Political Economy of Financial Systems

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Korean and Indian Experiences in Retrospect

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TABLE OF CONTENTS

PREAMBLE

An enormous infusion of liquidity during the COVID-19 pandemic and its subsequent withdrawal by Central Banks through sharply raising interest rates has led to the bubble and then collapse of mid-sized banks in the U.S. such as Silicon Valley Bank, First Republic Bank and Signature Bank. Such financial upheaval has once again brought the question of systemic fragility to the centre of highly charged policy debates. Increasingly, scholars view that the lingering questions related to the financial system's efficiency with reasonable stability cannot be resolved through a narrow prism of finance alone, rather doubts about this issue must be understood in its wider operating environment largely shaped by political economic determinants.

The financial systems indeed have the mandate to maintain an arm's length distance from the economy and operate precisely to benefit the stakeholders in the financial industry. However, their long-term aim is not only limited to benefiting stakeholders but the mandate is also to improve the performance of the entire economy by optimally allocating resources. Hence, any serious discussion about the efficiency of any financial system should have given adequate consideration to the operating environment shaped by political economic structures, such as state, business, finance, industry, bureaucracy and international context. A profound understanding of mutually reinforcing embeddedness between finance and its political economic context widens the scope and deepens our understanding to resolve the question of efficiency in a financial system.

Reflecting this trend, there are instances when similar financial systems demonstrate dissimilar performance. A compelling case to validate diverging efficiency patterns in a similar financial system belongs to twin Asian countries, Korea and India. The two prominent countries experimented with the similar category 'credit-based, price-administered' financial system yet both countries experienced sharply varying performance records. The categorization of Korea and India into one type of financial system is based on the classification proposed by John Zysman (1984).

India and Korea experimented with a state-controlled repressive financial logic, which according to Zysman, can be categorized as a 'credit-based, price-administered' system. This financial system operated under politically motivated administered prices. Having experimented with one type of financial system, Korea joined ranks with 'developed Asia' while India remained part of 'underdeveloped Asia'. The highly uneven developmental outcome has a lot to do with the question of the financial system's efficiency, which reminds ideas of James Jobin (1984), who has linked the efficiency of finance to functional factors such as a nation's economic growth. Tobin's proposition helps us to see how an alarming developmental contrast between India and Korea is clearly linked to their respective financial systems operating in different political economic realities.

This book examines how the political economic regulatory environment in Korea and India impacts the functioning of their largely similar financial systems based on price-administered credit regimes. A detailed comparative analysis of Korea's political economic dynamics of finance reveals that a market-conforming political economy positively impacted the functioning of its highly repressed financial system. On the other hand, the market-distorting political economy of India demonstrated how the efficiency of its financial system was adversely impacted by politically motivated government interventions. The findings from the detailed analysis of twin Asian case studies confirm the salience of political economy in explaining the performance of financial systems. It very well demonstrates how the mandate of a financial system is not limited to serving the interests of financial stakeholders and intermediaries alone but, its contribution should strengthen the country's overall economic performance.

A nuanced understanding of the political economy of finance presented in this book comes out of my doctoral dissertation, titled "The Political Economy of Financial Regulations: Korean and Indian Experiences in the Comparative Perspective," submitted under the supervision of Professor Yoon Young-Kwan in the International Relations Department of Korea's Seoul National University. I would like to express my sincere appreciation for his in-depth understanding of the issue. Additionally, I acknowledge the Academy of Korean Studies to support this research under the Seed Program for Korean Studies of the Ministry of Education, Republic of Korea and the Korean Studies Promotion Service (AKS-2022-INC-2230011).

Though plenty of time has passed since the submission of the dissertation however in recent times the findings of the thesis have acquired renewed relevance. The unfolding reality marked by recurring financial crises due to hurriedly implemented ideas of financial liberalization, as suggested by the MacKinnon-Shaw model, does not reveal the full story. In the face of the growing resentment towards unfettered financial liberalization, scholars see merit in reviewing earlier-era cases of financial repression. A general perception that financial liberalization leads to optimal allocation of resources in the economy may not be true in all cases.

There are ample instances when financial liberalization did produce devastating crises. From Latin America to East Asia, even not sparing the United States, the unfettered march towards liberal finance has experienced upheavals along the way. A surprising correlation between liberal finance and recurring financial crises around the world has prompted scholars to re-look at whether repressed financial systems with market-conforming political economies perform better than liberal financial systems under market-distorting political economies. To resolve this puzzle, looking in retrospect to a period when financial repression under a market-conforming political-economic order, as in the case of Korea, and financial repression under a market-distorting political economy, as in the case of India, may be of some help.

In broader terms, this study highlights the importance of political economy in understanding the role of finance in promoting economic growth. The analysis confirms that the operating environment of finance governed by a nation's political economy is key to determining the overall efficiency of a financial system. Any de-linkage between finance and its operating environment blurs our understanding of finance. Thus, the functioning of a financial system has to be seen in the light of its political economic context, which has the potential to change the efficiency of financial policies and, in turn, the overall performance of the economy.

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JNU, New Delhi
05 November 2024

CHAPTER 1

INTRODUCTION: BEYOND FINANCIAL REPRESSION AND LIBERALIZATION

1.1 General Background

The widespread move towards the deregulation and liberalization of financial systems worldwide met with unprecedented turmoil leading to serious debate about the system's fragility, efficiency, and sustainability.[1] In the 1980s, Latin America's neo-liberal financial experiments resulted in the famed 'lost decade'; in the mid-1990s, Mexican reform efforts brought devastating financial turbulence; in the late-1990s, hurried financial liberalization in East Asia caused a region-wide financial meltdown and Russian financial deregulation culminated in 'mafia capitalism'. In the early-2000s, liberalization in Turkey and Argentina witnessed a severe financial crisis, and in the late 2000s, financial markets in the developed world faced a massive downturn leading to the system's near collapse. Again, in the early 2020s, the collapse of US mid-sized banks such as Silicon Valley Bank (SVB), the First Republic Bank, and Signature Bank once again reminded the fragility of the financial system. The long list of financial upheavals is not yet complete as newer countries such as Sri Lanka and Pakistan are already under the IMF support system. These recurring financial crises have stimulated intense debate in academic and policy circles about achieving an optimal balance between the system's efficiency and its long-term stability.

The causes behind these crippling financial upheavals find their origin in the concerted move by many economies to supplement or replace 'financial repression' with 'financial liberalization'. In the 1950s and 1960s, the rationale behind the prominence of financial repression[2] in the newly independent countries of Asia and Africa was that their financial systems were largely dominated by foreign-owned banks with high concentration of branch networks in major metropolitan areas. Such banks specialized primarily in short-term lending and the bulk of it went to foreign-owned firms. In this context, the governments of developing nations decided that sweeping changes in financial practices were necessary to reorient the inherited system to act as a tool for development policy. Following this newfound understanding, a strong wave of bank nationalization gathered momentum in developing economies, including the Republic of India (hereafter India) and South Korea (hereafter Korea or the Republic of Korea).[3] Specialized industrial and agriculture banks were set up under public control, financial institutions were directed to lend to the selected industries under preferential terms, and interest rates were usually held below inflation rates. Soon after that, bank-based systems became the new mantra for financial intermediation. From Germany to Japan, including India and Korea, many aspects of bank-based finance have been incorporated with detailed suppressive instruments to reduce the cost of capital.

Contrary to this general trend towards financial repression, in the early 1970s, theoretical treatment of the relationship between financial systems and economic development started to dominate the literature on financial liberalization originating from the neo-liberal financial paradigm proposed by the McKinnon-Shaw model (1973).[4] According to this model, financial 'deepening' or development is an essential ingredient of capital accumulation as reflected in savings, investment, and productivity ratios. Financial deepening in turn contributes to the efficiency of a financial system and subsequently enhances economic growth.[5] The model argues that financial deepening is best facilitated by a competitive financial system in which interest rates are market-determined and there is an absence or at least insignificance of administratively driven priority credit allocation. This system has been categorized as a market-based system, aptly represented by the financial systems of the United States and Britain.

However, research inquiries associated with the post-Washington consensus and typified by the work of Stiglitz (1985, 1994, 1996) and his associates (Stiglitz and Weiss (1981); Stiglitz and Uy (1996), claimed that bank-based systems are inclined to state control over financial prices and flows. They argue that bank-based financial systems are more efficacious at promoting development than liberalized market-based systems. In contrast, the other line of inquiry, though its emergence also reflects disappointment with the results of financial liberalization, defends the notion that a liberalized and market-based financial system can be conducive to economic development (Levine 1992; Bencivenga et al. 1995; Levine and Zervos 1996; Demirguc-Kunt and Levine 1996a, 1996b, 1999).

Besides conflicting theoretical arguments, the empirical reality presented by countries such as Korea and India indicate that the real situation regarding the efficiency of financial systems is much more complicated than the above two paradigms indicate. Neither the financial repression nor financial liberalization hypothesis seems to provide a comprehensive answer to this problem. By analysing the efficiency gains demonstrated by the repressed phase of the Korean financial system and efficiency losses incurred by a similarly repressed Indian financial system, this book raises a theoretical puzzle: "How does a similar repressive financial system practiced in both India and Korea in the form of 'credit-based, price-administered financial system', [6] demonstrate a sharp variation in efficiency?" This study analyses the period when both India and Korea experimented with financial repression by manipulating the price of capital by leveraging the government's ownership of banks and keeping capital markets largely underdeveloped.

1.2 Broader Intellectual Context

The collapse of the 19th-century liberal international economic order marked the decline of an economic philosophy based on the free trade doctrine defined by Adam Smith's work, *Wealth of Nations* (1776). The great depression of the 1920s subsequently brought about a new economic debate led by John Maynard Keynes who questioned liberal economic philosophy by resurrecting the role of the state in the management of aggregates of demand and supply. The political economic consequences of the Great Depression made the Keynesian idea of fiscal expansion a very relevant policy tool in the hands of newly decolonized independent states. A Keynesian revolution that swept the post-WWII world economy left deep imprints not only on the management of the economy but also on subsequent debates about the organization of national finances.

Keynes's "general theory" provided persuasive arguments for many governments to artificially lower the cost of capital by repressing their financial systems. Interest rates were regulated to finance large government-led economic programmes. To put it differently, the widespread financial repression of the postwar years was an outcome of the prevailing Keynesian belief that fiscal expansion could jump-start stagnated and depressed economies. Following the logic of fiscal expansion, most of the governments in the postcolonial world resorted to pump-priming by repressing their repressed financial systems. Finance became the most important policy instrument for a state to fulfil its political economic objectives. In a bid to eliminate centuries-old grinding poverty, governments in the developing world intervened heavily in industrial policymaking. The state was present in the market to administer prices. In most cases, prices were controlled by administrative fiat. The world economy witnessed a new trend where political logic prevailed over the dictates of market forces.

However, post-WWII government splurge came to an end with the Latin American debt crisis of the 1970s. Governments in the developing world got a rude awakening to see the imbalances created by the unfolding debt crisis in Latin America. A great debt debacle discredited the 'interventionist state' and its proponent Keynesian economics. Once again, the pendulum of economic thinking started to swing back to liberal economic philosophy. By the early 1980s, the 'Washington Consensus' emerged as a neo-liberal counterpart to the developing economies' infatuation with state-led management of the economy. Reaganism and Thatcherism were presented as the new guiding light for developed economies – an ideology of reliance upon market forces, and the deduction of state intervention and expenditure to a minimum. The "Washington Consensus" powered by the IMF, World Bank, and Milton Friedman's 'monetarism' sidetracked the "Keynesian Consensus".[7] This fundamental change in economic thinking also affected debates about the role of finance in the process of economic development. Neo-classical economic revival in finance came with the financial model proposed by McKinnon-Shaw (1973), which argued for the deregulation of interest rates and the end of financial repression to accelerate economic growth. The model stressing for deregulation envisioned the role of the state in the marketplace only as an "umpire" at arm's length distance from the market. Convinced by the liberalization hypothesis and the greater push from international institutions such as the IMF and World Bank, many countries hurriedly conceptualized, internalized and firmly initiated detailed financial liberalization programs.

The intellectual and policy pre-eminence of the Washington Consensus was nonetheless short-lived. By the late 1990s, dissatisfaction with its dry certainties emerged even within the privileged circles of Washington. Noble laureate economist Joseph Stiglitz explicitly rejected the Washington Consensus and offered the post-Washington Consensus as a solution to market failures as well as statist distortions. The failure of the consensus occurred at a time when information-rhetoric and transaction-costs-theoretic analyses became prominent within economic theory. This has important implications for the gradually emerging successor to the old consensus. It is widely accepted among neoclassical economists that, although markets are by far the most efficient social mechanism for allocating resources and maximizing social welfare, information asymmetries among market participants and inescapable transaction costs decisively limit the efficiencies promised by the markets.

Simply put, how can cost and information externalities that often result in market failures be contained? Indeed, the post-Washington consensus, which emerged from the ruins of old market consensus, remains deeply conservative in fiscal and monetary matters; it does not in principle oppose deregulation and liberalization, and it is broadly in favour of free trade and privatization. The difference from the previous consensus lies perhaps in the following two elements. The first is advocating a 'milder' opening of the economy to the dictates of the market, drawing upon the experiences of market failure incidents. There was some room for interventionist policy by the state, insofar as such policies deal with market imperfections, thus improving the performance of the market system as a whole. In the same vein, institutions, particularly those relating to the financial sector, which are especially prone to market failures, are vital for developmental success. The second element is an emphasis on the non-economic 'glue' that holds society together. The concept of 'social capital' is of critical importance in this connection. The post-Washington consensus represents a welcome advance for thinking about the sustainability of economic development. The twists and turns in ideas and ideologies produced an intellectual context that effectively changed the paradigm of finance from government to market control. The post-Washington consensus contributed to striking a new balance between the state and the market.

1.3 Issue of Financial System's Efficiency

In this broader intellectual context, a pressing question of the financial system's efficiency dates back at least to *The Theory of Economic Development* by Schumpeter (1912). Although different economists place varying degrees of importance on finance, the theoretical arguments and empirical evidence largely suggest a positive, first-order relationship between the efficiency of the financial system and economic growth. For the Schumpeterian dynamics of creative destruction, the roles played by financial intermediaries in mobilizing funds, evaluating and selecting projects, monitoring entrepreneurs, and facilitating transactions are critical. However, partly because of the lack of a tractable theoretical paradigm, and by and large because of the dominance of the Arrow–Debreu paradigm (1954)[8], in which the Modigliani–Miller propositions (1958)[9] vitiate any consideration of finance, the financial efficiency–development link has been, until recently, only a matter of empirical interest. Moreover, these empirical works have focused mainly on the relationship between economic growth and the development of financial intermediaries.[10]

However, financial intermediaries form merely a part of the entire financial system. Given that the primary role of the financial system lies in the transfer of funds from surplus sectors to deficit sectors, which is not fundamentally different from other resource allocation problems, the emergence of financial intermediaries is also an answer to market failure (Arrow, 1974). Any satisfactory analysis of a financial system's efficiency thus has to adopt a systemic approach, incorporating capital markets as well as financial intermediaries, explaining for instance why capital markets are more important in one economy than in another. When transaction costs are not too high and informational asymmetry is not too severe, we expect markets to perform at least as well and perhaps better than intermediaries. Only recently have efforts been directed at the study of the financial system's efficiency as a whole.[11] A direct motivation to assess the efficiency of the entire system comes from the striking differences in the structural constructs of the financial systems, often classified as capital market-based systems largely practiced in the USA-UK, credit-based, price-administered systems of Japan-Korea, and credit-based, institution (financial)-dominated systems adopted by Germany.[12]

Analysis of the above mentioned dominant theoretical paradigms tends to concentrate on the efficiency variations among and between structurally differing financial systems; however, the efficiency variation within one type of financial system has received insignificant attention. The financial experiences of Korea and India demonstrate sharp efficiency variation within one type of financial regime, that is, the 'credit-based, price-administered system'. This sharp efficiency variation within one type of financial system raises a theoretical puzzle: "How does a repressive financial system of Korea, contrary to the basic assumptions of the McKinnon-Shaw model, demonstrate efficiency gains, whereas similar repressive financial system of India confirms the findings of McKinnon-Shaw model by demonstrating efficiency losses. In other words, the Indian case approves the assumptions of the liberal hypothesis whereas the Korean case demonstrates a significant diversion to liberal assumptions. This contradiction creates a complex theoretical puzzle in which hypotheses on financial liberalization and financial repression are unable to be clearly explained.

By carefully analysing theoretical development, the book attempts to fill the persistent void in the area of the financial system's efficiency analysis. It argues that the question of efficiency in a financial system is not confined to the sphere of finance alone; rather, the causes of efficiency variation are rooted in the wider political economic context. It argues that the variation in a financial system's efficiency is a byproduct of differences in political and economic regulations. Therefore, it is nonetheless desirable to have a comprehensive framework in which different political economic regulatory structures are embedded so that the question of the financial system's efficiency can be addressed accurately.

In explaining these efficiency variations, the book stresses that the efficiency of a financial system is not limited to financial structures alone but should be examined in the context of the broad systemic relationship between industry and finance, in which governments play an important role. The specific political economic and historical context within which particular financial systems relate to the industry is of critical importance and must be explicitly acknowledged. More specifically, the requirements imposed by the 'real' economy on the financial system differ over time and at different stages of a country's economic development. Additionally, an explanation of the causes of efficiency variation in the similar financial systems of Korea and India provides a logical framework that can help demystify a wider economic phenomenon: a sharp developmental contrast that evolved between Korea and India or, more generally, between the regions of East and South Asia during the second half of the 20th century.[13]

In the race to rapid economic development, Korea outcompeted India by a wide margin. Korea's sustained high growth performance generated theoretical and policy debates highlighting the nation's success, particularly its stable bank-based financial model, which served as a powerful interventionist policy tool for the 'developmental state'. The World Bank, the IMF, and the majority of academic research praised the success of East Asian economies in general and the Korean economy in particular.[14] Nonetheless, the pendulum of economic thinking swung back with the onset of the 1997 region-wide financial turmoil in East Asia. State intervention and financial repression were held responsible for the Korean economic woes. Questions were being raised about the merits of the credit-based, price-administered financial model and regarding the entire developmental philosophy based on the interventionist developmental state.

It is true that the Asian financial crisis inevitably poses a major analytical and empirical problem for advocates of bank-based systems: the crisis originated in the financial system, and appears to have been exacerbated by the strong 'relational' aspect of finance in these countries. Interestingly, the response is to attribute the crisis partly to the unravelling of the 'relational' and bank-based character of East Asian financial systems. Thus, Wade and Venroso (1998) argued that bank-based systems have proven particularly suitable for channeling the exceptionally high savings of Asian societies into investment. However, foreign pressure has been perceived to have encouraged these countries to adopt several uncoordinated features of market-based systems, especially to remove controls over international capital flows. This led to the dilution of the monitoring and control properties of their financial systems and contributed to the crisis.

The plausibility of this argument notwithstanding, it is notable that the problematic and crisis-inducing change of these financial systems is attributed exclusively to foreign pressure exerted on otherwise unproblematic bank-based systems. Once again, the debates surrounding the 2007-08 financial crisis in the developed world suggest that financial repression still retains the validity of promoting stability in the era of uncertainty. Indeed, one crisis alone should not undermine the valuable contribution of the credit-based financial mechanism that pulled Korea and the entire East Asian region out of poverty and underdevelopment. It is important to note that the financial stability and reasonable efficiency demonstrated by Korea's bank-based financial system still hold a few lessons to the promoters of the reform and restructuring of financial systems.[15]

On a differing note, India's credit-based, price-administered system of financial intermediation demonstrates inefficiencies of gigantic proportions. Reasons for the inefficiencies of the Indian financial system lie primarily in its political economic context, which promoted rampant market distortions. An alarming rise in the market-distorting political economy in India changed the relationship between industry and banks, both owned and managed by the government. The emergence of India as a classic case of state capitalism encouraged the government to control both industry and finance, which in turn gave rise to non-transparent financial intermediation. Thus, it was not financial repression alone but rather political economic distortions that contributed to the inefficiencies of India's financial system.

1.4 Political Economy Approach to Understanding Finance

The question of whether one financial system is superior to the other is likely to be futile without taking note of the regulatory environment deeply rooted in the political economic context. As John Zysman (1983) noted, there is no single way to restructure a financial system and reconcile resources and demands to organize and promote market forces; each particular financial system must be matched with an appropriate political economic strategy for development. There seems to be no single financial system that can universally help achieve efficiency and, in turn, economic success. The financial system that brought about British economic success in the early 19th century, for example, was very different from that Germany adopted in the late 19th century. The financial organization that supported the German industrial rise was in turn radically different from the Japanese financial system. Success does not come from copying a dominant form but from adaptation and local innovation. The financial system should be compatible with appropriate political economic regulations, which are largely responsible for the efficient functioning of the market mechanism. There are cases from Latin America to South Asia where the adverse impact of repressive financial arrangements was aggravated by market-distorting political economic regulations.

The absence of appropriate compatibility between the financial system and political economic regulations lies at the core of efficiency variation. In recent years, many developing economies have realigned with free market forces only in their financial systems; however, leaving aside the political economic systems to malfunction in a market-distorting fashion. This created incompatibility within a system and became a recipe for disaster. In Latin America, Mexico, and East Asia governments have attempted to make their financial systems conform to the rules of the market while negating the market-based functioning of wider political economic systems.

The outcomes of this incompatibility have resulted in massive financial crises that have created a new debate about the efficiency and viability of the national and international financial systems. As noted earlier, the question of the financial system's efficiency does not lie only in finance; rather, it is very much rooted in political economic regulatory structures. We thus argue for a distinct political economic approach that can accurately comprehend the inconsistencies and mismatches between financial structures and political economic systems. This approach has the potential to address the efficiency-inefficiency paradox that has long persisted between the two Asian economies, Korea and India.

To resolve this theoretical puzzle, the book employs a political economy approach to examine the variation in efficiency between the Korean and Indian financial systems. It argues that the success of the Korean financial system in powering rapid industrialization depends primarily on a market-conforming political economy, which lies at the core of Korea's financial system's efficiency. On the other hand, India's lagging economic development depends largely on its market-distorting political economy, which lies at the core of its financial system's inefficiency. Based on this efficiency-inefficiency paradox, this study argues for a theoretical innovation to accommodate financial repression with market conformity. This book offers an empirical basis for theoretical innovation. For the neo-liberal paradigm, there has been a challenge to either accommodate Korea-style partial market distortions aimed at improving the market or face growing criticism. To a certain extent, neo-structuralism aligns with Korea's market-conforming interventionist state tradition.

1.5 Issues Raised and Discussed

The book raises a set of issues related to the theoretical puzzle emanating from the assumption that 'similar financial systems can demonstrate sharply varying efficiency patterns.' The most important issue discussed in this book is the explanation of a paradoxical phenomenon in which similar repressive financial systems demonstrate efficiency gains, as in the case of Korea, and efficiency losses, as in the case of India. The Indian case proves the basic assumptions of the McKinnon-Shaw model, whereas the Korean case demonstrates a significant diversion to the core tenets of this model. The sharp contradiction exhibited by the two case studies creates a complex theoretical puzzle in which hypotheses of financial liberalization and financial repression are unable to explain this efficiency variation.

Why was there a variation in financial efficiency between Korea and India, which adopted very similar financial systems? The answer to this intriguing question can be found only when we incorporate wider political economic regulatory structures in the analysis of efficiency in a financial system. An analytical framework based on the inclusion of political economic variables looks at the developmental paths of Korea and India. There are clear divergences in the political economic paths of both countries, which consist of the state structure, industrial structure, corporate structure, institutional-bureaucratic structure, historical-colonial structures, and international power structure. This reveals that diversity in the political economic arrangements between Korea and India gave birth to two developmental models: 'market-conforming' in the case of Korea versus 'market-distorting' for India.[16] These two models represent two different developmental philosophies that substantially alter the operation and management of their respective financial systems.

It is safe to say that the political economic distinction between Korea and India lies at the core of the starkly different operating environments. This difference greatly affects the efficiency of their financial systems, specifically in the areas of priority credit, savings, and investment. Thus, along with political economic distinctiveness, regulatory issues related to the political operation of the financial system, such as resource allocation through the banking system and particularly priority credit policies, are discussed in detail. The issue that in a given political economic context repressive financial policy, such as priority credit, financial subsidies, and regulated interest rates can contribute to achieving reasonable efficiency is a matter of considerable importance. To highlight qualitative differences, the increasing role of capital markets in the resource allocation process has been briefly discussed. In sum, financial and political economic regulatory issues related to systemic efficiency dominate the discussion in this book.

1.6 Assumptions, Variables and Mechanisms

The main assumptions of this book are as follows: similar financial systems can have sharply varying levels of efficiency; 1) because the efficiency of a financial system is not exclusive to the financial regime alone; rather, it is deeply rooted in the regulatory structures of the political economy; and 2) because the operative mechanism of competitive market forces depends primarily on the structures of the national political economy.

The case studies of the Korean and Indian financial systems, primarily focusing on the phase when financial repression was the order of the day, validate the basic assumptions of this study. There is clear evidence suggesting that the financial systems of Korea and India belong to the same category of credit-based, price-administered systems; however, their performance differs sharply. This performance variation can be explained by looking into differences in their political economic systems, which impacted the operating environment of financial policies. The political economies of Korea and India have been organized under two differing developmental philosophies: market-conforming and market-distorting political economies. The distinct political economic context of Korea, primarily its export-oriented, private enterprise-led strategic industrial policy, provided the needed space for global market forces to sharpen the competitive edge of its financial policies. In contrast, the democratic political economic context of India created a penetrated state that has been unable to recast the import substitution regime. India’s public sector-led industrial strategy met with a publicly-owned banking system. This unholy nexus between business and finance gave rise to non-transparency leading to the problems of moral hazards.

The comparative empirical realities confirm that the market-distorting political economic system of India lies at the core of efficiency losses in the financial system, whereas, the market-conforming political economic system of Korea explains the efficiency gains of the financial system. This conclusion validates the basic assumption of this book that political economic regulatory structures affect the level of financial efficiency. To substantiate the logic that market conformity is a prerequisite for the efficient functioning of financial systems, a brief political economic analysis of differing financial systems of the U.S.-U.K., France–Japan and Germany have also been provided.

The theoretical arguments outlined in this book clarify that the two dominant financial paradigms – financial liberalization and financial repression – have not been able to explain the paradoxical situation where similar repressive financial regimes demonstrate sharp efficiency variations. To resolve this theoretical puzzle, the book employs a political economic approach. Thus, instead of a neoclassical type minimalist state and its free market logic, or a Keynesian interventionist state and its partial market distorting logic, the state tries to combine Korea’s rather successful balance of competition and cooperation in a wider neo-structuralist market-conforming framework where the state plays neither the role of an ‘administrator’ nor becomes only an ‘umpire’ but acts as a ‘player’ to activate market forces with an entrepreneurial spirit. The neo-structuralist arguments, primarily articulated by the Argentine economist Raul Prebisch, stress that there is an important role for government intervention, which not only makes these markets function better but also improves the functioning of the economy. [17] In addition, Arthur Lewis proposed piecemeal planning, as opposed to detailed central planning, to supplement market outcomes.[18] It is obvious that the structuralist tradition is not bent upon replacing the market but rather supplements the market in several ways, so government intervention can contribute to more efficient functioning of the market. Thus, the incorporation of political economic dimensions in the analysis of the financial system’s efficiency support also widens the existing neo-structuralist arguments.

1.7 Content and Chapter Organization

The first chapter introduces the broader issue – efficiency variation within one type of financial system – which has been explained by incorporating a distinct political economy approach. Theoretically, analysis resorts to neo-structuralist logic and articulates a third paradigm based on the enhanced compatibility between the financial system and the national political economy regime. Case studies of Korea and India have been examined in detail to provide a solid empirical base. A logical understanding derived from the facts drawn from the two Asian economies validates the basic assumptions that the efficiency of a financial system is not exclusive to the financial regime alone; rather, it is deeply rooted in the regulatory structures of the political economy.

The second chapter explains how the state, finance and industry interact. This highlights that the ever-changing balance between the state and the market has been guided by different perspectives rooted in broader theoretical ideas. By examining the role of the state as a regulator, administrator, or player, this chapter discusses three dominant perspectives – neo-liberal, Keynesian and neo-structural – that help shape the nature and direction of political economy which in turn impacts the operation and management of finance.

The third chapter outlines the evolution and development of distinct financial models and their relevant theoretical underpinnings. It traces three different financial models primarily based on varying degrees of state presence in the market. First, the state's role merely as an economic 'regulator' or an umpire expressed in the capital market-based financial model, most appropriately represented by the U.S. and U.K. Second, the state's role as an economic 'administrator' is linked with the credit-based and institution-dominated financial model, best represented by the German case. Third, the role of the state as a 'player' is visible in the credit-based, price-administered model, which is practiced in various forms in Japan, France, Korea, and many other developing economies, including India. Based on mechanisms to shift resources from savings to investment, price-determining methods, and the role of government, this chapter assigns the 'credit-based, price-administered' category for the financial system to both Korea and India.

The fourth and fifth chapters examine Indian and Korean cases to collect evidence and then draw insight into explaining efficiency variation in a similar financial system. The first case study of Korea in chapter four examines how a distinct market-conforming political economic model was instrumental in changing the operation and management of its financial system. Korean experience confirms that factors responsible for relative efficiency gains in its repressive financial system lie primarily in the 'market window' opened by its export-led industrial strategy. This facilitated market-based performance criteria to evaluate subsidized credit facilities or 'policy loans'. Korea instituted an export-based performance criterion that forms the core of the efficiency-enhancing credit mechanism. The analysis in this chapter validates the basic assumption that the efficiency of a financial system is not exclusive to the financial regime alone but is deeply rooted in the regulatory structures of a nation's political economy.

The second case study of India examined in Chapter V outlines the other side of the empirical reality where a market-distorting political economy changes the operation and management of its financial system in a way that negatively affects the system's efficiency. The analysis in this chapter argues that the relative failure of India's repressive financial system lies primarily in its import substitution-led industrial strategy, which successfully insulated the economy from the dynamic impact of competitive market forces. The empirical evidence presented here indicates the presence of a large priority credit sector without any clear linkage with market-based performance. In the market-distorting political economic context, priority credit policies had no market-directed checks. Thus, the empirical discussion supports the claim that market distortions in the political economic sphere negatively affect the efficiency of a nation's financial policies.

Chapter VI places the whole research exercise of this cross-country study of financial systems from a comparative perspective and derives policy lessons. This chapter examines variations in the organization of the "market-conforming" and "market-distorting" political economy of Korea and India. It attempts to assess how differing political and economic traditions, particularly their priority credit policies, interest subsidies, and the size of loans, play crucial roles in determining the efficiency of the whole financial system. Korea's experience offers valuable insight into how the state and market can be arranged in a much more competitive way. The specific outcomes of this study are categorized in this chapter and the areas of considerable interest are clearly defined.

Diverse regulatory structures rooted in the political economic realities of both countries are categorized as autonomous versus penetrated state structure; public versus private corporate ownership structure; export versus import-oriented industrial structure; economic versus politically motivated bureaucratic-institutional structures; direct vs. indirect colonial experiences; and the US versus the USSR–centred international power structure. Regulatory structures rooted in the financial system are divided into areas such as the allocation of resources by the banking sector and capital markets.

In addition to finance-specific lessons, this chapter proposes the usefulness of neo-structuralist theoretical insight, which argues that the competitive power of the market can only force the needed discipline; at the same time, there could be a crucial role for the state in shaping the market logic. Supplementing the neo-structuralist perspective, the market-conforming role of the state should also be similar to that of an entrepreneur who can move fast enough to change and review policies according to the shifts in overall economic conditions. In the case of a late developing economy such as India, where the market has not been functioning in a large part of the economy, the state should come to promote market outcomes but only with entrepreneurial insights and businessmen-like swiftness.

It is important to note that the universal applicability of the neo-liberal financial paradigm has obvious limits, especially in the context of developing economies. The developing economies in the Global South can learn from the symbiotic relationships among the state, the market, and society that the Korean developmental process skilfully incorporated. The relative success of intermediation provided by Korea's repressive financial system offers lessons to evaluate the ongoing cautious paradigmatic shift in the regulatory regime of finance in India and beyond. These policy lessons are relevant not only to India, which is reforming its economic and financial strategy after disillusionment from the socialist mixed economy model crafted after the centrally controlled Soviet economic system but also, to developed economies reeling under the fragility of deregulated finance. Neo-liberal market-based policy prescriptions may sound logical but the road to the "capital market-based financial system" first requires the market-conforming political economic arrangements on which the efficiency of capital markets can rest.

Chapter VII concludes that the deeper problems embedded in the nation's political economy must ultimately be given due consideration as the efficiency and performance of the entire financial system depend on it. This confirms that the political management of the financial system is an important factor in deciding its efficiency. The market-distorting and market-conforming political management of the financial system has played an important role in determining the varied efficiency levels of the Korean and Indian financial systems. In this context, it is safe to say that political economic systems form the core of the regulatory framework, which eventually became instrumental in the success and failure of the Korean and Indian financial systems. Without altering the political economic and ideological structures deeply linked to the state, corporate, industrial, technological, and institutional systems, any financial restructuring may not bring the intended results.

Notes

[1] Systemic financial fragility has been accepted as a meaningful economic concept. However, the structure of the dominant macro and micro theories of our time, which are built upon the modern version of Walrasian general equilibrium theory, ensures that money and finance are excluded from the core of the theory. Nevertheless, a number of economists have attempted to introduce financial considerations into the theory of economic growth. For details, see Tobin (1965), Johnson (1966), Sidrauski (1967) and Levhari and Patinkin (1968).

[2] There are three main elements of financial repression: first, the banking system is forced to hold government bonds and money through the imposition of high reserve and liquidity ratio requirements because it allows the government to finance budget deficits at a low or zero cost; second, given that government revenue cannot be extracted that easily from private securities the development of private bond and equity markets is discouraged; and finally, the banking system is characterized by interest rate ceilings to prevent competition with public sector fundraising from the private sector and to encourage low-cost investment Thus, the regulations generally include interest rate ceilings, compulsory credit allocation, and high reserve requirements.

[3] Indira Gandhi, the then Prime Minister of India expressed the intention of the government in the annual conference of the All India Congress Meeting in a paper entitled “Stray Thoughts on Bank Nationalization.” The paper was received with positive enthusiasm. Thereafter, her move was swift and sudden, and the government issued an ordinance and nationalized the 14 largest commercial banks with effect from midnight of July 19, 1969. Similarly, South Korean President Park Chung Hee extended government control over business by nationalizing the banks and merging the agricultural cooperative movement with the agricultural bank. The nationalization of the commercial banks was accompanied by the reorganization of BOK. An amendment to the BOK Act of 1962 transferred monetary policy authority from the BOK to the Ministry of Finance.

[4] In 1973 McKinnon and Shaw argued that, in the context of a typical developing country, financial repression would lead to both a decrease in the depth of the financial system and a loss of the efficiency with which savings are intermediate. Therefore, the McKinnon-Shaw paradigm of financial repression implied that the

complete liberalization of the financial sector was an essential precondition to achieve successful economic development. For details, see; Ronald McKinnon, Money and Capital in Economic Development (Washington DC: The Brookings Institute, 1973); E. Shaw, Financial Factors in Economic Development (New York: Oxford University Press, 1973).

[5] The question related to the efficiency of a financial system has been viewed generally through the lances of the efficient market hypothesis (EMH), which sees financial efficiency in the exclusive context of financial markets. Harry Roberts (1967) who first coined the term EMH has come to describe the categories of information sets, and concomitantly, of efficient market theories that are employed in the large body of empirical work. Fama (1970) subsequently articulated them in the form that is now in use. However, in evaluating the US financial system, James Tobin (1984) links the efficiency of a financial system with four distinct areas: 1. information-arbitrage efficiency 2. fundamental valuation efficiency 3. full-insurance efficiency, and 4. functional efficiency. Given the distinct context of developing economies, this study contemplates financial efficiency not in the strict boundaries set by EMH assumptions but links it to Tobin's 'functional efficiency' which takes into consideration the contribution of finance in the service of real sector development. In other words, the question of the financial system's efficiency cannot be separated from the economic growth. Patrick (1966) noted that causality runs both ways. Economic growth creates demand for financial services (the so-called 'demand-following' expansion of the financial system); economic growth is also preceded by financial development (the so-called supply-leading evolution of the financial system). Disentangling this two-way causality is not an easy task, although Jung's (1986) analysis of fifty-six countries (which include some of the Asia Pacific economies) suggests that causality changes over the course of economic development.

[6] This categorization, i.e. "credit-based, price-administered financial system" is based on Zysman's (1983) classification. For details, see John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca & London: Cornell University Press, 1983).

[7] The paradigmatic nature of the Washington Consensus is most clearly evident in the work of John Williamson who coined the name and set out a specific formulation of the approach at the end of the 1980s. For details, see Williamson, J., "The Washington Consensus Revisited", in L. Emmerij (ed.), *Economic and social development into the XXI century* (Washington D.C.: Inter-American Development Bank (distributed by John Hopkins University Press, Baltimore), 1997), pp. 48-61.

[8] Arrow, K. J.; Debreu, G., "Existence of an equilibrium for a competitive economy", *Econometrica* 22 (3) (1954): 265–290.

[9] Modigliani, F.; Miller, M., "The Cost of Capital, Corporation Finance and the Theory of Investment", American *Economic Review* 48 (3) (1958): 261–297.

[10] Notable empirical works include Goldsmith (1969) and McKinnon (1973). Fry (1988) provides various empirical evidence. For more recent evidence, see King and Levine (1993a) and King and Levine (1993b). Exceptions to this strand of empirical studies are recent works by Demirgu (1996), and Levine and Zervos

(1998) where the link between the development of the stock market and economic growth is studied as well.

[11] Allen (1993); Allen and Gale (1995); Allen and Gale (1997); Allen and Gale (2000) and Boot and Thakor (1996) are notable examples that attempt to provide a theoretical framework for modelling the financial system as a whole.

[12] This categorization is borrowed from the John Zysman (1983). However, it is to be noted that the term "market-based" is an oversimplification, and not to be understood as implying the absolute dominance of markets over intermediaries. It has a historical connotation and highlights the relative importance of markets compared to those in the "bank-based" system. Even in the United States where the development of capital markets is the most notable by any standard, total business funds raised through bank loans still exceeded those raised through securities in the 1980s.

[13] Asian region's developmental contrast began in the latter half of the 20th century, when parts of East Asia started to witness phenomenal economic take-off. Japan was the first country to demonstrate economic success par excellence by adopting salient regulatory features of continental Europe's credit-based financial model. The success of the Japanese financial system made other East Asian economies emulate this new hybrid system. It led to the formation of the so-called East Asian financial model where banking credit was the prime mode of corporate financing. Among many East & South East Asian countries, the Korean financial system resembles closest to the East Asian financial model. However, the Korean financial model is not an isolated case; it represents common characteristics of the East Asian financial system that finds its roots in Japan. Thus, analysis of the Korean financial model inevitably finds its reference in the wider East Asian financial model. With the unfolding of the regional developmental scene, a new picture of Asia emerges. One can see clearly, that Japan, then Korea, Taiwan, Singapore, and Hong Kong followed by Malaysia, Thailand, Indonesia, and China, became the part of brighter side of the picture. The other Asia is left behind in the darkness of underdevelopment. South Asia clearly falls on this darker side. India couldn't emulate East Asia's miraculous economic upsurge; however, it followed a similar financial pathway. The result was a very slow economic growth often termed as "Hindu Equilibrium" leaving the region as a complex developmental knot. For details, see D. Lal, 1988 (b). *Hindu Equilibrium.* Vol. 1 (Oxford: Clarendon Press).

[14] Bijan, Aghevli, and Jorge Marquez-Raurte, "A Case of Successful Adjustment: Korea, 1980-84", *IMF Occasional Papers,* 1985; World Bank, *Korea: Managing the Industrial Transition* Vol. 1 (Washington D.C. World Bank, 1987); Edward S. Mason, Mahn Je Kim, Dwight H. Perkins, Kwang Suk Kim, and David C. Cole, *The Economic and Social Modernization of the Republic of Korea* (Cambridge, MA: Harvard University Press, 1980); K.S Kim and M Roemer, *Growth and Structural Transformation* (Cambridge, Mass.: Council on East Asian Studies, Harvard University, 1979); Anne O. Krueger, *The Development Role of the Foreign Sector and Aid* (Cambridge, MA: Harvard University Press, 1978); Leroy P. Jones, and Sakong Il *Government, Business, and Entrepreneurship in Economic*

Development: The Korean Case (Cambridge, MA: Harvard University Press, 1980); Alice Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (London: Oxford University Press, 1989); David Cole and Young Chul Park, *Financial Development in Korea 1945-1978* (Cambridge, MA: Harvard University Press, 1983); Frederic C. Deyo ed., *The Political Economy of the New Asian Industrialism* (Ithaca: Cornell University Press, 1987); Robert Wade, *Governing the Market: Economic Theory and the Role of Government in Taiwan's Industrialization* (Princeton; Princeton University Press, 1990); Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press, 1991).

[15] For details about political economy of financial development in Korea and wider East Asian region, see Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press, 1991); David C. Cole and Yung Chul Park*, Financial Development in Korea, 1945-1978* (Cambridge: Harvard University Press, 1983); Ha-Joon Chang and Robert Rowthorn, *The Role of the State in Economic Change* (Oxford: Clarendon Press, 1995); Kim Dae Hwan, "Han'kuk kyonhie-ui songkwa-e taehan se kyonhae- 1960-1970 nyon-ul chungshim-uro" (Three Viewpoints of the Korean Economic Performance), in *Yon'gu nonmunjip* (Collection of Research Papers), Vo.II (Institute of Business and Economic Research, Inha University, 1988).

[16] The term "market conforming" corresponds to a distinct political economic model where the state intervenes in the market but the fundamental logic behind intervention comes from the market itself. In this model, the nature of state intervention is to enhance the functioning of the market, whereas, the term "market-distorting" corresponds to a distinct political economic model where the state intervenes in the market by following the political logic and ignoring the directions emanating from the market. In this model, state intervention distorts the functioning of the market. For further details, see section I, chapter V.

[17] Neo-structuralism, a third distinctive successor to the Washington Consensus, moves in a more liberal direction. This is an approach associated with the Economic Commission for Latin America (CEPAL) that produced the structuralist theory of underdevelopment in the 1950s under the leadership of the Argentine economist Raul Prebisch. According to neo-structuralism, neoliberal policies have simply been too costly and counterproductive. For details regarding the role of the state in facilitating the functioning of the market, see Joseph E. Stiglitz, "The Role of State in Financial Markets," in the proceeding of the World Bank Annual Conference on Development Economics 1993. Edited by Michael Bruno and Boris Pleskovic. (Washington D.C.: World Bank, 1994), pp. 19-52.

[18] Arthur, W. Lewis, *The Theory of Economic Growth* (Allen & Unwin, London, 1955), p. 384

CHAPTER 2

PERSPECTIVES ON THE POLITICAL ECONOMY OF FINANCE

It is crucial to understand how political economic arrangements affect the way the state, industry, and finance interact. In this regard, an efficient balance between the state and the market is key to optimally distributing financial resources among and between competing sectors. A well-functioning market requires an appropriate regulatory regime that only a competent state can design and institute. As a regulator enforcing rules, the role of the state in the marketplace has great significance. In recent years economists have developed a new approach to analyse the impact of politics on the economy, particularly treating policy-makers as self-interested agents responding to political incentives. [1] The political economy approach was initially applied to macroeconomic policymaking but now spreading to other areas of economic policy analysis, including policy interventions in the sphere of finance. This approach contrasts sharply with the view of policymakers as 'benevolent social planners' which is a common hypothesis in welfare economics.[2] There are a variety of ways in which states interact in the marketplace. As Zysman (1983) suggested, the government can be an economic regulator, an economic administrator, or an economic player. These three distinct roles of the state in the marketplace derive their logical rationale from three dominant, often overlapping theoretical paradigms: neo-liberalism, Keynesianism, and neo-structuralism.

2.1 Neo-liberal Perspective: State as an Economic Regulator

As a regulator, the state is like an umpire, which referees the behavior of others in the hope, that, if they follow a particular set of rules, a certain set of outcomes will occur. The role only as a 'regulator', not as an 'owner' or 'manager', has been accorded to the state is in line with the capital-based financial system where the state maintains an 'arm's length distance' from