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## **Savings, investment and the corporation in the East Asian miracle**

Singh, Ajit

University of Cambridge

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SAVINGS, INVESTMENT AND THE CORPORATION IN THE EAST ASIAN MIRACLE

Ajit Singh  
Professor of Economics  
University of Cambridge

In writing this paper I have benefitted from discussions with or comments from Yilmaz Akyuz, John Kregel, Rudy Matthias, Bob Rowthorn and Jong-Il You. The usual caveat applies.

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## **I.INTRODUCTION**

The East Asian countries have achieved a spectacular average rate of economic growth over the last 30 to 40 years, with very substantial diversification and economic development. Korea, for example, managed to transform itself from being a largely agricultural society in 1960 to the point where it became the third country after the US and Japan to export 256 K memory chips, developed by its own firms. It is no exaggeration to say that the post-WWII development of East Asia (including Japan) is the most successful story of sustained economic growth in the history of mankind.

How does one account for this extraordinary economic success?

There is no agreement on this question. Indeed, there is a continuing controversy in which the main protagonists are the World Bank with some orthodox economists on one side and a number of academic economists, not all of whom are heterodox, on the other. This debate is important for two reasons. Firstly, the World Bank professes to base its policy recommendations for countries around the globe on what it regards as the lessons to be drawn from the experience of these highly successful East Asian countries. Secondly, from an analytical point of view, the debate is clearly of central importance, precisely because of the fast growth of these economies over a sustained period. Thus, the resolution of this debate would inevitably have an important bearing on our general ideas on growth and development.

The outstanding issues in this controversy have recently been reviewed in Singh (1994, 1995a). It is common ground among students of the subject that East Asian economies have achieved extraordinarily high rates of savings and investment, often starting from very much lower levels two or three decades earlier. An equally significant and distinguishing characteristic of these countries has been their massive private corporate savings and investments. How can such large savings and investment rates, particularly in the corporate sector, be explained?

One of the main objects of this paper is to answer this question by analysing the savings and investment behaviour of the private corporations in these exemplary economies. The paper, however, goes beyond the savings and investment issues and makes the corporation itself and the relationship between the corporation and the government the focus of study. It is argued here that the leading actors in the industrial and technological advance in the large majority of non-communist industrialising economies, including the highly successful East-Asian ones, tend to be the large privately owned domestic firms and their managements. The received literature has not paid sufficient attention to these firms and to the business-government interactions. One important hypothesis which will be examined here is that in East Asia government policy was geared towards promoting high corporate profits, savings and investments.

The specific empirical questions which are addressed by this project are listed below.

a) How did the government policies on taxes, subsidies, protection, anti-trust, etc. help:

-Raise corporate profits;

-Ensure that these profits were reinvested.

b) Are there systematic differences in the financing of corporate growth between the highly successful and the less successful developing countries - between the East and South East Asian NICs on the one hand and the Latin American or South Asian countries on the other.

c) How are corporations organised in East Asian and other countries ? Who owns and controls them ?

What is the role of institutional investors and of the government? Are there systematic inter-country differences in these variables between successful and the less successful economies?

- d) More specifically, are large Latin American "groups" different from Asian "groups"? Is it true that as some students suggest that in a typical Latin American "group", corporations control the "group" bank; while it is the other way round in East Asia.
  
- e) How has the emergence and development of stock markets affected the pattern and financing of corporate savings and investments in these countries? Has the enormous growth of stock markets led to a rise in aggregate savings and investments in these economies?
  
- f) Why are some countries more successful than others in transforming high personal or household savings rates into high corporate savings rates and investment rates?

The present paper, which reports on the first phase of this project, answers some but not all of these questions. The paper is organized as follows: the following section outlines the main theoretical hypothesis concerning corporate profits, savings and investments which will be investigated here; it will also comment on their analytical and policy significance. It will in addition set out the broader intellectual context for concentrating attention on the large third world firm in late industrialisation. Sections III and IV investigate in detail the government-corporation relationships in - two exemplary East Asian economies - Japan, and South Korea respectively. The emphasis here is on the government-business interactions which affect particularly corporate savings and investment decisions. These sections also analyse inter alia corporate finance, corporate governance and other salient aspects of corporate behaviour in the two economies. Section V provides some tentative conclusions from the current phase of research. Further research will consider these issues in a comparative context in relation to other semi-industrial countries in South East Asia, South Asia, Middle East and Latin America.

## **II THEORETICAL HYPOTHESES AND THE INTELLECTUAL CONTEXT OF THE STUDY**

### **II.1. Savings and investment in the East Asian miracle**

As noted above, an outstanding feature of the high-performing East Asian economies has been their large rates of saving and investment. These countries topped the international league tables not just with respect to their long-term growth of GDP, but also in relation to national savings and investment rates.

What is the nature of the relationship between these variables (ie. savings, investment and longterm economic growth)?

#### **II.1.a. The neoclassical story**

The conventional neoclassical view ascribes East Asia's unusually high rates of savings and investment basically to sound 'fundamentals'. Specifically, it is suggested that prudent macroeconomic management, consequent low rates of inflation and low exchange rate fluctuations, coupled with good initial conditions (land reform, and hence relatively equal distribution of income and wealth, favourable human capital endowment due to universal primary education) led to fast growth of household incomes and savings. In this account, some countries were subject initially to financial repression (eg Korea in the mid 1960s). But once this was eliminated and real interest rates became positive, household savings rose further, as did investment.

The World Bank's (1993) study on the East Asian Miracle represents a considerable advance on this simple orthodox story. In response to the criticisms of the neoclassical analysis, it accepts that fast growing East Asian countries did not eliminate financial repression. It also acknowledges that governments in these countries adopted a host of measures to raise both the levels of savings and

investment, as well as to influence the allocation of investments. It is, however, argued that the financial repression practised in these countries was relatively mild and that this did not adversely affect savings.

In the neoclassical analysis, a high rate of savings leads to a high rate of investment. However, although investment is regarded as a significant determinant of economic growth, in the standard neoclassical story it is not the most important. The latter is thought to be technical progress which is measured in practice by the growth of total factor productivity (TFP). Other things being equal, the faster the growth of TFP, the faster will be the rate of a country's economic growth (World Bank, 1991).

The World Bank's East Asian Miracle study's estimates of the TFP growth rates indicated that these were considerably higher in the "miracle" countries than in other developing countries, and that this was a major reason for their superior economic performance. However, important recent studies on this subject by Young (1994) and Lau and Kim (1994) contradict the World Bank findings. Young's cross-country estimates of TFP growth, based on purchasing power parity data, show that Korea and Taiwan had lower TFP growth than did Bangladesh! Similarly Lau and Kim's (1994) econometric analysis of "meta production functions" across countries shows that South Korea and Taiwan have experienced hardly any technical progress at all. In other words, in terms of the TFP methodology, most if not the whole of economic growth of countries like Korea can be explained by the fast expansion of factor inputs, including inter alia capital inputs arising from very high rates of capital accumulation

An interesting neoclassical interpretation of these new empirical findings on TFP growth in East Asia is provided by Krugman (1994). He argues on the basis of these results that the high growth rates of the East Asian miracle economies are not sustainable. This in his view is for the following reasons. It is unrealistic to expect that countries which are already investing 40 % of their GDP will be able to raise their rate of investment much higher still. Krugman goes on to point out that these countries similarly already have highly educated and high quality labour forces which limits the scope for further



improvement in these sphere as well. In these circumstances, without technical progress, eventual decreasing returns to investment will set in and limit the growth potential of these economies. Thus Professor Krugman:

"From the perspective of the year 2010, current projections of Asian supremacy extrapolated from recent trends may well look almost as silly as 1960s-vintage forecasts of Soviet industrial supremacy did from the perspective of the Brezhnev years." (pp. 78).

### **II.1.b. The non-neoclassical view**

On the basis of the classical (non-neoclassical) paradigm, UNCTAD economists [see UNCTAD, 1994; Akyuz and Gore, 1994] provide a radically different interpretation of these empirical phenomena. They suggest that the high growth rates of the exemplar East Asian countries were mostly, if not entirely, due to their high rates of accumulation. In this paradigm, there is no reason why eventual decreasing returns should set in with high rates of investment since technical change is regarded as being 'embodied' in new capital goods; high rates of investment lead to faster technical progress, greater learning by doing, and through cumulative causation to a virtuous circle of greater competitiveness and faster economic growth. So what matters most in the UNCTAD view is not static resource allocation and getting prices 'right' or 'wrong', but the dynamics of the accumulation process and the associated technical change and the growth of productivity.<sup>1</sup>

In the non-neoclassical story, savings do not automatically get translated into investment. Nevertheless, in this analysis there is a close relationship between corporate savings and investments through profits. This is the causal linkage emphasized by UNCTAD economists - the dynamic interactions between profits and investment which arise because profits are simultaneously an incentive for investment, a

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<sup>1</sup>. Rodrik (1994) also regards high rates of investment as the key variable in East Asian success, although his underlying causal model is rather different from that of UNCTAD economists.

source of investment and an outcome of investment.

In support of this thesis, UNCTAD economists, Akyuz and Gore (1994), put forward three basic propositions:

- 1) High rates of investment played a major role in the exceptionally rapid growth of successful East Asian economies and this investment was, after an initial period, supported by high rates of domestic savings.
- 2) Profits increasingly became the main source of savings and capital accumulation.
- 3) Government policy accelerated the process of capital accumulation by creating rents and pushing profits over and above those that could be attained under free market policies.

Further, the UNCTAD economists hypothesize that the growth of corporate profits and savings was the critical element in the rapid increase in domestic savings in the "miracle" countries: "High profits increased simultaneously the incentive of firms to invest and their capacity to finance new investment. Higher investment in turn raised profits by enhancing both rates of capital utilization and the pace of productivity improvement. Thus, the propensities to save and invest were both raised, as was the pace of technological advance and the mass of profits. In this way East Asian NIEs have been able to avoid the kind of problems associated with Soviet-type investment not based on profits, as well as the Latin American phenomenon of profits without investment." What are the empirical predictions which follow from this non-neoclassical view of savings and investment? The most important of these may be listed below.

- 1) One should expect to observe high shares of corporate profits, savings and investment in GDP in the successful East Asian countries compared with other countries.

- 2) Successful East Asian countries should show greater corporate retention ratios (i.e. the proportions of after-tax profits retained within the firm) than others
- 3) For a given corporate growth rate, corporate savings in these exemplar countries should finance a greater proportion of corporate investment than elsewhere.
- 4) In a profits and investment driven system, one should expect to observe, other things being equal, worsening income and wealth distributions.

The first three of these propositions will be empirically examined and commented on in the following sections.

#### **II.1.c. Commentary on the non-neoclassical view**

UNCTAD economists have certainly put forward an interesting and plausible theory to account for the East Asian success. If validated by empirical evidence, it would have powerful policy implications for developing countries in the emerging new world economic order. This point is elaborated below.

The recently concluded Uruguay Round Agreements have, apart from trade liberalization, also extended multilateral rules and disciplines to a number of policy areas affecting industrial development and competitiveness with regard to both goods and services. Such policies -- generally defined as industrial policies -- have been extensively used notably by fast growing East Asian countries to foster exports and to achieve rapid structural change and economic growth.

However, a number of these policies will fall foul of the Agreements, particularly in respect to

provisions on trade related investment measures (TRIMS) (See further Singh, forthcoming). This could seriously handicap developing countries who wish to emulate the example of the successful East-Asian economies. Nevertheless, if UNCTAD economists are correct in their interpretation of East-Asian success, the follower developing countries have a way out of this predicament. This is because even though the post-Uruguay Round trading regime may restrict the use of a number of instruments of industrial policy with respect to the promotion of exports and the control of imports, it does not prevent resort to policies regarding domestic savings and investment. These, if UNCTAD economists are right, are just as critical to industrial success as traditional industrial policy.

In this connection, it is useful to reflect on the fact that, in the talks between the United States and Japan on strategic trade impediments, the purpose of which was to achieve level playing fields for the two countries, more than one hundred such impediments were identified. Interestingly, the latter included Japan's very high savings rate compared with that of the US. This was thought to give Japan an "unfair" competitive advantage and therefore the US wanted Japan to reduce its savings rate in order to have level playing fields. Naturally, the Japanese response was that the same effect could be achieved by the US increasing its own savings rate. Fortunately, for all its disadvantages for developing countries, the new WTO regime does not concern itself with the question of the level of savings compatible with level playing fields in current and prospective members of WTO.

Following the logic of the discussion above it may however also be useful to note that the acceptance of the UNCTAD view does not necessarily negate the traditional heterodox analysis which emphasises the role of targeted industrial policies followed by the East Asian countries during their periods of fast economic growth and rapid industrialisation (Amsden, 1989; Wade, 1990; see also Singh 1995a and 1995b). These industrial policies included inter alia measures to promote exports, control specific as well as general levels of imports, and were designed to attain current account equilibrium at high growth rates. In other words, the traditional heterodox writings viewed the East Asian development story in terms of pursuing long-term competitiveness (i.e. current account balance at the highest possible

long-term growth rates) primarily through policies with respect to exports and import substitution rather than through measures to change the propensities to save and invest. In fact, however, the governments in these countries implemented both sets of policies simultaneously - in that sense the Amsden-Wade industrial policy recommendations complements the profits-savings-investment policies which follow from the UNCTAD perspective.

Pursuing complementary means to attain the same ends would appear to be the optimal policy stance for even if one set of measures do not fully succeed, the others may work better and help reach the target. However, if the WTO regime effectively rules out traditional industrial policy, the UNCTAD measures acting on the propensities to save and invest, can by themselves, still constitute in principle an adequate industrial policy. This will particularly be so for the more industrialized of the developing countries, for example, Malaysia, Korea, or Thailand (see further, Singh, forthcoming).

## **II.2. The large corporation in late industrialisation**

It was noted in the Introduction that large third world firms are often the main vehicles for promoting industrialisation and technical change in semi-industrial countries. Yet, development economics, at either theoretical or empirical levels, has paid very little attention to the study and analysis of these firms in economic development. The literature emphasises capital accumulation and studies it by and large at a macroeconomic level. The question of investment allocation is indeed examined at a microeconomic level, but it is done within the context of cost-benefit analysis of investment projects. However, the literature has not paid sufficient attention to the fact that the leading actors in industrialisation and development, particularly in today's semi-industrial economies, tend to be large firms, organisations and managements. We have not so far begun to develop an analytical perspective on the nature and role of these entities in carrying out industrial development. There is no theory of the third world firm. Is a large third world firm much like a large firm in the advanced countries or is it different in any important respects?

To illustrate the significance of this point it is useful to draw attention to Aoki's (1990) work on the differences between Japanese and Anglo-Saxon firms. Aoki has emphasised the differences between the two groups of firms with respect to (a) their relationship with their workers; (b) their respective managerial cultures; (c) relationships with the providers of finance; (d) relationships with their suppliers and sub-contractors; (e) their respective ownership patterns. He has formalised these differences into a distinct theory of Japanese firm.

There are indeed very important differences between large third-world firms and those in the US and Western Europe either today or in the past when these countries themselves were industrialising. It is a remarkable fact that the private sector large third-world firms tend to be highly diversified industrial groups operating in a number of unrelated fields, i.e. they are what might be called "irrational" conglomerates. This kind of 'group' business organisation seems to have arisen in countries with diverse cultures, institutions and historical development. Such widely diversified groups comprise the leading firms in India, Korea, Mexico, Brazil, Argentina and many other countries. As Table 1 shows, of the 31 largest private industrial enterprises in the semi-industrial countries in 1987, 27 were diversified groups which were mostly family controlled.

The large third world firms have been increasing their share of world output. In 1962 there were only four third world firms - two from South Africa, one from India and one from Turkey among the five hundred largest industrial enterprises in the world. By 1992 this number rose to thirty three. It included twelve Korean companies whereas in 1962 there was not a single company from that country among the top five hundred (see table 2).

There are important differences between these third world conglomerates and the contemporary American ones. Many of the latter are products of the huge merger wave which swept American industry in the 1960s. Subsequently, a majority of these turned out to be unsuccessful. A number of

them became victims of the what Scherer (1988) has called the 'bust-up' takeover movement which was characterised by de-conglomeration, i.e. acquisitions followed by the sale of a number of divisions of taken over corporations<sup>2</sup>. In contrast, the third world conglomerates are by and large products not of merger wave but of organic growth in unrelated fields. Amsden and Hikino (1994) in a pioneering contribution suggest that the Third World conglomerates have been notably more successful than the US conglomerates of the last two decades and they provide an analysis of why this should be so.

The two authors go on to show that today's large third-world firms are also a different specie than the big firms in the US and Western Europe in the past when these countries were industrialising. As Chandler (1977) has demonstrated, large firms did play a key role in the industrialisation of countries like US and Germany in the late nineteenth century. These firms were also often diversified, but their diversification tended to be much more limited and was confined to technologically related activities<sup>3</sup>.

The special characteristics of contemporary giant third-world firms need systematic investigation. Whether or not a distinct theory of third world firm is required, an important building block in such research has to be a detailed knowledge of how third world firms finance their growth and what kind of capital structures they choose to have.

The following sections will, inter alia, provide information on corporate organisation and corporate finance in the two exemplar East Asian economies.

### **III INVESTMENT-PROFIT-SAVING NEXUS IN JAPAN DURING THE HIGH GROWTH PERIOD (1950-1973).**

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<sup>2</sup> See further Ravenscraft and Scherer (1987); Singh (1992).

<sup>3</sup> The Third World firms conform more to the pre-War Japanese model of the Zaibatsu - the large Japanese industrial groups. See further Amsden and Hikino (1994). See also below the differences between the Korean Chaebols and the Japanese Kieretsu.

We consider first at the macroeconomic level, the relationship between investments, profits and savings in Japan during the years 1950 to 1973. The analysis concentrates on this period because it is the most relevant from the perspective of developing countries. In the early 1950s, the Japanese level of industrialization and economic development was not all that different from that of many contemporary semi-industrial countries. As a consequence of the extraordinary economic growth in the 1950s and 1960s - when Japanese industrial production expanded at a phenomenal rate of about 13 percent per annum, GDP at 10 percent per annum and its share in world exports of manufacture rose by a huge 10 percentage points - by the early 1970s, Japan had graduated to the status of an OECD country. The Japanese experience since 1973, although it still has implications for developing countries, it is not as directly significant as the earlier period.

Table 3 shows the extremely high aggregate investment rates attained in Japan during this high growth period, compared with other leading industrial economies. Even excluding residential construction, Japan was investing more than a quarter of its GDP on average in the two decades 1953 to 1972. Dis-aggregation of these data shows that Japan invested 8 percent of GDP in the manufacturing sector in this period as against 4 percent in Britain and 6 to 7 percent (including investment in the construction sector) in France and Germany (Boltho, 1975). Table 4 indicates the Japanese advantage in real investment in plant and equipment with respect to West Germany and USA during the periods 1967 to 1969 and 1970 to 1974 respectively.

Table 5 provides information on gross aggregate as well as sectoral savings ratios in leading industrial countries during the two decades 1953 to 1972. The table shows that the average savings propensities of each of the three sectors in Japan was higher by a considerable margin than those in other countries. Moreover, as Boltho rightly emphasizes, the Japanese aggregate savings ratio increased at a faster rate throughout this period than that of any other country in the table.



What were the factors responsible for these high savings and investment rates in Japan, particularly those of the corporate sector? It will be argued below, that broadly speaking, there were two major forces at work:

- 1) The relationship between government and business in Japan which played a critical role in different ways in ensuring that corporate profits, as well as propensities to save and invest increased over time and remained at a high level.
- 2) The nature of the Japanese corporate organization and the relationship between the corporation and the financial system. These were important in ensuring that the Japanese corporations were able to take a longterm view in their investment decisions.

Policies adopted under both (a) and (b) will be elaborated on in the discussion below.

### **III.1 State intervention and profits**

Table 6 indicates that at the macroeconomic level Japan had a much higher share of profits in national income as well as considerably higher profit rates than other industrial countries in the period under consideration. In 1970 gross profits constituted more than a half of gross value added in Japan compared with less than a quarter in the UK and USA and about a third in countries like Germany and Italy. National Accounts statistics suggest that the story is much the same if the comparison is made on the basis of net rather than gross profits (Table 7). Moreover Table 8 suggests that during the period 1955 - 1973 most of the sample countries had a trend decline in the share of gross profits in the GDP while Japan recorded a small trend increase (although it was not statistically significant).

It must be emphasised that these high profits in the Japanese case were not the outcome of spontaneous market forces. Rather these materialised in important part from heavy state intervention which guided

the Japanese economy during this period. The government had two main proximate objectives: to attain a current account equilibrium at as high a growth rate as possible; to increase the private sector's propensities to invest and save so as to substantially raise the long term growth rate of the economy. Government intervention was directed towards correcting perceived "market failures". However the concept of "market failure" in Japanese economic philosophy is rather different from that used in traditional economic analysis. As Okimoto (1989) explains:

"At the risk of oversimplification, perhaps the United States' concern can be described as reactive, adhoc, and focused on market failures without reference to industry-specific goals. By contrast, Japan's approach is anticipatory, preventive, and aimed at positively restructuring the market in ways that improve the likelihood that industry-specific goals will be achieved. There is a fundamental divergence in expectations and objectives and hence in policy actions. Whereas Americans are content to let the chips fall where they may, the Japanese prefer to remove as much uncertainty as possible from the market processes. Their disposition to bend, twist, and shape the market is analogous to their practice of using ropes, wires, and strings to bend and twist the trunks and branches of trees into shapes that fit the Japanese aesthetic composition of a landscape, garden or *bonsai* plant."<sup>4</sup>

### **III.2 Corporate fiscal incentives**

The Japanese government sought to achieve the above objectives by building up the strength and capabilities of its corporations so that these could compete with their counterparts from advanced countries in the international market place. For this purpose a number of measures were taken which directly helped increase the resources available for corporate investment. These were coupled with a range of indirect policies which affected positively the external environment of the corporate sector and thereby also helped raise profits. Each of these sets of measures are briefly outlined below.

The direct policy instruments comprised, among other things, a wide variety of fiscal incentives to promote corporate growth. Initially, in the early 1950s, these included accelerated depreciation for

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<sup>4</sup> Quoted in Gore (1994).

important industrial equipment, a special deduction for export earnings, a tax free reserve for losses from export transactions, and reduced tax rates on interest and dividends. Over the next two decades, an extraordinary range of other tax concessions were added to this list. To illustrate, there were more than twenty five tax free reserves which were available to corporations by 1975 including: reserves for bad debt, reserves for loss on returned goods unsold, bonus reserve, reserve for retirement allowances, reserve for special repairs, reserve for repairs and guaranteeing certain products, reserve for price fluctuations, reserve for overseas market development, reserve for overseas investment loss and reserve for investment loss in the free trade zone in Okinawa. With respect to the effectiveness of these tax instruments, Tsuru (1993) notes: "The very fact that these special measures were pressed hard through the diet usually with strong support from business circles and often against the reasoned opposition of academic economists may be said to be an objective proof that they were considered by the business groups concerned at least to be of some assistance."<sup>5</sup> (pp. 107).

### **III.3. Profits and external environment for the Japanese corporation**

#### **III.3.a. Domestic competition<sup>6</sup>**

To promote investment and technical change, instead of permitting unfettered competition, the

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<sup>5</sup> For academic studies of the effects of these fiscal measures see Ackley and Ishi (1976); Pechman and Kaizuka (1976); see also Tsuru (1993).

<sup>6</sup> This and the following section are based on Amsden and Singh (1994).

Japanese government controlled and guided domestic competition in the relevant period in a purposeful manner. Competition in Japan has both been encouraged, but notably also restricted in a number of ways. This has been particularly true during the years of rapid growth, 1950 - 1973. The agency primarily responsible for the antitrust enforcement in Japan is the Fair Trade Commission. However, in the Japanese scheme of government it has much less power compared with MITI which is responsible for the country's industrial policy. Although the FTC has never been entirely toothless and antitrust-enforcement in Japan is not a totally meaningless charade, most scholars agree that in any conflict between the two agencies' objectives (e.g. over the promotion of large scale firms or price fixing arrangements during a business cycle downturn), it is MITI and its industrial policy which by and large have prevailed over the FTC and the competition policy.

To illustrate, it is useful to reflect on some of the blatant restrictions which were imposed by the Japanese Government in the 1950s and 1960s on domestic product market competition. To meet its myriad goals which continually changed in the light of economic circumstances facing the country, MITI encouraged a variety of cartel arrangements in a wide range of industries – export and import cartels, cartels to combat depression or excessive competition, rationalization cartels, etc. According to Caves and Uekusa (1976), in the 1960s, cartels accounted for 78.1 percent of the value of shipments in textiles; 64.8 percent in clothing; 50.0 percent in non-ferrous metals; 47 percent in printing and publishing; 41.2 percent in stone, clay and glass; 34.5 percent in steel products, and 37.2 percent in food products. Although these cartels functioned for only limited periods of time and there was wide variation in their effectiveness, Caves and Uekusa observed that "their mere presence in such broad stretches of the manufacturing sector attests to their importance." (page 147).

Similarly, believing that large scale enterprises were required for promotion of technical change and for Japanese firms to compete effectively with their western counterparts, MITI encouraged mergers between leading firms in key industries. The fact that the agency did not always succeed in its efforts (notably in the car and machine tool industries) does not detract from the anti-competitive bias of many

of MITI's policies and actions. The anti-competitive actions were often re-enforced through MITI's use of "administrative guidance" to firms and its discreet directions to industry associations with whom it invariably had close links.

However, these restraints on competition are only a part of the story. An equally significant part of is MITI's strong encouragement of vigorous domestic oligopolistic rivalry and international competitiveness. In general, whether competition was promoted or restricted depended on the industry and its life-cycle: in young industries, during the developmental phase, the government discouraged competition; when these industries became technologically mature, competition was allowed to flourish.

Later, when industries are in competitive decline, the government again discourages competition and attempts to bring about an orderly rationalization of the industry (Okimoto, 1989).

### **III.3.b. External competition**

Protection was of central importance in Japanese industrial development during the miracle years. Clearly the trade policy had to be complementary to the competition policy for otherwise a recession cartel for example, could have been easily overwhelmed by foreign imports. Similarly, import restrictions could have overwhelmed competition altogether were it not for the performance standards that industries receiving protection were forced to meet by the government (through, for instance, MITI's control over foreign exchange, etc.).<sup>7</sup> During the 1950s and 1960s, the Japanese economy operated under a regime of draconian import controls, whether practised formally or informally. As late as 1978, manufactured imports constituted only 2.4% of the Japanese GDP; the corresponding proportion in Britain and other countries of the EEC was five to six times larger. Even in the US which traditionally,

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<sup>7</sup> To illustrate, Japan's machine tool industry was given selective tariff protection specifically for those machine tools with potentially high income elasticities of demand and high productivity growth rates. But machine tool builders benefiting from protection were required to produce at least 50% of their output in the form of computer numerically controlled machine tools by a certain date (Amsden and Hikino, 1993).

because of its continental size, has a relatively closed economy, the volume of imported manufactured goods in the late 1970s was proportionally almost twice as large as in Japan. (Singh, 1995a).

Protection, together with restrictions on domestic competition, provided the Japanese companies with a captive home market leading to high profits which enabled them to undertake high rates of investment, to improve the quality of their products, and also to capture markets abroad. The latter was of particular importance to Japanese firms, since in return for protection, MITI often imposed on them export and world market share performance targets. Companies recognized that to move forward, to have access to foreign technology, licenses etc., they had to export. The emphasis on exports and on maintaining oligopolistic rivalry - instead of concentrating resources and subsidies on a single "national champion", which many governments in their industrial policies are prone to do - are the key factors which distinguish Japanese policies from those of other dirigiste countries.

### **III.3.c Macroeconomic environment**

Another important feature of external environment faced by Japanese firms during this period was the government's low interest rate policy. This policy helped both to increase the resources available to firms for investment as well as to enhance their willingness to invest. The government practised what may be called "financial repression" ie. it kept the interest rate structure more or less stable at relatively low levels. In effect, this amounted to credit rationing at the discretion of the Bank of Japan and other banks under the so called "window guidance" of the Bank of Japan. Credit rationing and low interest rates were also used to subsidise specific industries favoured by the government.

Table 9 provides information on the leverage of corporations in Japan, US and Germany. The figure show clearly that in terms of book value of assets the Japanese firms during the relevant period were highly geared. There is considerable literature on the accuracy of such measurements in view of the very conservative accounting methods used in Japan to record value of land and fixed assets.

Nevertheless, even when adjustments are made for difference in accounting conventions, Japanese firms during the high growth period were still found to be more highly geared than the firms in the US or Germany.<sup>8</sup> In view of these high gearing levels of Japanese corporations, the importance of the Japanese government's low interest rate policy cannot be exaggerated.

Leaving aside the question of credit rationing and interest subsidies, in macroeconomic terms, a low interest rate policy could only be sustained if there was an adequate supply of savings. This point will be taken up in subsequent discussion.

### **III.3.d Other government policies**

In addition to the policies outlined above which directly or indirectly assisted the corporate sector by either increasing corporate profits, or by enhancing the internal resources available to corporations for investment, the government also used other important instruments and policies to guide and help the corporate sector. The most significant of these was "administrative guidance" which many students of Japanese economy regard as the most effective of all the instruments used by the government to aid industrial development. Ackley and Ishi defined this uniquely Japanese practice in the following terms:

"The term 'administrative guidance' refers to a method, not a policy. It is a method widely used by the Japanese government to support or reinforce many sorts of policies, both microeconomic and macroeconomic. Essentially, administrative guidance involves the use of influence, advice and persuasion to cause firms or individuals to behave in particular ways that the government believes are desirable. The persuasion of course is exerted and the advice given by public officials who may have the power to provide-or withhold-loans, grants, subsidies, licences, tax concessions, government contracts, permission to import, foreign exchange, approval of cartel arrangements, and other desirable (or undesirable) outcomes, both now and over the indefinite future. But it is inaccurate to think of

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<sup>8</sup> See further Borio (1990) and Kojima (1995).

administrative guidance exclusively in terms of manipulation of carrot and stick. Rather, the Japanese tradition of private acceptance of government leadership and the wide-spread recognition that government officials have knowledge, experience, and information superior to that available to the ordinary firm, as well as the sharing of values, beliefs, and political preferences by government officials and business leaders, all contribute to the success of the method."

The latter was particularly important during the high growth period as what in effect MITI did in that period was to orchestrate investment and technology races among oligopolistic firms in favoured industries. Such races needed to be carefully controlled as otherwise excess capacity may be created which will adversely effect the further corporate inducement to invest. Scott (1991) outlines MITI's characteristic method in relation to the expansion of the steel industry in the 1950's: "Japanese firms were required to wait their turn to build a new plant while a competitor built new capacity and achieved high volumes. Next time the roles will be reversed. This kind of coordination was carried out under the aegis of the government by MITI. Later the system required the scrapping of old capacity as a condition for permission to build new. As a result Japan with a smaller home market than the US built 10 plants larger than any in the US."<sup>9</sup> (pp. 54).

In terms of economic theory, in the context of the real world of incomplete markets and ubiquitous potentialities of coordination failures, MITI actions in this sphere amounted to being the ringmaster and the referee to ensure coordination of investment decisions of corporations.

#### **III.4 Profits and savings**

It was seen earlier that not only Japanese aggregate savings ratios were high by international standards each sector of the Japanese economy - households, corporations as well as the government - saved

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<sup>9</sup> Quoted in Singh (1995a) page 25.



considerably more than its counterparts in other countries. The high saving propensity of the Japanese corporate sector can be attributed to high profits and high inducement to invest. It was also in part due to the particular feature of the Japanese financial system which permitted companies to follow a policy of low dividend payouts. (This issue will be taken up further in the next section.)

However, Akyuz and Gore (1995) point out that the high savings propensity of the Japanese household sector can also be attributed in part to high levels of profits in the Japanese economy. This is for two reasons. First, the household sector includes unincorporated enterprises whose savings propensities tend to be high and whose incomes depend on profits. Secondly, bonus payments to workers which constituted almost a quarter of their annual incomes were also basically a function of profits. Again, the propensity to save out of these bonus payments - which many workers particularly during this period regarded as windfall payments - is estimated to have been quite high.<sup>10</sup>

There are of course a whole host of other explanations for the high savings propensities of the Japanese household sector. These include the fast rate of growth of household incomes, the age and employment structures of the population, the lack of publicly provided social security<sup>11</sup>. Low income elasticity of demand for foreign goods, the low level of development of financing and credit facilities for consumers, formal and informal controls on imports of consumer durables can also be expected to have helped played a significant part in keeping household consumption low<sup>12</sup>.

### **III.5 The UNCTAD thesis: An initial assessment**

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<sup>10</sup> See further Akyuz and Gore (1994).

<sup>11</sup> There is a large literature on the subject of why Japanese savings have been so high. For a recent review see IMF (1995). See also Maddison (1992); Kojima (1995).

<sup>12</sup> See Felix (1994).

It would appear from the discussion so far that Japanese economic history during the high growth period is generally compatible with the analyses of UNCTAD economists, presented in Section II. We have seen that the government policies played a key role in raising aggregate profits in the economy and in enhancing the resources available to corporations for investment. These high profits together with other government policies are seen to have contributed significantly to the high savings and investment rates in the Japanese economy.

This assessment is however, incomplete since the analysis of profits in the previous sections has been conducted at a macroeconomic level. A fuller investigation of the subject must also consider the magnitude and significance of the corporate profit rates at the microeconomic level. Table 10 presents information on corporate profitability and profit margins in Japan, U.S. and Germany. The data indicate that contrary to the findings of the National Accounts statistics on the aggregate share of profits in GDP as well as profit rates on aggregate capital stock, both the rates of return and the profit margins of Japanese firms have been much lower than those of U.S. firms. The observed differences in the corporate rates of return in the two countries can in principle arise from differences in accounting conventions, taxes etc. However, detailed analysis shows that even allowing for these factors, Japanese firms in most industries have lower operating margins and returns on assets than the corresponding US firms<sup>13</sup>.

That the Japanese rates of return are lower than those of the US at the microeconomic level is not necessarily inconsistent with the much higher Japanese share of profit in the national income relative to the US. Indeed many economists regard it as a virtue of the Japanese financial system which allows Japanese firms to continue to survive and to invest even when their rates of return are very low. A lower threshold rate of return allows Japanese managers to undertake investments that US firms find

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<sup>13</sup> See further Blaine (1993). Blaine has carried out a comprehensive examination of the financial statement ratios of large firms in 13 major industries in the U.S. and Japan over the period 1985-89.

unacceptable. To the extent that a higher rate of investment allows faster turnover of capital equipment and hence greater technical progress and new product development, this give the Japanese firms a competitive edge over the American corporations.

Indeed the MITI Commission on Industrial Productivity (1989) regarded this factor as a major reason why U.S. firms lost out to the Japanese corporations in the U.S. home market in a wide range of electronic products. The Commission investigations showed that when a Japanese firm entered one of these markets, there was a fall in the rate of return of the existing U.S. firms in the industry due to greater competition. This often resulted in the U.S. firms leaving that industry fairly quickly and diversifying and investing their resources elsewhere since they could not accept such low returns. Japanese companies were however able to sustain these low rates of return for long periods.

Survey data on the objectives of Japanese corporate managers repeatedly show them to be much more interested in pursuing market share than earning a high rate of return on assets or increasing the wealth of the shareholders. Thus for instance, Doyukai's (1988) study of Japanese, European and U.S. firms, showed the three most important goals for the managers in Japan were improving firm's ratios of new products and businesses, followed by gaining market share and improving return on investment. Capital gains for shareholders ranked at the bottom of the list and was cited by almost none of the sample managers in Japan as an important goal for their companies. In the United States in contrast, by far the most important goal was improving return on investment, followed by capital gains for shareholders; gaining market share was the least significant objective. European managers showed improving return on investment gaining market share, and reformulation of international strategies as three important goals. Capital gains for shareholders was placed last on their list<sup>14</sup>. The important question raised by such studies is why are Japanese firms able to pay so little attention to share prices

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<sup>14</sup> Doyukai's study which is in Japanese is quoted in Kojima (1995). See also Abegglen and Stalk (1985).

and rate of return on assets. To answer this question, it is necessary to look at the relationship between the Japanese corporation and the financial system.

### **III.6 The Corporation and the financial system in Japan**

There are two main reasons why the Japanese companies are able to pursue goals such as market share and product improvement and be much less concerned with share prices and rates of return on capital, particularly in the short term. The first is that the Japanese corporations are not subject to the ever present takeover threat of the kind which the firms in the U.S. and U.K. have to endure. Secondly they have longterm and close relationships (as opposed to arms length dealing) with their "parent" banks.

The reasons behind these reasons lie in the organisation of the Japanese corporation and the nature of the financial system. In sharp contrast to the situation in the U.S. and the U.K., there are hardly any hostile takeovers. The main reason for this phenomenon is the nature of the share ownership in the typical large Japanese corporate group. Generally speaking, three quarters of the shares in such a corporation are likely to be held by suppliers, customers and the lead bank. In other words, there is a concentration of share ownership in a relatively small number of "safe" hands. Only a quarter of the outstanding shares are traded on the market which makes it almost impossible to mount a successful hostile takeover. The independent shareholders are obliged to defer to the far larger holdings of the corporation's stakeholders<sup>15</sup>.

There is evidence that the Japanese government, after the second world war, deliberately instituted in that country, a bank based rather than a stock market based system. Thus for example as Somel (1995) notes, the Japanese government prevented the securities market from growing by making securities unattractive for ordinary savers, restricted residents' and nonresidents' access to Japanese securities

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<sup>15</sup> See further Abegglen and Stalk (1985); Odagiri (1994).

markets and Japanese access to foreign securities markets and provided the finance and funds required by the deficit corporate sector through the banking system. From a sociological perspective, Dore (1985) suggests that in Japan, not only is the stock market viewed with suspicion by the general public, it also has rather inferior social status. It is the real wealth creating corporate sector or the government which attracts the best talent rather than the stock market.

Thus a typical large Japanese corporation is much less subject to the "short-termism" which is inherent in the Anglo-Saxon stock market economies<sup>16</sup>. The Japanese firm is regulated by internal group mechanisms, where the group bank plays a critical role. There are sound analytical reasons, as well as empirical evidence for the view that this kind of bank-based regulation is more conducive to long-term investment not only in plant and equipment, but more importantly in training and in firm-specific, often intangible, human capital<sup>17</sup>.

To sum up, the low observed corporate rates of return in Japan do not contradict the thesis of the UNCTAD economists. Rather the nature of the Japanese corporation, the characteristic features of the country's financial system and the relationship between the two helped to provide a gloss on their analysis. Moreover, these relationships also bear on another apparent paradox in relation to the UNCTAD thesis. The paradox arises from the fact that despite the very high gross profits and gross corporate savings as a proportion of GDP in Japan, the Japanese companies resort much more to external finance for meeting their investment needs than firms in other countries (see table 11). There fortunately is a simple explanation for this: Japanese firms use more of both internal and external resources to finance their investments since their growth rates and hence their need for investment have

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<sup>16</sup> There is a large literature on the stock market and the short termism that it typically engenders. For a recent review, see Singh (1995c). See also Stein (1988, 1989); Cosh, Hughes and Singh (1990); Porter (1992); Kojima (1995); Froot, Perold and Stein (1992). For an opposite point of view on the subject see Marsh (1990).

<sup>17</sup> See further Frank and Mayer (1990); Jacobson and Aaker (1993); Stiglitz (1993) and Allen and Gale (1995).

been much greater than that of firms in the other sample countries.

#### **IV THE GOVERNMENT AND THE CORPORATION IN KOREA**

The Korean story of successful industrialisation in the last three decades is intimately linked with the development and the success of the giant Korean corporations, the Chaebols. These are the large highly diversified, indeed, "idiosyncratic" conglomerates which have dominated the Korean economy during this period of extraordinarily fast economic growth. The Koreans have also followed a vigorous Japanese-type industrial policy - if anything, the policy has been even more and interventionist than the policy in Japan. It has also been marked by the close relationship between the government and business. However, the nature of this relationship in Korea has been somewhat different than that in Japan. Likewise, although there are broad similarities, there are also important differences between Japan and Korea with respect to (a) the organisation, ownership patterns and governance of the conglomerates in the two countries; (b) the respective financial systems; and (c) the industrial strategies. The discussion below will attempt to highlight the differences.

Table 12 provides the main indicators of development in Korea during the period 1962 to 1991. The economy achieved over these three decades a growth rate of GNP of over 10 percent per annum and per capita GNP of over 9 percent per annum. These are amazing rates sustained over a long period. It is therefore not surprising that per capita GNP rose from just about \$300 (at constant 1985 US dollars) in 1962, to well over \$5000, three decades later. These changes have been accompanied by radical structural transformations in the economy. The share of manufacturing in output and employment has risen to well over 25 percent in the early 1990s, compared with just 10 percent in 1962. Moreover, in the early 1990s, the country was investing almost 40 percent of its GDP and the domestic savings rate had increased from 3.2 percent in 1962 to 36.2 percent in 1990. The US dollar value of commodity exports increased at an annual average rate of well over 25 percent per annum over these three decades.

Real wages rose on average at a rate of 7.6 percent per annum. Arguably, the only possible blemish in this exemplary economic record is the relatively high rate of inflation, which has averaged more than 10 percent per annum over the whole period; indeed, in the decade of the 1970s, the rate of inflation was nearly 20 percent per annum.

#### **IV.1 Conglomerate organisation and the financial system in Korea**

The Korean industrialisation and catching up with advanced countries started in earnest in the early 1960s with the military coup by General Park Chung-Hee (later the President). Park made economic development the top priority of his regime. After an initial period of tension between the government and business, Park came to the view that the large private conglomerate businesses were to be the main vehicles for Korea's catch up. Thus he wrote: "One of the essential characteristics of a modern economy is its strong tendency towards centralization. Mammoth enterprise--considered indispensable, at the moment, to our country--plays not only a decisive role in the economic development and elevation of living standards, but further, brings about changes in the structure of society and the economy... Therefore, the key problems facing a free economic policy are coordination and supervisory guidance, by the state, of mammoth economic strength" (1962, pp.228-229, as cited in Amsden, 1994).

The government of Korea in its support of private business went one step further than the Japanese. It actively helped create large conglomerates, promoting mergers and directing entry and exit of firms, according to the requirements of technological-scale economies and world-demand conditions. The result is that the manufacturing industry of the country displays one of the highest levels of market concentration anywhere - whether among the developing or the developed economies. The top 50 Chaebols accounted for 15 percent of GDP in 1990. Among the largest 500 industrial companies in the world in 1990, there were 11 firms from the Republic of Korea - the same number as from Switzerland.

UN (1993) observes in relation to the industrial structure of the Republic of Korea:  
"Such a structure is the deliberate creation of the government, which utilised a highly

interventionist strategy to push industry into larger-scale, complex technologically demanding activities while simultaneously restricting FDI inflows tightly to promote national ownership. It was deemed necessary to create enterprises of large size and diversity, to undertake the risk inherent in launching high-technology, high-skill activities that would remain competitive in world markets. The Chaebols acted as the representative and spearheads of the government strategy: they were supported by protection against imports and TNC entry, subsidised credit, procurement preference and massive investments in education, infrastructure and science-technology network".

There are some important differences between the Korean Chaebols and the Japanese Kieretsu. In the Japanese Kieretsu, there is a sharp divorce of ownership from control. Although as noted in Section III, nearly three quarters of the shares in a Kieretsu member firm may be held in "patient" hands of other stakeholders, there is, nevertheless, very little family share ownership and control. In contrast, the Korean Chaebols are to a considerable extent family owned and controlled. The absence of family ownership means that the Japanese corporations are effectively run by professional managers. The Chaebols however, are run by the founding families who take the top management positions rather than professional managers<sup>18</sup>.

The second crucial organizational difference between the Chaebols and the Kieretsus derives from the important differences in the financial systems of the two countries. The Korean financial system during the high growth period was effectively under state control so that the relationship between the main bank and the "group" firms in Korea has been rather different from that in Japan. In Japan, the group's main bank may be subject to government persuasion through "window guidance" etc. by the Bank of Japan, but it is nevertheless a private entity. When the main bank is directly state owned and controlled as in Korea for much of the period, the relationship between the bank and the firms in the group becomes rather different. The state-owned bank provides the government with an additional layer of control as well as information about the group's activities. Lee (1992) has argued in defence of this kind of relationship between the financial system and the corporate organization, that the government

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<sup>18</sup> Professionalisation of management is however gradually taking place in many Chaebols. See further Amsden (1989).



and large private organizations together can be regarded as forming an internal organization. The relationship between the financial system and the corporations can therefore be conceptualised as an internal capital market. Following Williamson (1975), Lee suggests that such a financial system is not necessarily inefficient and can in fact be more efficient than a free market financial system which suffers from various market imperfections.

## **IV.2 Industrial strategy**

After a period of import substitution industrialisation in the 1950s and 1960s, the Korean government embarked in the second half of the latter decade on a purposive strategy of promoting exports, whilst maintaining protection of its own market. An essential purpose of this policy was to attain a current account equilibrium at as high a longterm growth rate of the economy as possible. This task was more difficult for Korea than for Japan for two reasons. First, Japan was relatively more developed than Korea. Secondly, Japan had a much larger internal market. Importantly, Japanese economic growth during the high growth period was not export-led. The share of exports in GDP increased only to a small degree in the two decades 1953 to 1973, from 6.5 percent in 1953 to 8.9 percent in 1973. Korean industrialisation on the other hand was definitely export-led. In the comparable period of high growth in Korea, its exports increased from 4.8 percent of GDP in 1963 to 34.0 percent in 1980 (Krueger, 1995).

To achieve such export-led growth required stronger government involvement in building up the capabilities of private corporations to compete in the international market. The government did this by a wide range of measures which helped the corporate sector to invest and to improve its technological development, as well as have the resources to finance these investment projects. Some of the policies adopted by the government for these purposes are elaborated below.

### IV.3 Domestic and external competition<sup>19</sup>

Although Korea industrial structure was dominated by large conglomerates, anecdotal evidence strongly suggests that competition among these diverse business group was very fierce. Contrary to a priori expectations as well as the experience of Japan during its high growth period, economic growth in Korea was not accompanied by declining concentration at either the industry or aggregate levels. This was due to the pattern of industrial expansion: "Korea's growth in value added is due first to expansion of existing firms, second to entry of offspring firms, and only to a minor extent to net entrance of new entrepreneurs" (Jones and Sakong, 1980, p.176).

The output of the top 5 and 10 business groups grew much faster than GNP, so that aggregate economic concentration rose spectacularly (Kim, 1987). Korea's all-industry average 3-firm concentration ratio remained higher than Japan's --- 62% compared with 56.3% respectively (in the early 1980s) (Lee and Lee, 1990). Between 1970 and 1982 the share of total manufacturing shipments produced under a competitive market structure decreased from roughly 40% to 30%, while the share produced by oligopolies increased from 35% to 50% (Lee and Lee, 1990).<sup>20</sup>

Nevertheless, there is ample evidence that the big business groups still exhibited highly rivalrous behaviour (Kim, 1992). This was because under rapid growth conditions, as well as the rules of the game which the state had established, there was neither the incentive nor the ability for big business to collude. The Korean government both contributed to the rise of big business, through its licensing and

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<sup>19</sup> This section is based on Amsden and Singh (1994).

<sup>20</sup> By 1987, however, the share of shipments in Korea produced under competitive market conditions did, in fact, rise, to 43%, while the share accounted for by oligopolies fell, to 40% (Lee and Lee, 1990). This rise of competition cannot be attributed to anti-monopoly legislation, which was introduced in the 1980s but which was implemented only weakly and sporadically. Thus, as in Japan, rapid growth in Korea was accompanied ultimately by declining industry concentration.

subsidized credit policies (it owned or controlled virtually all financial institutions), and went out of its way to insure that big business did not collude, by allocating subsidies only in exchange for strict performance standards (Amsden, 1989). After 1975 inter-group competition in Korea heated-up as each Chaebol, or diversified business group, tried to qualify for generous subsidies to establish a general trading company by meeting government performance standards regarding minimum export volume and number of export products (Cho, 1987).

Although the Korean government disciplined subsidy recipients, it also supported them for lengthy periods until they ultimately became internationally competitive. This enabled firms to have long time horizons for their investment plans. For example, in the Korean automobile industry, for 30 years no foreign cars were to be seen on Korean roads and no Korean cars were to be seen on foreign roads. All the same, the industry's leader, the 90% locally-owned Hyundai Motor Company, became the first late-industrialising automobile maker to export to Europe and the United States (Amsden, 1989). As Kim Mahn-Je, the first president of the Korean Development Institute, has noted: "It is true that the success of the Korean automobile industry was achieved by private initiatives. But it is also true that the success could hardly be attributed to market competition per se. Korean automobiles faced severe competition in the export frontiers. However, it was not market competition that stimulated the industry to grow strong enough to venture into the world market. I am not arguing that market competition was useless. Rather, I would like to point out that the environment was provided in which the private sectors' creativity and responsibility could be maximised" (1992, p.45).

#### **IV.4 Inducement to invest and the socialisation of risk**

As in Japan, the government in Korea played a critical role in enhancing and maintaining at a high level the corporate inducement to invest. However, the state in Korea was not just a referee or a ringmaster in orchestrating investment races, it was also a nursemaid and a fairy godmother to the chaebols. During the 1970s when the government implemented its extremely ambitious "heavy and chemical

industry" (HCI) program, it virtually became a co-partner with the leading chaebols and "socialised" the risks involved.

These risks - both technological and market - in the production and sale of sophisticated new products were indeed formidable for the Korean private corporations. Left to themselves, the private sector may not have undertaken these risky investments at all. However, goaded by the government, provided with finance at subsidised rates through the nationalised banking system, the fiercely competitive top chaebols were more than willing to fully participate in these new ventures. To illustrate, here is the story of the production of microwave ovens by the Korean company Samsung Industries, as told by an institution, the World Bank, not particularly known for its support of the state nursemaid of industrial production.

Korean manufacturing giant Samsung industries began making microwave ovens in the early 1970s in a cramped old laboratory, turning out a few hundred over priced ovens annually for the heavily protected domestic market. Today, Samsung makes 80,000 microwave ovens a week and ranks as the world's biggest producer. How did a Korean company with almost no experience manufacturing complex ovens beat better financed and more experienced US and Japanese companies?

The government's Economic Development Board was a key player in Samsung's success. Government officials were keenly aware that the Republic of Korea could not rely forever on low wage manufacturing. Just as the United States had lost countless textile industry jobs to Korea, they reasoned, so Korea would one day find it could no longer compete for labour-intensive manufacturing jobs with low-wage neighbours such as China and Indonesia. To prepare for that day, government officials, working in consultation with the private sector, developed incentives for new knowledge- and capital-intensive industries. Incentives varied widely and included the government's building industrial parks, subsidising utilities, giving tax rebates for exports, and making cheap loans for investment in new products. By 1980, urged forward by subsidies and incentives, Korean industry had moved into steel, ships, and even cars and was about to leap into world class electronics.

Samsung made good use of these measures; company managers met frequently with government officials to trade ideas and projects. Even so, penetrating the world microwave market dominated by Japan was no easy task. By the late 1970s, when global production hit 5 million per year, Samsung had made a total of only 1,460 microwave ovens. The company's first break came in 1980, when a US department store, looking for cheaper substitutes, ordered several thousand ovens. Soon production had risen to 100,000. When General Electric, unable to keep pace with the Japanese competition, decided to stop manufacturing microwaves itself and import the ovens under its own label instead, Samsung was a logical choice. The company has

never looked back, and it now exports the ovens under its own name as well as buyers' labels. (World Bank, 1993, pp. 130).

Another important example of heavy state intervention in support of industry is provided by the recession of the early 1970s. In view of the high leverage of Korean chaebols (see Table 13), the recession, coupled with devaluation and a rise in interest rates, threatened the financial viability of many strategic corporations engaged in HCI. The government responded forcefully with the Presidential Emergency Decree of August 1972, which declared a moratorium on corporate debt to curb market lenders. Kim, Shim and Kim (1995) note that all corporate loans from the curb market were converted into long-term loans to be paid on an instalment basis over a five year period with a grace period of three years. A maximum interest rate of 16.2 percent was fixed on these loans while the prevailing curb market rate was over 40 percent per annum.

Korea's HCI drive is often criticized by orthodox economists (see World Bank, 1993; Krueger, 1995) as an example of inefficiency and waste and general government failure. However, this assessment is disputed by many economists who point out that there were inevitable teething troubles with a highly ambitious program of this kind designed to fundamentally transform the structure of the Korean economy. On a long-term view, HCI can be regarded as being exceptionally valuable as since the mid-1980s it has been the main source of Korea's outstanding export success in the world markets (Amsden, 1989; Kim, Shim and Kim, 1995). Moreover, the latter three authors also suggest that HCI expanded the spectrum of the product mix in the economy and provided domestic producers enormous scope for learning by doing. They believe that the Korean experience confirms the Lucas (1993) hypothesis that the quicker the introduction of new products, the quicker the process of learning by doing and the faster the overall expansion of the economy. Kim, Shim and Kim conclude that the government's active risk sharing with private firms made an important contribution to the successful implementation of the HCI program.

#### **IV.5. The financing of corporate growth in Korea**

Table 14 provides comparative information on the financing of corporate growth for four industrial countries - the U.S., the U.K., Germany and Japan - and for Korea. The table is based on aggregate flow of funds accounts and refers to the non-financial corporate sector as a whole. The figures for the industrial countries refers to the period 1970 to 1989 and for Korea for the years 1975 to 1990. There are serious deficiencies of data in making such international comparisons, but as far as possible a broadly similar methodology has been used for the decomposition of the sources of finance for all five countries in table 14. It would have perhaps been more useful to compare the Korean pattern of financing corporate growth with that of other semi-industrial countries, but unfortunately the lack of comparable flow of funds data prevents such an exercise.

Table 14 shows that the Korean pattern of financing of corporate growth is much more similar to that of Japan than that of the other three industrial countries. The Korean corporations finance an even smaller proportion of their growth from retained earnings than the Japanese companies. The Korean companies also rely to a greater extent on new equity finance than companies in the U.K. or the U.S. where one might have thought a priori that stock market financing would be more important. The results of table 14 conform to the conclusions reached by Singh and Hamid (1992) and Singh (1995d) that large developing country corporations rely to a greater extent on a) external finance, and b) on equity finance than advanced country corporations.

The greater reliance on external finance by developing countries is not difficult to explain: given their much faster growth rates, the developing country corporations need both more internal and external funds to finance their growth. Indeed, Cho (1995) reports for Korea a consistent negative relationship between internal finance and loan finance, suggesting that the lower the level of internal finance, the greater the "need" for companies to finance its investment program from outside sources. The greater reliance on equity financing of the Korean than of the advanced country corporations is a more complex

subject which is not directly relevant to the purpose of the present paper. This issue is, however, fully examined in Singh (1995).

#### **IV.6. Profits, savings and investment at the macroeconomic level**

We have seen above that the Korean corporate sector relied heavily on external sources (mainly banks) to finance its growth. It is also clear from the previous discussion that at the microeconomic level, the Korean chaebols were not motivated by short term profitability but rather by their desire to maintain and improve the market share. It will be recalled from Section III that the Japanese firms behaved in a similar way, but the factors which were responsible for inducing such firm motivation were somewhat different in the Japanese case as compared with that of Korean firms. In Korea, the state played a much more overt and visible role in influencing firm motivation and behaviour.

We shall now examine the role of profits in the Korean economy at the macroeconomic level and consider how these might have contributed towards meeting the macroeconomic constraint and the equality of ex ante savings and investments at high growth rates. Table 15 provides information on the gross share of profits in gross production as well as aggregate profit rates for the Korean manufacturing industry over the last three decades. Unfortunately similar data is not available for other semi-industrial countries to permit a comparative exercise.

Two important points emerge from Table 15. First, the Korean profit share in the 1960s and the 1970s was very high - averaging well over 40 percent in both decades. The figures for both profit share and profit rates for two decades are similar to those of Japan in that country's high growth period. Secondly, we note a trend decline in both profit rates and profit shares in Korea after 1978. Between 1977 and 1987, average profit share declined by at least 5 percentage points. There appears to have been a further sharper decline since 1987.

Table 16 provides information on sectoral savings and investment ratios for Korea and a small group of other countries in Asia and Latin America for which flow of funds accounts are available. In considering this data, it must be born in mind that they are subject to serious statistical deficiencies. Moreover the data does not pertain to exactly the same period for each country. For example the Indian figures are averaged over the period 1970- 1982, the Chinese cover the years 1982 - 1986, Thailand 1981 - 1983, and Columbia 1970 - 1986. Nevertheless, these are the best comparable data on sectoral savings and investment behaviour available for LDCs and they do provide some useful insights.

The table reveals the following main points. First business investment as a proportion of GNP was greater in Korea than in any other country except China. In general, Malaysia and Thailand also recorded greater business investment ratios than the two Latin American countries in the sample - Colombia and Ecuador. Second, if we turn to savings, we again find that business savings in China, Korea, Thailand and Malaysia were considerably greater in proportionate terms than those in Colombia and Ecuador. Thirdly, the data show that in terms of household savings, the Korean record was no better than that of India and the Philippines and not at all that different from Colombia and Ecuador. So unlike the case of Japan, which it will be recalled from Section III had greater sectoral savings ratios for each of the three sectors relative to other industrial countries, the Korean superiority in relation to other developing countries is marked only with respect to business investment and business savings. It is also noticeable that although business savings in Korea are high in comparative international terms, these can finance only 40% of business investment; the rest of the finance had to be mobilised from the other sectors.

Turning to the thesis of the UNCTAD economists, one important point is that the high Korean profits would have contributed directly to raising business savings; these would most likely also have helped raise savings to some degree in the household sector (for much the same reasons as those for Japan discussed earlier). However, the rate of business investment in Korea has been so high that the government was obliged to mobilize resources from other sectors to finance this investment, so as to maintain macroeconomic equilibrium between savings and investments at high growth rates. By all



accounts this task of mobilisation was performed by the government with great effectiveness and efficiency.

## **V. CONCLUSION.**

Following the lead of the UNCTAD economists, this paper has concentrated on the role of the accumulation process in the exemplary East Asian economies both at the micro and macro-economic levels. It has therefore examined in some detail the salient features of the private corporations which have been the main vehicles for technological catchup and rapid industrialisation in these countries. The paper has paid particular attention to (a) the role of the government and government-business interactions; and (b) the relationship between the financial system and the corporation. It has emphasised the significance of these relationships for raising and maintaining at a high level the corporate propensity to invest in East Asian economies.

Although stimulating the "animal spirits" of the private corporations is an essential step in the accumulation process, it is by no means sufficient. The governments in Korea and Japan also adopted a wide range of policies to ensure that the main macro economic constraints on fast economic growth - The equality of ex ante savings and investments and current account equilibrium at high growth rates were achieved. For otherwise the growth and accumulation process will be frustrated with negative consequences for corporate propensity to invest.

The paper has emphasised the role of the government in ensuring high corporate and overall profits in order to satisfy the macro economic constraint on savings and investment. It has also drawn attention to other resource mobilisation measures which the governments in Japan and Korea carried out for this purpose.

The UNCTAD economists have done an important service by stressing the prime importance of the accumulation process in East Asian growth. Much of the debate on the subject has hitherto centred on questions of resource allocation, industrial policy choices and their effectiveness. Apart from its intellectual significance in its own right in accounting for the fast East Asian economic growth in the previous decades, this emphasis on savings and investment, as noted in section II, is particularly timely from a present-day policy perspective. In analytical terms, the focus on raising the propensities to save and invest can be regarded as an alternative way of enhancing a country's long term international competitiveness. It complements the traditional industrial policies of import substitution and export promotion which many developing countries, including the East Asian ones, have normally used for this purpose. However, in the post-Uruguay Round global economic order, if the traditional industrial policies have to be phased out, poor countries will necessarily be obliged to use the alternative measures implicit in the UNCTAD economists' thesis.

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