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Why Crony Capitalism Is Bad for Economic Growth

Until the Asian financial crisis of 1997, economists and policymakers alike devoted much attention to analyzing the causes of the rapid growth of the East Asian economies. Some viewed their growth as a miracle; others (such as the World Bank) attributed it to high rates of capital accumulation.[1] But regardless of the analyst's conclusions, all wanted to learn the lessons of the East Asian successes in order that other countries might emulate them.

Since the crisis, those same economies are said to have had a large number of failures of economic policy; it is even said that there was no success story. Among the failures, a faulty banking system and cronyism are widely regarded as most fundamental. In this chapter, I examine these conclusions. To do so, I do three things. First, I provide an analysis of cronyism and investigate how and why it might have such negative effects as are now alleged. Second, I consider the role of domestic credit expansion in enabling cronyism and in contributing to the crisis. I then turn to the experience of one East Asian country—South Korea—and provide a possible explanation as to how cronyism and the banking system might have performed so well for so long and then have led to the crisis of late

1. See World Bank, *The East Asian Miracle* (New York: Oxford University Press, 1993).

1997. The explanation may apply to other Asian success stories as well—the reason for focusing on Korea is my own comparative advantage in being somewhat more familiar with that economy and economic policies than with the other Asian-crisis countries. Even for Korea, what is suggested is a plausible explanation, rather than a tested and proven hypothesis.

At the outset, however, it is necessary to define cronyism, the subject under discussion. What is normally meant is that some of those close to the political authorities receive favors that have large economic value. Usually, these favors are not outright transfers of wealth (such as forgiving taxes or providing subsidies) but rather take place through provision of economic entitlements. These entitlements can take a variety of forms, but the ones that are most visible in the Asian crisis and the ones under discussion here normally entail ownership of a business or its operation. Ownership may come about when cronies are favored as state-owned enterprises (SOEs) are privatized. More frequently, however, economic entitlements have arisen by enabling the cronies—or, more accurately, the establishments they operate, which I shall call crony-operated establishments (COEs)—to receive privileged access to governmental favors that have economic value. It is a reasonable guess, although it would be hard to devise an empirical test, that the quantitatively most valuable favors received by COEs have been provision of monopoly or quasi-monopoly positions (often through the granting of import licenses only to COEs or the prohibition of imports of import-competing goods) and the extension of domestic credit at highly implicitly subsidized terms. A third form of cronyism—favoritism in awarding government contracts—is no doubt also important and may in some instances have been quantitatively as significant as the first two forms mentioned above.

Cronyism and Its Effects

Until the Asian crisis, it was widely recognized that SOEs were harmful and negatively affected economic growth prospects in most developing countries. In what follows, I shall argue that SOEs are almost exactly the same in their effects as cronyism and for much the same reasons: in both instances, the enterprises owe their existence not to their performance in a competitive market but to the nonmarket criteria by which they were established and are run. There are, of course, differences: the costs of SOEs are probably more transparent as they are normally financed out of the budget, whereas the costs of cronyism are more hidden in that profits are not necessarily publicly recorded and the value of privileged positions (monopolies, protective tariffs against imports of competing goods, favored access to subsidized credit, etc.) can be difficult to gauge; there may be a slight presumption that cronies are on average somewhat more competent as managers and somewhat more motivated to achieve profits and reduce costs. But, as I shall argue below, these are only mild presumptions, and there is undoubtedly a large random component in the performance of SOEs and of COEs.

Since there is much more analysis of SOE records than of COEs, in significant part because of the greater transparency noted above, it is useful to start by reviewing the ways in which SOEs are understood to be harmful to growth. It is then relatively straightforward to consider how COEs are similar to SOEs.

In some countries, governments have established state-owned enterprises in many lines of activity usually reserved to the private sector in developed countries. SOEs have operated tourist hotels, produced textiles, apparel, and footwear, run steel mills, and been in virtually every line of manufacturing, and most business service, activities. It is widely recognized that SOEs have been loss-making in many countries and have become major fiscal drains. In Turkey,

for example, SOE deficits had reached 5.8 percent of GDP by 1980, the year in which economic reform began.[2] Governments that invested heavily in SOEs also attempted to control the private sector by means such as requiring investment licenses, capacity licenses,[3] and/or permits for transporting goods, requiring private sector firms to train, provide housing and other goods and services for their workers, and by imposing price controls. These controls naturally resulted in low rates of return on investment for the private sector unless firms held monopoly positions, often sheltered by import restrictions or prohibitions. Then, private rates of return on capital reflected monopoly positions, not economic rates of return. Since much control over firms was exercised by the authorities, it is reasonable to regard these highly regulated and controlled firms as state-owned enterprises.

In the East Asian countries, however, private firms were generally free to seek profits, and the real rate of return to private capital seems to have (at least until the 1990s—see below) reflected an economic return on capital. Cronyism operated through other mechanisms. In some instances, cronyism resulted from the government's favoring large firms precisely because they were perceived to deliver economic growth. Over time, however, these firms, or more accurately their owners, grew sufficiently powerful that they held considerable influence with top government officials. In many instances, the mechanism for favoring those who were, or became, cronies was the issuance of bank credit.

When rapid economic growth began after policy reforms in the East Asian countries, most had highly underdeveloped banking systems and rapid rates of inflation. Ceilings were imposed on the

2. Organization for Economic Cooperation and Development, *OECD Economic Surveys: Turkey* (Washington, D.C.: OECD Publications and Information Center, 1991), p. 60.

3. Ridiculously enough, capacity licenses generally stipulate the maximum amount it is permissible to produce.

interest rates that banks might charge for lending (or pay to depositors), usually below inflation rates. Those who received loans from the banks at these controlled rates thus received implicit subsidies from the government. In these countries, various mechanisms were used by governments for directing credit. But regardless of how it was done, the favored borrowers profited significantly.

I postpone until the final section an interpretation of how cronyism evolved over time and contributed to the East Asian crisis. I first want to consider the mechanisms through which cronyism might work in terms of a simple analytical framework.

Assume that the only factor of production is capital and that growth occurs via the real rate of return on capital and the extent of capital formation (new investment).[4] In this model, given the pool of investible funds, the real rate of return on capital determines the total increment in output:

$$DY = R\ DK = R\ I = RS$$

I start by taking S, or savings, as the increase in the capital stock and hence investment, I, as given.[5] Except when explicitly stated

4. To make the model more realistic, one could add labor as a factor of production. If the population were growing, the real rate of return on capital would be driven by the change in the capital-labor ratio as well as by the degree of imperfection in the allocation of new investment. The complication would add little to the basic analysis presented below, although a declining real rate of return on capital could reflect a rising capital output ratio as well as the sorts of phenomena discussed here. This qualification is important for interpreting the East Asian experience and is addressed somewhat later in the section on cronyism in East Asia.

Also for simplicity, I assume that capital does not depreciate. Amendments to the model to account for depreciation would not change the results substantively, and the existence of depreciation can readily be taken into account in applications, as can be seen in the section on cronyism in East Asia.

5. In reality, there were sizable capital inflows in most of the East Asian economies that augmented domestic savings. When these flows were in forms that went through the banking system and were monetized, they accentuated the problems discussed below. When, instead, they were direct investments (offset by imports of machinery and equipment), their effect would have been just the same as an increase

otherwise, it will be assumed that the total level of investment equals domestic savings and is exogenous. I focus on *R*, the real rate of return on capital. The aggregate real rate of return is itself a weighted average of the rates of return on individual investments times the share of those investments in total investments:

$$R = \text{sum}\,(RI \times FI),$$

where *RI* is the real rate of return to capital in economic activity *I* and *FI* is the fraction of investment directed toward activity *I*.

In a perfectly competitive textbook economy, of course, the rate of return on each investment is equal and an efficient allocation of resources—in this case investment—results. Over time, the real rate of return on investment might fall if the capital-labor ratio rose and there were diminishing returns to capital. But diminishing returns to capital are less likely to occur at any significant speed in small open economies, where world demand for their tradable goods is highly elastic,[6] than they would be in a closed economy, where the price of the outputs of labor-intensive goods would start declining as output expanded.

Now consider a two-sector economy in which investments are made. One sector is public: it includes SOEs and highly regulated, privately owned firms (presumably in import-substitution activities).[7] The other is an economically efficient private sector (producing exportables, unprotected import-competing goods, and home goods in competitive activities that respond to appropriate relative

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in total savings and an equal increase in private-sector investment. For that reason, little is gained by explicitly considering capital flows in the model.

6. For a model demonstrating this high elasticity, see Jaume Ventura, "Growth and Interdependence," *Quarterly Journal of Economics* 107, no. 1 (February 1997): 57–84.

7. In the real world, these activities often include banking services, insurance, and other finance, as foreign firms are often ineligible to participate. In some instances, these activities are run by SOEs.

prices of inputs and outputs (i.e., world prices for outputs and market-determined factor prices that reasonably reflect opportunity cost). Then assume an allocation mechanism for investment between the efficient private sector, with a rate of return of *RP* across investments, and state-owned enterprises, with a rate of return *RS*. By construction, *RS* is less than *RP* and may be negative. Then the rate of return on total investment will be

$$R = FP \times RP + (1 - FP) \times RS,$$

where *R* is the economywide rate of return on investment and *FP* is the fraction of investment going to the public sector.

The growth rate for the economy will be

$$GY = R \times I/K = R \times S/K,$$

where *S* is the economy's aggregate savings and equals the economy's aggregate investment, *I*.

Clearly, the rate of growth will be lower than attainable, and it will be lower by more, the greater the fraction of investment allocated to the state-owned enterprises and the larger the differential between the private and the public sector's rate of return. In many developing countries, state-owned enterprises—not even counting highly regulated private firms—accounted for as much as 50 percent of all savings and rates of return were zero or lower, while rates of return on private economic activity were arguably on the order of 10 percent or higher. The economywide rate of return in those cases would have been about 5 percent, whereas the attainable rate would have been 10 percent (had there been little or no diminishing returns to private investment).[8] If the savings rate was 20 percent, lost

8. Reality is more complicated in several ways. Important among them is the consideration that some public investment is directed toward infrastructure. That part is almost certainly complementary to private sector investment. For purposes of the model used here, such infrastructure investment can be regarded as part of private investment.

real growth of GDP would be 1 percent per annum on these numbers. In more extreme cases of SOE losses at a rate of 5 percent of capital, a 25 percent savings rate, and a 15 percent rate of return on private investment with half of all investment allocated to SOEs, the growth forgone equals the difference between the 3.75 percent increment of GDP that would occur if all savings were allocated to private investment and the 1.25 percent growth that would actually take place—a 2.5 percentage point reduction in the rate of growth of GDP.[9]

This model can be complicated in a number of ways: The domestic savings rate could be an increasing function of the overall return on investment, in which case the savings rate would increase as the fraction of investment going to the private sector increased.[10] In the extreme case given above, if the domestic savings rate fell from 30 percent when the real rate of return was 15 percent to 20 percent when the real rate of return averaged 5 percent, the resulting drop in the growth rate from capital accumulation would be from an attainable 4.5 percent to 1.0 percent, with half of investment allocated to the SOEs.

One could also make savings a function of disposable income and model the government budgetary process as one in which taxes

9. These illustrative estimates are based on recorded orders of magnitude; if one followed the model, one would first estimate the fraction of private enterprise that was heavily regulated and controlled and combine that investment with that of SOEs and return on capital to attain a more accurate number. It will be seen below that the estimated rates of return in Korea are considerably higher than even these numbers suggest for the private sector during the years of rapid growth.

10. In Korea, the savings rate rose steadily after 1960 as the rate of growth of income and the real return to savers rose. It is possible, of course, that the substitution effect toward more savings could be outweighed by the income effect and that savings might fall. For present purposes, however, that does not seem relevant in light of the East Asian experience and the dramatic increases in savings rates that took place (whether because of high marginal propensities to save out of higher incomes or because of a strong response to high real returns).

were increased to cover SOE losses or the take of cronies, to anticipate an argument below.

One could also model a country in which politicians took as a goal that a specified target percentage of output should originate in public sector enterprises, in which case alpha *s* would be rising over time as the return on private investment threatened to increase the relative size of the private sector; with the declining share of investment in the private sector, the growth rate could drop even further. The state enterprises might experience a declining rate of return on investment over time, as politicians saddled enterprises with excess staff, poor location, and other costs. As the rate of return turned negative, growth would decelerate. If one combined the declining rate of return on investment with the share of output target, the overall rate of growth could decline over time and, if the real rate of return on public sector enterprise investments turned negative, could indeed become negative.[11]

Since population growth rates are positive in developing countries and high in many, labor force growth is also a source of real GDP growth. For countries with rapidly growing populations, however, the difference of 2 or 3 percentage points of real GDP growth per annum can be the difference between rising real per capita incomes and standards of living and falling ones.

An interesting issue—connected with cronyism—arises with regard to the granting of monopoly positions; in many countries, SOEs were established to produce import-competing goods; once the SOE was in production, imports were no longer permitted, and the SOE had a monopoly of that particular good. The economic rate of return to such an activity was negative to the extent that resources

11. Losses in SOEs and their continued importance in investment are certainly part of the story of poor economic performance in many countries of sub-Saharan Africa. It is estimated that, in India, the SOEs accounted for about 80 percent of all manufacturing investment and about 25 percent of output. See Pranab Bardhan, *The Political Economy of Development in India* (Oxford: Basil Blackwell, 1984), p. 102.

that could have earned a higher return in other activities were diverted to the SOE; with monopoly rents, however, some SOEs were financially profitable. For purposes of analyzing cronyism, the granting of monopoly positions can be regarded as a form of taxation (of consumers or private producers, depending on whether the SOE produces final consumer goods or intermediate goods) with a commensurate rise in the savings rate to cover the economic losses associated with the enterprise. In the national income accounts, of course, monopoly profits accruing to state-owned enterprises are treated no differently than other profits, and the opportunity costs of resources allocated to high-cost, import-competing industries are not reflected.

Before considering cronyism directly, it is useful to consider one possible variant of the SOE model. That is, suppose that, instead of investing in SOEs at negative real rates of return, the government were to use resources to provide for palaces, airplanes, luxury automobiles, and other luxuries for the ruling group, or elite. Suppose that a fraction of savings, equal to that allocated to SOE investments in the situation outlined above, was diverted to these purposes through taxation or through deficit financing (including possibly even borrowing from abroad).

To analyze the effects on growth, there must be two additional specifications. The first question is whether the palaces, airplanes, and luxury automobiles are maintained at public expense. The second is how these expenditures are recorded in the national accounts. Consider first the case where the airplanes, palaces, and other consumption items are maintained at private expense once diverted to the ownership of the elite and where these expenditures are recorded in the national income accounts as investments. In that circumstance, the rate of return on these expenditures is zero, and the case is precisely the same as that modeled above, with the specification that the return on investment is zero. If, instead, these expenditures are recorded as consumption, the domestic savings

rate falls commensurately, but the impact on growth is identical. Of course, if the resources to finance the consumption expenditures (or the SOE investments) are raised in ways that reduce the domestic savings rate, the negative impact on growth is even greater.

If the palaces, airplanes, and other luxury items are maintained at public expense, however, the ensuing maintenance costs are equivalent to losses incurred by SOEs.[12] If maintenance costs are a constant fraction of the stock of these consumption goods, and the stock of such items increases more rapidly than output over time, the overall rate of economic growth will decline unless the capital stock rises at an increasing rate.

With this simple framework we can now address the basic issues that arise with cronyism. Perhaps the basic question is what cronyism is. It might be the exemption from taxes or the direct allocation of consumption goods to a favored individual or group. In that case, the effects of cronyism on resource allocation and growth are no different from the effects of any other tax to finance government consumption or subsidy to some private economic activities. The effects of cronyism would be little different from the effects of such activities as a subsidy to the consumption of fertilizer or food grains.

However, suppose instead that the cronyism consists of extending to some individuals or groups favored status with respect to entry into economic activity. It is this form of cronyism that has been the focus of concern in East Asia. In countries pursuing import-substitution policies, this favoritism was exercised through the granting of import licenses for capital or intermediate-goods imports to these favored groups. Since foreign exchange was overpriced, it was rationed; since imports of most import-competing

12. For simplicity, I ignore the accounting and other questions surrounding depreciation and assume that investment and consumption items are infinitely lived.

goods were highly restricted, there was a monopoly profit conferred with the granting of these licenses. Cronyism could therefore take place through the trade regime and the import licensing that accompanied it. Activities that were privately profitable (because of monopoly positions) were socially unprofitable.

For countries pursuing outer-oriented trade strategies, however, favors could not be conveyed through privileges associated with the import regime. An alternative mechanism was to create a climate in which real rates of return on investment were high, and in which financing was available to favored parties at below-market rates of interest (i.e., through extension of domestic credit to favored activities or individuals and groups).

The Role of Domestic Credit in Cronyism

Since in most developing countries inflation rates were relatively high, ceilings on interest rates had the effect of provision of a sizable subsidy element, especially in the context of high real rates of return on investments. In the absence of well-functioning capital markets, a significant portion of new investment was financed by domestic credit creation. With excess demand, governments could direct domestic credit, and therefore resources, toward favored borrowers.

To provide an indication of the relative size and importance of these uses of domestic credit, table 1.1 gives some data for Korea during its period of high growth in the late 1960s. As can be seen, domestic credit was similar in magnitude to gross domestic capital formation, although domestic credit grew more slowly as profits of private sector companies increased. Lending rates of deposit-money banks were around 14 percent in the late 1960s and fell into the single digits by the early 1970s. By contrast, the curb lending rate (the informal market in which most Korean firms borrowed

TABLE 1.1
Korean Investment Relative to Domestic Credit, and Interest Rates, 1968 to 1972

	1968	*1969*	*1970*	*1971*	*1972*
Gross domestic capital formation (billion won)	414	556	627	726	831
Domestic credit	469	751	962	1,240	1,600
Credit to private sector	432	706	919	1,201	1,463
Lending rate of deposit-money banks (%)	13.4	13.9	8.4	7.8	3.7
Curb loan rate (%)	47.9	44.5	40.6	37.8	25.0
Producer price increase (%)	n.a.	6.8	9.6	8.0	14.2
Implicit subsidy on private domestic credit (billion won)	149.0	216.0	295.9	360.3	311.6
GDP	1,630	2,130	2,724	3,379	4,170
Percentage subsidy to private borrowers (% of GDP)	9.1	10.1	10.8	10.7	7.5

SOURCES: Data on gross domestic capital formation, GDP, domestic credit, and producer prices: International Monetary Fund, *International Financial Statistics*, yearbook (Washington, D.C., International Monetary Fund, 1998), Korea country pages. Interest rates: Wontack Hong, "Export Promotion and Employment Growth in South Korea," in Anne O. Krueger, Hal B. Lary, Terry Monson, and Narongchai Akrasanee, eds., *Trade and Employment in Developing Countries*, vol. 1, *Individual Studies* (Chicago: University of Chicago Press, 1981), p. 370 (table 8.14).

beyond the amounts for which they had been eligible through the deposit-money banks) was nearly 50 percent in 1968 and had fallen to only 25 percent by 1972, as the domestic rate of inflation of prices of producer goods rose. If one takes the subsidy element in the provision of domestic credit to the private sector as equal to the differential between the curb rate and the deposit-money bank lending rate, subsidies were equal to between 7.5 and 10.8 percent of GDP over the period 1968 to 1972. Quite clearly, these were quantitatively highly important, especially since a high fraction of

domestic credit was allocated to the export-oriented domestic manufacturing industry, which itself constituted at that time a relatively small percentage of GDP.

But, for present purposes, the important fact is that domestic credit was allocated in accordance with government instructions, and the subsidy element was huge. Insofar as recipients could earn high real rates of return on investments, they profited enormously. Wontack Hong has estimated that, in the late 1960s, the real rate of return on investment in manufacturing was about 37 percent.[13] If such rates of return were available only to those with access to domestic credit, the opportunity for profitable cronyism was enormous. The next section of this chapter attempts to explain how cronyism and its potential for misallocation could coexist with such a high realized real rate of return.

For present purposes, the point is that cronies can be favored through the granting of domestic credit when that credit is allocated at rates significantly below market. If cronies then use the proceeds to undertake investments that have the highest possible rates of return, the net effect of credit allocation is simply to transfer income to them; growth is unaffected. If, however, some (all?) cronies invest in projects that have lower-than-attainable rates of return (either because government officials attempt to pick the winners or because cronies are less competent entrepreneurs than those who would emerge through market processes), the analysis can be undertaken in precisely the same manner as that for the growth effects of low rate-of-return SOEs: Taking the average rate of return across crony investments times the fraction of investment undertaken by cronies and adding that to the rate of return realized among effi-

13. Wontack Hong, "Export Promotion and Employment Growth in South Korea," in Anne O. Krueger, Hal B. Lary, Terry Monson, and Narongchai Akrasanee, eds., *Trade and Employment in Developing Countries*, vol. 1, *Individual Studies* (Chicago: University of Chicago Press, 1981).

ciently allocated investments times the fraction so allocated will give a growth rate less than that if all investment were channeled through the latter source.

If, however, cronies take some fraction of loan proceeds for their personal consumption expenditures or their Swiss bank accounts, the analysis can again be amended. In particular, to the extent that cronies divert their lines of credit from investment to consumption, the net effect on growth can be treated as equivalent to investments with a zero rate of return or, alternatively, a fraction of investable funds that are diverted to consumption. If investments in SOEs yield a positive real rate of return while cronies simply divert the domestic credit extended to them to their private uses, SOE investments may prove superior to extension of domestic credit to cronies.

A final case needs to be considered. Assume that cronies have invested in loss-making enterprises but that, for whatever reasons, the authorities direct the banks to maintain evergreen accounts for the cronies. Under this arrangement, interest on the outstanding volume of bank credit is treated as paid and new loans to the cronies are extended in the amount of the interest; nonperforming loans do not show up on the books at all. If the banks do not extend any additional credit, cronies cannot invest, as there are no profits and their incremental domestic credit simply serves to maintain their liquidity.

In those circumstances, funds that otherwise might be directed toward new investment are instead allocated to offset the losses of cronies' firms. In the real world, how such evergreen accounts affect economic activity depends on the accounting undertaken. If firms record their losses and treat interest as paid with an offsetting loss to the company and accumulated debt, the negative returns to cronies will constitute a net subtraction from GDP. If, however, firms fail to record their losses and treat the proceeds of loans as financing new investments, saving and investment will be seen to rise as a

percentage of GDP, which in turn will overstate true output by the amount of the losses not appropriately recorded.

Cronyism in East Asia

For the sake of concreteness, I focus the discussion on Korea, although many of the attributes of the Korean economy during its rapid development phase were shared by Taiwan, Hong Kong, and Singapore at similar early stages of development. Moreover, rapid growth began only after major policy reforms had been undertaken.

It is often forgotten that, as of 1960, South Korea had the highest density of population in agriculture of any country in the world, with 70 percent of its population in agriculture; its savings rate was close to zero (with about 10 percent of GDP as investment financed by foreign aid); its per capita income was the third lowest in Asia; its rate of inflation in the mid 1950s had been the highest in the world; it had a multiple exchange-rate regime and a highly restrictive import licensing system with an acute foreign exchange shortage. There were SOEs established in many lines of economic activity, with the usual governmental efforts to control private economic activity.

The list of the woes of the South Korean economy at that time would fill several pages, even at this level of generality. But for present purposes, one other statistic is key to my interpretation of what happened: exports in 1960 constituted about 3 percent of GDP (88 percent of them originating in primary activities), while imports were about 13 percent. This must have meant that the economic return to allocating additional resources to exportables was high, while that to additional resources in import substitution was low or negative. This was borne out by a low real rate of growth of GDP: it had averaged less than 5 percent (with a rate of growth of population of almost 3 percent) from the end of the Korean War to 1960,

when the real return should have been high with opportunities for postwar reconstruction.

Between 1960 and 1963, economic policy changed radically. The country's leaders recognized that Korea would not be able to grow without earning more foreign exchange and that foreign aid would not provide a growing source of foreign exchange. Economic incentives were almost reversed. The exchange rate was moved to more realistic levels.[14] Quantitative restrictions on imports were greatly reduced in general and were eliminated for exporters' imports of raw materials, intermediate goods, and capital equipment. Tax policy was reformed and government expenditures rationalized so that the government budget deficit was virtually eliminated. Restrictive labor legislation was removed, with a subsequent increase in real wages at an average annual rate of 8 percent per year between 1964 and 1992 (and an immediate drop in the recorded unemployment rate from around 25 percent in 1960 to around 4 pecent by 1964).

Emphasis switched to achieving economic growth through exporting. Although government officials did not discriminate (at least in the 1960s) between activities (in the sense of favoring exports of one good or service over another—all foreign exchange–earning activities were accorded equal treatment), it can almost be said that they held an export theory of value. Exporters were given priority access to credit (which was, as already indicated, highly subsidized); ports, telecommunications, transport, and other infrastructure supportive of producers were expanded and improved. When an exporter had difficulties with any aspect of filling an order, he had almost immediate access to the president.

There are a large number of interesting aspects to the story. But

14. The real won return to exporters per dollar of foreign exchange was about the same between 1960 and 1970. This was achieved both by occasional exchange rate adjustments until 1964 and then a floating exchange rate and by announcing uniform across-the-board export subsidies and other incentives to exporters that accrued to them automatically.

for my purposes, the important points are these. First, as of 1960, there were enormous opportunities for highly profitable investments in exporting activities, given the distortions in the economy that had earlier discouraged them and the incentives that were then provided. Since it was doubtless economical for almost all new investment to be induced into these newly profitable activities, a credit-rationing regime that directed all credit to finance expansion of capacity for these activities was unlikely to result in serious misallocation of new credit. Moreover, in the early years, there were so many profitable opportunities for export activity that it probably made little difference which ones were in fact chosen. And the skill of the entrepreneurs undertaking them was probably also of second-order importance.

Hence, in the early years of the Korean period of rapid growth under an export-led growth strategy, it seems likely that credit could be and was rationed in ways that were not very different than would have occurred under an efficient market outcome. The resulting rate of growth of exports—a 40 percent per year average annual increase in export earnings from the decade starting in 1963—and the increase in the share of tradables, both exports and imports, in GDP from 3 and 13 percent to 30 percent and more by the 1980s attests to that.

A note about the real rate of return to capital in South Korea, both economy-wide and for manufacturing, is in order here. The economy-wide real rate of return on capital was roughly 60 percent in 1970, falling to about 20 percent by 1980, and remaining at that level until around 1990. The rate of return in manufacturing was lower in the 1970s[15] than the economy-wide rate of return, but by

15. This may reflect estimation error, or it may reflect the huge rural-to-urban migration in the 1970s as farmworkers (with low real wages) migrated to cities and were absorbed in activities with much higher real products. High overall growth, especially in the 1970s, may have been attributable both to the reallocation of labor (with significant increases in the real product of labor) as well as to capital formation.

the late 1970s, the two real rates were similar.[16] Moreover, these rates were falling in the 1990s. By that time, there had been some liberalization of the banking system (with higher nominal and real interest rates) but domestic credit still financed a great deal of capital formation.

Now consider the role of domestic credit. Whereas implicit subsidies to producers were large relative to GDP and investment in the 1960s, they were financing investments with high rates of return. Naturally, in a poor country, the extent of equity of the newly exporting firms was quite low and domestic credit financed a high fraction of expansion. But real rates of return were high, and the allocation of domestic credit caused few problems.

Over time, however, the subsidy element in granting domestic credit decreased as the liberalization of the financial system began. Estimates of this are given in table 1.2, on the assumption that an equilibrium real rate of interest in the financial market would have been 10 percent. As can be seen by comparing those figures to the ones in table 1.1, the subsidy element of domestic credit fell drastically on these assumptions. Moreover, domestic credit expansion as a percentage of GDP—while still too large to be sustainable at a virtually fixed nominal exchange rate—also declined.[17]

At the same time, the firms that had been so favored in the 1960s had become large relative to the Korean economy, and own-

16. In the mid 1970s, a heavy and chemical industry (HCI) drive was begun that targeted specific heavy industries for development. This was the only period during Korea's rapid growth where the government actually attempted to pick the winners and identify individual economic activities. The drop in the rate of return to capital in manufacturing in the late 1970s and early 1980s is probably a reflection of the poor results of the HCI drive; by early 1979, it was already being revamped and was recognized as having put great strains on the economy and jeopardized growth.

17. As long as Asian governments maintained fixed nominal exchange rates, expansion of domestic credit was virtually equivalent to increases in the contingent liabilities of governments. As such, one could regard the unsustainable component of domestic credit expansion as equivalent to financing additional investment through a fiscal deficit.

TABLE 1.2
Korean Investment Relative to Domestic Credit, and Interest Rates, 1990 to 1996

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Gross domestic capital formation (trillion won)	179	215	241	267	305	351	390
Domestic credit	102	125	139	157	186	214	254
Credit to private sector	102	122	136	154	185	213	256
Lending rate of deposit-money banks (%)	10.0	10.0	10.0	8.6	8.5	9.0	8.8
Curb loan rate (%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Producer price increase (%)	4.1	4.7	2.1	1.4	2.7	4.7	2.6
Implicit subsidy on private domestic credit (trillion won)	6	6	3	10	36	10	10
GDP	179	216	240	267	305	351	389
Percentage subsidy to private borrowers (% of GDP)	3.3	2.8	1.2	3.7	11.8	2.8	2.6
Increase in domestic credit as a % of GDP	—	10.6	5.8	5.7	10.1	8.0	11.0

SOURCES: Data on gross domestic capital formation, GDP, domestic credit, lending rate, and producer prices: International Monetary Fund, *International Financial Statistics*, Yearbook, 1998, Korea country pages. Implicit subsidy: calculated as per text.

ers of those firms were important sources of financing for political leaders. In addition, their enterprises accounted for a sizable share of GDP and employment; their favored access to credit had enabled them to expand, and credit rationing skewed toward these firms had apparently constituted a significant barrier to entry or to expansion of small firms.

Because of these factors, and probably also for other reasons, cronyism persisted in the form of favoritism toward the large firms. And, whereas it had been apparently justified by the high real returns earned in the 1960s and early 1970s, there was less justification as the Korean economy matured. Whether the real rate of return fell because of an increased capital-labor ratio and diminishing

returns to capital, because of the inability of *chaebol* owners to manage firms in ways appropriate to achieving high returns in the 1990s, or because the chaebol owners diverted domestic credit from their enterprises to maintain or increase consumption expenditures and investment figures are overstated (as the increase in nonperforming loans might suggest) are questions that it is not possible to answer.

Moreover, insofar as there were other economic activities deserving of credit and able to earn higher real rates of return than did the favored firms, the economic effects of the directed credit were the same regardless of which explanation is correct; favoring the chaebol in Korea (and cronies with inappropriate investment schemes or high consumption levels in other East Asian countries) resulted in a slowing growth rate. As the apparent[18] real rate of return to capital fell while the real rate of interest paid on banking lending rose, the degree of subsidy clearly dropped as a percentage of GDP (see table 1.2), and, since the chaebol were larger as a fraction of the Korean economy, the percentage of implicit subsidy fell even further.

Conclusions

There are interesting parallels between SOEs and crony capitalism. With SOEs, low real rates of return and losses are generated for a variety of political reasons: the desire of those in power to

18. I use the word *apparent* because, in some instances, domestic credit was granted to individuals who used the proceeds in two ways that were not investment. In some instances, there are newspaper reports of lending to finance consumption expenditures of cronies; to the extent that these expenditures were recorded as investment, it is not that the real rate of return fell, it is that the rate of investment was overstated. In other instances, domestic credit was extended to firms that were probably making economic losses but concealing the fact by overstating new investments. What appears to be a declining real return may in fact be in part an overstatement of investment.

expand employment despite the absence of productive opportunities; the mislocation of enterprises in favored regions regardless of increased costs; the appointment of managers whose competencies lie in the political rather than the economic arena; the inability to close down uneconomic enterprises; and the soft budget constraint.

In the case of crony capitalism, owners of companies receive credit and may expand because their size is a political asset (too big to fail). They may mislocate in the country's capital to be close to those they wish to influence regardless of cost; since the owners receive subsidized credit regardless of the prospective real returns, cronies can persist in business even when their activities are no longer economic; and since they receive subsidized credit, they in effect have soft budget constraints.

There is another similarity as well: in the case of SOEs, their losses are normally covered by transfers out of central government budgets and increase fiscal deficits. In the cases of cronyism, domestic credit expansion is financed by a capital inflow; the capital inflow is attractive to foreigners because of the government's commitment to maintain an exchange rate. As such, the increase in contingent liabilities of the banking system is parallel in crony capitalism to the fiscal deficit in the case of SOEs.

There is no question that the flaws in the financial system (and the overhang of nonperforming loans) must be addressed before rapid sustainable growth can be resumed. Moreover, especially as international capital markets have learned about emerging markets, there seems less and less choice of exchange rate regimes; only floating exchange rates and possibly currency board systems appear viable. In the future, it will be much more difficult for economies to attract capital inflows through fixing the nominal exchange rate and expanding domestic credit.

But nothing about these lessons implies that the economic growth of the 1960s and early 1970s was not spectacular; it was. Opportunities for high real rates of social and private return were

unleashed and were seized with consequent rapid growth. That the financial system was underdeveloped and the criteria for lending were flawed undoubtedly led to some misallocation of loanable funds, although bankers can make mistakes, too. But as the huge opportunities for profit that had arisen because of the alignment of incentives with real payoffs were seized, the economy developed and the scope for misallocation of investible funds increased.

As the real rate of return on capital fell for whatever reason, and the implicit subsidy in domestic credit also dropped, the flaws in the financial system and the commitment to cronies or chaebol became increasingly costly, just as SOE losses mount over time. Whether the problem is crony capitalism or SOEs, it seems evident that long-run satisfactory economic performance can be resumed only when means are found to allocate resources to best uses with arm's-length transactions.