem with such line of reasoning is that bureaucratic employment is easily reversible, as more

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<sup>21</sup> In addition, the Korean Central Intelligence Agency monitored bureaucrats.

<sup>22</sup> The 'political purification' of the bureaucracy did not happen in South Korea, but did happen in other developing countries, for instance Brazil and Mexico where political power was strengthened at the expense of a 'professional' bureaucracy. One of the most significant ways of making a bureaucracy more political is by allowing people to get hired and promoted by their political convictions rather than in South Korea which was based on academic merit.

‘politically correct’ applicants can get employed in a short time frame and making the bureaucracy an extension of the Democratic Republican Party.

### *Deliberation councils*

To increase the communication between state and business, deliberation councils were established for various sectors and for certain purposes. Deliberation councils consist of representatives from state and business and are non-legislative councils that, nevertheless, have a strong influence on policy making. Business can voice their opinions on policies and guide the state to more efficient policy making by identifying bottlenecks. Even though it is a non-formal set of meetings, policies can often not be approved without the concession of the councils.

Autocratic regimes in general suffer from poor information as people around the ruling elite fear to bring uncomfortable information (Campos and Root, 1996 pp.76-78). Therefore, most autocratic regimes lack an efficient system to obtain information about the adverse effects of their policies, the more powerful the dictator, the larger the difficulty. In addition the dictator is usually above the law, so promises are not enforceable. In addition, the businesses, fearing expropriation will hide more of their production for the dictator by being more secretive. To solve the commitment and information problem, the South Korea government imposed certain check-and-balances on its power and institutionalized the flow of information through various means for instance deliberation councils.

Deliberation councils have multiple functions. One is to allow business elite participation in policy making, allowing the policies to become more legitimate and thereby easier to implement (Campos and Root 1996 pp.99-108). Also, the deliberation councils decreased the high costs of coordination. Despite its official non-legislative nature, it was difficult to change or to introduce new policies without the approval or recommendation of the councils it concerned. Thereby, the councils played an important part in the political set-up where business had some influence on economic policy making.

The deliberation councils without doubt increased the credible commitment of the government. To use the wording of Campos and Root (1996 p.103) councils

functioned as ‘commitment devices’ as the changes of these institutional mechanisms would induce a damaging of the government’s reputation which is crucial for businesses to invest. They were intended to increase business investment; they were initiated in the period 1961-64 and in part reduced government pay-off by decreasing the independence of government in policy making.

### *Financial institutions*

To understand the government-business relationship during the 1960s, it is vital to look at the financial institutions. The banks had been privatized during the 1950s, but were re-nationalized by the Park government. The bank expropriation was conducted first by introducing the Temporary Law on Financial Institutions of June, 1961; which allowed all shareholders except the government from voting more than 10 % of their outstanding shares (Jones and Sakong, 1980 pp.103-104).

The government amended the Bank of Korea Act in 1962 to ‘facilitate the central bank’s cooperation with the nation’s long-term development efforts’ (Sakong, 1993 p.33). These institutional arrangements made it possible for the authorities to issue so-called ‘policy loans’ to specific sectors or even to specific industries. These loans often had preferential interest rates compared to ordinary loans. And even the ordinary loans interest rates were kept lower than the curb market rate or the equilibrium rate leading to a general negative real interest rate. According to Jones and Sakong (1980 pp.101-102), the allocation of under-priced credit was ‘the most important single instrument of government microeconomic control’. About two-thirds of the increased capital in the period 1963-74 came from increased debt. This meant that the businesses became reliant on credit for expansion and even survival, the government, being in control of the domestic banks, thereby had a great deal of political influence on the businesses.

Expropriation of banks might have had a negative initial effect on government-business relationships, but these negative effects were weakened by several factors. First, there was a history of national ownership of banks’ at the time such ownership was common in many countries and therefore not considered an anomaly. Second, the businesses feared a far more extensive expropriation than the one the government undertook, which made the losses of the banks easier to accept.



Indirectly, however, businesses might have become more secure against expropriation through government control of the financial sector. Had the government expropriated the businesses, the loans would default and the state banks would suffer major losses as a consequence. Therefore, the government would 'steal' from itself by expropriating the businesses. It is nevertheless hard to see that the government intended this effect; it is more likely an unintended side-effect.

In all, the re-nationalization of banks might be seen as an example of a non-intentional credible commitment. Banks would have fuelled investments regardless of private or state control, so the government motive for controlling banks to increase investments is not clear. However, state guarantees made it more difficult for the banks to default. But, the intention behind the expropriation of banks was not primarily to increase investments, but to increase the political power of the government. So, the causality criterion is not met.

#### *The institutional set-up*

Institutions were set up to facilitate economic development by making the economic policy making process efficient. Economic development became the most important objective; policy was formulated to increase business investments and produce economic development; and the policy was efficiently implemented through consensus building with business. In effect, the government's policy implementation was increased by reducing the government's policy formulation.

Two aspects of economic policy were important (Cole and Lyman, 1971 p.93). First, the Park government had the ability to push through unpopular reforms through its military control and its control over parliament.<sup>23</sup> Second, being military and the military traditionally removed from the power elite in South Korea, the Park government could break down traditional government-business elite patterns.

Table 3 shows a result from a questionnaire made by Jones and Sakong (1980) just to indicate how much policy implementation improved. While only 20.4 % of the

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<sup>23</sup> With unpopular, I mean with the general public, only to a lesser extent with business.

respondents thought that policies ‘almost always implemented’ or ‘always implemented’ during the Rhee regime, the comparable figure for the Park regime was a whopping 94.8 %! It is hard to see that this would be the case if there was no direct communication between state and business to build consensus.

Table 3 – Government Implementation		
Once the government has made a decision affecting business, how effective is it in insuring compliance? What about the Rhee government?		
	Park	Rhee
Always implemented: Impossible to avoid not complying	78.2 %	3.2 %
Almost always implemented: Sometimes possible to avoid complying	16.6 %	17.2 %
Implemented with modification	1.7 %	50.5 %
Seldom thoroughly implemented	3.5 %	29.0 %
TOTAL	100.0 %	99.9 %
Numbers		
Response	172	93
No opinion	24	103
TOTAL	196	196

Source: Jones and Sakong (1980 p.137)

The point is also that no matter which policy actually was implemented in South Korea, it was likely to be more effective than in many other developing countries. This is not a reason for the increased credible commitment, but a result of increased credible commitment.

## II. Industrial policy

There have been some controversies regarding the effect (and extent) of industrial policy. One (but definitely not the main) reason is that researchers differ in their definitions what constitute industrial policy.<sup>24</sup> I follow the Johnson (1982) definition, which sees industrial policy in a broad perspective, including interference in financial markets, labor markets, technological learning, and competition rules. I avoid the general industrial policy debate and solely regard the industrial policy effectiveness on

<sup>24</sup> An example from the World Bank (1993) is that industrial policy is defined by its selective element were some businesses are favored at the expense of others. Lall (1996) defined it as a deviation from the free market.

businesses investment decisions. Also, the interventions in the labor market are not considered.<sup>25</sup>

Again, it is impossible to look at all forms of industrial policy. To highlight industrial policy as a signal for credible commitment, three broad categories will be looked at, complementary investments, industrial support for favorable sectors, and government assistance to acquire foreign loans.

### *Complementary investments*

The 'Big Push' argument states that countries can be caught in a low level of development as investments in key sectors are dependent on each other, and the price mechanism from the market alone cannot coordinate these investments. Complementary investments are characterized by the 'crowding in' effect as the investment in key sectors with strong forward and backward linkages increases the probability for successful investments (Sakong, 1993 pp.46-47). The problem of coordinating complementary investments to get a 'Big Push' effect is one that comes from the lack of information.

This problem can in theory be solved by the government facilitating the role of a coordinator. In South Korea the government did. Using the institutional set-up described above, deliberation councils increased the flow of information between government and business as the government announced the sectors in which it would invest. Some of the key industries were too sensitive, too costly or too risky for business to invest. The solution was that the government themselves invested in these sectors and thereby signaled a commitment to economic growth because these investments increased the costs of government just for business to get better investment opportunities.

As part of the First Five Year Development Plan, the government invested in power and energy sources for industry and in key industries such as cement, fertilizers, iron

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<sup>25</sup> Labor unions were more or less banned in South Korea with the arguments of 'hindering pro-communist sympathy'. This probably was not the main reason, as Park in the beginning of the 1960s was not against labor unions. The real reason was probably to keep wages low making investments more profitable for businesses and thereby increasing incentives for business investments. The reason why I will not pursue this as a candidate for credible commitment is that the government control on labor is more a result of increased government-business trust, rather than a mechanism to achieve it.

and steel (Cole and Lyman, 1971 p.159).<sup>26</sup> As shown in table 4, the public sector increased during the 1960s in both numbers and as a share of GDP. One example, are fertilizers were the government owned Chungju Fertilizer Company. The government invested in the first fertilizer plant with high construction costs and long construction time and it took nearly five years before it was in effective operation. The government also constructed a second plant and allowed for a joint venture between the South Korean state and a private foreign owner for the third and fourth plant before allowing a private South Korean company to form a joint venture with a foreign partner (Cole and Lyman, 1971 p.197-198).<sup>27</sup> Among the areas most prioritized were agriculture and infrastructure to remove bottlenecks in the economy. Also in the areas of government primary responsibility such as power and railroad transport and in sectors where the government was more able to deliver more effective programs than the private such as fertilizers plants.

Table 4 – Public Sector 1960-72

Year	Number of enterprises	Sectoral Value added (billions of wŏn 1970 prices)	
1960	36	n.a.	Share of GDP
1963	52	80.4	6.98
1964	54	90.6	6.49
1971	119	246.7	9.17
1972	108	271.7	9.07

Source: Jones and Sakong (1980, p.149)

The response of business to incentives to increase manufacturing was higher than expected, this created bottlenecks in the economy which increased the social-overhead-capital sector (which the government controls directly) (Jones and Sakong, 1980 p.56).

The increased government spending in key industries and infrastructure was a clear example of a signal for credible commitment. It started in the time space 1961-64; it was intended to raise business investments and increased government expenses which

<sup>26</sup> Government expenses increased as a consequence and made it more important to increase government funding. The Office of National Tax Administration was established in 1966 greatly enhancing the tax collection ability by making tax collection as non-discretionary as possible, reducing tax evasion and eliminated many forms of corruption (Jones and Sakong, 1980 pp.111-115).

<sup>27</sup> The fifth plant was eventually put on government control after the private company imported illegal items shipped together with other imports.

it could only reclaim in the long-term.

### *Industrial support*

The term ‘industrial support’ is defined as the incentives for ‘favorable sectors’. These incentives were vital for directing business investments into preferred sectors identified by the government (Ok, 2004). What differentiates the South Korean industrial support from most other developing countries is the ‘discipline by the state over private enterprises’ to reward good performances and punish poor ones (Amsden, 1989 pp.14-15). The support of favorable sectors reduced investment risks, but did not occur as much in the First Five Year Development Plan relative to the Second Five Year Development Plan which identified several ‘strategic sectors’ which were given government preference.

There were rewards for those cooperated with the government and punishment for non-cooperation as the nature of industrial support also shifted over time. Rewards were in the form of subsidies in the beginning of the 1960s, while preferential loans and preferential exchange rate incentives seemed to be more used during the second half of the 1960s.<sup>28</sup> From 1965 more indirect measures were used such as an undervalued exchange rate, ‘favored access to credit and imported raw materials, and almost complete tax exemption on export production’ (Cole and Lyman, 1971 p.189-190). Punishment was usually through withholding these funds, but could also be more severe. According to Campos and Root (1996 p.60) Samsung lost a fertilizer factory which was expropriated after Samsung refused to support Park’s export market initiative. The government did not need these interventions frequently, the threat of them was sufficient to keep business in line.

The industrial support for favorable sectors was a key feature of the Second Five Year Development Plan. During the First Five Year Development Plan, incentives were more industry neutral. Therefore, the industrial support was not a credible commitment signal for the period 1961-64. The industrial support was, however, there

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<sup>28</sup> A short note on the concept of subsidies is needed because different authors again seem to put a different meaning in the word. For instance, Sakong (1993) meant all type of preferential treatment, including preferential loans and preferential exchange rate treatment. I, however, define subsidies narrowly and use the textbook version as a direct financial transfer from the government to the businesses, in effect a negative direct tax.

intentionally to raise business investments and did cost the government considerable resources making it a credible commitment signal the subsequent periods.

### *Loan guarantees*

The government assistance in the form of guarantees to acquire foreign loans is possibly the most noteworthy example of government-business partnerships. To increase investments in the beginning of the 1960s the Park government had to import capital to finance these as foreign aid would be scaled down (Cole and Lyman, 1971 p.169; pp.178-181).<sup>29</sup> The problem was that South Korean business lacked the creditworthiness in international credit markets. Therefore, the government used their creditworthiness and guaranteed the businesses loans. This was a policy which was used particularly for the already mentioned ‘favorable sectors’.

Therefore, to increase investments the government set a low interest rate and borrowed heavily abroad. The Foreign Capital Inducement Law in 1962 provided government guarantees to lenders which eliminated the risks of default and of exchange rate depreciation (Amsden, 1989 p.73). The first real effort to obtain foreign loans was in 1962 when aid levels declined and the investment targets of the First Year Development Plan had to be financed by other means (Cole and Lyman, 1971 p.181). The strategy was to make laws that would encourage foreign investment and make guarantees of repayment to foreign lenders.<sup>30</sup> The guaranteeing institutions were the Korean Reconstruction Bank (guaranteeing the repayment in won) and the Bank of Korea (guaranteeing convertibility) which operated on a case-by-case basis. The policy increased foreign loans and made the country less dependent on the US as financial sources became more diversified. The risk to the lender was decreased by the repayment guarantees. Laws in 1967 and 1968 made the system function more smoothly as the private loans could be approved by commercial banks bypassing the National Assembly (Cole and Lyman, 1971 p.182).

The government pay-off decreased as they took a major risk as moral hazard

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<sup>29</sup> The external debt of South Korea increased from 6.9 % of GDP in 1965 to 23.7 % of GDP in 1970, while the debt-equity ratio of South Korean firms increased from 92.7 % in 1965 to 328.4 % in 1970 (Lim, 2000 p.18).

<sup>30</sup> Foreign direct investments (FDI) never caught on in the 1960s, despite there being some incentives to promote them. The general mood in South Korea was, however, hostile to foreign ownership which might be part of the reason for why there were so few foreign investments.

problems increased. The government had to repay the loans if the loans defaulted; therefore the businesses had small risks in borrowing capital. The businesses had an incentive to over-borrow because the government bore most of the risk. Chang (2000 pp.776-777) called this the ‘socialization of risk’ and argued that the ‘social benefits’ of risk-reducing institutions might be beneficial if they exceed the ‘social cost’ created by moral hazard.<sup>31</sup> At a low stage of development in which South Korea was in the 1960s, this might have been the case.<sup>32</sup>

The policy of guaranteeing business loans was a credible commitment signal. The loans started in 1962, the government reduced its pay-off and the loans were intentionally meant to increase investments. Government assistance to acquire foreign loans was a direct cause for how the businesses were able to finance increased investment and was a direct cause for the business investments in the beginning of the 1960s and later.

### **III. The compromise of the established business elite investigation**

As mentioned, the government needed to punish the former Rhee business elite in order to preserve the legitimacy of their coup. But the government also needed the business elite’s support for investments. In the first months after the coup business leaders such as Samsung’s chief executive were displayed in the streets with banners reading ‘I was a parasite on the people’ (Campos and Root, 1996 p.34). Such a public disgrace is not a good way to way to start a partnership.

The government passed the Law for Dealing with Illicit Wealth Accumulation and an investigation into the accumulated ‘illicit wealth’ was conducted. Most of the country’s businessmen were arrested and threatened with confiscation of their assets. It was both in the interest of the government and the businesses to achieve a dialogue.

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<sup>31</sup> When an international recession hit in 1971 many South Korean firms could not meet their debt obligations. The government issued the Presidential Emergency Decree for Economic Stability and Growth on August the 3<sup>rd</sup> 1972 which made the left the owner and manager structure of firms intact (as opposed to major bankruptcies) (Lim, 2000 pp.21-22).

<sup>32</sup> The potential ‘social cost’ could be high. There was a massive over-borrowing by the businesses with hardly any improvement in profitability. This led to several interventions by the government to prevent massive bankruptcies, for instance in May 1969 when the government had to take managerial control of 30 firms (Lim, 2000 p.19). However the ‘social benefits’, the dynamic effects of increased investments and technological learning in the long-term are hard to measure because it is not given that profitability to individual businesses reflects true social contribution.

Meeting between the representative for the businesses, Samsung's leader, and the government, resulted in a realization that the key to prolonged political power was based on economic development. The settlement following the investigations, which looked at hundred-and-thirty businessmen, was mild. Around thirty had to refund amounts far lower than their presumed 'illicit wealth'. Moreover, some of the businessmen released made major 'contributions' to the government (Haggard et al., 1991). The meeting between Park, then Vice Chairman of the Revolutionary Council and the businessmen led to a deal where i) No criminal prosecution would occur; ii) With the exception of commercial bank shares, existing assets would not be expropriated; iii) Businessmen would pay down their 'obligations' by establishing new basic industrial firms and donate shares to the government (Jones and Sakong, 1980, pp.69-70).

The businesses after the meeting was concluded became involved in the economic policy making process (Jones and Sakong, 1980 pp.70-73). The 13 businessmen with the heaviest fines got permission to go abroad and solicit foreign capital. When the businessmen returned, a number of policy recommendations were made for instance the establishment of an industrial port at Ulsan, which was implemented almost immediately by the government.

The outcome of the investigations went against one of the student protests main aims, to seize back the wealth from the 'corrupt' business elite. Justifying the outcome, Kim Jōng-p'il, a leading revolutionary figure, and the cousin-in-law of Park, said the following (taken from Haggard et al., 1991):

Pardoning the illicit wealth accumulators was an obvious violation of the revolution's pledge to eliminate corruption and old evil practices. But it was necessary . . . If we punished businessmen under corruption charges, it was evident that our economy would be paralyzed. Of course, members of the revolutionary council insisted on prosecuting them, but I opposed it. It was essential to coopt them in order to carry out revolutionary tasks. I personally persuaded General Park to release those arrested and to give them new tasks. Moreover it was I who helped these businessmen form a new business organization, the Association of Korean Businessmen, the predecessor of the Federation of Korean Industries.



The investigation compromise was undoubtedly a message that signaled credible commitment. The coup was rationalized partly on the basis of destroying the ties that the business elite had. These actions decreased the legitimacy of the Park government, and were put in place to promote business investments.

#### **IV. Third party pressure**

The US was a strong political actor in South Korea in the 1960s. The South Korean government was dependent on US foreign aid which financed most of the imports South Korea had.<sup>33</sup> In 1961, U.S. aid accounted for 52 % of the budget on which Park (1970b p.28) commented:

Though nominally independent, the real worth of the Republic of Korea, from the statistical point of view, was only 48 %. In other words, the U.S. had a 52 % majority vote with regard to Korea, and we are dependent to that extent... It shows, dramatically, that our government would have to instantly close down if the U.S. aid were withheld or withdrawn.

There were some examples of how a US threat of an aid cut off could manifest itself. The US forced economic reforms following increased spending of the Park government when inflation increased to near 30 %. The resulting US pressure of an aid cut-off led to a policy where money supply was only allowed to grow at 5 % per year, while reforms the following year forced the government to a 50 % devaluation to get continued aid. Another example was how the return to civilian rule in 1963 followed US pressure, and the poor harvest of 1962 and 1963 weakened the decision making power of the Park government (Lim 2000 p.13). Another example was the US pressure to increase the interest rate in an attempt to increase domestic savings in August 1965 (Cole and Lyman, 1971 p.179). Despite protests from the businesses the move was made by the government.<sup>34</sup>

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<sup>33</sup> South Korea, an important Cold War partner, was almost exclusively relying on American aid. 70 % of all imports and 75 % of total fixed capital formation in the period 1953-1961 was financed with US aid (Cole, 1980; Pu, 1961).

<sup>34</sup> Private household savings reacted to the increased interest rates by going up from 0.18 % in 1965 to 4.15 % in 1966 (Amsden, 1989 p.74-75). But the savings declined the following year and have since not followed any systematic pattern with the interest rate. The domestic savings were never sufficient to satisfy the country's investment demand. Despite that the interest rate liberalization did little for savings and investment, it did signal credibility towards foreign lenders (ibid p.74).

One of the key political decisions that Park had to make was to normalize South Korea's relationship with Japan. In this respect the US influence was of help as the government could blame the US for forcing the country to do so. The normalization in 1965 produced student protests and urban riots, but with the US as a key player, the Park administration could let the US take part of the 'blame'. Nevertheless, protests became so widespread that the cabinet had to resign in May 1964. In the long run, the normalization with Japan produced increased trade, aid and technological exchange between the two countries which probably have been mutual beneficial (Cole and Lyman, 1971 pp.98-118).

U.S. pressure also had another indirect effect relating to the international market. South Korea resentment towards foreign domination and the foreign influence on South Korean politics led to a strong desire to make the country more economically independent. Through economic independence South Korea would increasingly obtain more political independence. Undoubtedly, the desire for increased economic independence was a major contributor for the strong export promotion to secure foreign currency.

In all, the external influence did have much to say for the political framework of South Korea. First, mass scale expropriation was not a viable option for the Park government as it most likely would have resulted in massive US protest. Second, the foreign dominance of South Korean politics made a reversal of the export drive even more unlikely as increased economic fortunes for South Korea in the form of increased exports would surely result in more political power for the Park government as they would be more independent in policy terms. Third, the Japanese normalization made possible increased trade and technology exchange that would benefit South Korea in the long-run.

The US influence was an external factor and could not be a credible commitment signal from the Park government. The export drive probably was a form of credible commitment, even though it did not occur in 1961-64 and it is not clear whether the government had any reduced pay-off in the short-run. The normalization with Japan benefited the businesses, but was resented by the general public. The strong student

protests against the Park government in 1964 signaled that the Park government was willing to reduce its own legitimacy in the short run to push through reforms that would benefit South Korea in the long-run and is clearly a signal for increased credible commitment.

### Credible Commitment in South Korea

In the table below, the results from the empirical analysis are summarized. The potential signals marked with an asterix are the signals that were credible commitment in the period 1961-64.

	Government Pay-Off			Timeframe	Intentions
	Pol.power	Ec.gains	Ec.Dev		
Economic Planning Board*	Red	None	Inc	Per.1	Dev
First Five Year Dev.Plan*	Red	Red	Inc	Per.1	Dev
Increased bureaucratic quality	Red	None	Inc	Sub.P	Dev
Deliberation councils*	Red	None	Inc	Per.1	Dev
Financial Institutions	Inc	Inc	Inc	Per.1	Pow
Complementary Investments*	None	Red	Inc	Per.1	Dev
Industrial Support	None	Red	Inc	Sub.P	Dev
Loan partnership*	None	Red	Inc	Per.1	Dev
Compromise*	Red	None/Inc	Inc	Per.1	Dev
US influence*	Red	None/Inc	None	Per.1	None
Export drive*	Inc	Inc	Inc	Sub.P	Pow
Japanese normalization*	Red	None	Inc	Sub.P	Dev

Red = Reduced; Inc = Increased; None = None or not applicable  
Per.1 = Period 1 (1961-64); Sub.P = Subsequent periods  
Dev = Economic development; Pow = Political power

Some of these factors, for instance the EPB, were broader than for instance the investigation compromise. Of all factors, the single most important was most likely the investigation compromise which at an early stage signaled that the government was willing to forego part of its own pay-off to increase economic development. The investigation compromise set the standard for a sufficient small group of business elite to support other measures signaling economic development.

### Conclusion

The Park government managed to promote investments to create a growth take-off using several mechanisms signaling credible commitment. These mechanisms were

identified using three criteria; i) The intention to raise investments; ii) The timing in the time frame 1961-64; and iii) That the government was willing to forego pay-off to signal credible commitment.

The most important mechanisms found were:

- Establishment of the Economic Planning Board (EPB)
- The First Five Year Development Plan
- Development of the deliberation councils
- Complementary industrial policy to decrease the problem of ‘missing markets’
- The government-business loan partnership
- The investigation compromise

It is difficult to give a comparative analysis which of these was the most important mechanism. There is, however, strong reason to suspect that the investigation compromise was the single strongest event signaling credible commitment as it was the first clear signal and it thereby was a prelude to the other mechanisms which reinforced the signals by the government.

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