

State-Directed Credit and Divergent Industrialization: A Comparative Study of India and South Korea, 1965–1985

Abstract

This paper examines the different paths of industrialisation taken by India and South Korea between 1965–1985 using a comparative framework based on state controlled banking and directed credit. While state influence over banking systems expanded in both countries, the goals and mechanisms of credit allocation diverged sharply. India adopted a more rule-based approach focused around priority-sector lending, rural banking expansion and broader financial inclusion whereas the South Korean government had a far more discretionary economy, funnelling credit towards export-oriented firms, strategically important industries and large-scale industrial investment. The paper analyses these differences across institutional frameworks, sectoral allocation, risk distribution, and the relationship between the state and firms. The evidence indicates that South Korea's concentrated allocation of credit was associated with substantially faster manufacturing and export growth, while India's approach achieved greater geographical and sectoral expansion of formal finance but with weaker financial efficiency and limited structural transformation. The findings suggest that state-controlled banking was neither inherently developmental nor inherently distortionary. Rather, its effects depended on the developmental priorities, allocation mechanisms, and broader industrial strategies within which financial intervention was embedded.

Keywords: State-directed credit, state-controlled banking, industrialisation, India, South Korea, developmental state, credit allocation, export-oriented industrialisation

JEL: O25, O14, G21, P11

Introduction

The importance of state-controlled banking arose from a widespread post-war belief that private financial markets alone were insufficient to mobilise and direct the capital required for industrialisation. Many post-colonial and developing nations of the world, like South Korea, India, Brazil, and Mexico, rejected the westernized adoption of Laissez Faire policy. They viewed private financial institutions as legacy structures of colonial exploitation and instead went on to adopt developmental financial systems where the state actively directed capital. Scarce domestic capital, weak financial institutions, and the large financing requirements of infrastructure and industry encouraged governments to use financial institutions as instruments of development. State control over banking consequently became an important feature of development strategies which allowed the government to use financial institutions to influence investment and mobilise capital towards national economic objectives. However, this adoption did not produce uniform developmental outcomes with countries like India and South Korea in particular, experiencing markedly different trajectories of economic growth and industrialization.

South Korea achieved its freedom from Japanese colonial rule on August 15, 1945. India became a sovereign nation and gained freedom from British rule on August 15, 1947. Between 1965 and 1985, both India and South Korea expanded state control over their banking systems with the intention of accelerating economic development. Despite adopting similar institutional tools, the two countries experienced dramatically different industrial outcomes. India experienced relatively gradual industrial expansion alongside persistent constraints on private investment whereas South Korea experienced rapid industrialization as well as the emergence of state-of-the art manufacturing firms. This divergence raises an important question on why and how state-directed finance contributed to such different patterns of industrial development.

By 1965, the two countries had already adopted distinct developmental orientations. India had established an import-substitution framework centred on self-reliance, domestic industrial capacity, employment, and broader socioeconomic development, while South Korea was increasingly pursuing an export-oriented strategy focused on rapid industrialisation and international competitiveness.

Existing research on the contrasting experiences of India and South Korea have largely focused on differences in state strategy and political incentives. Less attention is placed on the specific role of state-controlled banking in translating these broader developmental priorities into allocation of finance.

This paper aims to compare the allocation of funds of state-directed credit in the two countries, examine sectors and firms that received financial support, the approaches adopted towards corporate lending and financial risk, and the relationship between credit allocation and industrial development. The comparison aims to move beyond the question of whether state intervention was beneficial or not but instead examine the objectives underlying intervention influenced economic outcomes by studying the direction and pace of industrial development.

Empirical and Historical Context

Industrialisation required large and sustained investments in infrastructure, machinery, technology, and heavy industry, while domestic capital markets in many developing economies remained shallow and private financial institutions were poorly equipped to provide long-term finance at the scale required. This created a problem of capital mobilisation: governments seeking to accelerate industrialisation could not depend on private investment to direct limited savings towards the sectors that showed the greatest potential for structural transformation. The developmental role assigned to finance emerged partly from the belief that the state could coordinate investment over a longer period than private markets and overcome financing constraints.

This logic is closely related to Alexander Gerschenkron's theory of economic backwardness. Rather than treating late industrialisation as a simple repetition of the path followed by earlier industrialisers, the Gerschenkronian approach emphasises that countries beginning industrialisation later may require institutional substitutes for the mechanisms available to earlier developers. This insight when applied to East Asia supports the argument that institutions

should be understood in relation to the historical and technological context in which late industrialisation occurs. In countries where conventional financial institutions and systems were insufficient to mobilise the capital required like in the case of the Indian economy, state-controlled banks could perform comparable resource-mobilising functions.

Shin's discussion of East Asian industrialisation similarly stresses that institutional arrangements were historically specific rather than universally transferable, making the particular way in which each state used financial institutions central to understanding its developmental trajectory.

Before independence, India's financial system developed largely within a colonial context. Banking and industrial finance was shaped around trade and commerce rather than a coordinated national strategy. After independence in 1947, the Indian state increasingly assumed responsibility and directed economic development through greater state involvement in the economy. In discussing India's development, Chibber's Analysis notes that Indian elites were willing to trade off a strongly developmental state in favour of lesser growth for political stability and democratic legitimacy, highlighting the constraints within which India's ideology and strategy had been shaped. (Sinha, 2007).

According to the International Monetary Fund (IMF), nationalisation refers to the government taking control over a corporation by acquiring the majority of the whole stake in the entity. Nationalisation of banks marked a significant shift in the relationship between the state and the financial sector, bringing a much larger share of commercial banking under direct government control.

South Korea and India both adopted state-controlled banking during a similar period. In South Korea, commercial banks were nationalised in the 1961-1962 and their lending decisions were now subordinated to industrial policy. The state could therefore designate strategic industries and select the chaebols (family owned South Korean conglomerates) to establish the state-banks chaebol nexus (Shin, 2002). Nationalisation of 14 major commercial banks took place in India in 1969. It expanded the state's ability to direct credit towards underserved sectors and groups in Indian society to reduce regional imbalances and expand banking.

Before nationalisation of banks, both countries entered the period under study with different developmental orientations. South Korea was moving towards a development focused model centred on rapid industrialization and international competitiveness, while India had developed an import-substituting industrialization (ISI) model. India's large domestic market made the ISI model more viable. The country kept its developmental framework closely associated with domestic economic priorities to deal with skyrocketing unemployment, food insufficiency and rural disinvestment. At the same time, South Korea had a smaller domestic market that created stronger incentives to pursue export oriented industrialization with a developmentalist approach. South Korean elites had stronger incentives to maintain an efficient developmental state as a source of political legitimacy.

India's developmental strategy after independence was embedded within a broader mixed-economy framework rather than an attempt to leave industrial development entirely to market

forces. The Planning Commission became an important mechanism through which the state established national investment priorities. Five-Year Plans were rooted towards growth in industrialisation, infrastructure, and the expansion of the public sector. The state consequently assumed responsibility not only for providing infrastructure but also for directly undertaking production in sectors considered strategically important.

Importantly, India faced severe food shortages, unemployment, rural underdevelopment, regional inequalities, and a shortage of domestic capital. These constraints helped shape the rationale for import-substituting industrialisation, under which domestic productive capacity was developed rather than relying heavily on foreign manufactured goods. Further, self-sufficiency carried political significance in the context of a recently independent state.

India's newly developed self-sufficient framework prioritized food security and rural employment over industrial efficiency, using the Green Revolution to achieve domestic self-reliance.. Furthermore, this system operated under the restrictive "License Raj," a bureaucratic framework where state regulations heavily dictated corporate expansion and bank credit allocation. The emergence of the License Raj shaped the environment in which firms and financial institutions operated.

Commercial banks could increasingly be viewed not as autonomous institutions allocating capital according to purely commercial considerations, but as potential instruments through which the state could extend the reach of its existing developmental priorities. The framework of planning, public enterprise, industrial licensing, agricultural development, and regional redistribution therefore preceded bank nationalisation. Nationalisation was used as a tool to expand the state's ability to connect financial allocation with above mentioned objectives.

On the other hand, South Korea entered the post-war period after 1945 with an underdeveloped industrial and financial base. Its subsequent development followed a more explicitly catching-up strategy in which the government assumed an active role in organising industrial expansion. the government increasingly sought to overcome the limitations of the domestic market through export-oriented industrialisation. Rather than treating domestic demand as the principal foundation for industrialisation, export earnings were particularly important because South Korea required foreign exchange to acquire imported machinery, intermediate goods, and technology. Industrial policy consequently became closely connected to the country's external economic position.

Under Park Chung Hee, former president of South Korea, economic development became closely connected to the legitimacy of the state. The developmental state pursued rapid industrialisation not simply as an economic objective but as part of a broader project of national reconstruction, economic independence, and political legitimacy.

The industries that South Korea sought to develop- particularly heavy industry, machinery, shipbuilding, steel, automobiles, and later electronics-required large amounts of capital before they could become internationally competitive. Private financial markets were unlikely to allocate sufficient resources to these sectors because risks were high and their returns uncertain. State

control over banks offered the government a medium for mobilizing the domestic savings toward firms and sectors that were selected as strategically important.

The contrast between the two developmental visions establishes why state control over banking could perform different functions in the two countries. India entered the period with a developmental model in which finance had to serve multiple objectives, namely industrialisation, agricultural development, employment, regional balance, and wider access to economic opportunity. South Korea, by contrast, increasingly treated finance as a means of accelerating industrial upgrading, export expansion, technological acquisition, and international competitiveness. Thus, the nationalisation of banking should not be viewed as an isolated institutional event. It represented the incorporation of financial institutions into two already distinctive developmental strategies.

Existing research has approached the contrasting industrial trajectories of India and South Korea primarily through the broader political and institutional structures underlying developmental policy. But comparatively less attention has been given to how these developmental priorities were translated into the allocation of state-controlled credit. Chibber's analysis (Sinha, 2007) places the comparison between India and South Korea within debates surrounding the developmental state, emphasizing the relationship between the state and societal factors in shaping divergent developmental trajectories. It highlights how state strategies, business interests, and the political context interacted differently in the two countries and resulted in different outcomes rather than attributing outcomes solely to the capacity of the state. Similarly, Amsden's analysis of South Korea (Westphal, 1990) explains industrialisation through the interaction between a development-focused government and large business groups, with state support linked to the performance of firms and the development of industrial capabilities. India and South Korea's financial systems are directly comparable, arguing that both countries adopted a "Credit based, Price-administered System" despite ultimately experiencing contrasting economic outcomes (Uttam, 2005). Shin (2002) examines East Asian late industrialisation through a comparative framework encompassing South Korea, Japan, Taiwan, and Singapore, focusing on the different catching-up strategies and institutional arrangements adopted by these economies.

The analytical question is not whether India and South Korea both used state-controlled banking, but what each government asked its banking system to accomplish once it possessed the power to direct credit.

Comparative Analysis of Credit Allocation

1) Institutional Framework of State-Directed Credit

In India, nationalisation of banks was followed by the formalisation of priority-sector lending. The Reserve Bank of India formalised the definition of priority sectors in 1972. Subsequently, banks were required to raise the share of advances to these sectors to 33% by 1979 and then to 40% by 1985 (RBI, 2014). Priority sector lending ballooned from 14% in 1969 to 21% in 1972.

203 Following the growth pattern, total share steadily climbed to 28.6% in 1978, 35.6% in 1981, and
204 ultimately at 40% by 1985 (RBI, 2008).

205 South Korea's system was more discretionary. Cho and Kim (1995) define policy loans at the
206 time to include primarily export loans, equipment loans to export industries, agricultural and
207 fisheries loans, National Investment Fund lending, housing loans, foreign-currency loans, and
208 other government-supported lending. They found that policy loans constituted approximately
209 half of total credit supplied by domestic financial institutions during the 1970s. Between 1973
210 and 1991, policy loans averaged 61% of total deposit bank loans, with the figure reaching 63%
211 by 1981.

212 India's percentage refers to priority-sector advances as a share of scheduled commercial-bank
213 credit, whereas Korea's measure refers to policy loans within deposit bank lending. The
214 comparison is therefore structural rather than mechanical. India created a relatively rule-based
215 allocation framework, whereas Korea retained greater scope for strategic and discretionary
216 allocation. This distinction is analytically important. In India, the state changed the composition
217 and geographical reach of banking by defining categories that commercial banks were required
218 to finance. In Korea, the state could alter the allocation of financial resources in response to
219 changing industrial priorities. There exists an explicit divide in Korean credit policy into phases
220 corresponding to changes in industrial policy: export expansion during 1961-1971, heavy and
221 chemical industrialisation during 1972-1979, and subsequent attempts at financial liberalisation
222 and reduced credit support during 1982-1986 (Cho and Kim, 1995)

223 2) Sectoral Allocation of the State-Directed Credit

224 In India, nationalisation was explicitly intended to correct the urban and corporate concentration
225 of the banking system, promoting financial inclusion at all levels. RBI historical evidence shows
226 that, immediately before nationalisation, approximately 44 percent of total deposits and 60
227 percent of total credit were concentrated in five centres. The subsequent Lead Bank Scheme
228 and branch-licensing policy were designed to extend banking facilities into previously unbanked
229 areas (RBI, 2008). The Lead Bank Scheme assigned specific districts to designated banks to
230 drive aggressive rural branch expansion and eliminate credit imbalances across India.

231 The share of rural branches increased from 17.5% of total bank branches in 1969 to 36% in
232 1975, while the rural credit-deposit ratio increased from 37.5% in 1969 to 60.5% in 1981 (RBI,
233 2008). Credit allocation consequently became broader in both geographical and sectoral terms.
234 RBI records that advances to agriculture, exports and small-scale industries increased
235 significantly during the nationalisation period, while the share of credit going to industry
236 declined. Considered a major trade-off, increased emphasis on social benefit resulted in
237 economic stagnation in the country's growth, especially India's industrial sector.

238 South Korea pursued a different allocation logic. One-fifth of all export loans consisted of policy
239 loans that went straight to companies that exported goods. Another one-fifth portion was
240 towards foreign currency loans that allowed South Korean firms to import state of the art
241 technology, machinery and raw materials for industrialization. During the late 1970s, the

National Investment Fund of South Korea became specifically associated with financing the heavy and chemical industries (Cho & Kim, 1995).

3) Assumption of Risk

The RBI's historical account notes that, in 1978, commercial banks and regional rural banks were instructed to charge a uniform 9% interest rate on priority-sector loans, irrespective of loan size, reflecting the policy objective of reducing the cost of formal credit to rural borrowers (RBI, 2008). This represented a broad redistribution of financial risk. Instead of allowing commercial banks to select borrowers solely according to conventional profitability criteria, policy required them to extend finance to activities and borrowers designated as developmentally important.

Korea assumed a different kind of risk. Its policy-loan system attempted to overcome the financing constraints associated with large-scale industrial investment. Cho and Kim (1995) find that in the 1970s, foreign and bank loans accounted for approximately half of corporate sector funding, while policy loans provided especially low-cost finance. The Korean strategy therefore enabled firms to undertake investments that might have been constrained under purely market-based financing. However, this also meant that the state was increasingly exposed to the consequences of poor investment decisions. World Bank evidence shows that the heavy-industrialisation policies of the 1970s contributed to an overheated economy, low capacity utilisation in heavy industry and subsequent pressure for a shift in credit-allocation policies in the early 1980s (World Bank, 1987).

It is important to point out that directed credit did not eliminate investment risk but redistributed it. Korea redistributed risk towards the state and financial system in order to accelerate structural transformation, while India redistributed access to credit across a broader population and set of economic activities.

4) Conditionality for State Credit and the Firm-State Relationship

In India, eligibility for priority-sector finance was principally category based. A borrower qualified because the activity fell within a designated priority sector. The formal targets established in 1974 and 1980 demonstrate that the policy was designed around the volume and distribution of credit rather than around the subsequent performance of individual firms (RBI, 2014).

Korea's system created a closer connection between financial support and industrial objectives. Cho and Kim (1995) show that policy loans evolved alongside changes in industrial policy: export support was central during the 1960s and early 1970s, heavy and chemical industries became increasingly important in the 1970s, and financial support was subsequently adjusted as the government attempted to restructure and liberalise the economy (World Bank). Westphal (1990) similarly describes Korea's industrial policy as a system in which government intervention and market incentives were combined to accelerate industrial development.

Table 1: Credit allocation in India and South Korea

Dimension	India	South Korea
Main allocation principle	Eligibility by priority criteria	Strategic programme/sector
Primary objective	Broader access to formal finance and financial inclusion	Industrial transformation
Major emphasis	Rural development, growth in agriculture and SSI	Export oriented growth and strategic investment
Allocation style	Rule-based	Discretionary
Main performance criterion	Meeting lending categories/targets	Aligning with industrial objectives and export performance
Risks	Credit access and social developmental risks	Large scale industrial investment risk

Divergence in Credit and Developmental Outcomes

1) Manufacturing Performance

Table 2: Manufacturing Statistics of India and South Korea

Indicator	India	South Korea
Manufacturing value-added (1960)	\$5.5 billion	\$0.45 billion
Manufacturing value-added (1984)	\$28.4 billion	\$23.6 billion
Annual manufacturing growth	7.1%	17.9%

Source: World Bank comparative manufacturing data

World Bank comparative manufacturing data shows that manufacturing value added grew at an average annual rate of 7.1% in India and 17.9% in South Korea between 1960 and 1984 (World Bank, 1985)

The difference in growth rates is particularly striking because India's manufacturing sector remained larger in absolute value in 1984: \$28 billion compared with \$23.6 billion in Korea. The per capita income of India and South Korea revolved around \$85 and \$93 respectively, thus showing that both the countries had low overall national incomes and predominantly rural populations. They started the period with broadly comparable economic conditions. Korea's

advantage therefore lay primarily in the speed of industrial expansion, rather than in having a larger manufacturing sector by the end of the period (World Bank, 1985).

2) Export transformation

According to World Bank national accounts data, Indian exports of goods and services increased from \$1.97 billion in 1965 to \$12.22 billion in 1985, while exports as a percentage of GDP increased from 3.31 percent to 5.25 percent

Table 3: Export pattern and growth of India

Year	Exports	Exports/GDP
1965	\$1969 million	3.31%
1975	\$5561 million	5.65%
1985	\$12217 million	5.25%

Source: World Bank national accounts

According to the Bank of Korea data reproduced by the IMF, Korean exports of goods and services increased from \$290 million in 1965 to \$30455 million in 1985, while exports as a percentage of GDP increased from 8.6 percent to 32.9 percent.

Table 4: Export pattern and growth of South Korea

Year	Exports	Exports/GDP
1965	\$290 million	8.6%
1975	\$5883 million	27.2%
1985	\$30455 million	32.9%

Source: International Monetary Fund (2003)

South Korea's export transformation cannot be attributed to directed credit alone. Korea simultaneously used trade policy, exchange rate management, industrial policy, foreign capital and other instruments, with the financial system forming an important part of this policy architecture. Cho and Kim (1995) explicitly show that Korean credit policy was repeatedly adjusted in accordance with the changing focus of industrial policy. India, by contrast, experienced considerably more limited export expansion during the period. While Indian exports increased substantially in absolute terms, their share of GDP remained relatively low and declined slightly between 1975 and 1985, reflecting India's continued emphasis on import-substitution and domestic industrial development rather than an export-led growth strategy.

313 India's trade regime remained relatively inward-oriented during this period, with policy
314 restrictions limiting the role of external markets in driving industrial expansion.

315 3) Developmental Trade-offs

316 India's post-nationalisation banking system achieved a substantial geographical and sectoral
317 expansion. The share of rural branches doubled from 1965 to 1975, and the rural credit-deposit
318 ratio increased from 37% to 60.6% between 1969 and 1981 .However, the RBI also records a
319 sharp deterioration in banks' return on assets between 1975 and 1985 and identifies
320 weaknesses associated with the extensive system of directed credit (RBI, 2008).

321 The trade-off was therefore between financial inclusion and financial efficiency. The state
322 succeeded in expanding formal credit to previously underserved borrowers, but the lending
323 framework did not always provide banks with incentives to allocate funds according to
324 commercial productivity.

325 Although nationalisation significantly expanded banking access and increased credit to
326 agriculture and small-scale industries, it did not lead to a comparable transformation of the rural
327 economy. Rural areas continued to rely largely on low-productivity activities rather than
328 developing into more diversified industrial centres. Thus, while the policy was successful in
329 widening access to formal finance, its impact on changing the underlying structure of production
330 was more limited. At the same time, the focus on directing existing credit towards priority
331 sectors meant that less capital was available for firms and industries with greater potential for
332 expansion, productivity and technological development. As a result, the policy succeeded in
333 improving access to credit, but the broader economic environment did not always provide the
334 incentives needed for that credit to translate into sustained industrial growth.

335 South Korea experienced the opposite trade-off. Directed finance was sufficiently extensive that
336 policy loans averaged 61% of DMB loans from 1973 to 1991. (Cho & Kim, 1995).

337 The system helped finance the rapid expansion of strategic industries, but the heavy-
338 industrialisation drive also produced macroeconomic and financial pressures. World Bank
339 analysis identifies low capacity utilisation in heavy industry, an overheated economy, faltering
340 exports and the need to tighten financial discipline and alter credit allocation in the early 1980s
341 (World Bank, 1987). Korea's model involved a trade-off between speed and concentration on
342 the one hand, and financial stability and diversification on the other.

343 Discussion

344 The evidence suggests that the conventional distinction between a "strong" Korean
345 developmental state and a "weak" Indian developmental state does not adequately explain their
346 divergent outcomes.

347 India's nationalisation strategy was designed to correct the concentration and urban orientation
348 of the existing banking system. India used banking policy principally to broaden the distribution
349 of formal finance and align lending with social and sectoral priorities. The RBI records that

nationalisation was intended to channel scarce banking resources towards planned development, expand banking into rural areas and increase lending to neglected sectors (RBI, 2008). The subsequent increase in priority-sector lending from 14% in 1969 to 38% in 1984 demonstrates that this objective was achieved and resulted in a measurable change in the allocation of bank credit. (FinDev Gateway)

South Korea's policy loans constituted around half of domestic credit by financial institutions in the 1970s. The composition of loans changed with industrial priorities, particularly the transition from export promotion to heavy and chemical industrialisation (Cho & Kim, 1995) The Korean experience also demonstrates that the relationship between direct credit and development was not automatically positive. The heavy-industrialisation drive contributed to excess capacity and macroeconomic pressures, prompting a subsequent tightening of credit allocation and financial discipline (World Bank, 1987)

Table 5: Comparative Characteristics of State-Controlled Banking

Characteristic	India	South Korea
Primary developmental function	Broader access to finance	Accelerate structural transformation
Major achievement	Geographic and sectoral expansion of banking	Rapid manufacturing and export growth
Principal weakness	Reduced financial efficiency	Concentration and overinvestment
State's principal financial role	Distributor of formal credit	Mobiliser and allocator of investment capital

Conclusion

This paper began with the question of whether the contrasting industrial trajectories of India and South Korea can be partly explained by their differing use of state-controlled banking between 1965 and 1985. The evidence suggests that the relevant distinction was not whether the state intervened in finance, but what the state sought to accomplish through that intervention. Both countries moved toward extensive state direction of credit, yet state control operated as a transmission mechanism for substantially different developmental priorities.

India's post-nationalisation banking system was designed primarily to broaden the social and geographical distribution of formal finance. The expansion of rural banking and priority-sector lending reflected an understanding of development in which access to productive resources, employment and the reduction of financial concentration were objectives in themselves. This approach therefore treated credit not simply as capital for firms with the highest expected returns, but as a policy instrument for redistributing economic opportunity. The consequence

was a wider financial system, but also a weaker relationship between lending decisions and conventional measures of financial efficiency.

In South Korea, credit was more deliberately concentrated around industries and firms considered capable of accelerating structural transformation, increasing exports and acquiring technological capabilities. Credit operated alongside export incentives, industrial policy, foreign technology acquisition and broader state-business coordination. Its effectiveness therefore depended on the institutional strategy into which it was embedded.

The comparison consequently modifies the conventional proposition that state intervention in finance is either developmentally beneficial or economically distorting. India's experience demonstrates that state-controlled banking can expand the developmental reach of finance while sacrificing some degree of commercial efficiency; South Korea demonstrates that concentrated financial direction can accelerate industrial transformation while generating leverage, concentration and financial instability.

The findings thus support a qualified version of the paper's original hypothesis. State-controlled banking did contribute to the divergence between India and South Korea, but not because state control inherently produced either success or failure. Its effect depended on the developmental priorities that determined the allocation of credit. The contrasting outcomes, most visibly reflected in South Korea's much faster manufacturing expansion and India's broader financial reach, were consequently products of different relationships between finance, the state and industrial policy.

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