The Invisible Hand versus the Visible Hand: The Korean Case*

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The long-held neoclassical belief was that in free-market forces and *laissez-faire* lay the economic nirvana. The structuralists challenged it and deified the statist approach. Competitive markets and statism are two imperfect alternatives. The wisdom lies in pragmatically choosing between different combinations of the market and non-market approaches. This is what Korea did with sufficient ingenuity. The integration between the state geared to developmen-goalstal goals and the profit maximizing private sector worked rather well in Korea. The state intervention was non-ideological and based on the economic efficiency criteria. It was seen that interventionist measures was not allowed to stifle. However, there were several striking differences in the manner in which the state intervened in Korea and that in other developing countries. This article delves into the question of what made state intervention so successful in Korea. The Korean experience has several lessons for the LDCs that have not turned in a stellar growth performance.

I. Introduction

Adam Smith reacted against any ideas that supported the use of political power to achieve economic ends and dismissed them as mercantilistic. Since his invention of the term "invisable hand", economists have debated over the strengths and limitations of the market forces. In the Smithian vision of invisible hand markets were complete; all market information, according to him, was summarized in prices. But his vision is shattered when a decision unit, or an economic agent, has the market power.[1] By market power I mean a situation in which an individual's action can influence the equilibrium prices. This vision is also affected by what Fred Hirsch calls the "positional good". Many

[1]Halm (1989, pp. 86-105)

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sources of economic advantage depend on the relative position of a person *vis-à-vis* others, like someone holding an important job or having access to an uncrowded beach. Since the total supply of positional goods is fixed, "what winners win, losers lose." Relevance of the positional good argument for the less developed countries is tenuous because for them the most significant reasons for statism are infant industry development, infrastructure investment, dispelling structural impediments, underdevelopment of capital markets, promoting growth and industrialization and the like.

The *laissez-faire* ideas held sway in the nineteenth centry because economic activity, spurred on by the genie of technology, was expanding fast and free markets offered full scope of bringing its potential benefits to the society. At the same time the forces of expanding democracy felt suspicious of the state and considered it a preserver of *status quo* and a possible source of autocracy. It was seen as slow, unprogressive, bureaucratic and insensitive to the opportunities that the market could provide. Turning to a more recent period and the developing countries scene, the 1950s was an anti-free-market and anti-free-trade period, that is, the dominant thinking was essentially anti-neoclassical. The neoclassical economics is identified with free markets and with the assumption that whenever there is disequilibrium in the sense of a demand and supply imbalance, it gets corrected by the self-correcting mechanism inherent in the market system. But markets have their limitations in dealing with problems like financing of public goods, or in situations of strong negative or positive externalities and so forth. Markets can be arthritic in attaining several objectives of economic policy, namely, full employment, a desirable income distribution, avoiding inflation and preserving external economic balance. A long list of market imperfections emanates from monopoly and monopolistic competition, inadequate knowledge of market options, exposure to risk and uncertainty, and decisions between present and future where the decisions in the present have a bearing on the future prices. Thus, markets do fail in many circumstances and their failure has played a key role in a large part of the economic development litera-ture. This is the central stand of the structuralist school of economic thought, which saw the world as inflexible and markets as working obstreperously. According to the structuralists, economic development is inhibited by obstacles, bottlenecks and constraints, people find it hard to adapt, resources tend to be stuck and the supplies of most things are inelastic.[2] Economic and organizational dualism, two characteristic features of underdevelopment, further thwart the spontaneity of the market mechanism.[3] These circumstances make price signals untrustworthy which, in turn, justifies the role of the visible hand.

The Keynesian revolution, in the aftermath of the Great Depression, also encouraged a strong role for the visible hand in the macroeconomic management of the economy. Another factor which promoted statism was the concern for income distribution because the theory of competitive markets is mute on the income distribution pattern. This thinking evolved further, a new role of the state in the economy emerged, and an active public sector was a part of it. The role of the public sector was analyzed in a way similar to that of the private sector.

In economic analysis, the state is seen as Janus, the Roman God with two faces back to back, looking in opposite directions. In one role it is a benign and omnicient authority and a social guardian that maintains law and order, provides a framework for contracts and the necessary infrastructure of transport, communications and education, and corrects market failure through appropriate intervention and provides public goods. This role is in the Pigou-Mead tradition of welfare economics. In the other role the state is far from benign. It represents an aggregation of various interest groups, a stifler of market forces and is a continual source of distortions rather than a mechanism for correcting them.[4] Minimum wage laws, interest rate ceiling, rent control, tariffs are some of the principal examples of state-generated distortions. Thus viewed, the neo classical stand is diametrically opposite of the structuralists' view. Hindsight reveals that the latter can be faulted for a certain blithe optimism about the developmental capability of the state. Since the early 1960s, the neoclassical thinking in this regard has made a resurgence which is still continuing.

A. The Dues Ex Machina Role

When the markets fall short, or are apprehended to fall short of the optimal, society recognizes the gap and non-market or statist institutions arise to bridge it. However, making a choice between the statist and the market forces is not simple or clear cut, and hardly binary. Market forces need neither be antithetic to the non-market or statist

[2]Little (1982).
[3]Myint (1985, pp. 24-42).
[4]Quibria (1986).

approach, nor antipathatic to it. Markets can fail as much as the state, for instance, in attaining equity and "fairness" both the systems have faltered. Various situations where markets can become non-functional have already been enumerated. They make any instinct of total reliance on the market forces questionable.[5] In addition, there is general agreement among economists that the competitive markets cannot solve the problems associated with externalities in production and consumption and with the provision of public goods.[6] Besides, the behavior of "self-interested individuals," through group action, can also be intended to influence government rules and policy to favor the group at the expense of the society. The structuralists' justification for the visible hand has already been discussed. From these perspectives, several of the *dues ex machina* roles of the state become explicable, so do what the neoclassical economists consider as the irrationalities of the economic life. These roles are intended to eliminate whatever deviations from Pareto optimality that result from the failures of competitive markets. It needs to be stated that in this paper market interventions like protection under high tariff rates, import substitution, administrative direction of investment, minimum wage regulations, and exchange rate and interest rate control are being treated as *deux ex machina* roles of the state.

B. Its Functional Aspect

Kaldor separated the allocative market functions from the creative ones; the latter entails all the productivity raising market operations that cumulatively promote investment and innovation through increasing returns.[7] From the less developed countries' (LDCs) stand-point creative functions of the market are relatively more valuable than the allocative ones. Keynes pointed out the failure of the signaling mechanism in the capital and labor markets because of downward rigidity of interest rates and nominal wages, respectively. Since both these cases relate to investment and full employment, they relate to the creative functions of the market. Other than the rigidities, in a good many times, the responses to market signals are lagged. These lags are explained by the fact that the elasticities of supply and demand are larger in the long- than in the short-run. Markets, thus, work incre-

[5]Cairncross (1986, Ch. 3).
[6]Wellisz and Findlay (1988, pp. 59-80).
[7]Kaldor (1972).

mentally and all the required responses to price signals in terms of shifts in resources take time.[8] Structuralists' argument, therefore, was that if large changes have to be brought about in a short time and creative functions have to be stimulated, the system cannot be left to the market forces and, therefore, the *deux ex machina* role of the state becomes functional. In a developing milieu this kind of role is *a fortiori* relevant because there is a pressing need for rapid growth.

However, the flip side of this coin is that when the function of the state expands and substitutes for the allocative and creative functions of the market, the state mechanism invariably becomes overloaded with bureaucratic inefficiency, directly resulting in rent-seeking and waste of resources. Experiences of the last four decades show that the failure of the non-market mechanism is relatively more frequent. It is also better known and debated in the development economics literature. In addition, the magnitude of non-market failure has been known to outweigh the market failure. State control and direction of the economy bends the economic system to political and social demands rather than bending the producers and consumers to the fact-based economic reality. When the non-market mechanism dominates, economic decisions are taken from political or social perspectives, which result in factor and commodity price distortions. The cost of distortions is a deadweight loss, that is, a loss incurred both by the consumers and producers due to inefficient resource allocation. A statistical index of the major price distortions made by the World Bank concluded that the average growth rate of those LDCs having low distortions in the 1970s was about 7 percent a year—2 percentage points higher than the sample average. Whereas LDCs with high distortions averaged growth of about 3 percent a year—2 percentage points lower than the sample average. Thus, the causality seems to run from distortions, or lack of them, to results. Be it noted, however, that the price distortions alone were found to explain less than half the variation in growth rate among LDCs, the rest was the result of social, political and institutional factors.[9] This analysis is based on the proposition that price distortions generate static and dynamic costs measurable in terms of material economic welfare.

Experiences of the last four decades also indicate towards a relatively better performance of the markets from the stand point of static and

[8] Ardnt (1988, pp. 219-29).
[9] World Bank (1983, pp. 61-3).

dynamic performance. The former stands for allocative efficiency at a given point in time. The latter deals with economic growth and expansion over time and is not far from Kaldor's creative functions. Professional opinion, from the viewpoint of functionality, has constantly drifted away from statism and towards the market mechanism since the mid-1960s.

There can be no simple rule of thumb establishing a threshold of government activities, or how much statism is too much. Government spending as a share of GNP might be small but its regulatory and administrative clout may make the effective reach of the non-market sector extremely wide. The opposite of it may equally be true, that is, the government sector as a proportion of GNP may be large but the government economic activities may not be above the discipline of the market. For example, as in Sweden until the 1970s, a considerable part of the capital stock might be owned by the state but production methods, and composition and scale of the output may be regulated by the competitive markets in an open, internationally-oriented market economy.[10]

II. The Visible Hand in Korea

The popular perception that Korean growth was the result of an unrestrained play of the market forces is more *ignis fatuus*. The sway that the visible hand had over the Korean economy and the other Asian newly industrializing economies (ANIEs) was enormous. Hong Kong was an exception in this respect. The governments in these economies went beyond their function of providing public goods. The unprecedented growth of the 1960s progressed *pari passu* with blossoming of entrepreneurial activity and the governments nourished wholesome macroeconomic environment that encouraged investment from the private sector. They helped to maintain relatively open economies and, except for areas where incentives were offered, generally kept the crucial prices right. They went even beyond this and steered investment activities with the help of a wide range of incentives, thereby influencing the course and pace of industrialization and determining the evolving structure of the domestic economies. Although the governments were actively, consistently and coherently interventionistic, the market character of these economies was not eradicated and the initiative rested

[10]Wolf (1988, pp. 151-4).

with the enterprise with profit being its basic motive. Before the end of this section we shall see how. For the major part, the state tried to get things done by influencing the market, that is, by shifting the composition of what is profitable. To this end, the state determined that some sectors or industries were more important for the future growth of the economy than others, and it attempted to divert resources to them. Chen designated this strategy of strong government intervention in a private sector economic framework "neoclassical interventionism".[11]

Astonishing as it may appear, Korea has had a long history of state intervention in economic affairs. From the Shilla dynasty (57 B.C. to 935 A.D.) onwards state intervention in the economic life was accepted as a matter of fact and the markets were treated as a social phenomenon. The Confucian ethics that prescribed a vertical as opposed to a horizontal structure of the society, also legitimized submission to authority and subservience of the individual to the state have long been a part of the Korean value system.[12] The notion of market forces entirely left to themselves taking the economy on its optimal course does not accord with the Confunian concept of an orderly government which relies on the proper "rule of the men" rather than the "rule of the law." Subconsciously, therefore, the Korean bureaucrats equated the free play of market forces with near anarchy.

The government intervention during the Rhee regime (1954-60) was of a different variety from that in the Park regime (1961-79). During the former period the economic strategy was as myopic as it has remained in the economies of the south Asian LDCs and the business community had to be on good terms with the government because for foreign exchange and domestic credit it totally depended on it. High protection for their products and quantitative restrictions on imports allowed windfall gains in the domestic markets. Therefore, the business community cultivated corrupt officialdom. Spread of rent-seeking was rampant. As opposed to this, the kind of cooperation that developed between government and the business community over the 1960s and 1970s contributed a great deal to economic growth. During this period the government was highly centralized, authoritarian and had a clear vision of its priorities. Its primary objective was accelerated economic growth. For Park, economics preceded politics or culture and his government remained highly committed to growth and development. Other than the political commitment for economic growth at the high-

[11]Chen (1989).
[12]Kim (1982).

est level, the Korean economic bureaucracy during the Park regime was well-trained, disciplined and meritocratic which resulted in laudable performance standards.[13] In spite of the fact that the government was pervasively interventionistic, its intervention was pragmatic, utterly non-ideological and guided by the clear criteria of economic efficiency. Social and political objectives were not allowed to dilute the economic efficiency criteria; this weakness is egregious in a large number of LDCs, especially those in south Asia. Intervention *videut supra* did not mean annihilation of the market forces in favor of the statist approach. Where the markets worked, they were not disturbed. Where they did not, the government readily stepped in. The economy was not made totally insensitive to market signals. Korean ingenuity lay in its ability to do both, implement national planning priorities and expose the economy to market discipline, even international market discipline. Strategies like linking import licences to export performance is a proof. The government-business relationship was dynamic and stimulated the energy of the private sector resulting in repeated over-shooting of the plan targets.[14] As we shall see, the Korean miracle, thus, is not the success story of *laissez-faire* but of pragmatic and non-ideological mix of market and statist forces, a joint endeavor between the visible and the invisible hands.

As for the morphology of intervention mechanism, two dimensions may be taken into account: First, in terms of pressures brought to bear on entrepreneurial behaviour to ensure compliance with the interventionistic strategies of the state. Behaviour can be controlled by field manipulation or by command. The former expands an entrepreneur's opportunity set leaving him free to alter his behaviour, while the latter delimits it. In the former, compliance or non-compliance is the controlee's decision and is its own reward, while the latter has to be complied by an explicit or implicit threat for non-compliance.[15] The other dimension of the behavioural typology is the discretionary and non-discretionary control mechanism. The non-discretionary controls are those where application is automatic and in accordance with the definite rules, or the induced changes in prices, or the imposition of tariffs, of excise duties, or subsidy for a particular branch of industrial activity, or/and other instrument of intervention. Conversely, the discre-

[13]Amsden (1989).

[14]Das (1991).

[15]Jones and Sakong (1980, pp. 80-4).

tionary controls involve an individual decision by the administrative authority on a case-to-case basis. It is the direct form of intervention.[16] The developing economies rely heavily on the latter. Theoretically non-discretionary field manipulation is more effective because it achieves a desired deviation from the abandoning of the motivational and informational advantage of the invisible hand. In Korea it played an important role which is not to say that the government did not make extensive use of discretion, both in the manipulation of incentives and in command procedures. The government directed the use of resources and frequently influenced the decisions of individual firms.

A. Mechanics of Intervention

Korea was ostensibly a democratic country and could boast of active democratic institutions, but their areas of action were seriously restricted leaving the president and his staff at the centre of economic and political power. The president was served by a small number of competent advisors who were often more influential than high ranking public officials. The advisors provided detailed directions on policy making. Thus the process of economic intervention originated with the president, who set the state for the basic policy direction without laying down the precise policy content.[17] At the next stage in their intervention mechanism came the institutions like the Economic Planning Board (EPB), the Ministry of Finance (MOF) and the Ministry of Commerce and Industries (MCI). The EPB not only acted as an overload planning ministry but also controlled the budget and administrated prices. It also decided on the foreign loans, foreign investment and the transfer of foreign technology. The third and last stage was the producers' associations which doubled as government's agents, that is, their consultations with the government were a two-way process. The MCI interacted with and kept surveillance over the operations of these associations.[18] Detailed plans were prepared by them and the MCI gave them the final shape and monitored them.

Thus, important policy decisions were made by a small number of advisors and/or bureaucrats. Discussions or policy debates among the related ministries were not the forte of the government. A close link between the executive and the economic policy machinery was main-

[16]Jones and Sakong (1980, p. 86).
[17]Luedde-Neurath (1985).
[18]Michell (1984, pp. 41-8).

tained. A Planning and Control Office (PCO) was first started at the EPB for monitoring and evaluating the economic performance in 1961. The model was gradually extended to other ministries, because centralized decision making warranted strict surveillance.[19] This process had its rewards in speed and flexibility in policy formulation as well as its modification. Mason *et al.* cite an interesting example of Korea's reaction to the 1973 oil price hike. In two months the President's secretariat began a concerted effort to come up with a policy response, and in three months a sophisticated document was produced.[20] Speed in decision-making also had its costs in terms of occasional sub-optimal policy and better alternatives becoming available after the policy announcement. In such cases the government was quick to reverse the decision, and continued to believe that the rewards of speed and flexibility outweigh the costs. Similarly, there were benefits of being authoritarian. For instance, when interests outside the government tried to influence the economic policy and the government disagreed, it did not hesitate to override them in the manner impossible in more democratic circumstances.

B. The Parastatals

The presence of parastatals in the Korean economy is a proof of the government taking a functional, non-ideological line and being goal-oriented rather than process-oriented. In a mixed economy, public ownership is generally considered the most thorough-going form of microeconomic intervention. Whenever market imperfections were seen impeding growth, government chose to intervene with this instrument to achieve the desired macroeconomic objectives. Not all parastatals in Korea were created due to this reason. Several of them were a legacy of the colonial period. In 1960, over three quarters of the parastatals were directly traceable to activities run by the Japanese Colonial Government or confiscated from the private Japanese firms. Their operations during the Rhee regime suffered from corruption and gross mismanagement.

During the 1960, public sector controlled many utilities like electricity, oil and coal and industries like tungsten, steel, fertilizer, shipbuilding, air transportation and tourism. They were generally large firms located in monopolistic or oligopolistic markets. Some of these enter-

[19]Haggard, Kim and Moon (1987).
[20]Mason *et al.* (1980).

prises were newly established in the first half of the sixties, while in others fresh government investment was made to shape them up. They were generally in import-substituting industries, or in non-tradable goods rather than in exportables. The number of these enterprises increased from 52 in 1963 to 108 in 1972. The privatization policy brought this number down to 90 in 1984. Their share in value-added also increased from 7 percent of the GDP to 9 percent over the 1963-72 period, and rema-ined around the same level in the 1980s.

The public sector enterprises that were set up during the take-off period had high forward linkages. The planners saw their places on the economic scenario and created them with definitive objectives. This sector has remained relatively small in Korea. The enterprises were more than three times as capital-intensive as the Korean economy and more than double as the Korean manufacturing. While the public sector in the developing world has just acquired a certain notoriety for being a white elephant, in Korea it was relatively efficient.[21] However, the parastatals were less efficient than their private-sector counterparts, albeit the efficiency gap was not large. Better performance could logically be attributed to the same reasons for which the other forms of government intervention were effective. To bridge the efficiency gap the Government Enterprise Investment Management Act was revised in 1984, and new measures were introduced to revamp the public sector management. These measures have increased the autonomy of public sector enterprises and instituted higher performance evaluation standards.[22]

C. Chaebol

Chaebol is a system of large, family-controlled and family-owned industrial conglomerates. They are a source of highly concentrated private sector economic power. The MCI did not set out to create *chaebol*, but they did encourage companies that could produce with economies of scale and compete with large competitors in the international markets. *Chaebol* were expected to work as a catalyst for economic growth and generate employment opportunities. To this end, entrepreneures were persuaded to invest in new ventures and the new companies were allowed to emerge swiftly. Various incentives and preferential arrangements were provided and technical and infrastructural supports were

[21]Das (1991).
[22]Song (1985).

given. In terms of value-added, therefore, the *chaebol* sector is considerably larger than the public sector and has grown rapidly since the early 1960s lending to concentration of economic activity. It is extolled for generating rapid incremental improvements in productivity and quality. Unlike the public sector, it dominated export industries. The ten largest *chaebol* are Samsung ($ 31 billion), Hyundai ($ 27.8 billion), Lucky Goldstar ($ 22.8 billion), Daewoo ($ 15.2 billion), Sunkyong ($ 9. 3 billion), Ssangyong ($ 6.3 billion), Hyosung ($ 4.2 billion), Hanjin ($ 4.1 billion), Kia ($ 3.7 billion) and Korea Explosives ($ 3.4 billion). Figures in the parentheses indicate their 1988 sales volumes.

The chinese characters for *chaebol* are the same as for the Japanese *zaibatsu* and there are common characteristics between the two. There is, however, one significant difference. Namely, *zaibatsu* were centered around their own banks and other financial institutions. They are known to have an influence over the policy making machinery and the government. *Chaebol*, on the other hand, relied on government controlled credit institutions, and played a supportive or subordinate role to the government. This crucial fact affected the economic power of *chaebol* and the role they played in the economy. Korean firms were known to be high leveraged and the debt-equity ratio in manufacturing ranged from three or four to one. Since the commercial banks and other financial institutions were owned by the government, it had a substantial influence over the direction of *chaebol* expansion. In addition, international capital market borrowings could only be undertaken with the government authorization and guarantee, which constituted a substantial augmentation of government influence. Government's relationship with *chaebol* was not always amicable. Sometimes the government was able to have its way, notably over the Heavy and Chemical Industry (HCI) drive, but not always.

Again, there was a big difference in *chaebol* operations during Rhee and Park regimes. Numerous *chaebol* fortunes during the former regime were founded on their respective political influence. It enabled them to acquire import quotas and licenses, bargain-price acquisition of former Japanese properties, privileged access to cheap bank loans, and awards of government and the US army contracts in a non-competitive manner. Under Park's regime, to a certain extent, the privileged access to domestic credit and foreign exchange remained but other opportunities were eliminated. The *chaebol* support was not a matter of principle and the uncompetitive enterprises were not supported. One of *chaebol's* was allowed to collapse because its long-term competitiveness was suspected. Even for these privileges *chaebol* had to convince the bureaucracy of proper use and high productivity. The equation was simple, that is, the government swaped privileges and incentives for socially beneficial growth of productive activities. The unproductive but profitable opportunities were substituted with the productive ones, opportunities for rent-seeking were eliminated or drastically reduced and *chaebol* had to play the role broadly in accordance with the plan priorities. As it turned out, it helped them expand fast, but in the directions determined by the EPB and the MCI. Several of them have grown so large as to make their presence felt internationally and they are seeking to expand and build plants in low-wage Asian countries. Several of them can move the Korean industry into the forefront of current technology and indeed the largest ones are already doing so.

Inasmuch *chaebol* stands for the concentration of economic activity and are family-owned enterprises, the government has been persuading them to go public. It appears *a fortiori* relevant in the changed economic ambiance of the 1980s. Success so far has been meagre. The older companies in the Samsung group and the electronics groups were listed on the stock market, but none of the heavy and chemical industries were. To reduce the growing concentration of economic power the Chun government attacked the larger groups, forcing them to sell off certain subsidiaries which were unrelated to their main lines of business. The measure was targeted at twenty-six groups which held a total of 631 subsidiaries. In addition, the Monopoly Regulation and Fair Trade Law was enacted in 1981, to curb the dominant position of *chaebol* in the domestic market.

III. Major Points of Intervention

In what follows, I present a brief exposition of the other major areas of government intervention.

1) Domestic Finance: In Korea the security markets, that is, the stock and bond markets, were weak and the corporate sector depended heavily on bank credit for raising finance beyond retained earnings, which was the reason behind its high debt-equity ratio. In many industrializing LDCs, for instance, Brazil and Mexico, this ratio was much lower. The banks in Korea were owned by the government and the non-bank financial institutions were not allowed to grow rapidly. Therefore, they could not pose a serious challenge to the financial market domi-

nance of the banks. Having high debt-equity ratio under these circumstances amounts to involving the government in corporate financing. One advantage of such a credit-based financial system is faster investment than when the firms have to plough back profits or wait until the securities markets are well developed. The government can also restrict unproductive use of resources in mergers, speculation and spurious entrepreneurships. Second, this kind of financial system allows rapid sectoral mobility of funds and government can steer their movement. Third, the credit-based system helps in eschewing short-term orientedness inherent in the security-market oriented system. Fourth, control over the highly leveraged corporate sector through the financial system helped the Korean government in the implementation of its industrial strategy.[23] The financial lever provided enormous steerage capability to the Korean Government.

2) Industrial Policy: Over the 1962-71 period, Korea built its basic industries. During this period, the average investment to GNP ratio was 23.4 percent, while the domestic savings ratio was 14.6 percent. The financial gap was made up by foreign capital inflows. The Foreign Capital Inducement Act of 1966 promoted firms in selected industrial sub-sectors to borrow abroad by providing government guarantees on their foreign loans. This, first, encouraged investment and, second, enabled the government to keep control over the direction of investment. The intervention went deep down to enterprise level. Direct intervention was frequently resorted to and the state at times used compulsion to alter the decisions at the enterprise level. During the take-off period almost every major investment in the private sector was initiated by the government which, in turn, ensured that the companies that made such investments made profits as well. On the one hand this reduced risk for the firm and it had a salutary macroeconomic impact on the other. The state promoted or discouraged industrial ventures and went as far as matching firms and projects. It considered itself infallible in matching the "right" project with the "right" firm. The auto industry, electronics, machines tools and heavy industries are good illustration of this tendency. The inefficient enterprises were brought in line by a series of steps, beginning with advice and ending at coercion, which could include eliminating the firm completely or absorbing it into a more efficient one. That the economy was strictly supervised must be obvious from the description so far. The state also initiated

[23] Wade (1988, pp. 129-63).

major in-dustrial restructuring, for instance, the Heavy and Chemical Industry (HCI) drive, the industrial restructuring of 1980 and the industrial liberalization that began in 1983.

3) Foreign Trade: Imports were licensed and the eligibility was conditional upon the export performance. After the adoption of the negative list system of import restrictions, the tariff rates were lowered. Not all the products classified as AA could, however, be imported at will and they could be restricted by "scope of business" criteria. But firms were exempted from import duties on intermediate goods and raw materials imported for export processing. Export firms were provided loans at subsidized interest rates.

4) Foreign Exchange: Exchange rate reforms were adopted at an early stage and the system was made a uniform and flexible one in which the Korean Won was pegged to the dollar. The Won had a tendency to become overvalued due to periodic bouts of inflation. Therefore, it had to be depreciated periodically. The real effective exchange rate (REER) of the Won was watched carefully and endeavours were made to keep it stable so that the performance on the export front did not suffer.

5) Foreign Direct Investment: Although certain types of investment were wooed and granted generous incentives, the FDI legislation was not liberal. Balance of payments and technology transfer were among the important considerations in decisions about the FDI. The other consideration was the complementarity between the FDI and domestic investment in both export and domestic markets. Above all, the FDI proposal had to be compatible with Korea's development plans.

IV. The Unique Planning and Management Features

Economic intervention has created macroeconomic obfuscation and stagnation in many LDCs, particularly in South Asia and Latin America. But, except for the HCI drive, interventionistic approach succeeded in Korea. One often wonders why it spawned opposite results there? Why the results of statist intervention in Korea were so different from those in a multitude of LDCs with undistinguished growth the record? There are several underlying reasons: It has been stated that the President Park was highly committed to, if not obsessed with, economic growth. He infused the top political echelon and economic bureaucracies with the same enthusiasm about the goal. They received sound macroeconomic advice during the take-off phase, and accordingly bold decisions were taken and implemented. The institutional mechanism that was created was an integrated one that succeeded in development planning as well as efficacious implementation. Economic growth was greatly assisted by pragmatic planning. Many LDCs suffered from snags on these counts, that is, poor planning and tardy implementation. The executive branch of the government was far more active in Korea than the legislature, which was emasculated. It helped cut down long debates and agonizing delays over important economic decisions. The performance of the civil servants and public officials was measured in terms of their contribution to economic growth. Even the Chun Doo Hwan regime, that followed Park's, did not allow any slackening of efforts. A good deal of credit also goes to the Korean bureaucracy which was efficient at planning, implementing and monitoring. At least the upper echelon seemed to know what they were doing, and had a clear vision of the priorities. The top decision makers were relatively young and the positive side of youthfulness is dynamism. Once a policy was conceived, it was immediately enforced, and once the newly enforced policy showed signs of balking, it was abandoned forthwith without faltering.[25] The trial and error did result in some waste but, on balance, flexibility and adaptability contributed positively to rapid growth. There was strong and effective state guidance and coordination of the private sector. The top bureaucratic echelon running the economy was convinced that instead of passively following the market signals, they could come up with better and more imaginative alternatives to accelerate growth. The hindsight reveals that they were not wrong.

Another feature that distinguished Korean economy form other not-so-well performing LDCs was that the choice of policy instruments in Korea was made without any ideological predilections. Pragmatism was their hallmark. Instrument that worked was the choice of the day, be it public-ownership oriented or free-market oriented. Policy making process in Korea was open to a wide range of opinion inputs and the policy makers were receptive to the views of academics, Korean and foreign, as well as the business corporations. To be sure, the final decision process was a closed one. Policies were often made with a high degree of particularism and a low level of generality which, in turn, allowed policy fine-turning not seen in other LDCs. It has been adum-

[25]Hong (1987, p. 19).

brated that the government intervention went down to industrial unit level. In steering the private sector, the economic bureaucracy took no nonsense attitude. Since they were instrumental in directing some resources cheaply to the private sector, it must empower them to require this sector to meet the performance targets. Although the Five-Year Plans were master-minded by the state, they were executed by the private sector. Korean planning was such that it took it on itself to provide an economic environment that was favorable to the business enterprises and corporate world and left it to the business leaders to seize the opportunities. On occasions, as seen above, the selected enterprises of *chaebol* were also closely guided.[26] The Korean success, thus, was the result of a collaborative effort by the government and the private sector.

Wade (1988) has identified three characteristics of successful intervention in Korea: it was (a) promoting competitive production, (b) selective between industries, and (c) cumulative in its impact. Industries were not over-protected and competition was encouraged even between the protected industries. Coupling of protection with competition allowed the investment-inducing effect to swamp the lethargy-inducing effect of protection. Since the domestic markets were small, even infant industries were encouraged to export—albeit at a loss initially—exposing them to the rigors of international competitive pressure. Thus, the Korean definition of market success laid extra emphasis on export success. The industries selected for intervention were the "well-established" and "infant" industries. The former had to be made internationally competitive. Therefore, a neutral or an extended-neutral policy regime was devised for them. The latter industries faced a positive industry bias. The Korean government had a successful track record in identifying the "winners" among the infant industries. Indeed, there were cases where the wisdom of the government was questionable. A conspicuous example of it is the 1973 Heavy and Chemical Industry (HCI) drive in which the government was deeply involved. The enterprises created under this drive were protected by prohibitive tariffs. This drive was ill-conceived and met a sorry end. It has been stated that the parts of the economy which did not need government attention were benignly ignored, or allowed to go on their own momentum. The industries that were protected or benefited from positive industry bias got assistance through investment finance and/or fiscal incentives,

[26]Choi and Lee (1990).

reinforcing the effects of the other incentives. The institutional prerequisite for achieving this was a credit-based financial system.

An extraordinary element in the Korean case was that the state intervention in the form of *chaebol* support, export promotion drives and supporting selected industrial sub-sectors were not necessarily market repressing. By promoting competition and by letting the non-competitive sectors or enterprises die, the market dynamism was nurtured. Thus, the visible hand operated in a market-conforming manner. One can, therefore, infer that the whole exercise of planning, targeting and devising incentives was market-sustaining, not market-repressing. The former reduced risks and uncertainties for the industrial enterprises. Since market-repressing practices were generally avoided, opportunities of rent-seeking remained low. Presence of market-sustaining practices and lack of market-repressing policies turned out to be growth-inducing.[27] It will, therefore, not be an audacious generalization to say that the interaction of the two sub-systems worked well: one was statist and geared to developmental goals and the other was private sector which was geared to profit maximization.

V. The Changing Role of Government

Since 1980, the negative and counterproductive effects of state intervention have been painfully obvious. The after-effects of the HCI drive have hardly been forgotton. There is a negative side of too much statism that has been recognized not only by the business community and the public at large, but also by the economic bureaucracy. It is also recognized that the economy at its present stage does not need so much supervision. The government is, therefore, loosening its grip and adopting a moderate approach involving consultation and collaboration with industry in place of steering. It is publicly committed to reducing bureaucratic constraints and allowing free market forces a greater role. In December 1984, the new industrial policy was announced, withdrawing financial and other supports from the favored *chaebol's* and treating small and medium industries as the favored sector. The government has by and large stopped directing the conglomerates and they are free to go their own way. The weaker ones among them can no longer count on the financial props from the state and have become obliged to divest themselves of unproductive subsidies. So much so

[27]Johnson (1985, pp. 63-89).

that, as alluded to earlier, in 1985 the Kukje *chaebol* was allowed to go broke, and the financially sound and well-managed companies picked up the pieces. During the early eighties some of the government-owned banks were privatized but were not completely free to finance according to their discretion—albeit they have the ability to set interest rates within certain limits. Direct government intervention at micro level and indirectly through foreign exchange and licensing practices has also been ebbing. The emergence of a more democratic political system in 1988 has accelerated the movement towards free markets.

In some areas, like finance, the rate of change is discernibly slow. Some of the commercial banks are still not privatized. The conservatives at the heart of the financial system—the Ministry of Finance and the Bank of Korea—are ranged against withdrawing the visible hand.[28] However, the direction of change is firmly towards deregulation and increased competition. Several measures that the money and financial markets took in 1988 could never be taken in the past. The plan endorsed by president Roh Tae Woo for 1992 includes many moves to free the financial markets.

VI. Lessons from the Paradigmatic Case

The visible hand played a decisive and creative role in the Korean economic growth. The state could be credited with creating correct macroeconomic policy environment and pragmatic incentive packages. The government guidance and coordination of the private sector contributed to the private sector's attainment of the plan targets. Evidence from Korea suggests that when the state and market mechanism are brought together, the whole is greater than the sum. The opposite of it is also true. Conversely, evidence from the south Asian economies suggests that when the state pursues aggressive anti-market policies, the results are disastrous. The Korean case corroborates the conclusion of the *World Development Report 1991* regarding "market friendly" approach to development.

Through the credit-based financial system, the state provided financial and other support to *chaebol* and other industrial enterprises to enable them to exploit economies of scale. While providing such support, fundamentals like comparative advantage and competitiveness were not ignored. Analogously, when parastatals were created by the

[28]Wagsty (1989).

state, they were created due to sound economic reasons, not socio-political ones. The credit based financial system also allowed domestic investment to be directed towards planned sectors and sub-sectors. Foreign investment, in the similar manner, was wooed for the selected sectors. A wide array of incentives was provided for exports. Imports were regulated for balance of payments reasons but those needed by exporting and other industrial enterprises were liberal. In fact, exporting entitled an industrial unit to import. Exchange rate reforms were made early during the planning phase and subsequently the real effective exchange rate (REER) was kept under surveillance. This measure kept Korean exports competitive in the world markets.

An important moral of the Korean story is that economic growth is significantly conditioned by political commitment to economic growth and administrative competence of the government. Together they make for the necessary, although not sufficient, condition for economic growth. Reynolds, after an exhaustive study of the economic performance of LDCs over three decades (1950-80), concluded that general and administrative competence is the most important explanatory variable.[29] Soft authoritarianism is considered by some, like Johnson, contributing to the general and administrative competence of the state. A combination of soft authoritarianism in politics and capitalism in economics succeeded not only in ushering in the Korean economic miracle but it also succeeded in other East Asian dragons.[30] I hasten to add that authoritarianism is not an indispensable condition. States can be effective in implementing economic policies without it as well. Norway and Sweden are two gleaming examples of it.

If the visible hand works in a pragmatic manner and supports the market in performing (Kaldor's) creative functions, the results would be growth inducing. Care should be taken that where markets work, there is wisdom in leaving them alone, but if they give an impression of being arthritical, the state needs to intervene. A sagacious choice between the state and market—two imperfect alternatives—cannot be based on ideology, or an idealized vision of either of the two systems. It will have to be a pragmatic choice between different combinations of the two. This notion is at variance with the western free-enterprise kind of notion and is at odds with the conventional wisdom that state intervention in the economy is inevitably distorting and therefore inefficient. It is well within the realm of possibilities for the administrative apparatus

[29]Reynolds (1983, pp. 941-80).
[30]Johnson (1987, pp. 136-64).

of the state to reduce or avoid the failures of specific markets and produce efficient outcomes.

If in LDCs the state makes allocative decisions, a meaningful role for the market should be retained because of the plausibility of non-market failure. The complementarity between the two can only be ignored at the cost of attaining sub-optimality. Experiences of Eastern Europe, the former Soviet Union and South Asian LDCs have putatively demonstrated that a planned economy or a mixed economy with strong state control and anti-market penchant is sure to be arbitrary, grossly inefficient and wasteful in allocating scarce resources. Likewise, a market economy without some kind of government framework and direction is the shortest route to anarchy. Experience also suggests that Adam Smith overrated the prowess of the markets. They have to be seen operating within a social framework. State "rigging the markets" without imparing their dynamism and thrust would be the most optimal objective and valuable lesson.

VII. Conclusion

That a stiff dose of Adam Smith is the shortest short-cut to economic growth was, and still is, the conventional wisdom among the neoclassical economists. They naively heralded the Korean economy as a triumph of *laissez-faire*. Markets were considered complete, but even theoretically this stand is not correct because market forces cannot operate smoothly when some participants have market power or "positional goods". The structuralist and neoclassical visions of the free-market have alternately dominated economic thinking in the past decades. However, the market and non-market approaches need not necessarily be antithetic to each other.

In Korea, and in the other ANIEs, the state intervened to get the prices right and steer the investment activities with the help of a wide range of incentives. But care was taken so that the market character of these economies was not wreaked. The interventions worked both at macro and micro levels, as well as at the intermediate level through the *chaebol* and parastatal sectors. The state exercised effective control over the economy through control over the domestic financial markets, industrial policy, price controls and foreign trade and foreign exchange controls.

While LDCs in general are known to have suffered economic confusion because of state intervention, why did the Korean case spawn different results? The answer is that the Korean intervention was very different, rather unique, in its operation. The end result was that it worked in a market-sustaining rather than in a market-repressing manner. It was selective and sought to benefit from coupling market and non-market forces. Even protected and sheltered industries were subjected to market discipline at an early stage. The administrative capability and economic clairvoyance of the government are crucially important for an LDC, *a fortiori* at the take-off stage. The interaction of the two sub-systems, namely, the state geared to developmental goals and the profit maximizing private sector, has to work well. It apparently did work well in Korea.

The Korean experience teaches other LDCs to combine the statist and market forces in such a manner that the dynamism of the latter is not impared. The visible and the invisible hands play complementary roles. Four decades of development related experience strongly supports the "market friendly" role of government.

During the 1980s, the role of the visible hand in the Korean economy underwent a substantive change. The counterproductive aspects of excessive statism were recognized and the state soft-pedaled—even back-pedaled. Special supports for the *chaebol* were withdrawn and the market forces were allowed a freer play. Several other controls have been allowed to ebb away and in the latter half of the eighties the economy was significantly liberalized.

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