

# **FROM PLAYER TO REFEREE? THE STATE AND THE SOUTH KOREAN ECONOMY**

Marcus Noland  
Institute for International Economics  
1750 Massachusetts Avenue, NW  
Washington, DC 20036 USA  
mnoland@iie.com

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In 1963, when a wide-ranging economic reform program was initiated by President Park Chung-hee, South Korea's per capita income level was lower than those of Bolivia and Mozambique; according to the Penn World Tables, by the time of the 1997 financial crisis, it exceeded those of Greece and Portugal. During this period, economic performance was nothing short of spectacular: the country experienced only a single year of negative growth—1980 in the wake of the second oil shock and the Park assassination (figure 1), real per capita income growth measured in purchasing power-adjusted terms averaged more than 6 percent annually, and per capita income stood at more than eight times its level when reforms began.

During this period, the state intervened pervasively in all facets of economic life, from labor and capital markets, to product markets, to international trade and finance, meaning that rapid sustained growth occurred for several decades under a state-led development strategy in which the state was most definitely a “player” in the popular parlance.

Problems arose as the country approached the international technological frontier, and opportunities for easy technological catch-up began to erode. The disappearance of straightforward paths for industrial upgrading based on imitating the prior trajectories of more advanced economies put a heightened premium on the ability of government officials, corporate managements, and their financiers to discern emerging profit opportunities. The old development strategy was no longer adequate, but decades of state-led growth fostered a formidable constellation of incumbent stakeholders opposed to liberalization and transition toward a more market-oriented development model, and in 1997, in the context of the broader Asian upheaval, South Korea experienced a financial crisis with net clean-up costs that eventually amounted to 16 percent of 2001 GDP.

One might have anticipated that a shock of this magnitude would have contributed to thoroughly discrediting the old model, but old habits die hard: There is a two-way relationship between individual attitudes or preferences and local policies and institutions (Alesina and Fuchs-Schundeln 2005). Local practices influence individual's perceptions of the world, and individual's beliefs condition the politically acceptable bounds of policy. Because of the self-reinforcing nature of this feedback loop, change tends to come only slowly. Once established, it can take generations for local beliefs to converge toward

broader international norms. Perhaps conditioned by a history of pervasive intervention in the economy, South Koreans appear to have high expectations about what the public sector can deliver, but in a 2004 survey, business executives identified “policy instability” and “inefficient bureaucracy” as the two most problematic factors in doing business in South Korea (figure 2). With growth slowing and the polity seemingly afflicted by a kind of malaise, South Korea could be facing a situation in which the reputation-derived “Korean discount” acts as a semi-permanent self-reinforcing drag on economic performance.

This is the awkward legacy that the state-led model has bequeathed South Korea: Like an aging football star, the state can no longer be the player it once was—the game has simply become too fast and complex—but it seems unwilling or unable to trade in its player’s cleats for a referee’s whistle.

### **FROM PLAYER...**

South Korea inherited an economic legacy of state from Japanese colonial occupation (1910–45) that carried into the period of independence (1948), reflecting the dirigiste character of Japanese administration and the continuation of extensive controls by the US military authorities in the immediate post-war period. A continuing theme throughout South Korean economic history has been the critical role of the state, its role in the generation of rents, and the politicization of their distribution, starting with the first president of South Korea, Rhee Syng-man, who exploited the policy-generated rents to build political power.<sup>1</sup> According to Cho (1994), South Korean economic policy was aimed at maximizing the value of American aid in the aftermath of the Korean War (1950–53), which had devastated the country. Aid, which facilitated politicized rent distribution, financed most of the capital accumulation and, at its peak in the late 1950s, more than half the imports (figure 3).

A military government led by General Park Chung-hee took control in 1961. As shown in figure 4, when Park seized power, gross domestic saving net of aid was

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<sup>1</sup> See Cargill (1999) for a comparison of the Japanese and South Korean financial systems. See Jones and SaKong (1980) and Woo (1991) for examples of the use of state-derived rents for political power building.

derisory. Gross investment, financed mostly by aid, stood at a bit more than 10 percent of GDP, and the current account was in rough balance. After two years of poor economic performance, the military government unified the existing multiple exchange rate system, devalued the currency, raised the real interest rate, and initiated a series of wide-ranging reforms. Domestic saving net of aid began rising rapidly (looking at figure 4 one can understand why development economists adopted Rostow's take-off metaphor). Domestic investment began rising even faster.

While in some ways Park's reform package marked a fundamental departure from past practices (with respect to trade policy, for example), it retained an important role for the state in the development process. Bank of Korea's independence was ended, and it was made subservient to the Ministry of Finance and, ultimately, the Blue House. Incentives were firm-specific, tied to performance, and personalized. Export targets were specified in considerable detail by product, market, and exporting firm. Export performance was seized as a barometer of success—as one observer put it, “they were the only statistics that could not be faked.” Aside data concerns, exports were interpreted as a relatively clean measure of the relative competitiveness of domestic producers—local firms might be able to rig the small, protected domestic market, but this was not possible in the global marketplace.

Firms that did not achieve their targets were not subject to penalty; however, the targets were sometimes negotiated jointly with wastage allowances (a form of subsidy), and support was terminated to laggards. The president received monthly briefings on export performance, and the firm achieving the highest export performance could receive the national medal of honor, a public presidential commendation, and material benefits including relaxed tax surveillance (Westphal and Kim 1982).

The distinguishing feature of South Korean product markets has been the prominence of the *chaebol* (family-dominated conglomerates). In positive terms, such organizations might be considered an institutional response to conditions of scarce managerial or human capital and limited financial markets. This organizational form could also have been derived from rent-seeking behavior generated through state intervention in the economy, and a number of the *chaebol* had originated from business-government relations during the Rhee regime of the 1950s (Jones and SaKong 1980).

Pervasive regulatory entry barriers (and thus protection from competition for incumbents), and Park's penchant for sole-sourcing important infrastructural and other large-scale government-supported projects, in effect socialized risk and created opportunities for cross-subsidization across different business ventures, encouraging the *chaebol* to diversify into otherwise unrelated lines of business. By the 1980s, the top 10 *chaebol* accounted for more than 20 percent of national income (SaKong 1993, table A.20). Where industrial policies proved insufficient to call forth the desired supply response, the government established parastatal enterprises such as the Pohang Iron and Steel Corporation (POSCO).

The accumulation of capital contributed to rapid technological upgrading and a stunning transformation of the composition of output. In 1963, nonfuel primary products accounted for more than half of South Korea's exports, and human hair wigs were the third leading item. A decade later, South Korea's exports were dominated by manufactures such as textiles, electrical products, and iron and steel; only one primary product category, fish, made the top ten. As seen in figure 4, capital accumulation was financed primarily by growing domestic savings, augmented by a significant inflow of savings from abroad, reaching nearly 10 percent of GDP in 1971 and actually breaching this threshold in 1974 after the first oil shock.

A substantial academic literature (e.g., Westphal, Rhee, and Purcell 1981; Westphal, Kim, and Dahlman 1985) attempts to understand the sources of South Korean industrial competence and documents the varied forms of technological transfer and interaction between South Korean and foreign firms. Inward foreign direct investments were negligible during this period. Capital inflows arrived predominately in the form of technologically disembodied loans.

In 1972, Park, who had been reelected for a third term, pushed through the *Yushin* (Revitalization) Constitution, which in essence made him president-for-life. For a variety of reasons, he initiated the intensive promotion of heavy industry through what came to be known as the Heavy and Chemical Industry (HCI) policy. Modest financial-sector liberalizations that had been undertaken in the late 1960s were reversed in 1972, when interest rates were lowered and direct government control of the banking system was increased in order to channel capital to preferred sectors, projects, or firms (figure 5). In

order to finance large-scale projects, special public financial institutions were established, and private commercial banks were instructed to make loans to strategic projects on a preferential basis. By the late 1970s, the share of these “policy loans” had risen to 60 percent (Yoo 1994). These loans carried, on average, negative real interest rates, and the annual interest subsidy grew from about 3 percent of GNP in 1962–71 to approximately 10 percent of GNP on average between 1972 and 1979 (Pyo 1989).<sup>2</sup> With such a large share of national income at stake, the allocation of these highly subsidized loans became the focus of intense political activity. This policy of capital channeling rested on the twin pillars of financial repression and comprehensive capital controls to delink the domestic and international financial markets (Noland 2005). The won was kept nonconvertible.

In practice, this stance meant emphasizing indirect finance and maintaining limitations on foreign participation in financial markets and domestic firm access to foreign capital. Presumptively less compliant foreign banks could not be allowed into the market in any significant way, for if they were allowed to establish a significant presence, they would undermine domestic banks operating under the burden of “policy lending.”<sup>3</sup> Thus the financial system had to be built around a relatively small number of South Korean banks, and corporate finance had to be largely limited through regulatory fiat and tax provisions to borrowing from those intermediaries.

Alternative sources of corporate finance were suppressed: The development of money markets and bond markets was retarded and restricted to a limited range of maturities with no real secondary markets, and issuance was effectively dependent on bank guarantees. The government discouraged the development of an efficient auction and secondary market for government bonds, and no swap, bond, or interest futures markets existed. As for the stock market, in 1990 the government established a quarterly quota on new issues, and prior to the 1997 crisis, a backlog of more than 360 companies was

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<sup>2</sup> The definition of “policy loans” is imprecise, and various sources report significantly different figures. See Cho (1994) for discussion and SaKong (1993, tables A.18 and A.19) and Krueger and Yoo (2002) for alternative calculations.

<sup>3</sup> In the characterization of one South Korean economist, “Dominance of the Korean financial market by foreign institutions were abhorred, as it would deprive authority over various instruments of monetary control, weaken many customary, informal practices associated with industrial policy, and might also alter the public-good nature of the financial system” (Lee 1993, 7).

waiting to be listed (relative to the 776 that were already on the exchange). Criminal proceedings documented how firms were forced to resort to bribing officials to bring their initial public offerings to the market. As a result of these policies, corporate capital sourced through bank loans exceeded equity, bonds, and commercial paper combined until the late 1980s, and indirect finance from all sources was the primary form of corporate finance until 1991 (Cho 2002, table 4).

During its period of rapid industrialization, South Korea experienced a rapid shift out of rural employment into manufacturing and services. Accompanying this shift was a rise in recorded female labor-force participation. Hours worked were quite long, and few envied South Korea's safety record. Yet South Korea appeared to achieve "growth with equity." Measured wage inequality was low by international standards, as might be expected in the case of an industrializing labor-abundant country rapidly increasing its exposure to international trade (and *inter alia* the demand for low-skill labor in the export sector), though there is some reason to question the South Korean government statistics on this point (cf. Lindauer 1997). In certain respects, South Korean labor markets developed a dualistic structure in which the industrial employees of the major *chaebol* occupied a privileged position relative to similarly skilled workers (i.e., they were able to capture some of the rents accruing to the *chaebol*) (Park 1999).

During the Rhee government, South Korea copied its early (and largely inappropriate and ignored) labor laws from those of developed countries. In 1963, the military government revised the labor laws to discourage the establishment of independent labor unions and encouraged the organization of unions within a centralized system, established so as to facilitate government control. Subsequent legislation circumscribed union activities, and independent trade unions were effectively banned in 1971. The Korean labor movement subsequently developed a dualistic structure, with government-approved unions on the one hand and informal or underground unions on the other. Industrial unions were reorganized along Japanese lines as company unions to discourage strikes, and "third parties" were prohibited from intervening in labor disputes (some of the unofficial unions had grown out of religious organizations, and student radical groups were sometimes interested in inserting themselves into enterprise disputes). Although the labor laws were revised on several occasions during the 1980s,

the reforms did not adequately address this situation. After an uptick in the late 1980s, membership has continued to decline to the point that a smaller share of the South Korean labor force is unionized than is the case in the United States. Despite the relative absence of unions, labor markets remain fairly inflexible and dualistic. In the World Bank's report *Doing Business in 2006*, South Korea ranked 105 out of 155 countries evaluated in the ability to hire and fire employees (World Bank 2005).

Park was assassinated in 1979 during what amounted to a palace coup. General Chun Doo-hwan and his fellow officers more or less stumbled into power, driven more by intra-military rivalries and narrow career interests than by any real sense of where they wanted to take the country (Clifford 1997). Facing deteriorating economic performance, exacerbated by the second oil shock, Chun and his cronies turned to Western-trained economic technocrats, who were already attempting to introduce a stabilization policy and reverse the worst excesses of the HCI policy.<sup>4</sup> These technocrats implemented a policy of macroeconomic stabilization through which they began to liberalize and deregulate the South Korean economy. Despite the fact that the external shocks that hit South Korea during 1979–81 were actually larger than those experienced by a number of crisis economies including Argentina, Brazil, Chile, and Mexico, South Korea managed to avoid financial trouble until the early 1980s slowdown in global growth in the wake of the second oil shock and was able to re-attain high sustained growth by 1983 (Balassa 1985, table 1).

Multiple implications arise from these policies. First, the firms emphasized growth, not profitability, since risk was socialized, and increased borrowing made further borrowing advantageous under the “too big to fail” notion, promoted by the government's habitual interventions. From the standpoint of a lender, the bigger the firm, the more creditworthy it was, since size increased the likelihood that the government would intervene in the event that the firm got into financial trouble, which it did on a fairly routine basis. The implication was that firms became extraordinarily leveraged as

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<sup>4</sup> Chun literally scheduled early morning tutoring sessions. Perhaps there is something peculiarly Korean about this: It is hard to imagine the typical military dictator staying up late to study for his daily economics lesson.

growth became the name of the game.<sup>5</sup> Loans were the mechanism for growth and, paradoxically, debt signaled creditworthiness, a state of affairs that Yoo (1999) described as the “survival of the fittest.” Indeed, one study of corporate finance covering the decade 1977–86 found that “the largest firms have the weakest financial structure,” as measured by the degree of equity in their capital structures (Kim 1990, 342), while another found that the major *chaebol* were systematically less profitable than other South Korean firms (Krueger and Yoo 2002). A corollary to this system of corporate financing was the encouragement of extensive cross-shareholding, cross-loan guarantees, and nontransparency, all of which served to facilitate borrowing and had the effect of disadvantaging outside shareholders.

The pervasive pattern of government intervention created a symbiotic relationship between the government and the private sector, eroding private-sector autonomy and facilitating the corruption of the political system. The move toward more genuine political competition in the late 1980s arguably shifted the balance of power away from the government and toward the private sector, which became the source of badly needed campaign funds (Kang 2002a, 2002b). In the words of one contemporary observer, corruption “exploded” (Clifford 1997). With the exception of current President Roh Moo-hyun, every South Korean president since Park Chung-hee and/or at least one of their sons has been imprisoned on corruption offenses.

## ASSESSMENT

Did this policy package contribute to accelerating South Korean growth over what might have been obtained through a less interventionist strategy? For selective intervention policies to be successful, the market equilibrium must be suboptimal. Governments must be able to identify these opportunities for welfare-enhancing interventions, formulate and implement the appropriate policies, and prevent political market failures from leading the

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<sup>5</sup> In July 1997, just prior to the crisis, the average debt-equity ratio of the thirty largest *chaebol* exceeded 400 percent (Yoo 1999, table 9). By the end of 1997, it stood at 500 percent, and 600 percent of the debt of subsidiaries was included on a consolidated basis (Claessens, Ghosh, and Scott 1999). See also Krueger and Yoo (2002, table 6).

policies astray. In the case of South Korea, most conventional static neoclassical analyses have concluded that these conditions were not met, at least in the most interventionist period—that is, the HCI drive of 1973–79.<sup>6</sup>

But what about dynamic effects? Pack and Westphal (1986) argue that, in general, Korea’s selective intervention policy has been successful in fostering infant industries without significant losses in efficiency. The key has been to capture latent interindustry pecuniary and nonpecuniary externalities: “The Korean government can be seen as having achieved integrated decision-making by acting as a central agent mediating among market agents, forcing and facilitating information interchange and insuring the implementation of decisions reached...weighing costs and benefits from a collective standpoint and often intervening to reward cooperative players and punish uncooperative ones” (p. 99).<sup>7</sup>

Murphy, Shleifer, and Vishny (1989) formalize these notions in terms of Rodenstein-Rodan’s idea of the “big push.” Once again, there are multiple equilibria due to pecuniary externalities generated by imperfect competition with large fixed costs. They argue that industrial policy that “encourages industrialization in many sectors simultaneously can substantially boost income and welfare even when investment in any one sector appears impossible” (p. 1024).

Each of these papers claim that the possibility exists for welfare-enhancing industrial policies through government coordination activities to capture interindustry

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<sup>6</sup> See Noland and Pack (2003) for a survey of the evidence.

<sup>7</sup> Okuno-Fujiwara (1988) provides a formal example of this in the form of a model of the interdependence of the two industries where industrial policy has a positive role in the form of preplay communication to generate a superior coordinated equilibrium. In both this model and that of Pack and Westphal, the same outcome could presumably be attained through organizational integration. Pack and Westphal argue that in the case of Korea this is not feasible: “The externalities may flow in complex and inseparable patterns among (actual and potential) agents covering most if not all of the industrial sector” (p. 99), necessitating government intervention. However, the existence of the giant *chaebol*, spanning the industrial sector, would appear to undermine this argument. If the *chaebol* cannot internalize these externalities, then it is hard to imagine what institution could. Indeed, it is unclear why the government would be any better able to coordinate decisions than the *chaebol*. It should also be noted that the Okuno-Fujiwara model is a closed economy model. For the intervention to convey some purely *national* welfare enhancement, there has to be some nontraded aspect of the externality. Otherwise, foreigners have access to the same low-cost inputs, and the pattern of production in the downstream industry is indeterminate without additional assumptions.

externalities, thus promoting growth and industrial development without the standard efficiency losses. The key is the existence of interindustry externalities, which when captured expand the production set of the economy. However, neither the attempts to assess this directly through the input-output table (Noland and Pack 2003) nor indirectly via time-series econometric analysis (Noland 2004) suggest that these conditions were met.

If policies do not explain South Korea's extraordinary growth performance, what does? South Korea's geography is not auspicious—the existence of North Korea makes it, from an economic standpoint, an island; during this period, one neighbor, China, was effectively a closed economy, and another, Japan, was notoriously difficult to penetrate. Its major market, the United States, was far away. Nor is culture the explanation as the desultory example of North Korea demonstrates. Nor do South Korea's institutions appear to be uniquely strong, as will be discussed in greater detail below. Instead, at least part of the explanation is that South Korea was “deceptively poor” and that its contemporaneous level of income in the 1950s or early 1960s was a downwardly biased indicator of its underlying capabilities.

One might argue that South Korea is simply an example of neoclassical convergence. It started out poor, the rate of return on capital was high, and income rose rapidly as capital was accumulated. There is surely something to this argument—South Korea did start out poor, and the rate of return on capital was high (figure 5), but prior to the Park reforms in 1963, the rate of accumulation was actually low (figure 4), and much of it took the form of grant aid.

A more sophisticated version of this argument would highlight the role of human capital. As seen in table 1, in the 1950s, South Korea was unusual in that the level of human capital embodied in the workforce was high relative to the contemporaneous level of income, presumably because most of the capital stock had been destroyed in the Korean War (1950–53). Interestingly, the Koreans had been able to maintain at least some production in all industrial sectors following the expulsion of Japanese colonists in 1945, indicating that through whatever channels they had achieved a certain level of technical mastery. Table 1 suggests that this was a fairly capable population that simply did not have much physical capital to work with.

However, not only did South Korea have a high level of human capital relative to income, abetted by favorable demographics, it accumulated it more rapidly than other similarly situated comparators (figure 6). In the 1950s, the share of students receiving training in engineering and science, presumably of relative value in the production of industrial traded goods, was not much different than its contemporaries, but this share roughly doubled in the 1960s and remained above 30 percent for the next 30 years (table 2).

In addition, in Park, South Korea had a leader with a clear view of modernization through extensive contact with Japanese and American educational and military institutions. The country was also blessed with a thin layer of highly competent technocrats, many of whom had been educated in Japan or the United States, many on scholarships financed by US aid. (Indeed, the importance of sheer competence at the top cannot be overemphasized. South Korea was lucky to have a small but enormously important cadre of decision-makers who had some understanding of how a modern society was supposed to work—policymakers who through exposure to educational opportunities abroad had some notion of where they were heading and how to get there—an advantage that many other contemporaneously developing countries simply did not have.) Although there were considerable disagreements over policy (often between the US-educated economists on one side and Park and his fellow officers on the other), one gets the impression that these were disagreements over strategies to attain shared development goals—not fundamental differences about modernization.

Paradoxically, South Korea may have also benefited from its unusual endowments, specifically its lack of natural resources, in two ways (figures 7a and 7b). First, the absence of natural resources forced South Korea to specialize in manufacturing at a relatively low level of per capita income, and as capital was accumulated, despite the repression of labor, real wages increased monotonically reinforcing backward linkages and contributing to social peace.

Moreover, the lack of resource-derived rents removed a source of contestation of state control. Land was an issue, but it was confiscated from Japanese colonists, and following a land reform in rival North Korea, the South Korean government undertook a similar reform with US support. The result, despite contemporary South Korea's

obsession with inequality and redistribution, was “growth with equity”—at least relative to any real world comparator (table 3).

### **TRANSITION...**

In the late 1980s and early 1990s, the South Korean state found itself under internal and external pressure to change. Internally, the democratization in the late 1980s had led to a surge in popular demands for reforms. At the same time, industrial firms in increasingly capital-intensive sectors found themselves disadvantaged in international competition by relatively high domestic interest rates and limited options for corporate finance. Sources of foreign pressure included the US government and with the successful conclusion of the Uruguay Round of multilateral trade negotiation, the World Trade Organization (WTO). South Korea’s growing prominence and the end of the Cold War contributed to an environment in which South Korea’s trade partners were more demanding that Seoul abide by international trade commitments, and the establishment of the WTO’s new dispute settlement mechanism provided them the accepted diplomatic instrument to do so. Additional external pressures for policy change grew out of South Korea’s negotiations to join the Organization for Economic Cooperation and Development (OECD), a political commitment undertaken by President Kim Young-sam (1992–97) to demonstrate South Korea’s status as a developed country, arguably the first to graduate from the ranks of the developing to the developed.

The result of these internal and external drivers was a liberalization undertaken in the early 1990s that was less a product of textbook economic analysis than of parochial politicking. A combination of South Korean policy, its accession to the OECD, and the Basle accords on capital adequacy created unintended incentives for short-term bank borrowing. The highly leveraged nature of the South Korean economy, together with the currency and term mismatches embodied in the mid-1990s surge of foreign debt exposure, left the economy vulnerable to a variety of negative shocks, and in 1997, amidst a regional meltdown, South Korea experienced an economic crisis, evident in the

swing from roughly 7 percent growth in 1997 to a -7 percent contraction in 1998 before rebounding to more than 10 percent in 1999 (figure 1).<sup>8</sup>

In a sense, South Korea benefited from the vagaries of the electoral calendar—Kim Dae-jung, a former dissident, was elected president at the peak of the financial crisis in December 1997, entered the Blue House essentially owing nothing to the dominant interests in the society, and was free to blame the mishap on his predecessor. Indeed, one could argue that the relatively wide-ranging policy conditions attached to the International Monetary Fund (IMF) bailout package helped Kim to advance his own relatively liberal economic agenda more effectively than if the Fund or some similar organization had not existed. It is perhaps telling that among South Koreans, the 1998 recession came to be known colloquially as “the IMF recession,” identifying foreigners with responsibility for the distress.

Given this freedom to maneuver, President Kim moved resolutely to extract concessions from both the labor unions and the *chaebol*. The crisis forced a restructuring of South Korea’s systems of finance, regulation, and corporate governance and a dismantling of the pervasive controls on international capital flows that characterized the precrisis regime. In the financial sector, the government immediately closed two brokerage houses and a number of merchant banks (including some affiliated with the *chaebol*). The government began auctioning off two nationalized commercial banks while putting other financial institutions on short tethers. Labor-market reforms that the National Assembly had rejected the previous year were passed with alacrity. The social safety net was expanded in an attempt to deal with the country’s first experience with mass involuntary unemployment.

In the financial sector, prudential regulation was consolidated and strengthened through the creation of the Financial Supervisory Commission (FSC) and the introduction of new regulatory practices, approaches, and standards. What appears to be more difficult to change has been the lending culture of South Korean financial institutions (Mann

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<sup>8</sup> In these regards, the South Korean case is similar to those of Japan and Taiwan, which also combined state-led growth and capital controls and in the 1990s experienced financial crises costing double-digit shares of GDP. There is a gigantic literature on the crisis. For entry points into this literature, see Wang and Zang (1998), Noland (2000), Smith (2000), Coe and Kim (2002), and the website maintained by the NBER, <http://www.nber.org/~confer/2000/korea00/korea00.html>.

2000). In the aftermath of the crisis, lenders went from bingeing on corporate lending to bingeing on household lending: South Korean household debt registered the fastest growth in the world, increasing 18 percentage points of GDP in two years, before ending in crisis with the insolvency of the country's largest credit card issuer.<sup>9</sup>

Nevertheless, the improvement in the function of South Korea's financial system can be seen in firm-level balance sheet data: South Korean corporations on the whole have reduced their leverage, and access to capital increasingly is a function of profitability (Alexander 2003). This development is, in turn, facilitated by improved corporate governance through enhanced financial transparency, stricter enforcement of existing laws, and expanded scope for minority shareholders to seek legal redress.

South Korean equity markets have become more integrated with markets elsewhere. In part, this increase reflects the natural integration of markets following the removal of restrictions on foreign ownerships of South Korean stocks (foreigners now own approximately 45 percent of the shares on the Korean Stock Exchange) and the removal of restrictions on South Korean residents' ability to invest abroad. Yet despite these developments, the interest rate spread on South Korean sovereign debt remains higher than it was precrisis, and despite recent increases in stock prices, South Korean firms continue to trade at a discount relative to foreign comparators ("the Korean discount").

One potential explanation is that the market still lacks independent institutional investors capable of monitoring management. To the extent that such institutional investors exist in South Korea, they tend to be affiliated with the major *chaebol*, and though some foreign institutional investors and the nascent shareholder rights movement have exerted some salutary influence, it is fair to say that the country still lacks a real market for corporate control. In the World Bank's *Doing Business in 2006* report, South Korea ranked 87<sup>th</sup> out of 155 countries in investor protection (World Bank 2005).

It appears, at least to foreigners, that the South Korean government is ambivalent about their role in the economy.<sup>10</sup> Foreign investment in South Korea has never been

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<sup>9</sup> See IMF (2004) for a summary of the credit card debacle.

<sup>10</sup> See, for example, commentaries by Graham (2005) and De Jonquieres (2005).

high. For decades, the government pursued policies that successfully impeded foreign investment. Even when foreign firms managed to invest in South Korea, they were typically relegated to minority stake joint ventures with South Korean partners. These policies were in part an understandable response to the country's colonial history and fears that if the economy were opened widely to foreign investors, the country's assets would be bought up wholesale by Japanese investors.

But this is not the whole story. The state-led development strategy required that firms be responsive to government dictates. The bureaucrats rightly feared that foreigners would be less pliable than their domestic counterparts and thus required exclusionary laws and regulations to marginalize foreigners. Yet this approach that has outlived its usefulness appears to have inculcated in South Koreans unhelpful attitudes toward inward foreign investment. In the 2003 Pew Survey on Global Attitudes, one of the questions asked was whether respondents agreed with the statement that “our people are not perfect, but our culture is superior to others.”<sup>11</sup> The share in South Korea responding affirmatively to this statement was a whopping 90 percent—the highest in any country polled. Yet while an astonishing share of South Koreans apparently feel culturally superior to the rest of the world, they also apparently lack confidence in their culture's resilience—five out of six South Koreans think that it should be protected from foreign influence.

The problem is that such attitudes are not associated with economic success. Instead, they are red flags to foreign investors, who wonder if such views are indicative of the type of reception that they are likely to receive from government officials, their employees, their suppliers, and their customers. The FSC has threatened penalties against foreign investors who seek to influence corporate management decisions without registering their intentions in advance. In one highly publicized case, the scandal-plagued management of the SK *chaebol* successfully portrayed itself as the defender of the national patrimony and repulsed the bid by Dubai-based Sovereign Asset Management to replace its upper management. While it is understandable that South Koreans are concerned about reports that foreign investors such as Newbridge Capital have exploited

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<sup>11</sup> More than 40,000 people in 46 countries were surveyed on a variety of issues in this poll. See Pew Center for the People and the Press (2003) for methodological details.

aspects of South Korean tax treaties to avoid taxation, the appropriate response is to close the loopholes. Newbridge took an enormous risk when it invested in South Korea—something that South Korean investors were unwilling to do—and turned around a failed South Korean institution. The South Korean taxpayer, through the government’s ownership stake in Korea First Bank, has been a prime beneficiary.

A similar story could be told of Daewoo Motors, once part of the fraud-ridden failed Daewoo conglomerate, which has been revitalized by General Motors. To the benefit of South Korean consumers, the resurrection of Daewoo Motors also has returned a modicum of competition to the South Korean car market, which had become a virtual monopoly of Hyundai.

One can certainly question how important foreign investment is to economic development or whether its enhanced presence would exercise any decisive influence on performance. Yet given the structure of the South Korean economy, foreign investors, however self-interested, are a progressive force: they bring new technology, more professional styles of management; they act as a natural check on the still opaque family-dominated *chaebol*; and are less amenable to manipulation by a state apparatus that still seeks to dominate. It is hard to imagine the government achieving its goal of turning South Korea into a regional business hub without them.

### ....TO REFEREE?

Despite its sterling performance over four decades, there is a growing sense that South Korea’s economic performance has begun lagging potential. The rate of growth appears to be in secular decline (whether this is justified by the fundamentals is a separate issue), and in cross-country surveys of underlying structural characteristics, South Korea’s rankings appear to be drifting downward, with some notable exceptions mainly involving technological capacity or prowess. There are many potential reasons and explanations for this perception of relative decline. I will focus on one—political institutions—fully cognizant that it is not the sole or possibly even the most important driver.

Table 4 reports results for the 35 indicators comprising the “Public Institutions” section of the World Economic Forum, Global Competitiveness Index. This source

reports country scores based on surveying more than 7,000 business executives in more than 100 countries and could be interpreted as providing an indication of reputation, if not reality.<sup>12</sup>

On the whole, South Korea does not fare particularly well. Most of the rankings cluster around the 50<sup>th</sup> percentile—not with respect to the membership of the OECD, arguably the relevant comparator group—but with respect to 104 countries including some very small, very poor, and former communist ones. Looking at the rankings in descending order of South Korea's score, it would appear that South Korea does relatively well on some indicators that may signal basic bureaucratic capacity, such as extent of bureaucratic red tape, formalization of the economy, property rights, reliability of police services, and business costs of crime and violence. South Korea scores in the top third of the sample on all of these indicators.

At the other extreme, South Korea scores poorly on indicators relating to politics: Trust in politicians, effectiveness of law-making bodies, and prevalence of illegal political donations are all in the bottom third of the sample. On these indicators, South Korea's scores are similar to those of a number of formerly communist countries, such as Georgia, Bulgaria, and Bosnia-Herzegovina.

Given the inclusiveness of the sample, South Korea's scores on a number of indicators that might be considered fundamental institutions of a modern democratic polity are disturbingly weak: Efficiency of the legal framework is in the 54<sup>th</sup> percentile, tied with Jamaica, China, and Zambia; judicial independence is in the 46<sup>th</sup> percentile, tied with Morocco; irregular payments to the judiciary is in the 52<sup>nd</sup> percentile, tied with Colombia and India; and freedom of the press is in the 49<sup>th</sup> percentile, tied with Malta, Botswana, Bolivia, Latvia, and Slovenia.

Lastly, from the standpoint of business, the costs of corruption appear to be relatively high, in the 56<sup>th</sup> percentile, tied with Morocco, El Salvador, Namibia, India,

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<sup>12</sup> The survey asks respondents to judge local conditions relative to a global best practices benchmark on a scale of 1 to 7. The World Economic Forum and its network of local affiliates attempt to get a cross-section of respondents from firms of differing sizes across a range of economic activities. The potential weakness of this approach is that the respondents may not know enough about the best practice standard to make a meaningful comparison with local circumstances. Methodological details of the survey, conducted during the first five months of 2004, are reported in Loades and Angels-Olivira (2004).

Gambia, Jamaica, and Mauritius. However, both the relative lack of bureaucratic red tape, and other survey evidence that indicates that senior managements of business firms do not report inordinate amounts of time spent by with government officials, suggest that there may be considerable corruption at the highest level of politics, but once policy decisions are made, they are implemented relatively efficiently by the bureaucracy (Noland and Pack 2003). There are reasons to believe that such systems impose less of a deadweight burden on the economy than systems characterized by cascading corruption all along the line (Shleifer and Vishny 1993).

The countries that South Korea most frequently tied with in table 4—Thailand (6), Brazil (5), and India (5)—are all countries at lower levels of per capita income than South Korea. This suggests that the development of political institutions has lagged South Korea's economic development.

## **CONCLUSION**

The South Korean case is fascinating because it combines in an unparalleled manner heterodox policies, success, and crisis. The extent to which policies were a causal factor in South Korea's development or whether the primary explanation of its success can be found in an unusual set of starting conditions and the country's outstanding economic performance could have been replicated or exceeded under a different policy package is a subject of continuing academic debate. However, there is probably more consensus around the point that whatever the efficacy of the state-led model, it contains the seeds of its own destruction and transitioning from this model to a more market-oriented approach presents difficult political economy challenges.

Today South Korea is an awkward interstice as the country tries to work out the appropriate role of the state. While there is a consensus that the country cannot return to the ways of the past, there appears to be less of a consensus about the way forward. This difficulty is compounded by what appear to be—at least in the context of comparative data—institutional weaknesses in the political system. South Korea's economic development has, in effect, outstripped its political development. A strengthening of those

political institutions and a clear redefinition of the role of the state vis-à-vis the economy would appear to be a central challenge looking forward.

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**Table 1 Human Capital Index and per capita income, mid-1950s**

Country	Year	Human Capital Index	Per capita income	Ratio of Human Capital Index to per capita income
Japan	1955	1,673	519	3.2
The Philippines	1956	738	277	2.7
<b>South Korea</b>	<b>1955</b>	<b>494</b>	<b>217</b>	<b>2.3</b>
Israel	1954	1,200	609	2.0
Thailand	1955	302	181	1.7
Greece	1956	693	468	1.5
Malaysia	1957	334	351	1.0
United States	1955	2,293	2,443	0.9
Italy	1956	787	971	0.8
Turkey	1955	267	365	0.7
Argentina	1955	760	1,059	0.7
Mexico	1955	352	637	0.6
Spain	1955	389	652	0.6

Notes: Human Capital Index is educational expenditure embodied in the labor force. See Psacharopoulos (1973). Values for Japan, Mexico, Spain, Turkey, and the United States are interpolated from 1950 and 1960 observations; values for Greece and Italy are interpolated from 1951 and 1961 observations; values for Argentina and Thailand are interpolated from 1947 and 1960 observations. Per capita income is the purchasing-power-adjusted figure in international dollars from the Penn World Table

Source: Noland-Pack (2003)

**Table 2 Share of Science and Engineering Tertiary Graduates**

	Circa. 1957		Circa. 1997	
	Year	Share	Year	Share
Brazil	1957	10.5	1993	12.3
China	1960	40	1994	29.9
Egypt	1957	11.4	1995	10.2
India	1957	3.7	1991	16.3
Pakistan	1957	22.4	1992	11.2
<b>South Korea</b>	<b>1957</b>	<b>15.9</b>	<b>1997</b>	<b>39.4</b>
Taiwan	1957	30.6		n.a.
Turkey	1957	16.2	1994	23.6

Note: n.a. = not available. 1957 figure for Pakistan includes Bangladesh.

Source: UNESCO *Statistical Yearbook*, 1970, 1998.

**Table 3 Gini coefficients**

	1960		1970	1980	1990	2000
	income	land				
Brazil	53	85	58	58	60	61
China	n.a.	n.a.	n.a.	32	35	40
Egypt	42	67	40	38	32	29
India	33	52	32	32	30	38
<b>South Korea</b>	<b>32</b>	<b>39</b>	<b>33</b>	<b>39</b>	<b>34</b>	<b>32</b>
Taiwan	32	n.a.	29	28	31	32
Turkey	56	68	51	n.a.	44	40

Note: n.a. = not available.

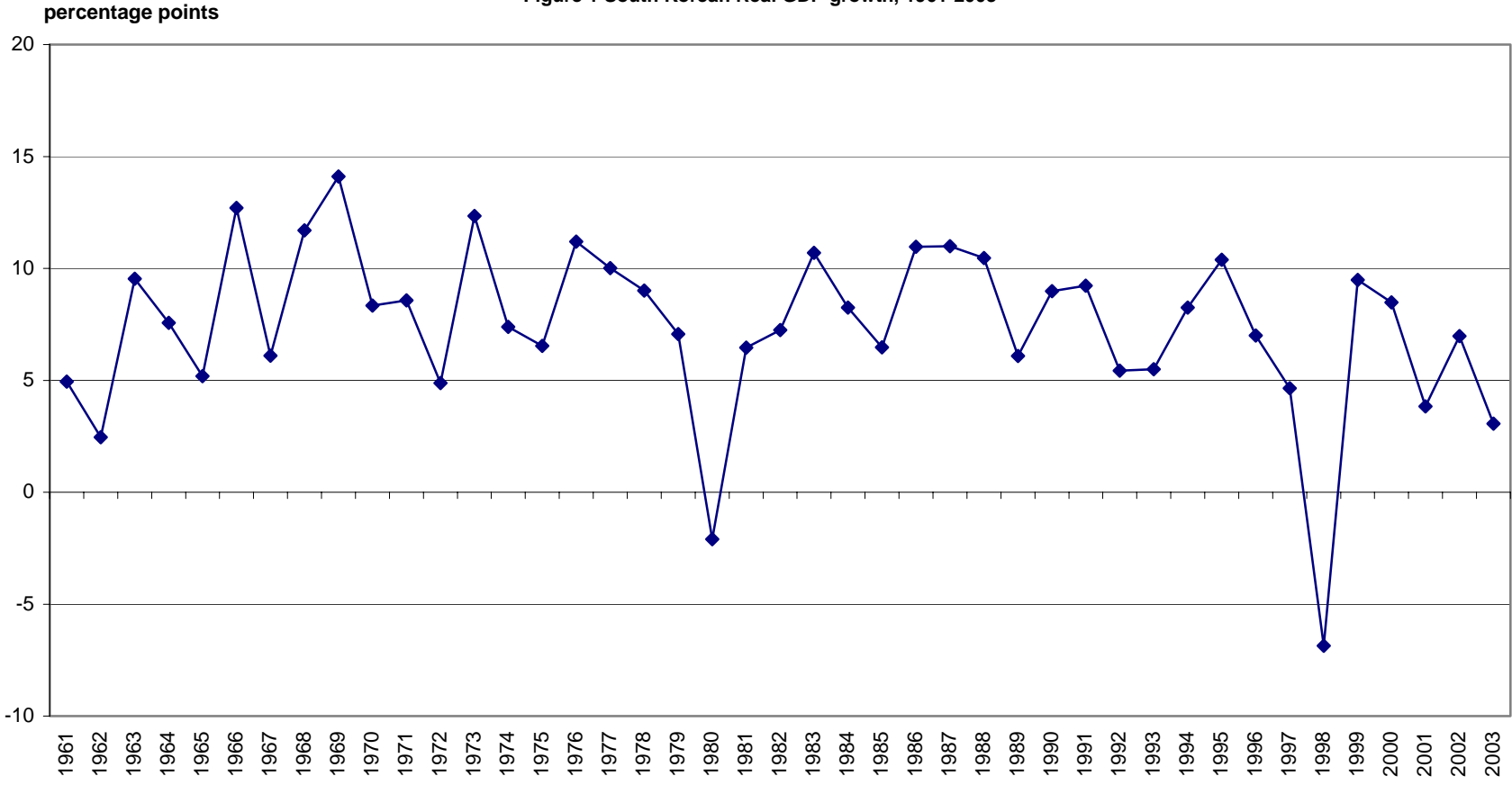
Sources: Land, Rodrik, 1994; income, 1960-1990, Deininger and Squire 1996; World Bank's World Development Indicators 2000.

**Table 4 Public Institution Indicators**

<b>Indicator</b>	<b>Percentile Ranking</b>	<b>Countries Tied with South Korea</b>
Extent of bureaucratic red tape	20	Jamaica, New Zealand, Bosnia and Herzegovina, Luxembourg, Cyprus, Sweden, Australia, United Kingdom, Japan, United States, Tunisia, Denmark
Informal sector	25	Botswana, Czech Republic, Sweden, Canada, Jordan
Property rights	26	Israel, Jordan
Reliability of police services	29	Portugal, Chile
Centralization of economic policymaking	30	Serbia and Montenegro, Taiwan, Norway, El Salvador
Business costs of crime and violence	31	Thailand, Mali, Ghana, Turkey
Intellectual property protection	35	Hungary
Pervasiveness of money laundering through non-bank channels	35	Gambia, Uruguay, Botswana, Ghana, El Salvador, South Africa, Slovenia, Morocco, China, Israel
Transparency of government policymaking	38	Thailand, Austria, France, Estonia
Pervasiveness of money laundering through banks	38	United Arab Emirates, India
Irregular payments in public utilities	40	Bulgaria, Cyprus, Brazil, Thailand
Organized Crime	43	Taiwan
Irregular payments in public contracts	45	China, Costa Rica, Hungary, Thailand
Judicial Independence	46	Morocco
Extent and effect of taxation	46	Uganda, Philippines, Latvia
Favoritism in decisions of government officials	47	Brazil, Malawi, Thailand, Costa Rica, Israel, Malta
Irregular payments in exports and imports	48	Brazil, Malaysia, Slovak Republic, Botswana
Freedom of the press	49	Malta, Botswana, Bolivia, Latvia, Slovenia
Diversion of public funds	50	El Salvador, Latvia, Egypt, Namibia
Irregular payments in judicial decisions	52	Colombia, India
Government effectiveness in reducing poverty and inequality	53	Indonesia, Bangladesh, Italy, Mali, Czech Republic, Kenya, Tanzania
Efficiency of legal framework	54	Jamaica, China, Zambia
Wastefulness of government spending	55	Mexico, Costa Rica, Ethiopia
Irregular payments in government policymaking	55	Hungary, Brazil, Mexico, Colombia, Mauritius, Zimbabwe
Business costs of corruption	56	Morocco, El Salvador, Namibia, India, Gambia, Jamaica, Mauritius
Business costs or irregular payments	58	India, Trinidad and Tobago, Italy, Algeria, Brazil, Argentina, Czech Republic, Guatemala, Mexico
Irregular payments in tax collection	61	Trinidad and Tobago, Ecuador, Poland
Burden of central government regulation	63	Hungary, Slovak Republic, Bulgaria, Greece, Macedonia (FYR), Czech Republic, Kenya
Burden of local government regulation	64	Morocco, Macedonia (FYR), Panama, Uruguay, New Zealand, Portugal
Efficiency of the tax system	66	Egypt, Vietnam, Russian Federation
Irregular payments in loan applications	66	Argentina, India
Policy consequences of legal political donations	66	Macedonia (FYR), Mali, Greece, Mexico, Thailand, Pakistan
Prevalence of illegal political donations	74	Croatia, Costa Rica, Italy, Jamaica
Effectiveness of law-making bodies	78	Georgia, Macedonia (FYR)
Public trust of politicians	82	Bulgaria, Georgia, Chad, Bosnia and Herzegovina, Honduras

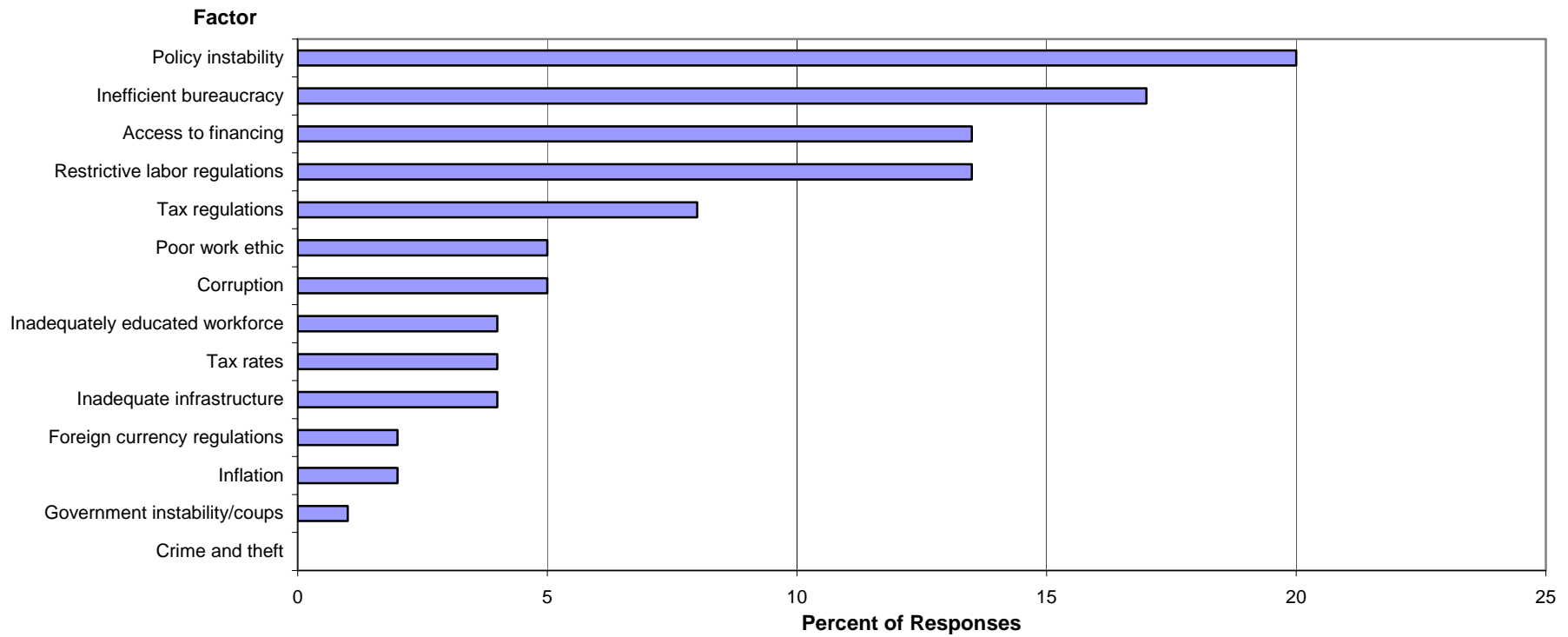
Source: Global Competitiveness Report, 2004-2005

Figure 1 South Korean Real GDP growth, 1961-2003



Source: World Bank's World Development Indicators, 2004.

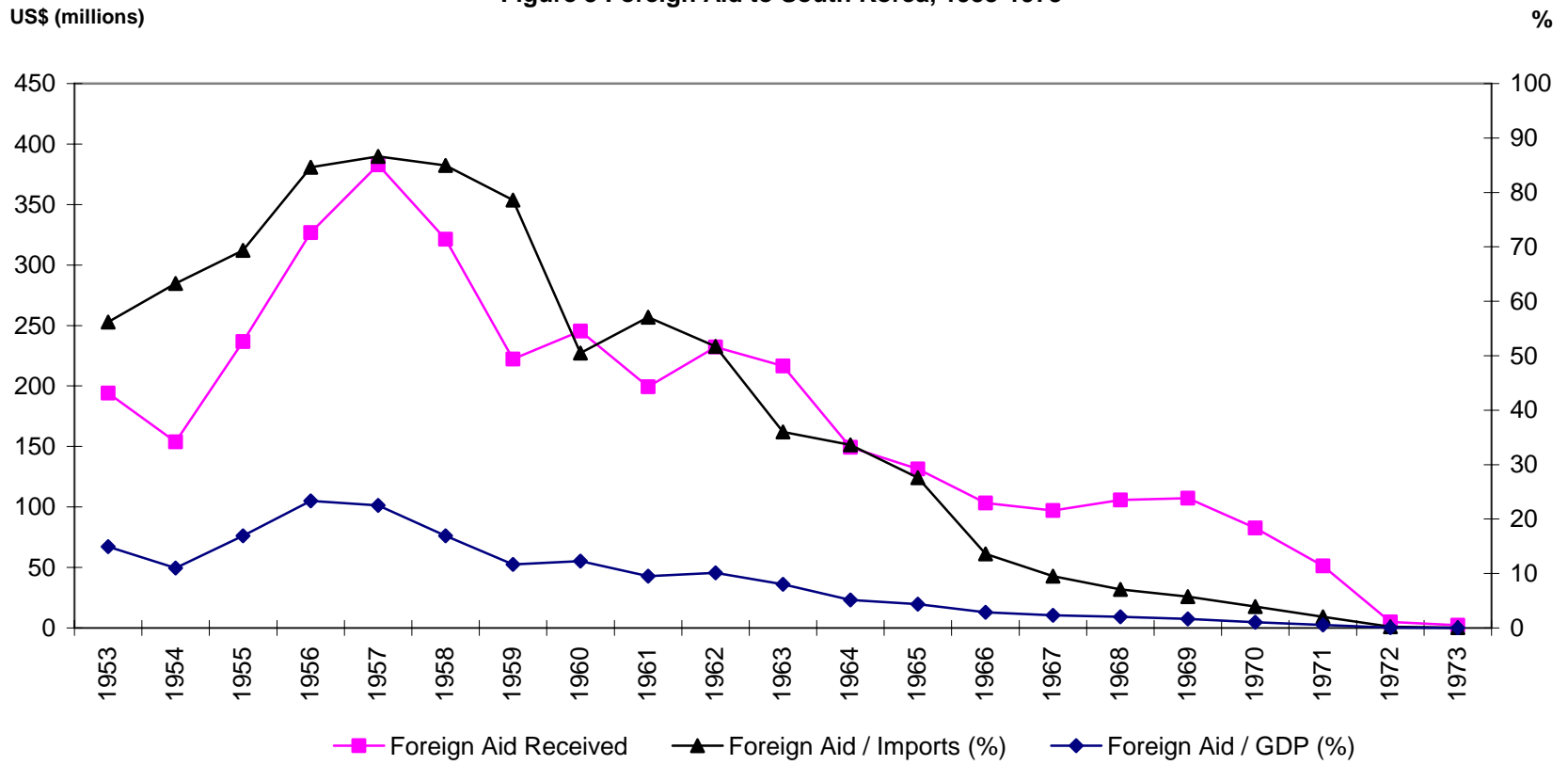
**Figure 2 The Most Problematic Factors for Doing Business**



Note: From a list of 14 factors, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

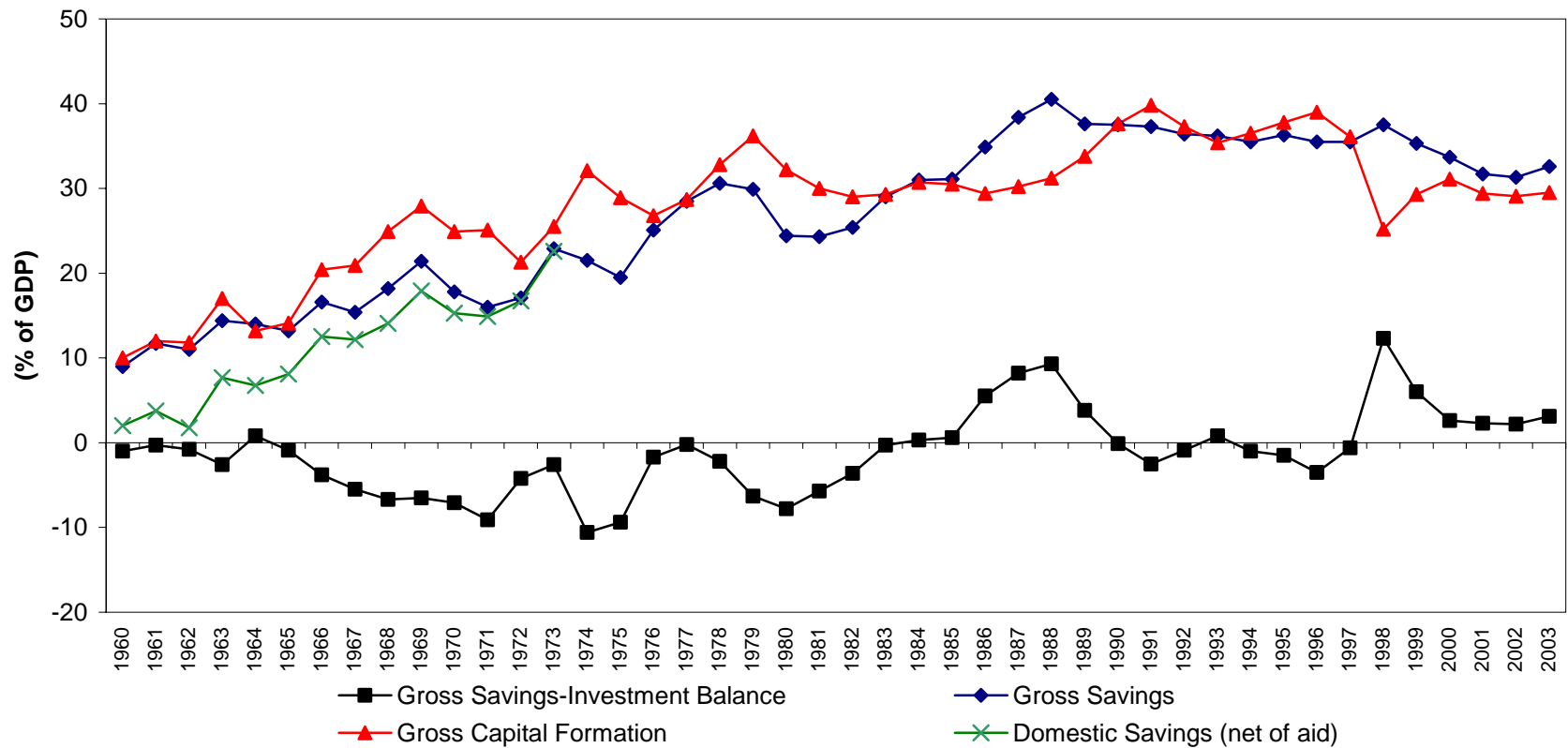
Source: UNESCO'S *Global Competitiveness Report*, 2004-2005

Figure 3 Foreign Aid to South Korea, 1953-1973



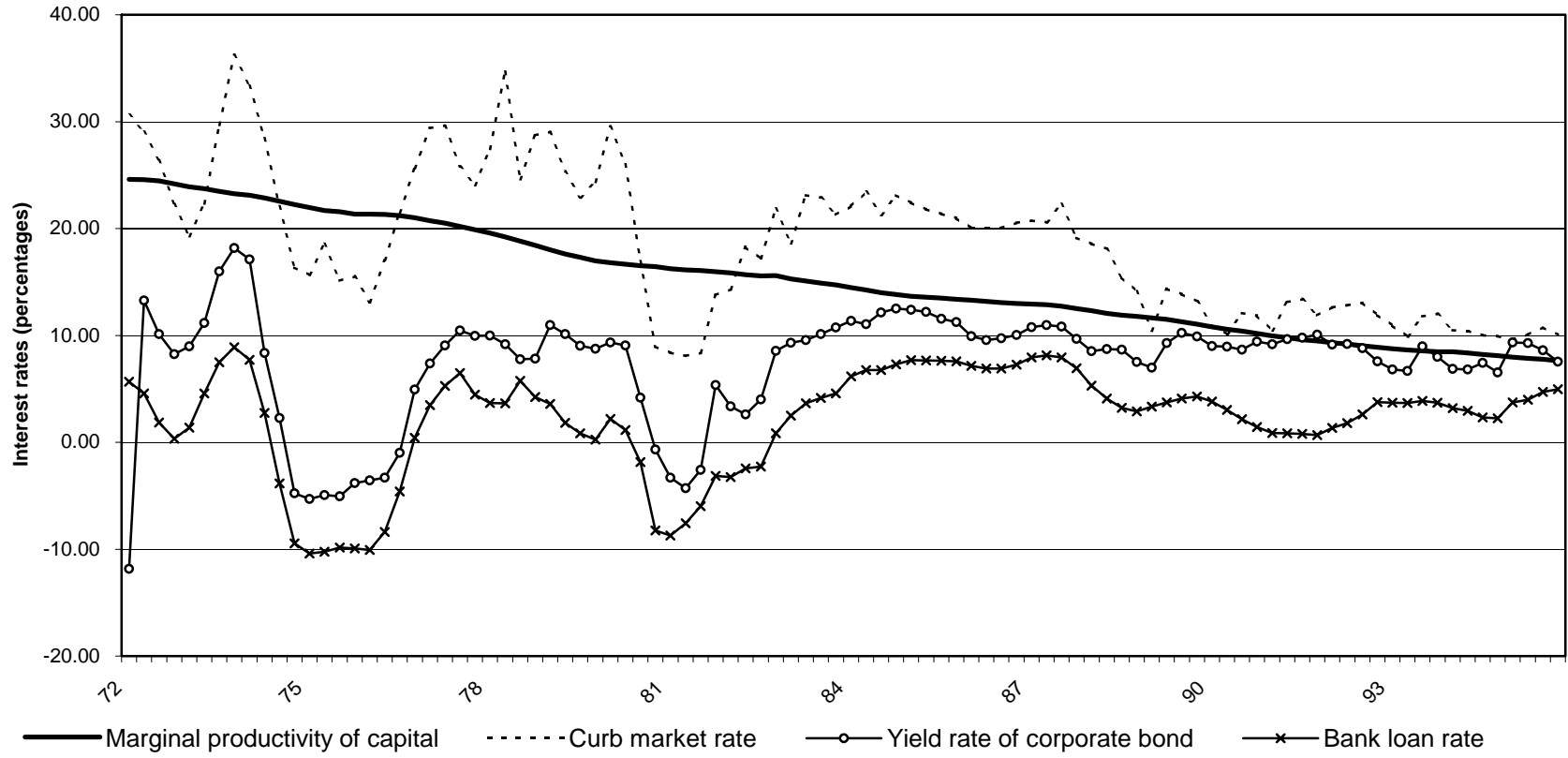
Source: Collins and Park (1988); World Bank's World Development Indicators; Bank of Korea.

Figure 4 South Korean Savings and Investment, 1960-2003



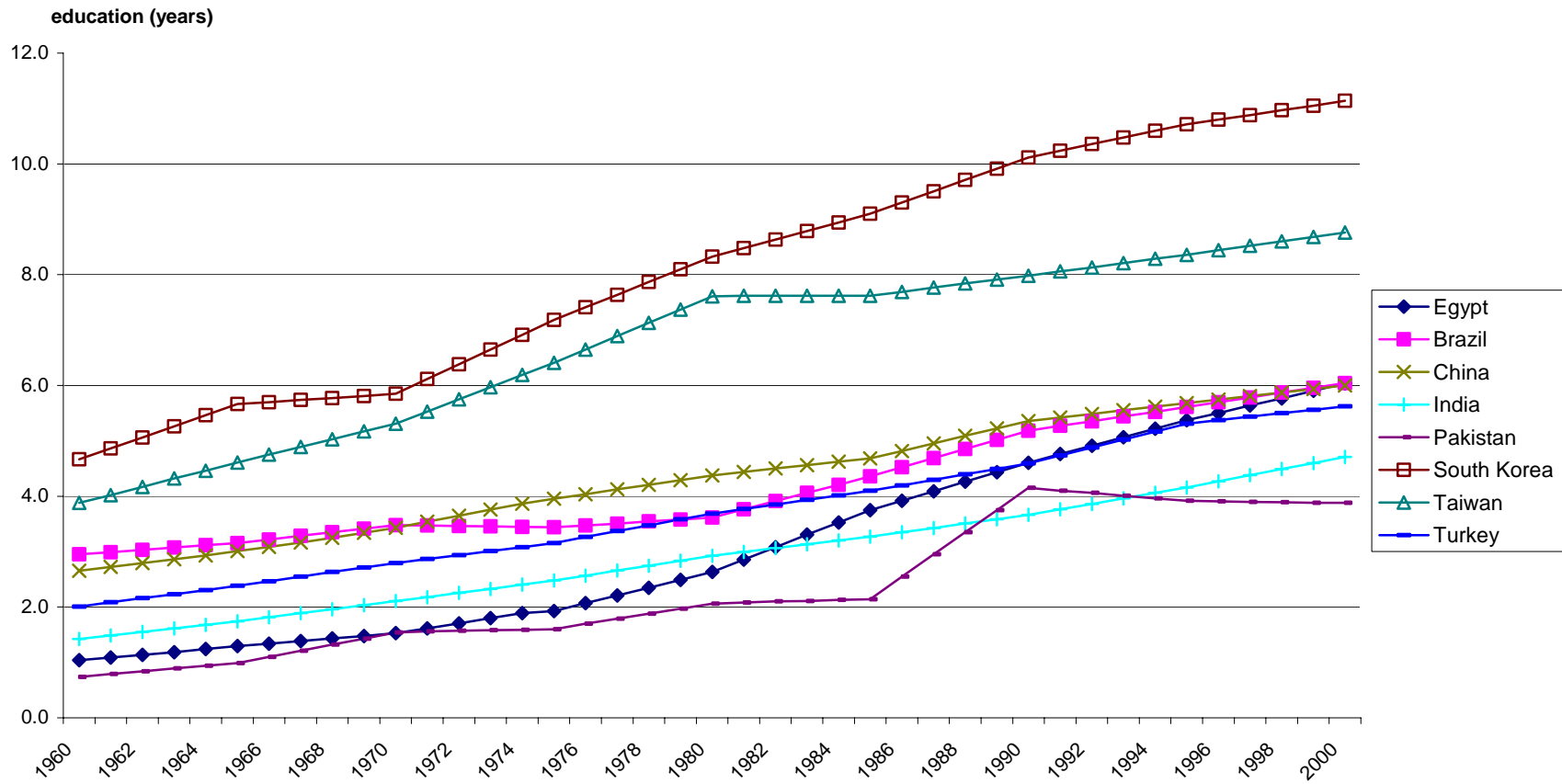
Source: Bank of Korea Economic Statistics System and World Bank's World Development Indicators.

Figure 5 Real Interest Rates



Source: Cho and Koh (1996)

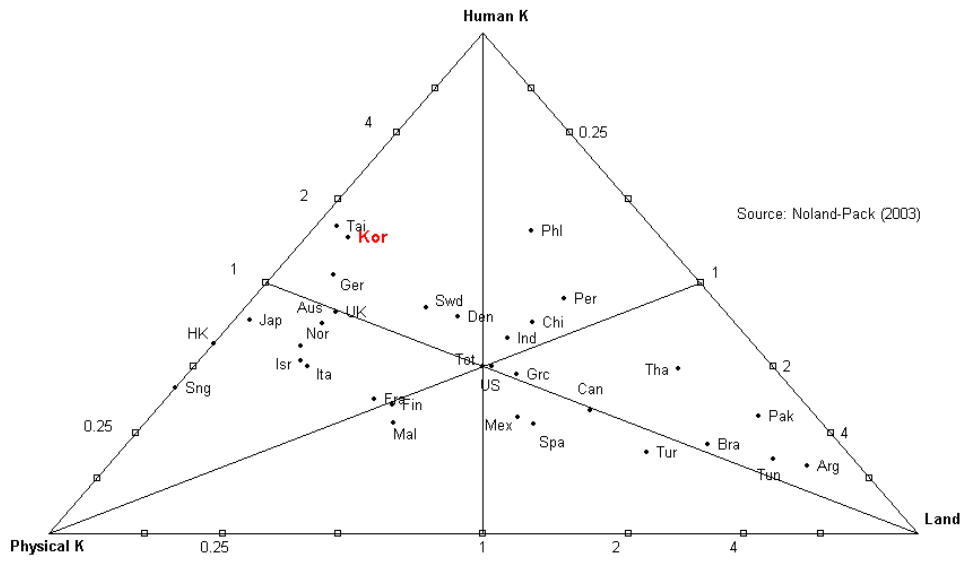
Figure 6 Human capital accumulation, 1960 - 2000



Note: Mean years of total education of the population age 15 and over

Source: Bosworth and Collins (2003)

**Figure 7a**  
**Endowment Triangle**  
**Land, Physical Capital, Human Capital ('68 data)**



**Figure 7b**  
**Endowment Triangle**  
**Labor, Physical Capital, Land ('68 data)**

