

# Property Rights, Development, and Financial Markets in South Korea\*

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Property-rights describe the rights individuals have over material and immaterial goods. From the point of view of the property rights approach, a financial market is primarily a market for "rights to exchange something (money) for goods". Efficiency in this market depends largely on the information available to intermediaries like banks and other financial institutions. Regulation of financial markets was at the heart of Korea's economic strategies for more than two decades. Here, the distribution of property-rights by the government was supporting export industries and at the same time hindering balanced development of the economic structure.

## I. Introduction

The study of South Korea by means of the Property-Rights Analysis is of some interest considering the fact that this country has often been characterized as a "Development Dictatorship". Development dictators are feudal lords, this term being applied to the ownership of existing property rights and the distribution of new property rights. South Korea's economic development is marked by phenomena that are open to Property-Rights Analysis: An early land reform, state-controlled trade unions, hierarchical corporate structures and a tight corporate concentration. Since such an analysis has to depart from microeconomic preconditions, a highly aggregated survey will be ignored here. Within these limits the financial sector itself becomes an object of study, because in related

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literature on this particular field there can indeed be found numerous statements with property-rights character, lacking, however, the specific method of analysis. The selection of topics presented in this paper is by no means designed to give priority to a single development factor in Korea. Such an individual development factor would be hardly identifiable.

Section II deals with those terms of the property-rights theory that are of basic importance for this study. Special emphasis is placed on the question whether the assumption of uniform rational behavior holds for different cultural spheres. Section III presents the monetary field from the aspect of property rights. Section IV deals with Korea's development. A brief historical survey is followed by a presentation of the specific features of the financial market development. Section V finally presents a more detailed analysis of some phenomena mentioned in Section IV.

## II. Property Rights as a Tool for Assessing Economic Reforms

### *A. Differentiation of the Neoclassical Approach by the Property-Rights Concept*

The property-rights concept represents an extension of the neoclassical analysis. The neoclassical idea of the economy is marked by relatively undifferentiated links between man and matter. In economic theory the *homo oeconomicus* is a facet of the *homo partialis*.<sup>1</sup> He has exactly those characteristics that are compatible with the requirements of the assumptions inherent in economic theory; driven to constantly achieving the target of utility maximization, the *homo oeconomicus* acts either as supplier of production factors or as consumer. The identification of man with these functions, however, is so strong that each target-oriented behaviour can be assigned to each individual function. So the functions literally develop lives of their own, which in the end dispense even with man; with his characteristics going beyond the tight functional definitions he is banned into a "non-economic" environment. If the model is extended by another agent, i.e. the state, even this agent can be broken down into its according functions, the target orientation of which then may be the maximization of a social welfare which has to be

<sup>1</sup>See Gesswein (1986, p. 24).

defined.<sup>2,3</sup>

The links between man and state on the one hand and the goods existing in the economy on the other hand are established via the term of property. In its general categories as public or private property this term does not correspond to the various existing real phenomena.<sup>4</sup> Lösch shows that with the slightest differentiation of the idea of property there emerge a multitude of property forms; *usus-abusus-usus fructus*. If we differentiate in terms of these specific rights in goods, we obtain 27 different forms of property. Moreover these rights may be exercised by the state and factor-suppliers individually or commonly. This alternative of common or individual exercise of rights alone indicates that besides goods rights with different grades (cf. partial rights) can indeed be an object of exchange. This kind of exchange is within the neoclassical framework<sup>5</sup> in that they continue to serve for the realization of targets such as maximization of utility, profits, and social welfare of each holder of rights.

The state appears as an institution that has been conferred specific property rights by individuals. The "social contract" is interpreted in economic terms. This, however, is not to be confused with the constitutional organization of the "state", which is not easily accessible for the property-rights approach.<sup>6</sup>

### *B. Optimum Allocation by Means of Transactions of Property Rights*

The significance of the legal framework for the analysis of economic action is demonstrated by the so called Coase-theorem,<sup>7</sup> accord-

<sup>2</sup>See Lösch (1983, p. 624).

<sup>3</sup>This paves the way for economics to claim "(sole) rule" over neighboring disciplines such as politics and ecology (see Blum 1984, pp. 37-55).

<sup>4</sup>Property rights therefore describe the "rights of persons towards other persons with regard to the handling of scarce goods" (Lösch 1983).

<sup>5</sup>Noting that little consideration have been given to property rights during the last 200 years, Bethell shows that the neoclassical approach not only has a strong affinity with the property-rights approach, but that the former actually needs the latter for the consolidation of specific results (Bethell 1986, p. 3).

<sup>6</sup>"...economics has to register the significance of the constitution as a pattern of rules of behaviour and as a minimum quantity of ethical norms upon which a community has decided and to which it binds itself. This means that above the economic system a set of values has to be established, with disregard to actual needs or requirements or even to actual material interest" (Krüselberg 1983, p. 76). The justification of assuming a set of values independent of actual needs is also dealt with in the field of the economics of constitution.

<sup>7</sup>Coase (1960, pp. 1-44).

ing to which, given the existence of external effects, the optimum allocation of factors is ensured only when there are well-defined property rights with the possibility of private exchange. In this case internalization of the external effect is done by originator and the party affected via the market. In literature little, if any, attention is paid to this solution of the problem of allocation with existing external effects.<sup>8</sup> A typical solution is rather the determination of an appropriate Pigouvian tax rate, the implementation of which is conferred upon the state.

The Coase-theorem may indeed be criticized for its being based upon restrictive prerequisites (for example, lack of transactions cost and, at a different level, a lack of financing bottlenecks). Just as unjustified, however, is the assumption of a costless Pigouvian-kind of intervention by the state. This is why Demsetz maintains that external effects would not harm the Pareto-efficiency of the allocation, if the cost linked with the internalization, whatever this may look like, actually exceeds the effect itself.<sup>9</sup> It is rather the transaction cost, here defined as the total resource expense as connected with the conferring of property rights, that constitutes the essential criterion for a decision upon alternatives of state internalization as against private internalization.

### *C. Creating and Changing Property-Rights Structures*

The inclusion of transaction costs in the utility assessment of a transaction constitutes an essential difference between property-rights analysis and traditional microeconomic theory.<sup>10</sup> This inclusion enables especially the explanation of the transfer of property rights between two or more individuals or between individuals and institutions, the latter being defined as a combination of several rights. At the same time this inclusion enhances a more differentiated illustration of the behaviour shown by these institutions, as each individual as holder of specific property rights aspires the maximization of his own utility, which is measured not only by economic categories. This fact is of importance of the study of a system marked by Confucianism like the Korean system, since decisions

<sup>8</sup>See for example, Rose, Wenzel, and Weigard (1981, p. 43). A more elaborate discussion of the Coase-theorem modified by Buchanan and Stubblebine is offered by Sohmen (1976, p. 224, p. 271).

<sup>9</sup>Demsetz (1967, p. 347).

<sup>10</sup>Lösch (1983).

which on the surface appear to be economic decisions are strongly influenced by other, i.e. culture specific factors.

This is why in the property-rights theory the methodological individualism is especially emphasized. The banning of man into the "non-economic environment" of the economic analysis is avoided in that the concept of the *homo oeconomicus* has experienced a significant extension. Property rights are also "...the political rights of participation and human rights, the latter being relevant for economic analyses to the extent to which they exert influence on the interrelations among individuals and among groups of related people, respectively, as far as the actual possibilities are concerned that these persons have to dispose of scarce goods".<sup>11</sup> The general objective of utility maximization is open to the consideration of sub-objectives, which can be better operationalized, and thus it is more easily accessible for empirical testing. From the basis of the economic analysis, now extended by the property rights, emerges the question of how property rights are created and changed in a society, and how they in turn affect the economic activities, as traditionally defined, as well as the very property rights. As is mentioned above the constitutional framework is at first not included in the consideration. The discussion is much more about the structural changes undergone by the property rights that, on account of the according transactions, take place within a certain framework.

On the assumption that these transactions are not free of cost, property rights will be exchanged as long as there is a positive net gain from exchange. The structure of property rights thus figured is then supposed to be efficient.<sup>12</sup> Against this theory, however, may be held the same criticism that was held before against the Coase-theorem. The change of a "legal" system in terms of creating new property rights has to be distinguished from the above described exchange of property rights. This change always presupposes a confirmation by a competent social instance.<sup>13</sup> Hesse denotes those changes which are independent of the approval by all members of society as legal changes by decree. He thus describes a society, in which at least one authority as a "constitutional" product exists as an essential institution. It is exposed to the influence exerted by those members of society, who are interested in a change of the

<sup>11</sup>*ibid.*

<sup>12</sup>See Hesse (1983, p. 84) and Posner (1981).

<sup>13</sup>Hesse (1983, p. 95).

property rights and who use their power for this.<sup>14</sup>

For those members of society interested in a change of rights the cost caused by their use of power consists of the efforts for the conquest of the authority needed for their own objectives and of the cost that arises for this authority to justify the aspired change toward society. In contrast to this, there are efforts of the affected people who resist and who, if necessary, try to increase their potential of power by forming coalitions. These efforts go together with cost for the spreading of one common "ideology". The lower the cost, the larger the coalitions may be. The more homogeneous the coalitions (in terms of internal distribution of power) the more equal the distribution of the profit achieved by a coalition. This is equated by Hesse with a tendency towards the constitutional state.<sup>15</sup> Therefore the following conclusion may be drawn: The process of changing property rights, i.e. a reform of property rights, brings forth institutions, which in turn lead to new opportunities for exchange of property rights. Although from the welfare-economics-point of view there cannot be an equivocal assessment of these processes,<sup>16</sup> they doubtlessly point to evolutionary institution building. Thus the change of property rights, similar to the internalization of external effects, can be described as an exchange process via the market, for which transaction cost in its wider sense is important and which is leading to an economically efficient solution.

If distribution and/or nature of the given property rights are unknown, the probability of an efficient solution decreases. Uncertainty about the power of other party's rights does not allow the ex-ante determination of an efficient use of resources. This applies especially to the assessment of the relations between the constitu-

<sup>14</sup>As regards possible ways of exerting influence it is highly significant to ask whether such an instance is positioned within the constitutional framework or without. This is, because both lobbyists as well as the instance are faced with unequivocal limitations in case the instance is positioned within. Bethell considers this typical, documented by the constitutional evolution of Great Britain, and necessary for the change or the new acquisition of property rights: "The crucial point about such a society is that its government officials...are not themselves considered to be above the law. The law is something that applies to all" (Bethell 1986, p. 6).

<sup>15</sup>Influence exerted by pressure groups in order to obtain decisions in the field of economic policy that are in line with their intentions exists in democratic systems as well as in systems without a democratic legitimization (see Dee 1986, p. 6). A progress towards the constitutional state thus cannot be equated with the tendency towards democratization.

<sup>16</sup>Bethell (1986, p. 98).

tional authority on the one hand having the final decision on any change of property rights and the related parties on the other hand. In reality an unequivocal distinction between individual interests and communal well-being is more often than not impossible. Dee points to the fact that an economic policy marked by individual interests can produce an equilibrium in the politico-economic "market" at the same time, being suboptimal from a purely economic point of view.<sup>17</sup> If the politico-economic equilibrium is highly weighted in the individual utility function, the implementing cost of individual/group interests are reduced.<sup>18</sup>

#### *D. Economic Development as Function of the Property Rights*

Up to this point this paper has been discussing the process of changing property rights ignoring its integration into an economic and social target framework, which has to be determined normatively. It is rather structural shifts that have been considered so far, shifts which were brought forth as adjustments of the distribution of property rights to external changes of data and which do not necessarily present a process of development. If the term development is defined in accordance with Röpke's definition,<sup>19</sup> i.e. the growth of an economy accompanied by institutional changes in accordance with Schumpeter's idea of "destructive renewal", it is about exogenous processes from the point of view of the neoclassical theory of growth, but it is about endogenous processes from the point of view of the property-rights approach. This approach thus comes very close to classical thinking: the innovative activity of any person as an economic unit will ultimately depend on factors that exert direct influence on any individual property right.

In this context there may be mentioned at a first level the ability of the individual to identify new combinations of property rights which are increasing his utility. At a second level then the implementation of these combinations depends on structure and rigidity of the given property rights. The above shown pattern has to be applied here. Only at a third level those basically allocative processes appear which are described by neoclassical theory of growth. Therefore the theory of growth extended by the analysis of institutions and property rights, respectively, seems to be more suitable

<sup>17</sup>Dee (1986, p. 7).

<sup>18</sup>See Section II. E.

<sup>19</sup>Röpke (1983, p. 111).

for dealing with the broader range of development. It thus seems to be more appropriate for an explanation of a major part of economic growth.<sup>20</sup> Accordingly a development-enhancing figuration of property rights must guarantee the readiness of individuals for innovation, i.e. their search for permanent "truck and barter" concurrently involving the aptness to change of the existing property rights. This is not to be confused with the need for the sharpest possible reduction of the limitations of actions (being only another way of perceiving property rights), since it is especially the motivation of individuals to renew which depends on a certain legal protection, for example, from imitation or from intervention. And it is also not the removal of obstacles avoiding an optimum factor allocation which is here of utmost importance. First this last level is only the result of innovative behaviour and secondly the contribution of such an improved allocation to growth is comparably small.<sup>21</sup>

### *E. Rational Behavior and Property Rights*

The property-rights approach differentiates the notion of property as it prevails in the neoclassical theory, thus providing the possibility to work out hypotheses on specific interests connected with different forms of property (of goods and rights). This is especially important for the model of a society marked by insufficient information, i.e. where information is not evenly distributed. Then rational behaviour of individuals has to be supposed in the sense of "subjectively rational behavior".<sup>22</sup> This, however, does not yet solve the problem of unequivocally delimiting the notion of rationality, which is important for the inclusion of the property-rights approach in the analysis of economic development, especially of those in differing cultural spheres.<sup>23</sup> The use of resources for transaction purposes

<sup>20</sup>See, for example, Denison (1979).

<sup>21</sup>See Röpke (1983).

<sup>22</sup>See Gesswein (1986, p. 22), who also refers to Tietzel (1981, p. 120).

<sup>23</sup>Gesswein distinguishes three forms of rationality: absolute, prescriptive, and descriptive rationality, the latter category allowing, besides rational acting, also for "irrational, emotional, affectual and traditional behavior". This distinction between rational behaviour on the one hand and non-rational behavior on the other hand may probably be admissible for societies that are homogeneous with regard to their conception of rationality. There is, however, no sufficient operationality for its application to heterogeneous groups. This applies as well to the transfer of a certain notion of rationality to other cultures. In the field of autochthonous traditions for example, Riedel and Pollak write that these have to be seen in connection with mystical and religious phenomena and systems of values and that they are above all indicators for man's struggle for survival



may also include other targets besides the maximization of an economic net-utility. These other targets may include even the voluntary self-restraint during the implementation of changes.

Such a hypothesis on behavior would indeed be justified for societies marked by Confucianism and it would facilitate the explanation of patterns of certain economic and political processes.<sup>24</sup> Therefore the analysis of property rights seems to be especially relevant for those societies which do not correspond to the implicit assumptions of behavior as expressed by the theoretical pattern of "western" economics.<sup>25</sup>

#### *F. Summary of Section II*

The property-rights approach differentiates the traditional notion of property in terms of potential legal figurations. The three basic forms of *usus*, *usus fructus*, and *abusus* determine the relationship between individuals and property.

The power of each individual's property rights depends on the possibility to exercise these rights without harming the rights of other individuals. From the above mentioned distinction we note that, depending on the nature of the ownership of goods, it is possible to exercise a right individually or commonly. If with the exercise of a right arises an infringement of other persons' rights, this is an external effect, which can be internalized by exchange of rights, i.e. by compensation via the market.

and his ability to organize every sphere of his life (see Riedel and Pollak 1986, p. 13). As far as objectives are concerned, these statements correspond with the definitions of rational behavior. However, as regards contents, there is a strong difference. For the operationalization of the term of rationality within the analysis of property rights the extended version mentioned last appears to be more suitable.

<sup>24</sup>In Confucianism power and socially responsible self-restraint are closely linked. This calls for a high degree of confidence on the part of the "ruled". In case this confidence is abused "...Korean could be devastatingly rebellious and anarchically disrespectful of authority" (Hahn P.C. "Towards a New Theory of Korean Politics." In Wright E.E. *Korean Politics in Transition*. Seattle, 1975, p. 321, quoted by Dee 1986, p. 33).

<sup>25</sup>The suitability of the property-rights approach for an explanation of historical processes of development is argued about in literature. While Gesswein considers its self-restraint to contractual exchange as excluding "all other social interrelations", Lösch stresses the changeability of the individual utility functions and their interactions with the exchange conditions. It is rather the latter interpretation which seems to come up to the possibilities of the property-rights analysis, if we disregard the problems connected with operationalizing the utility concept. Thus, in the presence of alternative approaches, Gesswein's reproach of a model Platonism has to be rejected (see Gesswein 1986, pp. 53-102; Lösch 1983, p. 627).

Independent of external effects, the exchange of property rights continues as long as its marginal utility does no longer exceed the marginal cost connected with this exchange of rights.

In societies, in which changes of the system of property rights are not always decided unanimously (and determined via market processes), changes of property rights depend on the confirmation by a social instance, which is exposed to influence by the individuals concerned.

Economic development in terms of economically innovative behaviour depends on the predictive success awaited for these innovations. With regard to economic and political reforms the following questions arise from the approaches of the property-rights theory:

- 1) which areas of rights are influenced by the reforms?
- 2) what in general is the initial situation in the areas mentioned?
- 3) which legal relationships important for present structures of rights exist?
- 4) what is the contribution of reforms to development likely to be?

### III. A Property-Rights Approach to the Analysis of the Financial Sector: Money as a Right of Conversion into Real Assets

So far monetary phenomena have only rarely been analysed with reference to property rights. Transaction costs, dealt with by Tobin and Baumol when explaining money demand, are at the very core of this approach. Alchian<sup>26</sup> stresses one particular function of money: it reduces the cost of information-gathering in the process of exchange of real goods, because it can easily be identified itself. The importance of money, therefore, increases with the degree of division of labour in an economy. By stressing the importance of money as a means of gathering information Alchian reduces emphasis of the typical functions of money (medium of exchange, unit of account, store of value). This may be justified for all but the last function, because it is particularly the characteristic of money to be easily identifiable which is closely related to the store-of-value function.

Alchian may neglect this point since, at first, he does not include the time-dimension in his model. When transactions are not divided into a selling and buying part but are performed infinitely quickly,

<sup>26</sup>Alchian (1977, pp. 133-40).

only the present quality of money matters. Money in this case is a production factor that reduces transaction cost.

However, the importance of the store-of-value function increases as soon as the time factor is included and transactions are separated into a buying and selling part. In this case money will reduce transaction costs only if its quality can be assessed free of cost, i.e. if future changes in the value of money are known. If not, additional costs would arise in order to gather information, which in turn would be detrimental to the quality of money. Alchian's approach can be extended by this element of uncertainty without basically changing his hypothesis. On the contrary, if one applies Alchian's interpretation of money (being an efficient means of collecting information about goods from so-called "experts") to money itself, the role of banks can be derived directly; they are simultaneously experts and dealers in money, including all variants of quasi-money.<sup>27</sup>

Gesswein,<sup>28</sup> employing the property-rights-approach, arrives at a similar role of money: He sees money as a "unspecified right of conversion", an "abstract claim to property towards society"<sup>29</sup> of its owner. This claim or right is obtained when goods are sold for money. This exchange takes place because both the reduced transaction costs (Alchian) and the satisfaction of the need for readiness to make transactions increase individual utility.

These welfare-increasing effects of money are out of the question, but it has to be asked whether the existence of money can really be deducted from the transaction process, i.e. the sale of real goods. In this case money is created only parallelly to the production of goods. It is always covered by past or certain future production, and thus there is no scope for inflation.

Examining the compatibility of the property-rights approach with qualitative-static theories of money, Gesswein arrives at a positive result:<sup>30</sup>

- 1) the real theories of money, based on the subjective axiology,
- 2) theories of convention, stressing formal or informal agreement,

<sup>27</sup>"This analysis explains the use of money, which good becomes money, ...the reputation of experts as an integral part of their capital values, and the reasons experts are also dealers". This explanation aiming at the relationship between goods and money can be applied to money-money relationships as well (Alchian 1977, p. 139).

<sup>28</sup>Gesswein (1986, p. 139).

<sup>29</sup>In German, "unspezifiziertes Umtauschrecht", "inhaltlich nicht ausgestaltetes Recht auf Eigentum gegenüber der Gesellschaft", *ibid*, p. 148.

<sup>30</sup>*ibid*, p. 128.

- 3) theories stressing the transfer of claims,
- 4) functional theories stressing cost-reducing effects

do not contradict the property-rights approach because they explain money as a clearly defined set of rights. However, he rejects compatibility with the so-called theory of confidence on the ground that it contradicts the underlying assumption of rational behaviour. The theory of confidence is based on the idea that money emitted by the state is accepted by the public as long as there is confidence in the state's policies. The exclusion of this theory can hardly be understood. First, in the case of "privately emitted" money, there has to be confidence in the future availability of goods, too, and second, the allocative and cost-reducing effects of property-rights are of special importance in a world marked by uncertainty. Finally, leaving this theory unconsidered reduces the extent to which it reflects realities: the major part of society accepts the state as final decision maker as regards the distribution of property rights. Confidence is an implicit determinant of money demand, and preserving it is a normative requirement that can indeed be justified. Richter points out that in order to regulate the conditions of money use the "institution of money" needs an "elementary currency order". It consists of the "accounting order" and the "purchasing power order".<sup>31</sup> The latter makes clear: Achieving confidence in money is an important function of this order.

Therefore this approach could be rephrased in such a way that the property rights-oriented explanation of money has to deal mainly with the individual acceptance of money. It will be accepted when the holder can be sure of both kinds of benefits mentioned above, i.e. its creating liquidity (readiness for transactions) and reducing transaction cost. They, in turn, depend on whether money will be acknowledged as a right of exchange into real goods in the long run. A part of the production can be expected to vanish because of leakage and consumption thus reducing the ratio of goods to money stock. In terms of the property-rights approach there occurs a dilution of the right to dispose of real goods. Putting it either way, the process of inflation matters. The transaction-cost reducing effect of money then deteriorates corresponding to the uncertainty about the future rate of inflation; the volume of liquidity decreases in proportion to the rate of inflation. Thus the inflation rate shows the

<sup>31</sup>Richter (1988, p. 209).

degree to which the money holder is deprived of his property rights, he himself having only marginal control over inflation. Only if the inflation rate was to be determined in advance, certainty about money's future role as a right of exchange into real goods could be established<sup>32</sup> and we would arrive at a stamp money as conceived by Gesell<sup>33</sup>: its nominal value is sustained by payment of a stamp fee by the money-holder. This is equivalent to a negative interest rate. Gesell's concept is based on the assumption that money is hoarded, i.e. withdrawn from the circular flow. The "optimum rate of inflation" derived from neoclassical growth theory relies on a similar assumption: A substitutional relationship between investment in real and monetary assets leads to an absorption of savings by financial investment when the return on money exceeds a certain limit.

A negative interest imposed on holding money is the reverse of a positive interest on credit.<sup>34</sup> In this case current rights are exchanged for future rights. This will occur, if the expected return on granting credit exceeds the present benefit of holding money.

The different categories of utility of money and monetary assets (credit) can be distinguished according to Roman law as follows: *usus*, *abusus*, *usus fructus*. The first two kinds of rights are sold by the lender to the borrower as well as that part of *usus fructus* exceeding the borrower's credit cost (the lender's return). The cost consists of interest only when transaction costs are distributed equally amongst both partners.

*Usus*, *abusus* and the remainder of the *usus fructus* add up to the borrower's net benefit. If he doesn't have to exercise all obtained rights<sup>35</sup> for the original purpose, he can maximize his utility by on-lending the surplus to another borrower. This may be termed direct finance of deficit units by surplus units. Financial intermediation takes place, if the original borrower, now in the position of a lender, shares the *usus fructus* with another borrower and transfers to him *usus* and *abusus*. Lending always implies a future payment commitment on the part of the debtor which is the reverse of the asset (money) obtained from the creditor. To assess the borrower's

<sup>32</sup>According to Richter such an index-based currency corresponds with a valoristic conception of money. It is optimal only in the case of costless measurement of future inflation. See Richter (1988, p. 214).

<sup>33</sup>Gesell (1947). For a critique of Gesell, see Veit (1969, p. 167).

<sup>34</sup>The interest load on holding money is equivalent to a zero interest rate on monetary assets, see Veit (1969, p. 169).

<sup>35</sup>See Richter (1988, p. 214) for a distinction of categories of rights related to money.

quality specific information and skills are necessary.

Alchian's model of a pure barter economy has already been mentioned. There, indirect exchange of goods via expert-traders minimizes transaction costs. Transferring this concept to financial markets, banks are those organizations which, because of their unique combination of factors of production, achieve the intermediation of a set of rights called money at the lowest possible cost. They have a particular comparative advantage in gathering the kind of information necessary for the assessment of borrower's quality.

Banks and money are of relevance only when imperfect information is assumed.<sup>36</sup> Uncertainty about the information available means that there has to be a certain degree of confidence in Alchian's experts. They in turn have to trust in the predictability of their partners' behaviour. Hesse calls this the "existence of normative behavioural expectations".<sup>37</sup>

Whether property rights, i.e. in our case money, are exchanged depends on

- 1) the kind of transferred/exchanged components of rights,
- 2) the utility associated to those components,
- 3) whether the utility can be expected with certainty.

In particular these elements determine whether

- 1) surplus production (= savings) pays off for the potential lender,
- 2) surplus is held as monetary asset or real asset,
- 3) monetary assets are held as money or other less liquid assets, (assets endowed with other components of rights),
- 4) banks in their position of intermediaries contribute to the optimum allocation of surplus funds.

In the context of economic policy one may ask whether the allocation of financial resources is the optimum with regard to the superior normative objectives set by political authorities.

Apart from this point the question of compatibility of "political" objectives and individual utility maximization is to be dealt with. This is a problem untypical of the property-rights approach, which is based on methodological individualism, admitting at its extreme only those political objectives which are compatible with an optimum set of rights.

However, viewing the conditions of a developing country an inves-

<sup>36</sup>See Alchian (1977) and McKinnon (1973, p. 52).

tigation of government strategy with regard to the achievement of objectives seems to be interesting, thereby slightly neglecting the choice of objectives. In the case of Korea that means primarily an investigation as to whether the strategy of export-promotion has been supported by the structure of property rights. In a second step the question of alternative structures and strategies arises. In this paper analysis will be confined to property rights which are of relevance to financial markets: Are conditions transaction costs, of sets and components of rights, and of expectations conducive to financial markets which have to support a specific development strategy?

#### IV. Development, Financial Markets, and Property Rights

##### *A. A Brief Survey of Korea's Socio-economic Development*

For more than 500 years, i.e. from 1392 until 1910, Korea was ruled by the Yi-dynasty. The foreign policy aimed at isolating the country from its ambitious and rivalling neighbours, Japan and China. This resulted in a homogeneous, but static social structure which due to Confucianist tradition restricted economic and technological progress, too.<sup>37</sup> That situation of a "recluse-kingdom"<sup>38</sup> was radically changed in 1910 by Japanese colonial rule. It is not clear whether a change of the internal socio-economic situation came along with the external opening forced upon the country. As a matter of fact during Japanese occupation there was increased investment in infrastructure, agriculture, and mining. Impacts, however, came from Japan, which viewed Korea as a supplier complementary to its own economy.

Korean rule of the country in a true sense and a Korean political system were established only after economic and political shocks of the war had been overcome. The internal structure of military dictatorship, installed by Park Chung Hee in 1961, was of a Confucianist type: Power was transferred to the one person at the center which was supported by a bureaucracy, consisting of the social elites. While the century-old structures were restored with relatively few changes, military now took the posts that had been occupied by

<sup>37</sup>In German, "Existenz normativer Verhaltenserwartungen", Hesse (1983, p. 102). Own translation.

<sup>38</sup>See Schulz (1981, p. 9).

<sup>39</sup>"Einsiedler-Königreich", see Luther (1980, p. 208).

civilians before 1910. "Militarization of the Confucianist system"<sup>40</sup> did have considerable impact on both political stability and economic progress. For example, in 1982 about one third of the population in working age and probably two thirds of those employed in industry had passed through military service.<sup>41</sup> Not only did this contribute to sound technical training<sup>42</sup> but also the spreading of ideals like discipline, responsibility for the social collective, and abstention from consumption were promoted.<sup>43</sup> Confucian tradition was combined with the requirements of industrialization and integration into world markets: Political rest and low wages contributed to international competitiveness. The government's right to exist resulted from both a traditional system of power and the accomplishment of economic goals; It was independent of democratic procedures.

Still there were tensions within the ruling military class. They were, however, reduced or eliminated by distributing posts in the economy and administration.<sup>44</sup> Schulz estimates that until 1980 job rotation in order to muster political support led to about 40,000 job switches. He reports of a case when ten new (loyal) parties were founded in order to split opposition within the ruling class.

Thus the highest strata of the Korean political hierarchy were characterized by mutual dependence.<sup>45</sup> This has to be seen against the background of a modern legal system, rooted in Europe and contrasting heavily with Korean legal traditions. The executive was granted full scope by the legislative "which is employed by the government to a large extent in order to attain the developmental goals".<sup>46</sup>

A rather rough chronology of Korea's development strategies shows a sequence of import substitution, export diversification and

<sup>40</sup>Schulz (1981, p. 38).

<sup>41</sup>Data from Schulz (1981) and World Development Report (1984, p. 293).

<sup>42</sup>See Dee (1986, p. 20).

<sup>43</sup>Dee mentions six categories of Korean values: "fatalism (including the desire to avoid risk), familism, authoritarianism, emotional humanism (where maintaining continuous active relations with others becomes an end in itself, not a means to achieve cooperative goals), ritualism and anti-materialism (placing more emphasis on honour, prestige, integrity and virtue than on material reward)". *ibid*, p. 8.

<sup>44</sup>A change of government brought about an increase in the power of particular pressure-groups having their own individual interests, *ibid*, p. 8. It may therefore be concluded that the cost of carrying through their particular interest, and the cost of forming coalitions for that purpose, were lower in times of political crisis.

<sup>45</sup>This nexus of political and economic interests can be described by the property-rights theory.

<sup>46</sup>Riedel and Pollak (1986, p. 51) and Table 1.



finally a selective combination of elements of both strategies. Every change of strategy was initiated by the government. The decision in favour of export-orientation was taken by the short-lived democratic government of 1960. Amongst others, the set of major instruments for export-promotion contained liberalized capital imports, including foreign direct investment,<sup>47</sup> selective tax- and tariff-exemptions, support for joint ventures, and subsidized loans for exporters.

It has to be pointed out that it was especially credit policy with its interest regulation which contributed to even closer ties between export-oriented industry and government. Alongside rather informal personal relationships, influence via general economic planning, and specific instructions for investment in state-owned enterprises,<sup>48</sup> there appeared substantial relationships of economic dependence. Typically, Korean export-industry was undercapitalized. Low-interest loans led to heavy indebtedness of this sector with the government-controlled banking system. In the end cheap finance resulted in increased government influence in private industry. This fact has to be taken in consideration when analyzing the reform of the financial markets of the 1960s by means of the property-rights approach.

## *B. Korea's Financial Markets since the Mid-1960s*

### *A) Overview*

Until 1965 there existed only a rudimentary and heavily regulated financial market. In 1973 McKinnon, calling the Korean financial markets "financially repressed"<sup>49</sup>, showed that real return on time deposits was mostly negative and heavily fluctuating, from +5.3 % to -14.6 %. However, the period of 1977-86 showed even stronger fluctuations (-24.1 % in 1980, +8.2 % in 1986), without being given the same attribute of financial repression. As a matter of fact in the mid-seventies the Korean government permitted a certain

<sup>47</sup>Foreign investors were offered the opportunity of repatriation of the original dollar investment, i.e. without exchange-rate risk (see Chelminsky 1986, p. 19). This policy led to the development of a capital market denominated in a parallel-currency. All negative aspects of the dollar-debt were left with domestic borrowers because repatriation ought to be legally guaranteed. Chelminsky, however, does not give detailed information here. See as well IMF (1986).

<sup>48</sup>Until 1986 several companies in the shipbuilding, transport, mining, steel and banking sectors had been privatized. See Chelminsky (1986).

<sup>49</sup>McKinnon (1976a, p. 109).

orientation of formal, regulated markets towards the informal and unregulated markets. At the same time new unregulated operations were allowed or at least tolerated. Thus, erratic movements of the real interest rate were accompanied by institutional liberalization.

The 1965 change in monetary policy is not only a case in point for financial reform in general but was a decisive moment in the history of the Korean financial markets. It brought about a substantial increase in deposit rates and temporary abolition of ceilings on loan rates. Activity of banks grew depending on the difference between their capital cost and their return on lending business. Increasing promotion of export industries meant a return of interest ceilings. According to Virmani 80 % out of total lending were "forced lending". The results of this policy were typical for regulated credit markets: At the micro-level the bank's evaluation of borrowers concentrated on the amount of real security pledged; at the macro-level there occurred a considerable expansion of the monetary base,<sup>50</sup> which accelerated inflation. Five years after the reform the following was typical of the financial markets:

- 1) slightly less direct control of credit compared with that of the time before the reform, but still widespread regulation of interest rates which, together with inflation, punished savers,
- 2) banks suffering from low margins and returns,
- 3) preferential treatment of exporters who showed a high present value of real security, whereas the innovative potential of those producers that might show a high future value of securities or high returns on investment was ignored.

Until the mid-eighties the government's attitude towards financial market policy shifted several times, one reason, amongst others, certainly being the oil-price shocks. However, a coherent concept for financial market policy like that in 1965 was not discernible.

Concurrence of government intervention, external shocks, and underdeveloped financial markets contributed to the economic crisis of the early eighties. Switching several times from monetary expansion to contraction and back again, the government at the same time made more use of forced lending to priority sectors like heavy- and chemical-industry.

In addition to this, worldwide recession was detrimental to exporting companies, some of which faced with bankruptcy resorted to

<sup>50</sup>McKinnon (1976b, p. 87).

extremely risky operations: The problem of moral hazard on the part of the borrowers worsened the banks' situation, driving some of them close to illiquidity. In the end the government had to come to rescue by channelling money into the economy via the banking system.

### *B) Financial Enterprises Participating in the Financial Markets*

During the past 25 years the financial sector has become diversified with respect to the types of enterprise. This development has been induced by direct government intervention (reprivatization, founding of new companies), as well as by indirect government influence via the market mechanism (liberalized licensing of new business activities). Since the beginning of the 1980s the following institutions have come to be distinguished:<sup>51</sup>

- 1) central bank
- 2) commercial banks
- 3) specialized banks
- 4) development institutions
- 5) savings banks
- 6) mutual funds
- 7) life insurances
- 8) large scale industry
- 9) institutes of the curb market
- 10) institutes of the informal market

Institutes 1) to 7) are subject more or less to tight government control: the central bank has been under direct control since 1961. It supervises all other financial institutions except for the specialized banks which by law receive instructions from their respective ministries.

### *C) The Credit Market*

From the mid-1970s on government regulated interest rates were a prominent feature of the credit market. The nominal interest rates for short term finance to first class borrowers, at first stable, were adjusted to the curb market trends from 1979 on. Thus market forces had at least an indirect impact, but the uniform rate did not allow for a distinction between different kinds of collateral or different maturity periods. For the banks this meant high transaction

<sup>51</sup>Virmani (1985).

costs and a low spread at the same time. The latter resulted from relatively high deposit rates, which were to promote cashless money transfer. The total effect of all this was a declining share of commercial banks in total financial market activity.<sup>52</sup>

This contrasts with a heavy increase in trade credit, granted by the large industry to their suppliers. Finance of that kind was not subject to interest regulation, and transaction costs were definitely lower, because lenders and borrowers had a close relationship. Finance of small and medium scale industry was dominated by large industry which thus built up a segmented financial market.<sup>53</sup> Large industries took over the function of allocating funds but at the same time increased dependency of the medium scale industry on final producers. Two interpretations are possible: First, Alchian's view of the expert/dealer-function is validated here. Second, this reminds of the money-lenders in rural credit markets. The current efforts of the Korean government for promotion of medium scale industry may be rooted in this situation.<sup>54</sup>

#### *D) The Bond Market*

The importance of large industry for capital allocation is confirmed by the situation on the bond market, where these companies increasingly (re-) financed their loans, especially since commercial banks were permitted to guarantee bonds. One may draw a parallel with nonvoting shares,<sup>55</sup> because risk is transferred from borrower to bank. Nonetheless, as the spread was higher than in the loan business, banks made extensive use of this instrument.

Again, banks preferred borrowers for which sufficient information on present collateral was available. Expected returns of companies were of minor importance, because information was lacking. So banks were averse to risk. Another indication of the banks' drive for security is given by the collateralization of credits by bonds, which at the same time constituted the only kind of secondary bond markets existing in Korea.

<sup>52</sup>Virmani (1985, p. 22).

<sup>53</sup>Sometimes the "Chaebol" obtained funds from official (low-cost) sources and transferred them to the informal sector, which made them net creditors of the whole financial market. See Dee (1986, p. 33).

<sup>54</sup>The government tries to encourage direct exports of medium scale producers by arranging direct contact to foreign markets. The Small and Medium Industry Promotion Center at Eschborn, Germany, serves this purpose.

<sup>55</sup>Virmani (1985, p. 35).

### *E) The Stock Market*

Stock trading is restricted heavily by government regulations.<sup>56</sup> To be listed, minority-holding requirements have to be met. As the stock market is relatively narrow and share prices fluctuate heavily, only control via majority of shares seems interesting to the stock owner. It is for this reason that Virmani suspects formal minorities to build real majorities. This view is supported by the close interlacing of stockowners and financial institutions like for example insurance companies. This will hamper a further development of the stock market. Another, secondary effect concerns information available of the listed companies. Prices are less responsive to profit prospects than to (easily manipulated) demand and supply conditions. For this reason they do not serve as a means of evaluating the future situation of companies, but contribute to the prevailing method of decisions basing on the present day status. This, as has been shown, is detrimental to innovative firms.

## **V. A Property-Rights View of the Korean Financial Markets**

In the following there shall be discussed some features of the development of Korean financial markets which are open to an interpretation by property rights criteria. We do not ask whether property right offer an alternative analytical tool, but whether this approach leads to additional and valuable information.

### *A. Direct State Intervention*

Both sectoral promotion of industries and the support of ailing banks are prominent examples of state intervention.

Specific promotion of industries was primarily attempted by means of interest rate ceilings for credits. In theory banks would evaluate expected risk and return of borrowers in order to live up to their role as experts in the field of capital allocation and mobilization. Interest rates would then differ according to project quality, maturity period, and the banks own liquidity. However, regulation of credit rates led to a debatable allocation of funds as well as a worsening of capital mobilization.

It can be seen that limitation of property rights extends to sever-

<sup>56</sup> *ibid*, p. 45.

al levels, as long as there exist property rights. Minimum deposit rates prevented banks from passing on the spread-narrowing effect of ceilings for loan rates, resulting in deteriorating profitability. As a consequence the banks reduced their business activity.

In the early 1980s the government's decision to indirectly support ailing banks by an injection of new liquidity into the market was further sighted. The justified fear of the government that collapsing banks would have negative external effects, and especially that fear of a general loss of confidence in the whole system, made it grant financial support to a kind of self-help mechanism among banks. This might have been unnecessary, if the sound banks had had sufficient capital resources for taking over the ailing ones. As a matter of fact, the regulations prevented capital accumulation. So the government, assuming final responsibility, had to take over the cost of this rescue operation. Seen from the point of view of property rights, this is a kind of second-best solution.<sup>57</sup> The example given might be interpreted as an illustration of Coase's theorem. The takeover of ailing banks by sound ones, i.e. an interbank-exchange of property rights was a market-based solution that only had to be financed.<sup>58</sup> This example highlights the importance of confidence and expectations within the analysis of financial matters. Confidence is an intangible asset of banks. It is, therefore, a part of a bank's set of property rights, too.

### *B. Indirect Exertion of Influence by the Government*

As an example the introduction of guaranteed bonds may be cited here. On the one hand this instrument would not have been used by banks under normal conditions, because it meant, as in the case of interest ceilings, a passing of risk from debtor to intermediaries. On the other hand, it seemed favourable compared with lending. Again, risk aversion of banks was strengthened, giving borrower evaluation a security-bias and thus discriminating innovative entrepreneurs.

### *C. Market Segmentation*

Since credit regulations were not applied to all intermediaries in

<sup>57</sup>According to Richter support of that kind is in line with "a right to be saved". Those claims would be typical for multi-level banking systems (Richter 1988, p. 221).

<sup>58</sup>This is not true for the support of sick industries via a state rescue company, the Korean Heavy Industries Corporation. See Dee (1986, p. 18).

the same manner, segmented markets evolved. Large enterprises were in a position to take over the financing of middle scale industries because they had the appropriate market information. These markets were not regulated, which kept enterprises in (information advantage) and banks out (lack of experience and information). This is a kind of vicious circle: banks are not competitive enough to play the game, and will not become competitive, because they don't play it.

#### *D. Industrial Concentration*

Both regulation of financial markets in general and the company law in particular have contributed to the evolution of large groups of affiliated companies, the so-called chaebols. Although they may correspond with the Korean's understanding of society which attaches a high value to the group-principle, they discriminate innovative newcomers. This is of particular importance, because neither is there a market for venture capital nor are banks willing to assume risk. As a result the *status quo* of Korea's industrial structure is stabilized.

#### *E. Moral Hazard*

Property rights of the banks were limited by several regulations. This led to an inappropriate risk-evaluation and consequently to a number of failures, both on the borrower and the lender side. In times of economic crisis the probability of instable, i.e. extremely risky behavior of debtors increases. If they succeed, their situation improves a lot. If they don't, more fresh money from undercapitalized banks that have a large stake in the company can be expected. Again, banks are trapped in a vicious circle.

#### *F. Summary of Section V*

One may conclude that the government's policies had a very complex impact on the economy. Taken all aspects together, it was detrimental to the evolution of a banking system that is able to function efficiently, i.e. function at the same time as experts and as dealers for capital. Transaction costs were high, markets were segmented and capital mobilization proved to be insufficient. Economic policy means influencing the structure of property rights, which in turn induces feedbacks and transmissions via market and non-mar-

ket effects. In the financial markets adjustments to changes can be very quick. New equilibria have to be analysed with respect to

- 1) the so-called "Nirwana Approach"<sup>59</sup> (is an efficient factor allocation warranted by the property rights?)
- 2) the attaining of targets set by the development strategy.

Table 1 may give a vague idea of how the instruments of economic policy have influenced property rights in Korea. There, eight areas (A ~ H) are listed in a matrix. Each of them (on the horizontal axis) may be passively affected by an increase (+) or a reduction (−) of property rights. On the other hand they (on the vertical axis) can actively change the distribution of property rights.

This way of presentation shows how and where property rights were accumulated during three different phases of economic policy. It is intended to be a first step towards the development of a "pay-off matrix" which Bernholz suggested for the analysis of complex structures of property rights.<sup>60</sup> A more elaborate analysis may lead to a matrix showing quantitative variables and fewer blanks. It should also be larger in order to include other aspects of the property rights of finance and money. The impact of politically-induced inflation on the wealth of holders of financial and real assets, respectively, could also be included. Analysis of inflationary effects seems to be of particular interest in the Korean context, as economic policy created imbalances in both the real and monetary sphere.<sup>61</sup>

The matrix in Table 1, being a general analytical tool, shall be used to explain the changing structure of property rights in Korea in three different economic settings:

- 1) export promotion by means of preferential credit facilities (interest rate ceilings),
- 2) capital mobilization by means of guaranteed bonds and minimum interest rates on deposits,
- 3) frequent change of monetary policy and support of ailing enterprises (banks and industries) during the recession of the early 1980s.

<sup>59</sup>Krüsselberg (1983, p. 61).

<sup>60</sup>Bernholz (1988, p. 225).

<sup>61</sup>The promotion of heavy, chemical and construction industries resulted in excess supply in the early 1980s; direct interventions in the credit market and varying monetary policy were detrimental to the control of money supply.



**TABLE 1**  
**THE CHANGE OF PROPERTY RIGHTS BY SOME INSTRUMENTS OF ECONOMIC POLICY**

	A	B	C	D	E	F	G	H
<b>1) Sectoral Promotion by Means of Interest Ceilings</b>								
A: Exogeneous								
B: State			+			-		
C: Large Industry		+						
D: Middle Industry			+				+	
E: Household/Entrepreneur								
F: Banks			+	-	-		+	-
G: Informal Sector								
H: Individuals								
		+1	+3	-1	-1	-1	+2	-1
<b>2) Capital Mobilization by Means of Guaranteed Bonds and Minimum Interest on Deposits</b>								
A: Exogeneous								
B: State						-/+	-	+
C: Large Industry								
D: Middle Industry								
E: Household/Entrepreneur								
F: Banks			+	+	+			+/+
G: Informal Sector								
H: Individuals								
			+1	+1	+1	0	-1	+3
<b>3) Reactions to Recession: Changing Policies/Rescue of Enterprises</b>								
A: Exogeneous		-	-	-				
B: State				-		+/+	-/-	+/+
C: Large Industry								
D: Middle Industry								
E: Household/Entrepreneur								
F: Banks			+	+				
G: Informal Sector				-				
H: Individuals								
		-1	0	-2		+2	-2	+2

In the following there will be given a brief explanation of the processes reflected in the lines and rows of the table.

**1) Sectoral Promotion by Means of Interest Ceilings**

Line B: The government extends property rights of large exporting industries by improving their access to credit facilities and

by worsening the opportunity of banks to build up an asset portfolio based on risk/return aspects.

Line C: By making extensive use of cheap credit the export industry narrows its capital base and, for this reason, gets more dependent on government assistance and more subject to government influence.

Line D: In a similar way the middle-scale industry's independence is reduced as dependence on finance from large industries and the informal sector increases.

Line F: The high stakes taken by banks in granting loans to large industry makes them vulnerable to bad debtors (moral hazard), while at the same time other potential borrowers with better profit prospects have to make use of the informal market's funds.

## 2) Capital Mobilization by Means of Guaranteed Bonds and Minimum Interest on Deposits

Line B: At the same time the government restricts opportunities of banks to build a portfolio and allows them to apply a new instrument of finance. This withdraws funds from the informal sector and improves investment opportunities of individuals (households and other economic units).

Line F: By guaranteeing bonds the banks take over risk from investors/savers (C, D, E, H), and they increase domestic ability to pay by introducing an improved and cashless payments system.

## 3) Reactions to Recession: Changing Policies/Rescue of Enterprises

Line A: World recession, mutual dependence and a narrow capital base reduce the room for maneuver of both government and export-industry.

Line B: Changing financial conditions increase transaction costs of the middle-scale industry. Direct support (rise of interest rates) and indirect support (liquidity assistance) favour banks and individuals, reducing the scope of the informal sector.

Line F: Within industries most affected by the economic crisis an increased tendency towards moral hazard can be observed. The banks become more easily exposed to blackmail.

Line G: Temporary drying up of the informal financial markets leads to a financial squeeze of middle-scale industries.

## VI. Summary

Property rights describe the rights individuals have over material and immaterial goods. This approach is based on the idea of methodological individualism. It allows for the description of social institutions with respect to conditions of existence and behavior, and their tracing back to actions of utility-maximizing individuals. If we consider behavior to be (subjectively) rational only, which is utility-maximizing, the property-rights approach is widened, but more difficult to be operationalized.

From the point of view of the property-rights approach, a financial market is primarily a market for "rights to exchange something for goods" (= money). It can be demonstrated that a lowering of transaction cost, a store of value and a transfer of partial rights in money constitute the basic characteristics of a financial market. The handling of payments and capital allocation can be performed at minimum cost, if the intermediaries' (amongst others banks) capital consists to a large extent of information that makes them "experts" and "dealers" at the same time.

First success of the Korean export-oriented development strategy coincided with stringent measures for a reform of the financial sector in the mid-1960s. As a matter of fact the government made extensive use of financial institutions in order to promote exporting industries. The property-rights view identifies especially the improved general conditions for large and export-oriented industrial groups. The burden of this strategy was carried mainly by middle scale industries and banks:

- 1) middle-scale industries saw their independence reduced,
- 2) disincentives to innovative sectors, again especially middle-scale industries, were created,
- 3) banks were not allowed to engage in business activities that would have led them to develop efficient methods of intermediation.

Altogether, the Korean government has changed the structure and distribution of property rights in a way that was in line with the goal of export promotion. At the same time there incurred considerable costs in terms of domestic economic imbalances. These results are confirmed by existing economic literature. Property

erty-rights analysis, therefore, seems to be an appropriate way to improve the consistency of economic and development planning.

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