THE STATE AND THE FINANCIAL SYSTEM IN THE REPUBLIC OF KOREA

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Master of Philosophy

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CERTIFICATE

This is to certify that the dissertation entitled **"THE STATE AND THE FINANCIAL SYSTEM IN THE REPUBLIC OF KOREA"** submitted by **Mr. Vimal Anand** in partial fulfilment of the requirements for the Degree of **Master of Philosophy (M. Phil)** of the University, is an original work and has not been submitted for the award of any other degree of this University or any other University to the best of my knowledge.

We recommend that this dissertation be placed before the examiners for evaluation.

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DEDICATED TO MY FAMILY . . .

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Vimal Anand

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New Delhi,

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CONTENTS

CHAPTER I

EVOLUTION OF THE FINANCIAL SYSTEM IN KOREA

> *"Financial markets essentially involve the allocation of resources. They can be thought of as the "brain" of the entire economic system, the central laws of decision making: if they fail, not only will the sector's profits be lower than they would otherwise there have been, but the performance of the entire system may be impaired."*
>
> - Joseph E. Stiglitz[1]

INTRODUCTION

The importance of the financial system for an economy could be very well gauged by going through the vitals of the developmental process in the so-called (hitherto) "tiger"economies of East Asia, and its subsequent involvement in the wide spread economic crisis in the region. The consequences of the functions and malfunctions of this "brain" of the economy have been on full exposition in the developmental stories of the economies in the world over the period and more recently, in East Asia. Various shortcomings in the financial systems of the different victim economies of the East Asian financial crisis have been attributed to be among the primary factors underlying the crises in East Asia. The on the ebb economic crises in East Asia and subsequently, in other parts of the globe, have once again activated a long standing debate that has engaged economists around the world - regarding the importance of the financial systems in the national economy and the role of the state therein. Subjects of discussion are not just countries in crisis, but a system in crisis - a system not yet sufficiently adapted to the opportunities and risks of

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1 Joseph E. Stiglitz, "The Role of State in Financial Markets", *Proceedings of the World Bank Annual Conference on Development Economics* 1993, The World Bank, 1994.

globalization. The crisis has been notable both for the severity and the virulence with which it has affected not only countries within Asia but also emerging markets in other regions, necessitating extensive official financial support and assistance, especially from the IMF. The economic and social aftershocks of the crisis were more severe than earlier anticipated. Following the July 1997 devaluation of the Thai bath, the currencies of other East Asian countries experienced severe pressures in foreign exchange markets and began to depreciate. Several emerging markets outside the region - notably, Brazil and Russia - were also adversely affected by a shift in sentiment about emerging market vulnerabilities. Mid-1977 onward saw considerably devastating financial turmoil in countries like Thailand, Korea, Indonesia, Malaysia and the Philippines. The second half of 1997 saw the demolition in the media and in the popular perception of the 'myth' of the "Asian Tiger". In a few short months, gone was the hyperbole on Confucian values, the peculiarity of Asian conditions where democracy and economic prosperity worked at cross-purposes, the pragmatism of crony capitalism and the efficiency of other non-market cozy relationships that defined the arrangements between the political and the economic elite. The precipitate pace of this loss of favour, is in sharp contrast to the slow and grudging admiration for the original Asian miracle. Strangely, the crisis that befell the economics of Southeast and East Asia, do not by any mean negate the considerable achievements that they have made in achieving social and educational improvement, in creating a modern industry, physical infrastructure and a work force and environment, which produce an impressive range of sophisticated goods that can compete on quality and cost with the best in the world.

One such economy is the Republic of Korea (South Korea)[2]. The

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2 Henceforth referred to as "Korea"

financial crisis and the resulting economic meltdown in Korea during 1997-98 led to a $58 billion IMF bailout to avoid national insolvency. Korea faced the plummeting of its different indicators of economic growth which had been on a constant high for long. Notwithstanding the recent economic turmoil witnessed in Korea, there can hardly be any doubt that its economic performance during the last three decades was a miraculous achievement. The country was exploited by Japanese colonial economic interests until the end of the Second World War. Subsequently, in the early fifties, the War (1950-53) tremendously devastated the country. It is to the credit of its leadership that the country was able to emerge from the depths of poverty to become the eleventh strongest economy in the world within matter of a few decades. This astounding feat has won for it many admirers and even more students trying to explain how this phenomenal growth was achieved. Free market-friendly economists would argue that the reason was Korea's approach to free enterprise and outward looking economic policies. Protagonists of state-sponsored/supported economic thrust claim that it was all due to the government's policy of "controlled freedom", and massive expenditure on infrastructure and social sectors. Yet another explanation associated with the economist, Paul Krugman, is that it was all due to massive investment in capital and labour. It may not be possible to pin-point the exact responsibility for the growth, but all the three explanations may be right at the same time.

In the light of the deep implication of the financial system in the recent Korean financial crisis and the subsequent fire-fighting measures to salvage the sagging economy, this study (dissertation) aims to do a very comprehensive analysis of the financial system in Korea. The remainder of this chapter will first give a brief summary of the Korean economic development since independence and then go on to study the evolution of the financial system of Korea. As the 1997-98 financial crisis in Korea (and most of East Asia) has acted like a spur for me in embarking on the current study, and the genesis of the crisis is largely seen to be in the fault-lines in the financial system and the overall obsolescence in the entire economy, this Chapter assumes significant pertinence towards giving comprehensives and completeness to this dissertation. Chapter 2 will probe the characteristic strong positive state intervention which has played a major part in stimulating the Korean economic-cum-financial development. It will look at the state-finance interrelationship, which has increasingly come under serious scrutiny, especially since the recent crisis. It will be Chapter 3, then, wherein we discuss the financial deregulation and liberalization process in Korea with stress on the post-1980 period. This will be done amidst the international context that has seen the globalization of finance, and the dynamics of the global financial order. With these (first three) chapters forming the background and context, Chapter 4 will explain the 1997-98 Korean financial crisis and subsequently, deal with the management of the crisis(es). And Chapter 5 will provide the conclusion of the dissertation wherein the findings in the preceding chapters would be re-examined and summarized.

OVERVIEW OF KOREA'S ECONOMIC DEVELOPMENT EXPERIENCE

Korea's economic growth performance in the past three and a half decades has been cited as an exemplary model of rapid economic development and has been termed an "economic miracle". Lucas (1993)[3] even constructed a model for the occurrence of economic miracles based on the Korean growth

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[3] Robert E. Lucas, "Making a Miracle", *Econometrica*, vol. 61, 1993, pp. 251-72.

example. The Korean economic success soon brought into circulation a growth model named "the Korean Model".

Korea started its process of economic development in the early 1960s with a small industrial base and little accumulated capital and technology. The history prior to 1962, when the modern economic development process of the Republic of Korea commenced, was of extreme turbulence in the form of the oppression of the Japanese occupation and the overwhelming devastation caused by the Korean War. On top of this unstable political history, Korea is a small country with few natural resources and little usable land, which comprises only 11 per cent of its total area. This was one of the disastrous consequences of the arbitrary artificial territorial division of the Korean pensusula.. In addition, the country experienced marked population growth since 1953, to the extent that its density per unit usable land became one of the highest in the world.

The post-World War II division of the country had already severed whatever industrial link existed between the north and south, and the Korean War (1950-53) almost completely destroyed the production facilities and infrastructure of the economy. In the 1950s, Korea was a typical low income developing country having emerged out of a very debilitating colonial rule[4]. Its economic condition was marred by decreasing growth and rising unemployment. Like other Asian countries, it was basically an agrarian economy with about 68.3 per cent of the work force depending for their livelihood on agriculture, forestry and fishery, and only 1.5 per cent on manufacturing. The situation was aggravated by political instability, a rapidly expanding supply of the domestic currency, won (W), rampant inflation, an extremely complex market system and an inability to meet most of the basic needs of the consumers. Additionally, because of a lack of planning experience,

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4 The Korean peninsula was under the Japanese colonial rule from 1910-45.

the government went through a long period of trial and error in its development projects. The rapid growth of population[5], accelerated urbanization and unemployment further complicated the economic problems.

Until the 1960s, the economy depended on foreign economic aid. From 1953 to 1960, it received US $ 1.9 billion from the United Nations Korean Reconstruction Agency (UNKRA) and USAID, a level of about US $ 10 per head.[6] The latter financed nearly 70 per cent of total imports between 1953 and 1961 and 75 per cent of total fixed capital formation. About three-quarters of all aid was in the form of commodity exports[7]. The economic policy pursued during this period may be loosely characterized as one of import-substitution of non-durable consumer and intermediate goods behind a protective wall of high tariffs and stringent quotas.

Though the economic reconstruction and development process in Korea had started in the early 1950s, it gathered momentum after coming into power of Park Chung Hee through military coup in May 1961. In spite of the triggering of a long period of political tumult and authoritarianism, economic development continued fairly unhindered with the right initiative coming from the political leadership. The military justified its intervention in politics by reference to the task of economic development; as Park Chung Hee - the

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5 Population was exploding at a rate of 3 per cent p.a. after the baby boom period that began in 1954. The migration of millions of people from the north during the war added to existing socio-economic problems.

6 I.M.D. Little, "The Experience and Causes of Rapid Labour-Intensive Development in Korea, Taiwan, Province, Hong Kong, and Singapore and the Possibilities of Emulation", in Lee, E (ed.), *Export-led Industrialization and Development*, ARTEP, ILO, 1980.

7 See R. R. Krishnan, "The State and Economic Development in Korea", in Sharma, R.C. and Kim, D. (ed.), *Korea-India Tryst With Change and Development;* Khama Publishers, New Delhi, 1993, p. 122.

President of the Republic of Korea from 1963 to 1979 - wrote in 1962: "... the key factor of the May 16 Military Revolution was to effect an industrial revolution in Korea."[8] The economic policies of the junta were initially driven by short-term political concerns rather than a coherent strategy.

With the new government, the high-aid era drew to a close, but the emergence of a new social, economic, and political force had already become evident. The 1950s had decreased the size of agricultural enterprises and had witnessed the death knell of the nobility, along with an increase in the size of industrial enterprises and the tentative groping toward a symbiotic relationship between the state and the progenitors of large diversified business groups (*chaebol*). The rise of the *chaebol*, moreover, relit some of the glimmer of economic activity that had been characteristic of the 1930s. But on the whole, by the early 1960s, the prospects of Korean development, especially in the eyes of the US officials, were extremely gloomy.

When Gen. Park took over, the Korean economy was in dire straits with most Koreans poverty-stricken and the per capital GNP being less than US $100. The country lagged behind its northern counterpart (North Korea) both in terms of per capita income and industrial production capacity. President Park tended to regard politicians as no more than libertines, and at first, heavily suppressed political activities. Discussions concerning economic affairs were encouraged, however. Park's philosophy can be found in his oft-quoted remark that "for such poor people like the Koreans on the verge of near starvation, economics takes precedence over politics in their daily life and enforcing democracy is meaningless". This became the basic philosophy behind Korea's

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8 Park Chung Hee, *The Country, the Revolution and I*, 1963 (Publisher not indicated).

trade and industrial policy in the early 1960s, which assumed that : the higher, the faster, and the more the economy grows, the better.[9]

The Supreme Council for National Reconstruction (SCNR) was set up by the military government and a new era in the political and economic history of Korea began. The SCNR with Gen. Park as Chairman sought to transform the bureaucracy, the political and economic systems in a lightning speed through various measures including "purification campaign". In fact, during the Third, Fourth and Fifth Republics, the 'military elite' came to occupy a pre-eminent position in politics, administration and economy.

The Park regime put forward the economic well being of the nation as the overriding common good. In the name of the nation, it tried to produce economic dynamism by state initiative. The dominant position of the state in the economic development process was expressed by the concept of 'guided capitalism': as formally stated in the First Five Year Plan in 1962, which was formulated by the short-lived Chang Myon government (Second Republic, 1960), "...the principles of enterprises ...will be observed, but in which the government will either directly participate or indirectly render guidance to the basic industries and other important fields."[10] Rather than promoting *laissez faire* capitalism, the Park regime turned to guided capitalism aimed at central control of the economy. This can be seen clearly by the dominant role of the state in planning and regulating economic activities. The regime established the Economic Planning Board (EPB) in 1961 as a key planning agency, with

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9 See Mark L. Clifford, *Troubled Tiger: Businessmen, Bureaucrats and Generals in South Korea*, New York, 1994.

10 See Paul W. Kuznets, *Economic Growth and Structure in the Republic of Korea*, New Haven, 1977.

which other ministries, such as those of Finance, and Commerce and Industry, would make overall plans and regulations.

The government's commitment to economic development made it to initiate a series of Five Year Development Plans that successfully transformed Korea into one of the fastest growing economies in the world. The period 1962-71 marked the breakthrough in the country's modern economic development, because of the significant progress made in strengthening the industrial base and implementing fundamental changes in the natión's development strategies through both policy reform and institutional change.

As a result of Korea's limited natural resources and small domestic market, the government adopted an outward-looking development strategy that emphasized the growth of exports. The essence of this strategy in the 1960s was the promotion labour-intensive manufacturing exports in which Korea had a comparative advantage. To implement this strategy, the government mobilized both internal and external resources on the basis of the market mechanism. Among the significant reforms undertaken in the 1960s were: revamping of trade policy, which included readjustment of exchange rate for export-promotion; direct export subsidies and trade incentives including a variety of tax exemptions, reduced rates on public utilities, tariff rebates for imported products destined for re-export etc.; interest rate reform (1965), promotion of industrial investment by increasing corporate tax incentives; enactment of the comprehensive Foreign Capital Inducement Act (1966); revamping of tax administration; state-guided economic planning; founding of the Export Promotion Council; and creation of the Five-Year Plans through the EPB.

In the early 1970s, Korea experienced dramatic changes and challenges both at home and abroad. A new climate of protectionism spread rapidly, along with the world-wide stagflation caused by the first oil crisis. Labour-intensive light industries, whose international competitiveness was gradually weakening as a result of rapid wages, faced fierce competition from other developing countries.

These circumstances as well as the desire to build up a "wealthy country and strong army" forced the Korean economy to modify its strategic objectives. The government induced industrial restructuring by promoting heavy and chemical industries such as shipbuilding, iron and steel, automobiles, machinery and petrochemicals. The government initiated this drive with the announcement of the Heavy and Chemical Industries (HCI) Development Plan in 1973. Investment in these newly favoured sectors were encouraged through tax and financial incentives. As a result, the share of HCI products in exports expanded from 13 per cent in 1970 to 39 per cent in 1979.

By virtue of the successful transformation of HCIs into new export sectors, Korea was able to retain a strong pace of growth throughout the 1970s. Its remarkable progress let Korea emerge as one of the Asian newly industrializing economics (NIEs), along with Taiwan, Singapore and Hong Kong.

From the late 1970s, the side effects of the growth oriented development strategy and the inefficiency of dirigisme had become conspicuous. They acted as major constraints on sustained economic growth by distorting the allocation of resources and weakening the economy's long-term growth potential. In addition, the second oil crisis hit the Korean economy severely. In 1980, the Korean economy experienced its first ever negative annual growth with a huge current account deficit.

Recognizing the far-reaching nature of the structural problems, the government undertook a series of structural adjustment measures in order to enhance economic efficiency. Priority in management of the economy was shifted from growth to stability. In line with this policy stance, tight monetary and fiscal policies were implemented. Private initiative was increasingly encouraged through deregulation and efforts were made to correct sectoral imbalances. The opening up of the domestic market was accelerated. There was also a government-led rationalization, by way of special loans, mergers and acquisitions in industries which were in trouble due to over ambitious investment or poor management. The 1980s also saw the deregulation and liberalization of the financial system (to be discussed in Chapter 3). As a result of these measures the Korean economy recorded a remarkable performance in the later half of the 1980s[11] (1986-89, see Tables on the following pages).

However, in 1989, the Korean economy's growth slowed abruptly. Exports turned sluggish owing to wage hikes and external factors such as the vanishing of the "three lows"[12] and rapid catch-up growth by late-starter developing countries (esp. in South East Asia). But soon the growth picked up from 1990, stoked by brisk domestic demand.[13]

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11 See Bank of Korea, *The Korean Economy,* 1997 (internet).

12 Namely, low oil prices, low international interest rates and low value of the U.S. dollar in terms of the Japanese yen (mid-1980s onward).

13 Bank of Korea, *ibid.*

KEY ECONOMIC INDICATORS IN THE 1960s

	1962	1969	ANNUAL CHANGE 1962-69(%)
PER CAPITA GNP (US$)	87	210	12.5
REAL GDP GROWTH RATE (%)	2.1	13.8	8.7
CURRENT ACCOUNT BALANCE (MILLION US$)	-55.5	-548.6	-
TRADE BALANCE	-335.3	-991.7	-
EXPORTS	54.8	658.3	41.5
IMPORTS	390.1	1,650.0	24.7
GROSS DOMESTIC INVESTMENT RATIO (%)	11.8	27.9	-
GROSS SAVING RATIO (%)	11.0	21.4	-
PRODUCER PRICES (%)	13.4	6.7	12.9

KEY ECONOMIC INDICATORS IN THE 1970s

	1970	1979	ANNUAL CHANGE 1970-79(%)
PER CAPITA GNP (US$)	253	1,647	22.9
REAL GDP GROWTH RATE (%)	8.8	7.1	8.8
CURRENT ACCOUNT BALANCE (MILLION US$)	-622.5	-4,151.1	-
TRADE BALANCE	-922.0	-4,395.5	-
EXPORTS	882.2	14,704.5	36.4
IMPORTS	1,804.2	19,100.0	27.7
GROSS DOMESTIC INVESTMENT RATIO (%)	24.3	35.8	-
GROSS SAVING RATIO (%)	18.1	28.5	-
PRODUCER PRICES (%)	9.2	18.6	15.5
CONSUMER PRICES (%)	16.3	18.2	15.1

KEY ECONOMIC INDICATORS IN THE FIRST HALF OF THE 1980s

	1980	1983	1985	ANNUAL CHANGE 1980¡-1985(%)
PER CAPITA GNP(US$)	1,597	2,014	2,242	5.3
REAL GDP GROWTH RATE(%)	-2.7	11.5	6.5	6.2
CURRENT ACCOUNT BALANCE (BIL. US$)	-5.3	-1.6	-0.9	-
GROSS DOMESTIC INVESTMENT RATIO(%)	31.9	29.4	30.3	-
GROSS SAVING RATIO(%)	23.2	27.6	29.8	-
PRODUCER PRICES(%)	38.9	0.1	0.9	10.1
CONSUMER PRICES(%)	28.8	3.4	2.4	10.5

KEY ECONOMIC INDICATORS (1986¡-1988)

	1986	1988	ANNUAL CHANGE 1986¡-1988(%)
PER CAPITA GNP(US$)	2,568	4,295	24.2
REAL GDP GROWTH RATE(%)	11.6	11.3	11.5
CURRENT ACCOUNT BALANCE (BIL. US$)	4.6	14.2	-
GROSS DOMESTIC INVESTMENT RATIO(%)	29.2	31.1	-
GROSS SAVING RATIO(%)	33.7	39.3	-
PRODUCER PRICES(%)	-1.4	2.7	0.5
CONSUMER PRICES(%)	2.7	7.1	4.3

KEY ECONOMIC INDICATORS(1989;-1992)

	1989	1991	1992	ANNUAL CHANGE 1989;-1992(%)
PER CAPITA GNP(US$)	5,210	6,757	7,007	13.0
REAL GDP GROWTH RATE(%)	6.4	9.1	5.1	7.5
CURRENT ACCOUNT BALANCE (BIL. US$)	5.1	-8.7	-4.5	-
GROSS DOMESTIC INVESTMENT RATIO(%)	33.8	39.1	36.8	-
GROSS SAVING RATIO(%)	36.2	36.1	34.9	-
PRODUCER PRICES(%)	1.5	4.7	2.2	3.1
CONSUMER PRICES(%)	5.7	9.3	6.2	7.4

KEY ECONOMIC INDICATORS(SINCE 1993)

	1993	1994	1995	1996	1997 1ST HALF
PER CAPITA GNP(US$)	[illegible],484	8,467	10,037	10,548	-
REAL GDP GROWTH RATE(%)	5.8	8.4	8.7	6.9	5.9
CURRENT ACCOUNT BALANCE (BIL. US$)	0.4	-4.5	-8.9	-23.7	-10.5
GROSS DOMESTIC INVESTMENT RATIO(%)	[illegible].2	36.2	37.4	38.6	-
GROSS SAVING RATIO(%)	[illegible].2	35.4	36.2	34.6	-
PRODUCER PRICES(%)	1.5	2.8	4.7	2.7	3.7
CONSUMER PRICES(%)	4.8	6.2	4.5	5.0	4.4

Source: All the above data have been downloaded from the website of the BOK on the Internet.

The governments of Chun Doo Hwan (1980-87) and Roh Tae Woo (1987-92), which succeeded Park's regime continued emphasizing on the export-led growth and other strategies of the Park era with added emphasis on liberalization and deregulation. With the coming of President Kim Young Sam in 1993 and the implementation of the short-term stimulation package termed the "Hundred-day Plan for the New Economy", in line with the "Five Year Plan for the New Economy", more and more steps were taken to make the atmosphere investor-friendly. Though interspersed with occasional contractionary phases, the Korean economy grew remarkably well and smoothly till the 1997-98 crisis befell it.

The economic development success of Korea resulted in its emergence as the 11th largest economy of the World and led to its inclusion in the Organization for Economic Cooperation and Development, OECD - the so-called rich countries' club in December 1996[14]. The phenomenal growth of the Korean economy was more or less consistent at an average of 8.6 per cent p.a. for over three decades till the first half of 1997 (see the Tables).

Socioeconomic Factors And Human Capital Accumulation. The economic success story, also known as the "Korean Miracle", cannot be taken to be complete without acknowledging the tremendous achievement of the Koreans in human resource development and reform of the socioeconomic environment. Unlike countries like India, where there is a caste system which precludes a person from advancing in social status, the class distinction between the noble (*yangban*) and ordinary people was largely destroyed in Korea during Japanese colonial rule (1910-45). The destruction of the

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[14] Korea became the first Asian nation after Japan to join the OECD.

traditional social hierarchy played a major role in motivating Koreans to invest in human capital.

Just before liberation in 1945, 90 per cent of industrial assets were under Japanese ownership, and the rest belonged to a handful of Korean landowners. Between 1949 and 1951, land was distributed to poor farmers through the Land Reform Bill and large landowners disappeared. As a result and due to the uniform effect of the Korean War, Korea saw an unusual equalization in assets and income in the 1950s and became a rare case among developing countries.

Korea has maintained one of the World's most competitive educational systems, in which access to higher education is determined by a uniform standard. Not surprisingly, the literacy rate of Korea is over 95 per cent.

Such an environment of equal status with fair competition created great potential for vertical mobility in society: the general public was given almost equal opportunity and strong incentives to move up the "status ladder" by investing in human capital or by entrepreneurial activities. Of course, human capital accumulation and active business promotion at the individual level would have been unlikely but for the strong, positive initiative of the state. Thus Paul Krugman was led to refute the commonly argued line of thinking in his now famous article. He maintained that the Korean growth was input driven rather than efficiency driven, fueled mostly by the mobilization of large amounts of labour and capital. Coincidentally, this piece of Krugman also went on to gain popularity for having seen an inkling of an impending crisis in East Asia.[15]

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[15] Paul Krugman, "The Myth of Asia's Miracle", *Foreign Affairs*, vol.73(6), November/December, 1994.

To sum up the Korean economic development experience, at the end of the Korean War, Korea was broke and mostly agrarian, with few resources or markets to speak of. It was a charred wasteland with a minuscule GDP per head. But from the early 1960s, under the dynamic initiative and leadership of President Park, a mixture of hardwork, vigorous schooling, state-enforced austerity and imported technology transformed the place. The Koreans started exporting cheap textiles, wigs and toys in the 1960s, then embarked on a massive push into heavy industry a decade later. By the 1980s, the country was churning out ultra-sophisticated 64 K memory chips, only the third country in the world (after US and Japan) to do so. The 1990s saw Korea become the 11th-largest economy in the world and it earned its way into the OECD. State directed bank loans at negative real rate of interest allowed "strategic" industries to invest and expand at a sizzling pace. Exports grew from $ 33 million in 1960 to $130 billion in 1996. A nation of muddy subsistence farmers was transformed, in a single generation, into the world's largest producer of ships and memory chips, its fifth-largest car maker and its eleventh-largest economy.[16] Its development path of state-led, export-oriented industrialisation gave the world, especially the developing countries, a new model of growth - the Korean Model, and a new story - the Korean Miracle, to talk about and emulate. But unfortunately this miracle is now being rethought by many economists as a "myth" after the recent financial meltdown.[17] The Korean economic development process can thus be encapsulated in terms of four stages: (1) import-substitution industrialization (ISI) based on U.S. economic aid in the 1950s; (2) export-oriented industrialization (EOI) based on

16 The Economist, "South Korea - The end of the miracle", November 1997.

17 For example, Paul Krugman, Jayati Ghosh, etc.

labour-intensive, light manufacturing in the 1960s; (3) industrial depeening consisting basically of Heavy and Chemical Industries (HCI), along with export-oriented industrialization with selective use of ISI in the 1970s; and (4) liberalization and internationalization of the economy in the 1980s and the first half of 1990s.[18]

EVOLUTION OF THE KOREAN FINANCIAL SYSTEM

> *"**If finance is an economy's nervous system, financial institutions are its brain**. They make the decisions that tell scarce capital where to go, and they ensure that, once there, it is used in the most effective way"*
>
> *- World Development Report, "Knowledge for Development" 1998/99*

A developed and efficient financial system plays an important role in economic growth. *The World Development Report, 1989* highlights the importance of financial systems in economic development. It summarises the importance of the financial sector in the following words:

> A financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialisation in production. Financial assets with attractive yield, liquidity and risk characteristics encourages saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables economic agents to pool, price and exchange risk. Trade, the efficient use of resources, saving, and risk taking are the cornerstones of a growing economy.[19]

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18 Richard P. Appelbaum and Jeffrey Henderson (ed.), *States and Development in the Asian Pacific Rim*, Sage Publication, California, 1992, p. 122.

19 *World Development Report, 1989,* World Bank, OUP, New York, 1989.

A developed financial sector performs two growth-promoting functions: (1) it facilitates trade and specialisation; and (2) it facilitates capital accumulation.

In Korea, the financial system has served as the fulcrum of industrial policy and as a fundamental tool with which the policymakers could induce business cooperation and compliance. Thus, government control over finance has been a persistent feature of the politico-economic structure of Korea.

The shaping of a modern financial system of Korea can be said to have commenced during the Japanese colonial rule (1910-45). With the inauguration of the independent government in 1948, it requested foreign advisors to prepare a financial reform plan. Reflecting the prevailing notion of independent central banking system at the time, the plan submitted in 1950s and immediately accepted by Korean policymakers, envisioned a highly liberal financial system in Korea.[20] The foundation was laid with the transformation of the Bank of Chosun into the fully independent central Bank of Korea (BOK) through the Bank of Korea Act and the General Banking Act (June 1950), based on the plan. But no sooner this was done, than the Korean War broke out. The budding BOK's autonomy and independence was inevitably compromised. Instead, the Ministry of Finance (MOF) took over monetary policy, relegating the BOK as war-time money printer. Commercial banks, which came into the hands of the Korean government following the repossession of the Japanese-owned shares and had been planned to be privatized,[21] were subject to tight government control as well.

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20 A.I. Bloomfield and J.P. Jensen, *Banking Reform in South Korea,* New York, 1951.

21 *Ibid.*, p. 73.

As the reconstruction began from around 1954, the government reorganized the financial system. First, it strengthened the long-term development financing system. The central and commercial banking systems were realigned under the new institutional bases provided by the BOK Act and the General Banking Act. The MOF turned the then Industrial Bank into the Korea Development Bank (KDB). The KDB, however, depended heavily upon the BOK for its leading resources. And it was true for other development banks such as the Korea Agricultural Bank. These specialized banks' share of credit increased rapidly. By the end of 1955, the KDB's share alone accounted for over 40 per cent of total bank lending.[22]

Second, the government enacted the so-far defunct General Banking Act and hastened to privatize commercial banks. Initially the government tried to restrict, in response to public worry about economic concentration, the upper limit of private ownership of bank shares and the transfer between large shareholders. But these restrictions rendered futile all six successively held auctions in 1956. Only after those restrictions were significantly released, the privatization move could be completed in 1957.

As expected, major *chaebol* groups could acquire the controlling shares of the commercial banks. As a result, commercial bank loans began to be largely "monopolized" by those *chaebol* firms. And political funds were also raised through these privatized banks.[23] But it should be noted that, after the privatization, the relative position of the four commercial banks in terms of

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22 David C. Cole and Yung Chul Park, *Financial Development in Korea, 1945-78* Cambridge, Mass: Harvard University Press, 1983, p. 52.

23 Myo Min Im, *The History of Banks in Korea* (Seoul, 1963), pp. 133-136.

their share of commercial banks in total bank credit outstanding declined substantially.[24]

With the military government taking power in 1961 the quite liberal financial regime of the 1950s was almost completely demolished. First of all, the "Temporary Law Regarding Commercial Banks" was promulgated, which restricted the voting rights of large stockholders and then "nationalized" the commercial banks by repossessing the shares held by large stockholders (being accused of as illicit wealth amassers).[25] The tainted image of the commercial banks since their privatization in 1957 and the public's concern about economic concentration through financial monopolization, and the public anathema against corruptive political interference's provided partial justification to this nationalization move. The heavy reliance of the commercial banks on the government and the BOK loans for the lending resources at the time provided a further justification. Second, the military government amended the Bank of Korea Act in May 1962, and thereby made it explicit that it was the government, not the central bank, that was to be held ultimately responsible for monetary policy. It thereby effectively ended the recurrent controversy over the independence of the central bank and the continued struggle between them.[26] The government made it clear that it would use the BOK as a ready

24 Cole and Park, *op.cit.*, pp. 54-55 (Table 11).

25 Instead of punishing the accused leading businessmen as criminals or appropriating their illicit wealth outright, the military government took this opportunity to elicit their support for and active participation in the economic development plan.

26 On the controversies since around 1957 over the constitutionality of the Bank of Korea Act and the proper relationship between the government and the central bank, see Byong Kuk Kim, *Central Banking in a Developing Economy* (Seoul: The Korean Research Center, 1965), The Korean Studies Series, vol. 12, pp. 77-90.

source of government debt financing.[27] Moreover, it authorized the BOK's direct acceptance of industrial finance debentures issued by the KDB and indirect route for government borrowing from the BOK.

Third, the list of specialized development banks was further expanded: the Central Federation Agricultural Cooperation and the Medium Industry Bank in August, and the Citizen's National Bank and the Central Bank of Fisheries Cooperatives in 1962. The political motive behind the establishment of the first two banks could be found easily from the fact that farmers and medium and small businessmen had had to rely heavily on private money lenders.

In addition, the military government revised the Korea Development Bank (KDB)'s charter to increase its capital, to authorize it to borrow funds from abroad, and to guarantee foreign loans obtained by private firms. In particular, the authorization of the KDB's foreign borrowing and loan guarantee indicated the government's ready reliance on foreign capital as a major source of financing for economic development in the wake of the declining foreign aid and the changing U.S. aid policy.[28]

Indeed, the level of foreign aid continued to decline and was to be terminated soon.[29] The military leaders understood the changing U.S.

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27 In tne period of 1950-62, a maximum of 97 and a minimum of 86 percent of the total government debt financing was made by borrowing from the BOK. *Ibid.*, p. 105.

28 For the backgournd of the change in the U.S commitment, see David C. Cole and Princeton N. Lyman, *Korean Development: The Interplay of Politics and Economics* (Cambridge, Mass: Harvard University Press, 1979), p. 90.

29 Foreign aid received continued to rise between 1953 ($ 201.2m) and 1957 ($ 382.9m). In 1957, aid as a percentage of imports amounted to 86.6 per cent. From 1958 on, the amount of foreign aid began to decline sharply: 1959 ($222m) 1961 ($ 207m), , 1965 ($134), respectively. See Ann O. Krueger, *The Development Role of the Foreign Sector and Aid* (Cambridge, Mass: Harvard University Press, 1979).

commitment to loans instead of aid clearly and began to devise mechanisms to enhance foreign borrowing. It was under these circumstances that the Korean government promulgated the "Law of Guaranteeing Foreign Loans" in July 1962, whereby capital imports could be financed by long-term export credits and sent an economic mission abroad to secure financing for major projects included in the Five-Year Plan.[30] The speeding up of the "normalization of foreign relations" talks with Japan, the most promising source of foreign financing and technology, during 1961-65 was made in this context.[31]

The government policymakers' turn to foreign loan, in lieu of foreign aid, as a major source of financing for economic development plans changed the role of Korean banks and the attitude of business greatly. Firstly, the domestic banks became facilitators and guarantors of external finance.[32] But they did not actually intermediate between the foreign lenders and domestic borrowers, as the foreign loan negotiations were conducted directly between them and approved by the Economic Planning Board (EPB). The banks basically issued the guarantees on instruction from the government and took little responsibility for evaluating either the economic or financial feasibility of the guaranteed loan development projects. As a result, the banks played a very limited role in the decision-making process regarding these loans, and thus had little basis for being held accountable for bad loans. It was the government

30 Krueger, *ibid.*, pp. 110-111.

31 The normalization talks and settlement with Japan was an extremely hot and controversial political, economic an social issue in the 1960s. On the detailed description and analysis of this process, see Cole and Lyman, *op. cit.*, pp. 98-118.

32 Cole and Park, *op. cit.*, pp. 60-61.

that had to take extraordinary measures whenever the guaranteed-loan projects proved unsound.

Thus, with the active interest and initiative coming from the government headed by President Park Chung Hee, the financial system in Korea started acquiring shape and maturity. A competent financial system was put on the rails of evolution and since the mid 1960s it grew considerably and achieved a more diversified structure. By the early 1970s Korea was able to have a rather elaborate financial system with a variety of modern and specialized financial institutions.

Financial Institutions In Korea

The financial institutions in Korea may be divided into three categories by function: a central bank, that is the Bank of Korea, banking (or monetary) institutions[33] including commercial and specialized banks, and non-bank financial institutions/intermediaries (NBFIs) including development, savings, investment, insurance and other institutions. In addition, there are institutions which are related to the securities market as well as quasi-financial institutions which do not fall into the category of financial institutions, but which are engaged in financial activities in a broad sense.

Bank of Korea. The Bank of Korea, which is the central bank of the Republic of Korea[34] was established in June 1950 under the Bank of Korea

33 Also known as deposit money banks.

34 The BOK is analogous to the Reserve Bank of India (RBI) in India, but structure and funtion-wise it is closer to the central bank of Japan...

Act. The Bank performs the usual functions of a central bank, maintaining the value of money and serving as a banker to the banking sector and the government and as a supervisor of banking operations under instructions from the Monetary Board, its supreme policymaking body.

Banking Institutions

I. Commercial Banks

(i) *Constituent Institutions and Main Characteristics*

The commercial banking sector has played a leading role in mobilizing financial savings and financing capital needs of the economy. As of end of June 1997, commercial banks consisted of 15 nationwide commercial banks, 10 local banks and 69 foreign bank branches.[35] Most of the nationwide commercial banks have a fairly long history, but the local banks were set up more recently, form 1967 to 1971, for greater balanced regional economic development. Also, in 1967, foreign banks were allowed to open branches in Korea.

Each group of commercial banks in Korea has certain distinctive characteristics.

First, nationwide commercial banks have adopted a branch banking system throughout the country. The total number of domestic branches of the nationwide commercial banks amounts to 4,042. They are authorized to engage in long-term financing in addition to short-term financing. Long-term funds

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35 Bank of Korea, *Financial System in Korea*, 1997 (Internet).

have, however, been met, in part, by way of frequent roll-over or renewals of short-term loans.

Second, local banks have each adopted a branch banking system within a province, except for ten branches in Seoul and up to two branches in each of six major provincial cities which are not home to their own head office. Their main business clients are small and medium enterprise in their region.

Third, foreign bank branches have tended to specialize in the wholesale banking business.[36]

(ii) Sources and Use of Funds

The nation-wide banks held total assets amounting to about 223 trillion won, representing a 78 per cent share in the total assets of commercial banks as of the end of 1996.

Their principal source of funds are deposits in domestic currency. At the end of 1996, deposits in domestic currency and negotiable certificates of deposit (CDs) accounted for 49 per cent and 7 per cent of total sources, respectively. As to uses of funds, the nation-wide commercial banks operated the largest proportion, 42 per cent, as loans and discounts.

The financial structure of the local banks is similar to the nation-wide commercial banks, except for the fact that the share of securities investment in their uses of funds is relatively high, whereas that of foreign exchange business is small.

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36 *Ibid.*

Foreign bank branches' most important source of funds is the inter-office account which, as of the end of 1996, represented 60 per cent of their total sources while deposits in domestic currency constituted only 2 per cent. Loans in foreign currencies accounted for 24 per cent of their total use of funds and inter bank loan in foreign currencies represented 19 per cent of their total uses of funds.[37]

II. Specialized Banks

The government also established a number of specialized banks in the 1960s to lend financial support to underdeveloped or strategically important sectors. As of the end of June 1997, there were five specialized banks: the Industrial Bank of Korea, for the financing of small and medium enterprises; the Korean Housing Bank, for housing loans - which changed its status from a specialized bank to a nationwide commercial bank in September 1997; the credit and banking sector of the National Agricultural Cooperative Federation, for agricultural and forestry loans; that of the National Federation of Fisheries Cooperatives and its member cooperative, for fishery loans; and that of the National Livestock Cooperative Federation, for livestock loans.[38]

The specialized banks share the following main characteristics.

First, they were established to provide funds to particular sectors whose supply of funds through commercial banks was insufficient due to limited

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37 *Ibid.*

38 *Ibid.*

availability or low profitability. With subsequent changes in the financial environment, however, they have expanded their business into commercial banking areas, although their share of funds allocation to their relevant sectors is still relatively high. Now most specialized banks have, by and large, the same pattern of business as the commercial banks.

Second, they rely heavily on deposits from the public for their source of funds in addition to the issue of debentures and borrowing from government. Therefore, they compete with commercial banks in acquiring deposits.

Third, they are, in principle, directed and supervised by the government. Some areas of their business operations are, however, subject to the control of the Monetary Policy Committee. The same minimum reserve requirements and maximum interest rates are imposed upon the specialized banks as on the commercial banks.[39]

III. Non-Bank Financial Institutions (NBFIs)

(i) Constituent Institutions and their Functions

Non-bank financial institutions (NBFIs) can be broadly classified into five categories according to their business activities: development, savings, investment, insurance and other institutions. Most NBFIs were introduced in Korea during the 1970s in order to diversify financing sources, to promote the development of the money market, and to attract funds into the organized market.

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39 *Ibid.*

As of the end of June 1997, development institutions consisted of the Korea Development Bank, the Export-Import Bank of Korea and the Korea Long Term Credit Bank. They provide medium- and long-term loans or credit for development of key sectors such as the export or heavy and chemical industry with government funds and funds financed by the inducement of foreign capital or the issue of special bonds.[40]

Saving institutions consist of the trust accounts of banks, mutual savings and finance companies, credit unions, mutual credit unions, mutual credit facilities, community credit cooperatives and postal savings. They grant various small loans with funds financed by special deposit-taking in the form of time deposits.[41]

Investment institutions act as financial intermediaries in the money and capital markets. They consisted of 30 merchant banking corporations, 26 securities investment trust companies, and the Korea Securities Finance Corporation as of the end of June 1997.[42]

Insurance institutions consisted of 21 domestic life insurance companies, 7 joint ventures with foreign insurance companies, 2 branches and 3 subsidiaries of foreign life insurance companies, and postal life insurance during the same period as above.

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40 *Ibid.*

41 *Ibid.*

42 Ibid.

In addition to the above mentioned financial institutions, there are other institutions such as securities companies, leasing companies, and installment credit companies, of which the last group commenced its operations in 1996. These institutions function as supplementary financial institutions although they do not act as financial intermediaries.

IV. Money and Securities Market

(A) Money Market

The money market in Korea embraces the call market and a wide range of other financial markets including those for Monetary Stabilization Bonds (MSBs), negotiable certificates of deposit (CDs), repurchase agreements (RPs), corporate bills including commercial paper (CP), and Treasury bills (TBs).

During the period from 1980 to 1996, there was a sharp increase in the outstanding balance of money market instruments. This was chiefly due to product innovation and the expansion in the number of financial institutions handling these instruments.[43]

(B) Securities Market

The securities market is also an important financial market. The growth of the securities market in Korea has been quite impressive. Encouraged by government efforts and the improved investment climate with sustained economic growth and the gradual opening of the stock market, the role of the securities market in mobilizing funds has been greatly strengthened. In

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43 *Ibid.*

addition to raising equity capital for corporations, the securities market has diluted some of the concentration of equity ownership. Institutions which are related to securities market include: the Securities and Exchange Commission, the Securities Supervisory Board, the Korea Stock Exchange with twenty five securities companies as members, the Korea Securities Finance Corporation, the Korea Securities Settlement Corporation, and the Korea Securities Dealers Association.[44]

During the period from 1980 to 1996 the traded value of listed stocks jumped more than one hundred fold from 1.1 trillion won to 14.2 trillion won and the stock price index recorded around a six-fold increase. In line with this, direct corporate financing through the securities market showed a notable increase.[45]

Finally, there are a few **quasi-fianancial institutions** which do not fall into the category of financial institutions, but are engaged in businesses similar or closely related to those mentioned above. They include the National Investment Fund, the National Housing Fund, leasing companies, non-life insurance companies, venture capital companies, the Korea Credit Guarantee Fund and the Credit Insurance Fund.[46]

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44 *Ibid.*

45 *Ibid.*

46 *Ibid.*

Trends in the Market Share of Financial Institutions

There have been enormous structural changes in the financial system in recent decades and these are reflected in the market share of different institutions. The market share of banking institutions has shrunk considerably while that of non-bank financial institutions has grown rapidly.

The market share of banking institution in terms of won deposits dropped sharply from about 71 per cent in 1980 to around 32 per cent in 1996 while that of non-bank financial institutions increased from about 29 per cent to around 68 per cent during the corresponding period. Among them, the share of saving institutions has risen especially sharply. As for loans and discounts, the market share of banking institution contracted form about 63 per cent to about 42 per cent while that of NBFIs expanded form 37 per cent to around 58 per cent during the same period.[47]

These large shifts in market share were caused largely by differences in regulatory treatment: NBFIs were for long allowed relatively greater freedom in their management of assets an liabilities and, most importantly, permitted to apply higher interest rates on their deposits and loans than those of banking institutions.[48]

Going through the evolution and development processes of the financial system in Korea in the preceding pages, we have seen that it has grown

47 *Ibid.*

48 *Ibid.*

considerably and achieved a more diversified structure since the mid-1960s. Between 1965 and 1970, the system grew rapidly in overall size. Since the early 1970s, the financial system has responded to the evolution of the real economy. The 1980s and pre-crisis 1990s saw it embracing the world wide trends of liberalization, deregulation and internationalization/globalization. As the Korean economy has become rapidly industrialized and more complex, there has been some diversification as the NBFIs have experience substantial growth. There has also been significant developments in direct types of financing, in the form of commercial paper, bonds, and debentures. The development of he financial system has therefore been influenced by the pattern of growth in the real economy and by financial policies.[49]

The average ratio of total financial assets increased from 0.9 in the first half of the 1960s to 3.1 in the first half of the 1980s and about 6 in the first half of the 1990s.[50] As domestic financial sources were insufficient to meet the ever growing fund demand, however, Korea used foreign capital to close the savings gap. The amount of outstanding foreign loans has grown steadily since the early 1960s, and the ratio of total foreign loans to GNP rose form 7.0 per cent in the first half of the 1960s to about 49.0 per cent in the first half of the 1980s and over 60 per cent in 1990s.

The study of the evolution of the Korean financial system would lead us to divide it into five periods:[51]

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49 The financial policies would be discussed at some length in the succeeding chapters.

50 Korea Annual, 1997.

51 Partially derived from Dukhoon Lee, "The Role of Financial Markets in Korea's Economic Development", *KDI Working Paper No. 8801*, KDI, Seoul, 1988.

i) Period of Financial Stagnation (Independence to 1965)

ii) Period of Rapid Financial Growth (1965-1971)

iii) Period of Deceleration of Financial Growth (1972-79)

iv) Period of Liberalization and Financial Deregulation (1980-1996)

v) The 1997-98 Crisis and Subsequent Reforms Period (1997-till date)

Let us now look at the other characteristic and inalienable aspects of the Korean financial system *seriatim* in the forthcoming chapters.

CHAPTER 2

STATE - FINANCE INTERRELATIONSHIP

"...it is very easily forgotten that [international financial] markets exist under the authority and by permission of the state, and are conducted on whatever terms the state may choose to dictate, or allow."

- Susan Strange, in *Casino Capitalism* (1986)[1]

The orthodox view (esp. of the neo-classical school[2]) that Korea owed its success to the absence of government [state] intervention has come under strong criticism from outside the World Bank (and also from within). "If there has been a grumbling of dissent from inside the World Bank, there has been a crescendo of disagreements from outside the World Bank. A large number of economists .... agree on one thing , namely, that state intervention has been considerable in the economy."[3] As Wade and others[4] have made clear, the role of the government was important. Korea's economic success partly depended on the ability of the state to support and actively promote industrial and trading interests, and in particular to provide the essential social overhead investment.[5] In fact, the Korean state has been the most interventionist among the East

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1 Susan Strange, *Casino Capitalism*, Basil Blackwell, Oxford, 1986.

2 As expounded by Balassa (1981), Krueger (1979) and others.

3 J. Henderson, "The Role of the State in the Economic Transformation of East Asia", in C. Dixon and D. Drakakis-Smith (ed.), *Economic and Social Development in Pacific Asia,* Routledge, London, 1993.

4 Robert Wade, *Governing the Market:Economic Theory and the Role of Government in East Asian Industrialisation*,Princeton University Press, Princeton, NJ, 1991; and Alice Amsden, *Asia's Next Giant*, OUP, Oxford, 1989; etc.

5 Robert Castley, *Korea's Economic Miracle: The Crucial Role of Japan*, Macmillan Press, 1997.

Asian NICs. "By means of planning, direct or indirect ownership and control of enterprises and financial institutions, control of foreign exchange, ... the Government [state][6] has played a crucial role in adjusting the scale of the market, and incentives, in pursuit of its desired economic, social ...objectives."[7]

Theoretical Underpinning

The contemporary concept of the state owes its origin to Machiavelli who expressed this idea in the early sixteenth century as 'the power which has authority over men' (*The Prince*). According to Weber's definition, which is widely acknowledged in modern political theory, " a 'state' is a human community that (successfully) claims the *monopoly of the legitimate use of physical force* within a given territory." R.M. MacIver, in his famous work, *The Modern State*, has sought to distinguish the state from other kinds of associations in that it embraces the whole of people in a specific territory and it has a special function of maintaining social order. It performs this function through its agent, the government, 'which speaks with the voice of law' (p. 22). Harold J. Laski, in *An Introduction to Politics,* similarly points out: "... The state, so to say, is the crowning-point of the modern social edifice, and it is in its supremacy over all other forms of social grouping that its special nature is to be found." (p. 9) The constituent elements of the state include: population, territory, government and sovereignty.[8]

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6 The terms *state* and *government* are used interchangeably in this dissertation while depicting their role in the economy, although the former is more inclusive than the latter.

7 J. Chung. "Republic of Korea - Economy", *The Far East and Astralasia,* 26th edn., Europa Publications, London, 1995.

8 O.P. Gauba, *An Introduction to Political Theory* , Macmillan India Ltd., 1995, (3rd Edn.) pp. 56-57.

Since its conception, the term 'state' has been used in various ways and combinations, e.g., 'slave-owning state', 'feudal state', 'capitalist state', socialist/communist state', 'hard/soft state (by Gunnar Myrdal, in *Asian Drama*, 1967), 'authoritarian state', 'strong state', 'bureaucratic state', as well as 'pre-state society', 'strong state' 'stateless society', etc. The empirically-oriented political scientists of the liberal tradition used the term 'state-building', especially in the context of developing societies, which signified a renewed interest in the concept of' 'state' as an institutional and constitutional mechanism.[9] Then, in the 1980s attention swung back to the state, as exemplified by T. Skocpol,[10] 'Bringing the State Back In'. However, in contrast to the earlier concept of the state as an institutional structure, it was redefined as an active agent of shaping and reshaping society.[11] It is in this context that the term 'state' is constantly referred to in political economy (and in this dissertation) and has been often substituted by the alternative, the 'developmental state' and sometimes even the 'entrepreneurial state.' The states in East Asia and many developing countries have been given credit for playing a positive economic role. They have increasingly taken the central role in industrialization and overall economic development. In fact, states in modern history have always intervened to spur economic activity, right since the First Industrial Revolution. To catch up in the twentieth century has required still heavier doses (than those in the industrialized West) of government support because backwardness has been relatively greater. Not

9 As against the earlier distaste of the liberalists for the term 'state'.

10 P. Evans, D. Rueshemeyer and T. Skocpol (ed), *Bringing the State Back In: Strategies of Analysis inCurrent Research*, Cambridge University Press, Cambridge, 1985).

11 Gauba, *op.cit.*, p. 56.

only have states in late-industrializing countries (like Korea) intervened by protecting infant industries, they also have intervened by providing private investors with a battery of incentives that, simplified, boil down to subsidies. The tariff epitomizes the age of intant industry protection. The subsidy, which includes tariff protection and financial incentives, epitomizes the struggle to industrialize [at the states' initiative] after the Second World War.[12]

Under a diversity of disequiliberating conditions in economically backward countries, the state's role in late industrialization is to mediate market forces. It has intervened to address the needs of both savers and investors, and of both exporters and importers, by creating multiple prices. According to Alice Amsden, "... the state in late industrialization has set relative prices deliberately "wrong" in order to create profitable investment opportunities."[13]

The state's intervention in economic development can be discussed in the context of organic statism, whereby the state assumes the responsibility for defining the common good of the whole society (nation). By replacing private initiative with overall state guidance and regulation in economic and political activities, the state exercises a greater control over different class groups.[14] This phenomenon of active intervention by the state in shaping the economic-political system is often referred to as "state-corporatism".

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12 Amsden, *op.cit.*, pp. 12-13.

13 Amsden, *op.cit.*, pp. 13-14.

14 See Hyun-Chin Lim, *Dependent Development in Korea, 1963-1979;* Seoul National University Press, 1985, pp. 75-76.

THE STATE AND ECONOMIC DEVELOPMENT IN KOREA

Several factors have determined the capacity and autonomy of the states in East Asia, including the historical role of the state, the state's autonomy from domestic partisan interests, and its domination of society have long been part of East Asia both intellectually and culturally. In East Asia, the origin of the state, regardless of how one defines it, can be traced back to the beginning of the societies. Since the Qin dynasty established a centralized state almost two thousand years ago, the states in China, Korea, and, to a lesser extent, Japan, have developed elaborate and complex structures with an absolute (or symbolic) emperor and elaborate bureaucracy that wielded not only political but cultural and economic power over society. States in East Asia are historically expected to be militarily creative, spiritually impressive, and economically productive. East Asians expect the state to foster economic growth not only to benefit the public but to build the country's military potential.[15]

The capacity of the East Asian States has been determined by the strong elitist orientation, which allowed the Confucian paternalistic state to be staffed by the best educated elites. Korea, along with Japan and Taiwan, followed the Chinese tradition of recruiting civil servants from the best-educated individuals through a competitive civil service examination. The state examination system kept the channel to political power open for talented and ambitious individuals.

Another factor that has influenced the role of the state in East Asia is the contact and sometimes humiliating experiences of East Asian states with the

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15 R. Hofheinz and K. Calder, *The Eastasia Edge*, Basic Books, New York, 1982.

Western powers in the modern era. Unable to defend themselves from external pressure, the old feudal regimes in China and Korea collapsed; one became a semi -colony, and the other a colony. As they recognized their backwardness and were subjected to Western imperialist aggression, the East Asians came to believe that they needed a powerful state that would use its overwhelming political power to resolve their problems at once.

The modern experience with foreign powers nurtured the East Asian proclivity to view existing world markets as favouring economically strong actors - who at least have more choice than economically poor ones, even in an ideal free trade regime - and to regard power relations as having a crucial bearing even on economic comparative advantage. Thus from the beginning, the East Asian states tended to show a strong nationalist attitude.[16]

While their modern experiences with foreign powers led East Asian states to develop a strong nationalistic tendency, their turbulent socio-political experiences more recently, have further contributed to the strong internal autonomy of the states.

In sum, the hard state nurtured through the traditon of the Confucian Chinese culture and strong nationalism made it possible for the East Asian countries including Korea, to view the state as a mobilizer for economic development - a goal accepted as a common good, beneficial to all members. Although explicit coercion was, in reality, frequently employed, the Confucian

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16 In the extreme, China and North Korea (DPRK) adopted a stance of self-reliance and closed their economy to any foreign influence. Even for the followers of an outward-oriented development strategy, such as Korea (South, ROK) and Taiwan, self-reliance or economic independence had great appeal, and the outward orientation was accepted only as a means of attaining self-reliance.

values helped to justify, and, to a certain extent, actually moralize, political authority by stressing the collective interest and the ruler's responsibility to take care of the needs of the ruled.[17]

The state in Korea has been characterized as a developmental state, as opposed to the regulatory state of the West, because it has played an active, intervening role in economic development.[18]

Prior to the formation of the Republic of Korea in 1948, the American Military Government in Korea (USMGIK) and the fledgling Korean state achieved a major significant task by intervening in a crucial land/agrarian issue which had far-reaching socio-economic and political consequences. The pre-capitalist colonial legacy of skewed land holding pattern and oppressive tenancy system was dismantled. Land reforms based on the principle of 'land to the tiller' were introduced and the industrial assets of the colonial state and the Japanese industrialists were taken over. These led to the emergence of a more egalitarian socio-economic order which enormously contributed to the industrial transformation of the sixties and seventies.

While it presided over a certain amount of import substituting industrialization, Syngman Rhee's regime (1948-60) was more predatory than developmental.[19] The 1950s paralleled the millennium of (Yi) dynastic

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17 Keun Lee, *New East Asian Economic Development - Interacting Capitalism and Socialism*, M.E. Sharpe, Inc., New York, 1993. For more on the relation between the Asian values and economic development, see Francis Fukuyama, "Asian Values and the Asian Crisis", *Commentary*, February 1998.

18 Chalmers Johnson, in Keun Lee, *ibid.* Also see Peters B. Evans, "The Future of the Developmental State", *Korean Journal of Policy Studies*, vol. 4, 1989, pp. 129-146.

19 *Ibid.* (Evans, P.B., 1989), p. 132.

rule that ended in 1876 in that more energy was spent plundering the existing surplus than producing more, the surplus itself arriving in the alluring form of U.S. foreign aid for war reconstruction.[20] The Korean state used its power and authority to distribute this external aid which gave it an additional instrument to intervene in the economic and political processes.[21] But despite massive U.S. aid, government deficits constituted a major drain on domestic savings. Rhee's dependence on private sector donations to finance his political dominance made him dependent on clientilistic ties with individual businessmen and, not surprisingly "rent-seeking activities were rampant and systematic".[22]

The state activism in Korea got a massive fillip with the coming into power of the military regime headed by Park Chung Hee in 1961. The Park regime put forward the economic well-being of the nation as the overriding common good as already mentioned earlier (in Chapter 1). In the name of the nation, his regime tried to produce economic dynamism by state initiative. In the drive towards industrialization led development, the government of Korea, starting from 1962, intervened repeatedly and at different points in the economic process. The dominant position of the state in this process was expressed by the concept of "guided capitalism"[23]: as formally stated in the

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20 The average annual inflow of aid from 1953 through 1958 was $270 million excluding military assistance, or roughly $12 per capita per year. This was nearly 15 per cent of the annual GNP and over 80 per cent of foreign exchange. See D.C. Cole and P. Lyman, *Korean Development*, Harvard University Press, Cambridge, Mass., 1971.

21 Amsden, *op.cit.*, pp. 38-39.

22 T. Chang, in Evans, *op.cit.*

23 But the term was discarded during the Second Five Year Development Plan (1967-73).

First Five Year Plan in 1962, "the principles of free enterprises... will be observed, but in which the government will either directly participate in or indirectly render guidance to the basic industries and other important fields".[24] Rather than promoting *laissez-faire* capitalism, the Park regime turned to guided capitalism aimed at central control of the economy this can be seen clearly by the dominant role of the state in planning and regulating economic activities. The Economic Planning Board (EPB) was established as a key planning agency - "superagency" in the economic field - with which other ministries, like the Ministry of Finance, and the Ministry of Commerce and Industry, would make overall plans and regulations. These tasks were coordinated on a before-and-after basis by the Economy and Science Council under the direct leadership of the President.[25]

Korea's was a mixed economy, with the plans being indicative rather than mandatory. During the Park regime, four FYPs were launched, tailored to the fluctuations of the domestic and international economies. Each plan gave priority attention to specific targets for growth rates of GNP, agriculture, industry, trade, investment, technology induction, savings, social development, social welfare and so on. The enforceability of plans was derived from administrative measures and legislation.[26] Intervention through government

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24. Paul Kuznets, *Economic Growth and Structure in the Republic of Korea*, Yale University Press, New Haven, 1977, pp. 199.

25. An interesting fact here is that Korea adopted guided capitalism from the Japanese development experience. The Japanese model of development is highlighted by the state's careful guidance of outward looking development in an indicative planning method. See Ezra F. Vogel, *Japan as Number One: Lessons for America*, Harvard University Press, Cambridge, 1979, pp. 153-96

26. Lim, *op. cit.* p. 76

regulation was also characteristic of the Park regime. Regulations focused on credit rationing, tariff protection, exchange rates, tax exemptions, etc..

The effectively centralized administration cooperated closely with business interests. State intervention was "market augmenting" (as opposed to "market-suppressing") in the sense that it reduced uncertainties and risks related to business, generated and disseminated information about opportunities, and inspired an attitude of expansion among the people.[27] Economic expansion was boosted by state intervention to create price distortions that directed economic activity toward greater investment. In Alice Amsden's words, the state "set relative prices deliberately 'wrong' in order to create profitable investment opportunities."[28] Besides, the state exercised discipline over private enterprise as a part of the vision that drove the state to industrialize in Korea Discipline comprised two interrelated dimensions: (a) penalizing poor performers; and (b) rewarding only good ones.[29] The discipline exerted by the state, and the rise of big business, were interactive. Big business consolidated its power in response to the government's performance-based incentives. Even the infant industries were encouraged by the state under its reward scheme. The sternest discipline imposed by the Korean government on virtually all large size firms related to export targets. Pressure to meet ambitious export targets gave the Big Push into heavy industry its frenetic character. Thus, in the late 1970s, the Korean state turned in an even more interventionist direction in an effort to develop HCI under its export-oriented

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27 Lee, *op.cit.* p. 25.

28 Amsden, *op.cit.* pp. 13-14.

29 *Ibid.*, pp. 14-15.

industrialization model. Besides, firms were subject to several general controls in exchange for government control.[30]

State and private business maintained a close, long term, cooperative relationship, and the state participated in enterprise decision-making almost like a business partner – thus the coming into vogue of the euphemism "Korea Inc.". The symbiotic relationship between the state and big business represented by the *chaebol* (large family-owned industrial conglomerates) was founded on the fact that the state had access to capital in a capital scarce environment. Through its ability to allocate capital the state promoted the concentration of economic power in the hands of the *chaebol.*

The state did not leave the allocation of resources to market mechanism. To direct the flow of resources to the desired industries and firms, the government used a variety of instruments including control over credit, industrial licensing, import control, foreign exchange, control, control over foreign investments, tax incentives, etc.. The state had complete insulated control over FDI and this insulated most of the industries from any foreign control.

The impressive record of industrialization of the sixties and seventies under the captainship of Park Chung Hee gave Korea the boost to become one of the fastest growing economies in the world. Between 1961 and 1979, Korea achieved considerably high and uninterrupted economic growth, accounting for an annual average growth rate of 9.2 per cent in GNP. Thus, by 1979, when President Park was assassinated and succeeded by another military-man (Chun

30 See. Amsden, pp. 16-18, for those general controls on firms.

Doo Hwan), the Korean economy had reached W.W. Rostow's "take-off stage"[31] and the subsequent regimes had just to put in the minimum necessary efforts to sustain the developmental process already initiated. The state-economy relationship had become deeply entwined and the role of the state as an interventionist power in the economy had become firmly etched. The state's economic role had been in different ways institutionalized. Heavy involvement of the state continued even after Park's demise despite explicit language calling for the achievement of a free market economy, using such devices as deregulation, decentralization (local autonomy), privatization, and liberalization of trade and investment policies.

To sum up, aside from the existence of a growth-committed, hard political leadership and national consensus on goals, three important constituents of the effective state-led mechanism for speeding up economic development can be identified. First, state activism in Korea was based not only on purely political state authority but, more important, on its real economic power, which derived from state ownership of banks or loanable funds; the state's financial control over big business worked as a highly discretionary and qualitatively different control instrument that was not available in minimal (*laissez-faire*) states. Second, the business were subject to a double discipline mechanism - namely, market discipline, and market-conforming network discipline based on the intimate long-term relationship between the well-informed state agencies and business. Third, state activism played a part, more prominently, in targeted strategic sectors and big businesses than in small business-oriented private sector.[32]

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31 W.W. Rostow, *The Stages of Economic Growth*, Cambridge University Press, Cambridge, 1960.

32 See Lee, *op.cit.*

RELATIONSHIP WITH FINANCE: Policies and Implications

As we have seen, the support given by the Korean government to economic development has been unprecedented. Intervention consisted of trade and exchange rate policies (e.g., tariff protection, setting of export targets, liberal import policy for inputs into exports) financial polices (e.g., nationalization end control of banking sector, raising of real interest rates) selective support for the *chaebol,* establishment of large public enterprises, controls over ownership of Korean industry, tight controls over direct foreign investment, controls over and allocation of foreign loans, suppression of trade unionism, promotion of the technical education and vocational training, establishment of R&D centres, acquisition of foreign technology and so on.[33]

One important set of tools for state intervention consisted of financial instruments in the formal sector.[34] The heavy involvement of the state in the banking and financial system/sector in Korea was designed to facilitate the management of the economy in general and local capitalists in particular. The banking and financial institutions functioned as the arm of the state bureaucracy in promoting (capital) accumulation. The state ran them as an extension of itself in order to maximize the domination of the accumulation process.[35]

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33 Castley, *op. cit.*, pp. 294.

34 R.R.Krishnan, "The State and Economic Development in Korea", in R.C. Sharma and D.Kim (ed.), *Korea-India Tryst with Change and Development*, New Delhi, 1993.

35 Lim, *op. cit.* p. 101.

According to Keun Lee,[36] for state activism to be effective, state ability for financial control is critical. One often does not notice the critical difference between the state's financial control through credit allocation and other control instruments, such as tariffs, import quotas, tax incentives and entry or trade licenses. First, financial control implies more discretionary control. In credit allocation, the state can not only control the financial ability of firms, but can also force the firm's compliance in other matters. Second, a qualitative difference is that the state's financial control is not based on its political authority, as it is for other instruments supported by legislation or regulations; rather, the state's financial control is based on the state's economic power, which is associated with its ownership of either banks or funds themselves. Third, whereas most other controls, except licensing, are aimed at specific industries or sectors, and thus affect firms only indirectly, financial control is directly aimed at individual firms. In this regard, a simple but fundamental fact should be noted: the state's financial leverage over firms translates into control because firms have a strong motivation to improve their performance and because firms believe that credit supply is critical. In Korea, the firms' motivation for success derived from private ownership and the expectation that they will be the beneficiaries of their good performance. Thus even if big business were subject to a so-called soft budget constraint because of special connections with state agencies, that did not necessarily lead to weak motivational efficiency, but in fact, led to exactly the opposite behaviour, i.e., excessive risk taking.[37]

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36 Lee, *op. cit.* pp. 21-22.

37 Yung Chul Park, in his "Development Lessons from Asia: The Role of Government in South Korea and Taiwan", *American Economic Review*, vol. 80(2), pp. 118-21,

As mentioned earlier,[38] in the absence of sufficient resources at its disposal in the first decade of its existence, Korea had to sustain itself on the U.S. economic assistance. This role of the state was basically either distributive or appropriational.[39] Moreover, to maximize aid inflow, Syngman Rhee's government designed macroeconomics policies featuring low interest rates, an overvalued exchange rate, a deficit budget financed by borrowing from the central bank (BOK) when taxes and aid-generated revenues were insufficient, and BOK financing of commercial bank credit to the private sector. Such policies inevitably produced an internal financial gap between government transactions and private transactions, and an external financial gap between import demand and foreign exchange supply. The state under the leadership of President Rhee and his cohorts, then allocated aid entitlements in exchange for political campaign contributions. A GAO report[40] noted that "laxity" by the BOK in the allocation of aid dollars to importers encouraged speculation and led to collusion between supplier and importer, shipment of defective merchandise, kickbacks, and over pricing.

The controversy generated by the Rhee regime's allocation of bank loans led the U.S. in 1955 to force conditions on Korea requiring devaluation. But U.S. policy gradually shifted after 1956 from a focus on the exchange rate to inflation and the root cause of macroeconomics imbalances in monetary and

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mentions risk taking in the form of excessive and duplicative investment in the heavy industry drive in Korea in the late 1970s.

38 See pp. 45-46, cf.

39 See p. 45-46, cf.; Evans, *op cit.*, pp. 132-133, Amsden, op.cit, p. 39.

40 GAO (Government Accounting Office), *Report on Examination of Economic and Technical Assistance Program for Korea, International Cooperation Administration, Deptt. of State, Fiscal Years 1957-61.* Part 1, Washington D.C., 1962.

fiscal policy. In 1956, Rhee ordered that a Financial Stabilization Program be elaborated. The Ministry of Finance worked closely with advisors to the U.S. aid mission in developing the programme, and others followed each year. The stabilization programmes were successful at slowing inflation, but the positive effects on investment and development were not forthcoming. GNP peaked at 7.7 per cent in 1957, declined to 5.2 per cent in 1952, 3.9 per cent in 1959 and 1.9 per cent in 1960.[41]

This slowdown reflected in part the growing inefficiency and exhaustion of import-substitution. As a World Bank assessment noted, however, the stabilization programmes also contributed to the slowdown in growth, particularly as they corresponded to a decline in American aid.[42] But even more importantly the said programme could not address the underlying political structure that was distorting the allocation of resources and hampering a more rational planning process. Polices that appeared a complex and confusing patchwork from an economic perspective can be explained by Rhee's use of the instruments of economic/financial policy - allocation of foreign exchange, bank credit, import licenses, and the distribution of state-owned enterprises - to sustain and build a base of support - for self perpetuation.[43]

The relatively liberal financial regime in the 1950s was almost completely demolished right after the military government took power in 1961 under Park

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41 Stephen Haggard, Byung Kook Kim and Chung in Moon, "The Transition to Export led Growth in South Korea: 1954-1966", *The Journal of Asian Studies* 50, no. 4 (November 1991)

42 World Bank, *The Current Economic Position and Prospects of the Republic of Korea,* The World Bank, Washington, D.C., 1964, pp. 4-5.

43 S. Haggard, *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries*, Cornell University Press, Ithaca, New York, 1990, p. 57.

Chung Hee's leadership. Mark Clifford writes: "Park Chung Hee's understanding of finance was primitive when he took power. He had a deep distrust of financiers and suspected them of being involved in illicit activities. [So] Park quickly, and shrewdly, seized control of the financial system."[44] First of all, the new government promulgated the "Temporary Law Regarding Commercial Banks", which restricted the voting rights of large stockholders, and then "nationalized" the commercial banks[45] by repossessing the shares held by large stockholders (being accused of as illicit wealth amasses).[46] The tainted image of the commercial banks since their privatization in 1957 and the public's concern about economic concentration through financial monopolization, and the public anathema against corruptive political interference provided partial justification to this nationalization move. The heavy reliance of the commercial banks on the government and the BOK loans for their lending resources at the time provided a further justification. Second, the government amended the Bank of Korea Act in May 1962, and thereby, made it explicit that it was the government, not the central bank, that was to be held responsible for monetary policy. It thereby effectively ended the recurrent controversy over the independence of the central bank and the continued struggle between them.[47] The government made it clear that it would use the

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44 See Clifford, M. L., *op. cit.*, p. 61 and n. 37 on p. 66.

45 The Rhee government had denationalized the banking system a decade earlier to appease American pressures. See Amsden, *op. cit*, p. 16.

46 Instead of punishing the accused leading businessmen as criminals or appropriating their illicit wealth outright, the military government took this opportunity to elicit their support for and active participation in the economic development plan.

47 On the controversies since around-1957 over the constitutionally of the BOK Act and the proper relationship between the government and the central bank, see Byong Kuk Kim, *Central Banking Experiment in a Developing Economy*, Korea Research Center, Korean Studies Series, vol. 12. 1965, pp. 77-90.

BOK as a ready source of government debt financing.[48] Moreover, it authorized the BOK's direct acceptance of industrial finance debentures issued by the KDB, and indirect route for government borrowing from the BOK.

Third, it further expanded the list of specialized developmental banks: the Central Federation of Agricultural Cooperatives and the Medium Industry Bank in August, and the Citizens' National Bank and the Central Federation of Fisheries Cooperatives in late 1962 - to rid the common people from the net of the private moneylenders.

In addition, the military government revised the Korea Development Bank (KDB)'s charter to increase its capital, to authorize it to borrow funds from abroad, and to guarantee foreign loans obtained by private firms. In particular, the authorization of the KDB's foreign borrowing and loan guarantee indicated the government's ready reliance on foreign capital as a major source of financing for economic development in the wake of the declining foreign aid and the changing U.S. aid policy.[49]

Indeed, the level of foreign aid continued to decline and was to be terminated soon.[50] The military leaders understood the changing U.S. commitment to loans instead of aid clearly and began to devise mechanisms to enhance foreign borrowing. It was under these circumstances that the Korean government promulgated the "Law of Guaranteeing Foreign Loans" in July

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48 In the period of 1950, a maximum of 97 and a minimum of 86 per cent of the total government debt financing was made by borrowing from the BOK. Ibid., p.105 (Tables 6-10)

49 Cole and Lyman, *op. cit.*

50 *Ibid.*

1962, whereby capital imports could be financed by long-term export credits and their repayment could be guaranteed. The government granted tax concessions for foreign borrowing and sent an economic mission abroad to attempt to secure financing for major projects included in the Five-Year Plan.[51] The speeding up of the "normalization of foreign relations" talks with Japan, the most promising source of foreign financing and technology, during 1961-65 was made in this context.[52]

The government policy-makers' turn to foreign loans in lieu of foreign aid, as a major source of financing for economic development plans changed the role of Korean banks and the attitude of business greatly. First of all, the domestic banks became facilitators and guarantors of external finance. But they did not actually intermediate between the foreign lenders and domestic borrowers, as the foreign loan negotiations were conducted directly between them and approved by the EPB. The banks basically issued the guarantees on instruction from the government and took little responsibility for evaluating either the economic or financial feasibility of the guaranteed-loan development projects. As a result, the banks played a very limited role in the decision-making process regarding these loans, and thus had little basis for being held accountable for bad loans. It was the government that had to take extraordinary measures whenever the guaranteed-loan projects proved unsound.

Big business began to look foreign borrowing as a new, rich ground for economic rent-seeking. By the early 1960s, as foreign aid declined and the

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51 Krueger, *op. cit.*, pp. 110-111.

52 The normalization talks and settlement with Japan was an extremely hot and controversial political, economic, and social issue in the early 1960s. On the detailed description and analysis of this process, see Cole and Lyman, *op. cit.*, pp. 98-118.

single fixed exchange rate system was adopted in 1961 in lieu of the multiple exchange rate system, they realized that the two traditional rich grounds of economic rent-seeking — foreign exchange allocation and special import licensing — gave way to domestic and foreign credit.[53] It was for this reason that foreign borrowing was embroiled so often with political bureaucratic corruption.

The interest rate reform of September 1965, which doubled the annual time deposit rate from 14 to 30 per cent, while creating a negative spread between the commercial banks' lending and deposit rates, marked a watershed in the history of financial policy in Korea.[54] First, it brought forth a nearly seven fold increase in total bank deposits over the four years from 1965 through 1969. Second, more importantly, it triggered a massive inflow of foreign loans guaranteed by the KDB and commercial banks.[55] The gap between the international and domestic interest rates, which amounted to 19 per cent a year as a result of the domestic interest rate hike, prompted private investors to rush for foreign capital as a new and profitable source of financing. Moreover, the upsurge of foreign borrowing entailed a corresponding demand for domestic credit as operating capital, to which the government responded

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53 Leroy P. Jones and Il Sakong, *Government, Business, and Entrepreneurship in Economic Development: The Korea Case* (Harvard University Press, Cambridge, 1980), p.273.

54 The reform was undertaken on the advice of John Gurley, Edward Shaw and Hugh Patrick. See J.G. Gurley, E.S.Shaw, and H.T. Patrick, "The Financial Structure of Korea", U.S. Operations Mission to Korea, July 1965.

55 Total foreign loan guarantees almost doubled in 1966, and were nearly equal to the total of outstanding domestic bank loanks. From 1968 on, commercial banks assumed a significant role in the guaranteeing activity. Cole and Park, *op. cit*, p. 62.

again by allowing even foreign cash loans.[56] It is to be noted here that the real motive behind the interest rate reform in 1965 was to make business turn to foreign borrowing. This is predicated on the fact that the policymakers realized that there was a self-evident limit to domestic money creation and the that foreign borrowing should be a major conduit of long-term development financing.

But from around 1969, this high investment financing mechanism broke down, as foreign loan repayment began to rise rapidly. The foreign exchange reserve almost stopped increasing and it thus could no longer serve as a money creator. Due to the inability of the government and banks to make up for the severely reduced money creation from foreign sector and partly under the International Monetary Fund (IMF)'s pressure, the government was forced to adopt economic stabilization policies and many business firms, large and small, ran for private loan market and came to the brink of bankruptcy.

Under these circumstances, the government undertook "restructuring of the foreign loan-based firms" in 1969. Among 86 firms that borrowed heavily from abroad, 30 were subject to the restructuring attempt. The government directed the concerned banks to turn their bad loans into equities, and to reschedule them in addition to new loans provided to meet foreign repayment requirements. This restructuring episode of 1969-70 set the first precedence of how the government would respond to the financial difficulties of big business, so long as they complied with the government directives.

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56 The outstanding balance of foreign loan increased from \$210 million in 1965 to \$ 2,250 million in 1970.

Despite the bail-outs, the high indebtedness and the consequent financial distress of Korean business firms continued in the early 1970s.[57] Particularly, the 18 per cent devaluation in 1971, undertaken in an effort to boost faltering exports in the worsening world trading environment dealt a severe blow to large export firms which had borrowed heavily from abroad. The continuing financial distress needed drastic measures to cushion the debt-ridden firms and to curb the expansion of private money markets. Thus, the government announced the historical "Presidential Emergency Decree for Economic Stability and Growth" on August 3, 1972. It placed a moratorium on all private loans incurred by firms, besides several other alleviations. The measure was a great boon to the enterprises, large and small, relieving their financial difficulties, at one fell swoop. In partial justification for the extraordinary measure, the government began to emphasize the disclosure of big businesses. In December 1972, it thus enacted the "Public Corporation Promotion Law", which empowered the Ministry of Finance to designate big business firms eligible to go public and, in certain cases, even compel them to do so, while providing preferential tax incentives.

The August 3 Emergency Decree was "significant in that it marked the end of the partial financial liberalization policy the government had initiated with the reforms in 1965 and a complete return to the financial repression of previous years."[58] But, even more significantly, it helped pave the way for the

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57 The ratio of net equity to total assets of manufacturing firms precipitated from 51.6 per cent in 1965 to 24.2 per cent in 1971. To put it differently, the debt/equity ratio rose from 83.7 per cent in 1965 to 313.4 per cent in 1972. The Bank of Korea, *Financial Statements Analysis*, 1978.

58 Cole and Park, *op. cit.*, p. 159.

government's HCI drive in the 1970s, the success of which hinged so much on the availability of a cheap, sufficient, long-term capital.

As a follow-up measure, the Ministry of Finance enacted the "Short-Term Financing Business Act of 1972", and began to encourage the establishment of a variety of NBFIs, including investment and finance companies, mutual savings and general finance companies.

With the beginning of the HCI drive the government further strengthened its control over banks over the 1970s. It established more of the specialized state - run banks, and earmarked a part of the funds of the commercial banks as "policy funds" and channelled them toward key heavy industrial sectors. As a result, policy funds proliferated in the 1970s and the financial market continued to be segmented - of both domestic and foreign financial resources.

Once this selective and discretionary credit allocation system was in place, the government could channel greater financial resources toward HCIs designated as "strategic industries", and bring forth a high rate of economic and export growth, and the significant improvement in industrial structure and export commodities composition during the 1970s. But it was not without cost. Most importantly, big business and *chaebol*, the principal beneficiaries of cheap and other privileges, made excessive "duplicative" investments in major HCIs, further weakening their financial structure.

The continued and intensified control of the financial system in the 1970s produced devastating results by the late 1970s. As the second oil price rise and the consequent world-wide and domestic economic recession hit the economy,[59] big business, rather than small enterprises, began to stumble first in the face of sudden economic recession. Banks, which had already begun to accumulate a huge stock of non-performing debts, were not in a position to respond to their demand for capital effectively.[60] This situation presented a formidable challenge to the new government in the early 1980s.

When the new government under Chun Doo Hwan took over, the growth of the financial sector was so retarded that it failed to keep pace with the rapid growth of the real sector.[61] Under these circumstances it attempted to restructure the excessive and "redundant" investments, made by rival *chaebol* groups, by fiat in an effort to alleviate their capital demands. During 1980-81, it initiated a restructuring programme toward several industrial sectors in which the financial problem was more pronounced. However, the restructuring attempt failed despite the unusual threatening stance of the government in cases of non-compliance with its directives.

Yet another attempt of the new government at improving the financial structure of big business in September 1980 failed to produce visible result.[62]

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59 It should be remembered that the political vacuum created by President Park's assassination in October 1979 presented a high degree of uncertainly about the further course of economic policy in general and heavy industrialisation in particular.

60 As of 1984, non-performing debts accounted for 9 per cent of total credit outstanding by five commercial banks, reaching 1.65 times their equity.

61 e.g., Total bank deposits increased only 6.7 times during 1970-77, while total sales of manufacturing firms increased 10 times in the same period.

62 This attempt was announced in less than a month after President Chung's inauguration as, the "Measures to Strengthen the Business Resilience". Apart from the stated objective, it was significant in that it represented the new government's pledge toward amelioration of economic concentration by a number of *chaebol* groups.

The lesson to policymakers for these two unsuccessful and frustrating attempts was clear enough: The direct and selective intervention by the government in the allocation of financial resources had only entailed far more intricate problems and distorted incentives on the part of both the big business and banks. In particular, they were struck by the fact that in neither of these unsuccessful episodes, banks were held accountable. Moreover, given the extremely weak financial structure of big business, economic stabilization would only result in the increase in bad loans, necessitating the further supply of relief loans, and thereby negating the effects of economic stabilization.

Among others, this bitter experience and a tremendous setback that the government policymakers had undergone during the difficult period of economic adjustment in the early 1980s constituted the backbone of the subsequent financial liberalization and deregulation. In fact, however, financial liberalization was only part of a wide-ranged economic policy reforms in the decade. But it expected to send the strongest signal that the government-business relations would be fundamentally changed. It had political import too, for the new government committed itself to the building of a more equitable economy and society.

Big business also favoured the policy. They would now be free from the government's disposal and would be able to own and control financial institutions to meet their rapidly increasing fund requirement more flexibly.

And it was only natural that the BOK (central bank), commercial banks, and other FIs welcomed financial liberalization that would give them the long-desired self-autonomy and some respite from the continued state intervention.

Keeping in view the significance of the financial liberalization-cum-deregulation starting in the early 1980s on the rapid rise of Korea to become the 11th largest economy of the world, and also, on the subsequent financial crisis of 1997-98, it would be pertinent to have a look at the different components of the process in a separate chapter (following, Chapter 3). The chapter would try to place Korea's financial deregulation amid the domestic and international setting.

In this chapter, however, we saw how the entire financial system especially, the BOK, as the central bank for the nation, was the dominant instrument in the state control of the economy. The BOK supervised the whole banking system in line with official policies. It examined overall transactions of deposits and lending activities of other banking and financial institutions, and regulated interest rates, exchange rates and reserve requirements for the maintenance of the domestic economy. In Korea, the state owned all banks and NBFIs wholly or partly. By holding a significant portion of equity, the state exercised its control over these banks and financial institutions. While commercial banks engaged in long-term finance, NBFIs engaged in short-term finance. A more significant role in promoting industrial development was played by specialized banks. By 1978, these banks held 36.9 per cent of assets, 30.6 per cent of deposits, and 42.5 per cent of loans held by all domestic banks.[63] The number of state enterprises increased from 52 in 1963 to more

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63 BOK, *Financial System in Korea*, different issues.

than 120 in 1979. The expansion of state enterprises after the sixties was a response to the inherent characteristics of economic development in Korea.

The kind of financial system which operated in Korea can, in Robert Wade's[64] words, be referred to as "government-dominated credit-based financial system (rather than a capital market-based system[65]). In a credit-based system, the capital market is weak and firms rely heavily on credit to finance investment. This makes them heavily dependent on banks - to the extent that banks are the main suppliers of credit. However, if banks are themselves dependent on the government, then firms become heavily dependent on the government. In such an institutional environment, financial repression (in the form of control of credit allocation by the government) becomes the norm, and firms exhibit high debt- equity ratios. In Korea too, during the 1970s, debt equity ratios were 300-400 per cent. (In the industrialized countries, the figures were below 100 per cent). Thus, until 1980-83 and even after the financial deregulation of the mid-1980s in Korea, the government exercised *de facto* control of the banking systems through personnel policies, appointment of senior managers, range of service and the like.

The system, according to Wade,[66] permitted faster investment (in Korean conditions). Second, long-term performance was the dominant consideration and finally, the state-dominated financial system provided the

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64 Robert Wade, "The Role of Government in Overcoming Market Failure: Taiwan, Republic of Korea and Japan", in H. Hughes (ed.), *Achieving Industrialization in Asia*, (Cambridge: Cambridge University Press, 1988).

65 In a capital market-based financial system, securities (stocks and bonds) are the main source of long-term business finance. Borrowers can choose from a broad spectrum of capital and money market instruments offered competitively through a large number of specialized financial institutions. See, Islam and Chowdhury, *op. cit.*, pp. 140-141.

66 Wade (1988), *op. cit.*, p. 134.

government with the necessary political clout to implement its industrial strategy.

But the state-controlled system also had its own short comings, as we have already seen, and a number of which started exhibiting themselves in the wake of the recent financial crisis — as we shall see in the succeeding two chapters.

CHAPTER 3

FINANCIAL DEREGULATION: DOMESTIC AND INTERNATIONAL SETTING

In the preceding two chapters we saw that the state [government] began to intervene heavily in the financial system when Korea embarked on a policy of outward-oriented growth in the early 1960s, to direct insufficient domestic savings toward investment in export industries. The state's intervention was intensified in the 1970s as its industrial policy shifted to the HCI drive. Bank interest rates were controlled at below the market-clearing level. Credit was also allocated by lending directives set up by the government. Toward the end of the 1970s, the government's promotion of HCIs gave rise to severe distortions in resource allocations and to internal and external imbalances in the economy. To make things worse, the oil price hike, social and political turmoil, and a bad rice crop during 1979-80 brought about serious stagflation in the Korean economy. This poor performance and great imbalances in the Korean economy provided momentum for re-evaluating the industrial and financial policies implemented in the 1970s and for pursuing a new policy in the 1980s.[1]

The new policy package aimed at achieving economic balance through economic liberalization. To correct the over-investment in HCIs and distortions created by the strong protectionist polices in the 1970s, the government had respect for the market mechanism and competition and as a result limited government intervention.[2] The import liberalization ratio rose from 68.6 per

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1 Won-Am Park, "Financial Liberalization: The Korean Experience," in A. Krueger and T. Ito (eds.), *Financial Deregulation and Integration in East Asia*, (Chicago: University of Chicago Press, 1995), p. 248.

2 *Ibid.*

cent in 1979 to 91.6 per cent in 1986. The average nominal tariff rate for all commodities declined from 35.7 per cent in 1978 to 18.5 per cent by 1988. The incentive system for strategic industries, such as preferential credit and tax treatment, was realigned in a system of more indirect and functional support. The tax reform of 1981 substantially reduced the scope of special tax treatment for key industries. This new industrial incentive system culminated in the Industrial Development Law effective from July 1986 that defined some areas of market failure in which the government might intervene for industrial rationalization.[3]

Dukhoon Lee writes, "As the Korean economy became much larger and more complex, it became clear that the government-led economic policy and caused adverse effects, such as inflation, inefficiency across all economic sectors, and serious sectoral imbalances. The policy-makers, therefore, began to re-evaluate economic policies. Consequently, the government began to shift the leading role of the economy to the market and implemented wide-ranging structural adjustment policies starting from the early 1980s. These policies were aimed at enhancing economic efficiency by assigning a greater degree of reliance on market mechanisms and by promoting competition. The change in economic management necessitated corresponding changes in the role of the financial sector. Subsequently, various measures for liberalization and competition promotion in the financial sector have been taken since 1980".[4] The financial deregulatory process that we shall review

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3 *Ibid.*

4 Dukhoon Lee, "The Role of Financial Markets in Korea's Economic Development", KDI Working Paper No. 8801 (Seoul: Korea Development Institute, 1988), pp. 34-35.

was only part of the new economic liberalization policy package.[5]

Throughout the 1970s, commercial banks in Korea were subject to extensive government intervention, and the government was the major shareholder of these banks. Financial deregulation of the 1980s, under the government of President Chun Doo Hwan, thus commenced with the removal of various restrictions on bank management and the privatization of commercial bank ownership in 1981.[6] Regulations on commercial banks in the spheres of the organization, budget, branching, and business practices were greatly loosened.

The primary objective of the privatization was to let banks have owners who would really mind the efficiency of the banking operations. But a strategic consideration that it would contribute to government revenue also played an important role. Furthermore, it was expected that the provision of "good stocks" would help boost the weak stock market.

During 1981-83, the government sold all its shares in all nation-wide commercial banks. To prevent bank ownership from being concentrated among Korea's large conglomerates, the *chaebol*, ownership by a single shareholder was restricted to 8 per cent of the total.[7] The government also chartered two

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5 See Nam (1992), Cho and Kim (1993), and Park (1994) for more on Korea's financial deregulation and financial opening.

6 The Hanil Bank was chosen as the first target of privatization by the Ministry of Finance in 1981.

7 In spite of the effort to limit concentration of ownership by the private purchasers of these shares, it is widely believed that the *chaebol* succeeded in gaining control of individual banks. (They also had controlling interests in some NBFIs such as insurance companies and investment and finance companies.)

joint-venture commercial banks with Korean and foreign partners to increase competition, and loosened regulations on chartering NBFIs such as investment, mutual savings, and finance companies. In addition, it continued to broaden and diversify services supplied by financial institutions.

In a major effort to allow banks more managerial autonomy, the government privatized four nation-wide commercial banks by 1983 and amended the General Banking Act in 1982. Furthermore, various other kinds of regulations and government directives were gradually abolished or substantially eased since the late 1970s. The government also decided to stop forcing commercial banks to make preferential policy loans.

The government's management of credit and interest rates also improved. Although the government continued to set ceilings for bank loans and deposits, it decided to switch from direct credit controls to indirect ones through the management of banking reserves in 1982. Important progress was also made toward a more rational interest rate structure. Most preferential interest rates applied to various policy loans were abolished and subject to the same rate as general loans by June 1982, and further policy loans were restrained. In early 1984, financial institutions were allowed to set their own lending rates within a given range according to the credit worthiness of the borrowers. This action was followed by a series of measures deregulating interest rates in the organized financial sector. Such measures included the lifting of the upper limit on inter-bank call rates and issuing rates of unsecured bonds in 1984, the decontrol of yields on convertible bonds and debentures with bank payment guarantees in 1985, and the freeing of interest rates on certificates of deposit (CDs) and issuing rates of debentures with bank payment guarantees and financial debentures issued by deposit money banks in 1986.

This series of interest rate deregulations culminated in the decontrol of bank and non-bank lending rates in December 1988. These measures were a significant step toward financial deregulation. As interest rates rose after they were decontrolled, however, the government revoked the plan. Furthermore, economic slowdown and labour disputes in 1989 hindered progressive liberalization toward the end of 1980s. Not until August 1991 did the government release the four-phase schedule for the full liberalization of interest rates in the domestic financial market.

There was also a significant progress toward diversified financial services and a universal banking system. Various new financial instruments were introduced to reorganize short-term and long-term financial markets and to enhance the role of financial institutions as savings mobilizers. The restructuring of the financial industry because of concern as the new financial instruments that crossed between banking and securities promoted competition among financial intermediaries. The financial intermediaries were concurrently allowed to broaden the range of their financial transactions. The distinction between banks and non-banks, therefore, became blurred, and competition started increasing in the financial market. Also, technological advances, particularly computerization, enabled financial institutions to supply more sophisticated financial services, such as on-line systems, cash dispensers, and night depositors.

Korea has not had any formal legal restrictions against a universal banking system since the decision was delegated to the Monetary Operation Board, but Korea generally has maintained a specialised banking system.

Banks are limited in dual operations, but some are already in the securities business and involved in short-term financing through the acquisition of subsidiaries. In March 1991, Korea's eight short-term finance companies were changed into two banks and five securities companies. Table 3.1 summarizes the major events in Korea's financial deregulation since the early 1980s.

Financial Market Opening

Domestic financial deregulation in Korea since the early 1980s was accompanied by a gradualist approach to financial opening so as to internationalize the Korean financial markets. While deregulation in the domestic financial market proceeded faster than financial opening in the first half of the 1980s, the latter went faster in the later half of the 1980s because the current account ran surpluses during 1986-89 after chronic deficits in the previous years.

Prior to Korea's current account surplus in 1986, some measures were implemented to open domestic financial markets gradually. The basket-peg exchange rate system was adopted in 1980. The forward exchange market was The current account surpluses in 1986-89 provided further impetus to deregulate foreign exchange transactions in areas such as, position management documentation requirements, and the international use of the won. By deregulating a substantial portion of current account transactions, Korea accepted the obligations of the IMF's Article VIII[8] in November 1988.

[8] Members that accept Article VIII undertake to refrain from imposing restrictons on the making of payments and transfers for current international transactions and from engaging in discriminatory currency arrangements or multiple currency practices

Table 3.1 Highlights of Korea's Financial Deregularion since the Early 1980s

Financial liberalization programme

Introduction of corporate paper	1981
Privatization of nationwide commercial banks	1981-83
Abolition of beneficial interest rates on policy loans	1982
Alleviaiton of government intervention in the internal operation of banks	1984
Introduction of negotiable CDs	1984
Introduction of a band for bank loan rates	1984
Indirect opening of the stock market through the Korea Fund	1984
Introduction of cash management accounts by shortterm finance companies	1987
Introduction of bond management funds of by securities companies	1987
Relaxation of entry barriers to financial industry, including banks, life insurance, (lease, and investment trust)	1988
Opening of the life insurance industry to foreign firms	1988
Announcement of phased deposit and loan rate deregulation	Dec. 1988
Opening of the securities industry to foreign firms	1991
Announcemnt of a four-step interest rate liberalization plan	1991
Conversion of some short-term finance companies to securities companies or banks	1991
Opening of purchase of individual equity stocks on the Korea Stock Exchange to foreign investors	1992

Foreign exchange and capital account liberalization

Switch to a basket-peg exchange rate system from a dollar-peg	1980
Foreign exchange forward transaction impletmented	1981
Interest rate swap allowed	1984
Switch to a negative systems in foreign direct investment policies	1984
Issuance of convertible bonds (CBs), warrant bonds (WBs) and depository recepits (DRs)	1985
Fiancial futures allowed	1987
Transition to an IMF Article VIII country	1988
Foreign exchange call market established	1989
Switch to the Market Average Exchange Rate System	1990
Switch to a negative system in foreign exchange mangement	1992

without IMF approval. By October 1997, 141 members had accepted Article VIII status. (*The Europa Yearbook 1998*, vol.1)

Furthermore, investments by foreigners in domestic securities were permitted and facilitated through the issuing of beneficiary certificates for foreigners and equity-linked overseas securities (CBs, WBs and DRs) by domestic firms, as well as through the additional establishment of overseas country funds - the Korea Europe Fund in 1987 and the Korea Asia Fund in 1991. The watershed was the introduction in March 1990 of the so-called Market Average Exchange Rate System for the determination of exchange rates, whereby rates were allowed to fluctuate daily in accordance with the changes in market supply and demand.

In promoting liberalization of capital account transactions, the government sought first to deregulate foreign direct investment (FDI) in Korea and Korean direct investment in foreign countries. Since 1984, when the positive list system for approving FDI (wherein, only a few industries were allowed to be open for FDI) was replaced by a negative list system through the Foreign Capital Inducement Law (amended version), the government progressively liberalized Korea's FDI system by shortening the list of non-permissible categories of business for foreign investments.[9] An automatic approval system was adopted as well to facilitate foreign investment.

The significant step toward financial opening was taken in 1991. Effective from January 1992, foreigners were allowed to purchase Korean stocks, up to 3 per cent of the outstanding shares of each company for each individual; no more than 10 per cent of a company might be foreign-owned, however. The government also authorized the operation of foreign securities

9 This change increased the share of the manufacturing industries open to FDI to 92.5 per cent. See Economic Planning Board, *Analysis of economic policies of the 1980s*, (Seoul: EPB, 1986), pp. 31-33.

companies in Korea. At the same time, domestic security companies were urged to explore overseas markets to help Korean firms issue securities directly in foreign markets. In addition, the Foreign Exchange Management Act (FEMA) was revised in 1991 so that the positive system, whereby all foreign exchange activities were initially deemed prohibited unless stipulated otherwise, was replaced by a negative system which permitted in principle all activities except those specified. Table 3.1 also summarizes the major events in the financial market opening since the early 1980s in Korea.

In the area of banking, the government allowed another 37 foreign bank branches to operate in Korea since 1981 raising the total number of foreign bank branches doing business in Korea to 69 (as of June 1997)[10] and lifted the discriminatory restrictions on foreign bank branches. In 1985, the foreign bank branches were given access to the trust business and the rediscount facilities at the BOK for short-term export financing. Since 1986, the rediscount facilities for all of their operation were made available on the same conditions that were applied to domestic banks. By the same token the government removed the exclusive privileges reserved for foreign banks.

Reasons For Credit Control System Reforms

With the commencement of financial deregulation in the early 1980s, the credit control system, based on the assumed collusion among banking institutions, was found to be illegal under the Monopoly Regulation and Fair Trade Act (MRFTA). For this reason, the system was reformed into an official regulatory system following the revision of the General Banking Act at the end of 1982. The act states that the Monetary Board may restrict, by fixing

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10 Bank of Korea, *Financial System in Korea*, 1997.

ceilings, the aggregate volume of outstanding loans, guarantees, or assumptions of obligations of a banking institution for any individual business group.

The credit control system underwent significant changes in its objective and characteristics since 1984,[11] reflecting the progress in financial deregulation as well as political and social changes. These changes resulted in concentration of credit control mainly on the 30 largest business groups (*chaebol*) while control on other corporations eased.

The credit control system was reformed for the following reasons. First, by the early 1980s an excessive number of groups and companies were subject to credit control (see table). In addition, since the amount of available credit for a company was decided on the basis of its past credit requirements, small but quickly growing companies were in dire need of credit. In order to correct such inefficiencies, the number of business groups subjected to credit control was reduced, and basket credit control was adopted which regulated the share of large business groups in the total credit of banking institutions.

Table 3.2[12] Number of Corporations subject to Credit Control

	End	March	End	End	October	June	March
Corporate Type	1984	2985	1987	1988	1989	1991	1993
Business goups	161	63	50	50	48	50	50
Member not belonging	1,459	691	807	845	913	-	1,014
companies not belonging	280	-	-	-	-	-	-

Source: Office of Bank Supervision and Examination (1992)

Notes: Criteria for selecting corporations to be subject to credit control:

July 1984: (1) Business groups which have more than 20 billion won in total credit (loans

[11] See also pp. 70-71, cf.

[12] Sang-Woo Nam, "The Principal Transactions Bank System in Korea and a Search for a New-Business Relationship", in T. Ito and A. Krueger, *op.cit.*, p. 281.

plus payment guarantees) from banks and their number corporations. (2) Corporations that do not belong to a business group but have more than 10 billion won in total credit or more than 5 billion won of loans.

March 1985: Business groups that have more than 100 billion won in total credit and their member corporations.

January 1987: Business groups that have more than 150 billion won in total credit and their member corporations.

June 1991: The 50 largest business groups selected on the basis of loans from banking institutions (excluding loans of major corporations) and their member corporations.

February 1993: The 30 largest business groups selected on the basis of loans from banking institutions (excluding loans of major corporations) and their member corporation.

Second, the extensive nature of credit control hampered the credit evaluation capability of banking institutions and unduly limited corporate activities. Thus, with the progress in financial liberalization during the 1980s, the major emphasis of the credit control system was placed on discouraging real estate acquisition and investment in other companies.

Third, the objective of easing the concentration of economic power and promoting fair access to bank credit gained importance in the credit control system. The government seemed to believe that promoting economic development by depending heavily on large business corporations might no longer be efficient. At the same time, people became more concerned about allocative equity and more critical of large corporations after the democratic reforms in 1987. As a result, the credit control system assumed a rather complicated nature, reflecting certain political and social considerations. Consequently, a strong basket control system was adopted in 1988, which led to a steady reduction of the shares of the 5 largest of the 30 largest business groups in total bank credit.

Finally, credit control also played an important role in monetary management because the monetary expansion caused by the foreign sector was enormous as a result of the large current account surpluses between 1986 and 1989.[13]

As exports stagnated and the current account returned to deficit in 1990, there was renewed concern about the growth potential of the economy as well as the international competitiveness of the manufacturing sector. In this connection, the credit control system was criticized for impeding the capability of corporations to respond flexibly to the changing economic environment and to strengthen their competitiveness.

As a result, the tight credit regulation of the 1980s began to be relaxed in 1991. The criterion for selecting business groups subject to credit control was changed from those with total bank credit of more than 150 billion won to the 50 largest borrowers from banking institutions. This criteria was further relaxed in 1993 to the 30 largest business groups. Also, to encourage specialization, each of the 30 largest business groups was allowed to select, from among its member companies, upto three "Major Corporations", to be exempt from credit control.[14]

BLUEPRINT FOR THE LIBERALIZATION AND OPENING OF THE FINANCIAL SECTOR

The current account surplus in the later half of the 1980s not only

13 *Ibid.*

14 *Ibid.*, pp. 260-82.

stimulated financial opening but also aroused trade and financial conflicts with the United States. Accusing Korea of "manipulating" its exchange rate, the U.S. demanded that Korea advance its trade and financial liberalization programmes and make them more transparent. Korea and the U.S., to settle pending issues in their financial conflicts, agreed in August 1989 to hold financial policy talks as needed.[15] Having had several discussions since 1989, both parties agreed to set out the three-stage Blueprint for the Liberalization and Opening of the Financial Sector. The first-stage and second-stage blueprints were announced in March and June 1992, respectively. Extending these, the third-stage blueprint was announced in June 1993.

The third-stage blueprint covered crucial areas such as interest rate liberalization, control of bank loans to the *chaebol*, short term finance, and foreign exchange and capital account liberalization. Table 3.3 outlines the third-stage blueprint, which meant to be the cornerstone for Korea's financial liberalization. It aimed to achieve substantial liberalization of Korea's financial sector by 1997.

Effects of Financial Deregulation

Korea's financial deregulation (liberalization) since the early 1980s could be characterized as cautious and slow in terms of its order and speed within a decade. The influence of government diminished gradually in financial markets as its industrial policies were not easily separated from financial policies. The cautious approach to financial opening was preferred to prevent external factors from creating additional disturbances in the process of

15 Won-Am Park, op.cit, pp. 251-52.

domestic financial deregulation. Despite the slow pace of financial liberalization, Korea's financial market and financial policies changed greatly after the early 1980s.

Table 3.3 Third-stage Blueprint for the Liberalization and Opening of the Financial Sector (Announced June 1993)[16]

Phase 1 (1993)	1.	Liberalize all bank and non bank lending rates (except for policy loans) and long-term deposits over two-year maturity.
	2.	Issue Monetary Stabilization Bonds and government bonds of close to market interest rates.
	3.	Operate monetary (M2) targets flexibly.
	4.	Liberalize call markets.
	5.	Widen the daily won-dollar trading margin from 0.8 to 1.0 per cent.
	6.	Switch to the notification system for FDI into Korea.
Phase II (1994-95)	1.	Liberalize all lending rates and rates for short-term marketable instruments.
	2.	Establish indirect monetary controls
	3.	Deregulate loans to large conglomerates.
	4.	Develop short-term financial markets.
	5.	Further widen the daily won-dollar trading margin
	6.	Further ease requirements for underlying documentation prior to foreign exchange transactions.
	7.	Expand limits on foreign investment in the stock market.
	8.	Allow foreign participation in primary markets for some bonds.
	9.	Ease requirements for opening branches of foreign securities companies.
Phase III (1996-97)	1.	Liberalize all deposit rates except for demand deposits (allow money market certificates and money market funds).
	2.	Utilize open market operations as main monetary policy tool.
	3.	Operate the Loans Management System as a prudential regulation.
	4.	Introduce free-floating rate system.
	5.	Eliminate requirements for underlying documentation for the usual foreign transactions.
	6.	Allow foreign borrowing through commercial loans.
	7.	Allow foreign financial institutions to hold stock of domestic banks.

16 *Ibid.*, p. 252.

Changing Structure of Financial System. The financial deregulation since the early 1980s stimulated financial intermediation as shown in the figure (following page). As economies grow, there is a tendency for the ratio of financial institutions' assets to GNP to increase. However, financial deepening[17] stagnated in the 1970s as the ratio of domestic financial assets to GNP rose only modestly form 212 per cent in 1970 to 240 per cent in 1980. In contrast, the ratio doubled during 1980-93 with progressing financial deregulation.

Financial deepening since the early 1980s has been driven by the growth of NBFIs. While the ratio of banks' financial assets to GNP stagnated since the early 1980s the ratio of the NBFI sector's financial assets to GNP jumped remarkably (see Table 3.4). The rapid growth of NBFIs can be confirmed by the composition of financial savings in Table 3.5. The share of bank deposits among the total financial savings declined from 46 per cent in 1980 to 24 per cent in October1993. In contrast, the share of non-bank deposits increased from 38 per cent to 68 per cent during the same period.

The growth of NBFIs was possible because they operated under relatively free conditions with respect to interest rate control, burden of policy

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17 Financial deepening involves the monetisation of an economy, and the rise of financial institutions. With financial deepening savings are increasingly held in financial assets rather than in non-financial assets. This is likely to improve the efficiency of intermediation between savers and investors. The extent of financial deepening in an economy can be judged by tracing the evolution over time of such key financial variables as currency, M1 or M2 ratios to GDP, the best measure being the ratio between total financial assets to total real assets. In the absence of comparable data on total financial and real estates, most researchers rely on the M2 to GDP or GNP ratio. See Chowdhury and Islam, *op.cit*, p. 132.

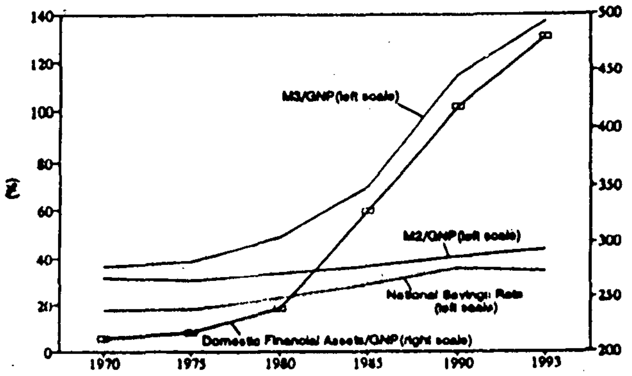

Fig. Trend of financial deepening
Source: Economic Statistics Yearbook (Seoul: Bank of Korea, various issues).

loans, entry barriers, and ownership regulation in order to absorb informal market funds into the organized financial market. The growth of NBFIs contributed to deepening the financial market, but it resulted in another disequilibrium in the financial market, that is, lack of competition between banks and non-banks and slow progress toward a universal banking system.

Table 3.3 Ratio of Financial Assets to GNP (%)

Year	Financial Sector[a]	Deposit Money Banks	Life Insurance and Pension Funds	Other[b]	Nonfinancial Sector (domestic)
1975	72.7	53.3	2.7	16.7	136.4
1980	100.6	64.0	6.0	30.6	139.7
1981	107.6	64.8	7.1	35.7	147.6
1982	122.6	71.8	8.5	42.3	165.2
1983	129.2	73.2	10.0	46.0	165.7
1984	134.0	71.3	11.5	51.2	170.3
1985	144.9	74.8	12.8	57.3	172.8
1986	145.1	71.9	14.7	58.5	177.0
1987	150.7	70.5	16.4	63.8	185.4
1988	157.5	67.7	18.4	71.4	186.4
1989	183.7	73.5	21.4	88.8	212.0
1990	191.5	74.8	23.3	93.4	214.9
1991	198.2	75.0	24.4	98.8	214.2
1992	213.1	78.8	25.8	108.5	223.5
1993	226.3	79.6	26.5	120.2	234.2

Sources: Flow of Funds (Seoul: Bank of Korea, various issues); *National Accounts* (Seoul: Bank of Korea, various issues).
[a]Excludes the Bank of Korea.
[b]Includes nonmonetary financial institutions and securities companies.

Table 3.3 **Ratio of Financial Assets to GNP (%)**

Year	Financial Sector[a]	Deposit Money Banks	Life Insurance and Pension Funds	Other[b]	Nonfinancial Sector (domestic)
1975	72.7	53.3	2.7	16.7	136.4
1980	100.6	64.0	6.0	30.6	139.7
1981	107.6	64.8	7.1	35.7	147.6
1982	122.6	71.8	8.5	42.3	165.2
1983	129.2	73.2	10.0	46.0	165.7
1984	134.0	71.3	11.5	51.2	170.3
1985	144.9	74.8	12.8	57.3	172.8
1986	145.1	71.9	14.7	58.5	177.0
1987	150.7	70.5	16.4	63.8	185.4
1988	157.5	67.7	18.4	71.4	186.4
1989	183.7	73.5	21.4	88.8	212.0
1990	191.5	74.8	23.3	93.4	214.9
1991	198.2	75.0	24.4	98.8	214.2
1992	213.1	78.8	25.8	108.5	223.5
1993	226.3	79.6	26.5	120.2	234.2

Sources: Flow of Funds (Seoul: Bank of Korea, various issues); *National Accounts* (Seoul: Bank of Korea, various issues).

[a]Excludes the Bank of Korea.

[b]Includes nonmonetary financial institutions and securities companies.

Table 3.4 **Composition of Financial Savings (period end; %)**

Period	Bank Time and Savings Deposits Including CDs[a]	Nonbank Deposits	Securities	Intersectoral Transactions
1972	70.0 (82.2)	22.2	13.2	−5.4
1975	60.2 (65.8)	27.6	15.6	−3.4
1980	45.9 (51.5)	37.8	21.8	−5.4
1985	36.3 (42.3)	53.6	24.4	−14.3
1990	25.6 (38.8)	60.3	29.9	−15.8
1991	25.3 (38.9)	59.5	30.1	−15.0
1992	24.7 (40.9)	64.2	27.9	−16.7
Oct. 1993	23.6 (42.0)	67.8	26.5	−17.9

Source: Fiscal and Financial Statistics (Seoul: Ministry of Finance, various issues).

[a]Numbers in parentheses are bank time and savings deposits including both CDs and money in trust (the latter being formally classified as nonbank deposits).

Table 3.5 **Share of Policy Loans (ratio to domestic credit; %)**

	Monetary Institutions							
Year	Subtotal	Government Funds	Credit to KDB and KEXIM	Foreign Currency Loans	Trade Financing	Housing Loans	Other Financial Institutions	Total
1973	48.2	5.3	3.4	6.6	11.5	[illegible]	52.8	49.3
1975	40.9	3.5	1.8	8.6	8.5	2.8	52.4	43.5
1980	49.1	3.0	1.5	15.5	10.3	5.6	43.9	47.4
1981	45.7	2.9	1.5	12.6	10.0	4.2	41.1	44.1
1982	40.3	3.0	1.0	11.5	8.3	5.7	38.8	39.7
1983	41.2	3.2	1.0	9.8	8.2	6.3	36.6	39.4
1984	40.7	3.5	1.0	8.7	7.7	6.4	31.7	36.8
1985	39.3	3.5	0.9	7.7	7.4	5.9	30.2	35.3
1986	40.6	3.6	1.0	7.5	7.0	5.5	24.1	33.1
1987	45.7	3.5	5.8	9.7	4.2	5.5	20.5	33.6
1988	46.4	3.6	7.9	8.9	1.9	8.2	17.3	31.9
1989	46.4	3.8	7.9	8.2	1.7	6.6	14.1	29.2
1990	46.3	3.6	7.7	8.5	2.0	7.0	12.7	27.8
1991	41.9	3.7	6.9	8.8	1.9	7.1	12.0	24.9

Source: Korean Economic Indicators (Seoul: National Statistical Office, various issues).

Behaviour of Financial Intermediaries. Deregulation also affected the behaviour of financial institutions. First, financial deregulation resulted in the reduction of policy loan burdens, causing the share of policy loans in total domestic credit to decline markedly form 47 per cent in 1980 to 25 per cent in 1991 (see Table 3.6). This fall was mainly achieved by the swift development of NBFIs such as investment and insurance institutions whose loans were not directed by the government and the shrinkage of some NBFIs such as development institutions whose loans were mostly policy related.

Second, while financial deregulation encourage banks to manage their assets and liabilities more carefully, there was not any significant changes in the composition of bank assets as shown in Table 3.7. The sectoral composition of bank loans extended each year also did not change distinctively in the way that is expected with financial deregulation (Table 3.8)

Third, financial deregulation did not bring about a rapid expansion in lending in the 1980s (due to the cautious and gradual approach to financial liberalization in the 1980s) but the lending did expand drastically in the second quarter of the 1990s and it was mostly by the foreign institutions, as we shall see in Chapter 4. Moreover, the actual asset market boom in Korea in the latter half of the 1980s is attributative to the yen and won appreciation vis-à-vis the U.S. dollar.[18]

Monetary Policy. Financial deregulation/liberalization brought with it important changes in monetary policy from direct monetary controls to indirect

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18 Ibid, p. 257. Also see Yung Chul Park and Won-Am Park, "Capital movement, real asset speculation, and Macneconomic adjustment in Korea". In H. Reisen and B. Fisher (ed), *Financial Opening*, (Paris: OECD, 1993) pp. 93-115.

Table 3.6 Accounts of Deposit Money Banks (%)

	Domestic Assets							
Year	Cash	Due	Securities	Loans and Discounts	Loans in Foreign Currency	Foreign Assets	Other	Total
1970	3.7	14.9	2.4	49.3	6.9	13.8	9.0	100.0
1975	3.7	14.4	2.6	41.8	4.9	9.4	23.1	100.0
1980	8.0	7.1	7.8	46.4	9.9	11.4	9.5	100.0
1981	11.0	4.7	9.8	46.8	8.1	10.4	9.2	100.0
1982	10.5	7.2	8.3	48.0	7.5	8.3	10.1	100.0
1983	9.3	3.7	10.9	48.9	6.3	8.4	12.4	100.0
1984	12.0	5.3	10.2	47.0	5.3	7.9	12.3	100.0
1985	9.9	9.9	6.8	49.4	4.8	7.4	11.9	100.0
1986	8.4	9.0	7.9	51.3	4.9	6.5	12.1	100.0
1987	11.7	8.3	8.3	47.8	6.1	5.8	12.0	100.0
1988	13.6	8.9	8.1	46.6	5.4	5.6	11.7	100.0
1989	12.3	6.8	8.5	50.1	5.2	4.3	12.8	100.0
1990	14.9	5.5	9.1	46.7	5.2	4.3	14.3	100.0
1991	13.2	5.7	9.6	47.8	5.5	4.4	13.9	100.0
1992	10.2	5.9	10.3	48.7	4.9	4.8	15.3	100.0
1993	7.5	6.0	11.6	49.5	4.5	5.6	15.3	100.0

Source: Monthly Bulletin (Seoul: Bank of Korea, various issues).
Note: Figures are ratios to total assets excluding acceptances and guarantees.

Table 3.7 Sectoral Composition of Bank Loans Extended (%)

Year	Financial Sector	Government	Business	Individuals
1970	0.0	0.6	63.5	35.9
1975	1.5	3.7	68.1	26.7
1980	2.5	0.8	63.4	33.1
1981	6.9	0.0	52.5	40.6
1982	1.4	2.2	61.9	34.4
1983	1.1	4.2	49.8	44.9
1984	4.9	0.9	66.9	27.3
1985	−0.9	3.4	76.3	21.1
1986	−0.5	−1.2	75.9	25.8
1987	11.4	−1.0	49.0	40.6
1988	12.9	−1.2	52.5	35.8
1989	31.9	0.7	40.6	26.8
1990	−6.3	2.7	60.9	42.6
1991	−1.1	1.8	66.2	33.1
1992	14.7	1.0	57.8	26.4
1993	3.1	1.6	64.9	30.4

Source: Flow of Funds (Seoul: Bank of Korea, various issues).
Note: Figures are ratios to the total bank loans made each year.

Table 3.8 Sectoral Increases in the M2 Supply (end of year; billion won)

Year	Government Credit	Private Credit	External Sector	Other	Total
1985	40	6,462	−1,595	−1,047	3,860
1986	170	6,765	2,424	−4,091	5,268
1987	−1,656	6,115	9,030	−7,043	6,446
1988	−2,174	8,642	10,212	−8,021	8,659
1989	−1,993	16,871	2,365	−7,543	9,699
1990	−1,458	19,068	118	−7,660	10,070
1991	778	20,840	−3,117	−3,463	15,038
1992	−271	14,060	4,066	−5,342	12,513
1993	−1,919	18,136	5,397	−5,654	15,961

Source: Monthly Bulletin (Seoul: Bank of Korea, various issues).

ones. First, in 1982, the authorities replaced direct control over bank lending with an indirect reserve control system. Since 1982, there has been no formal direct control of bank credit except for measures to restrict loans to large conglomerates.

Second, efforts were made to restore such traditional central bank policies as the rediscount policy, reserve requirement policy, and open market operations. The emphasis of the rediscount policy was made on setting the rediscount ratios and changing the eligibility criteria of bills presented to the BOK. The reserve requirement ratio was lowered markedly during 1980-82 because the authorities recognized the ineffectiveness of the high reserve requirement policy and the increased financial burdens of banks caused thereby. The authorities also tried to use open market operations more frequently by financing fiscal deficits more through bond issues and offering Monetary Stabilization Bonds at interest rates close to market rates.[19]

Third, even with financial deregulation, the authorities have been using monetary (M2) growth as the intermediate target variable since 1979. The practice of monetary targets had both good and bad aspects in Korea. Monetary targeting certainly served to curb inflationary pressure when the economy was on the verge of overheating. At the same time, however, rigid monetary target encouraged the government to rely on direct monetary controls. Sometimes the M2 amount was managed by adjusting the balance sheets of financial institutions.

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19 See Moon-Soo Kang, "Monetary Policy Implementation under Financial Liberalization: The Case of Korea", in Reisen and Fisher (ed.), *op.cit*, pp. 201-26; and Sung-Tae Ro, *Korea's Monetary Policy* (1962-92) (Seoul: Economic Research Institute, 1993).

The progress toward indirect monetary control was interrupted by huge current account surpluses in the latter half of the 1980s, since the monetary expansion through the foreign sector created additional burdens in controlling the money supply (see Table 3.9). On one hand, the excessive money supply necessitated more rapid foreign exchange and capital account liberalization and even a floating exchange rate system. Thus monetary polices in the later half of the 1980s were concerned mainly with the balance of payments and exchange rates. The current account surpluses accelerated the progress in financial opening and exchange rate floating, leading to the won's appreciation.

On the other hand, the monetary expansion from the foreign sector hindered the deregulation of domestic financial markets. For instance, the measure deregulating lending rates in December 1988 was revoked quickly for fear of a rise in interest rates in the process of monetary contraction. Also, the BOK had to issue such large amounts of MSBs[20] as to assign them to NBFIs at interest rates below market rates. Furthermore, the money growth targets became more important than any other indicators that could be used to assess domestic economic conditions and the stance of policies.[21]

Exchange Rate Policy. Korea maintained a *de facto* dollar-peg system until 1980 although the system was officially named the unified floating exchange rate system. Under this system, Korea's real exchange rate tended to appreciate. Recognizing the adverse effects of real appreciation on its trade account, Korea adopted the Multiple Currency Basket Peg System in February 1980. The new system was instituted to stabilize the real effective exchange

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20 MSBs stands for Monetary Stabilization Bonds.

21 *Ibid.*

rate of the won. Overall, it could be said that Korea's exchange rate policy evolved from a nominal anchor approach in the 1970s into a real target approach in the 1980s.

Korea adopted a new exchange rate system, however, after many international institutions including the IMF and the U.S. Treasury criticized Korea's earlier system, called the Market Average Exchange Rate System in March 1990 to make exchange rates better reflect market fundamentals. Under the new system, the won-dollar exchange rate would change to reflect the demand and supply of foreign exchanges, albeit within a daily trading margin. The daily won-dollar trading margins widened several times, from the initial 0.4 per cent above and below the base exchange rate to 1.0 per cent in October 1993. Under the Market Average Exchange Rate System, the real effective exchange rate of the won tended to depreciate.[22]

However, Korea was lucky to face sustained improvement in terms of trade during its first decade of financial deregulation. In fact, the improvement in the terms of trade was substantial enough to offset the won's real depreciation.[23]

The Overborrowing Syndrome. Financial deregulation in Korea led to an extremely fatal phenomenon called the "overborrowing syndrome" among the Korean companies especially among the five largest *chaebol*. With the liberalization of the various previous restrictions on capital import, the Korean *chaebol* were able to borrow freely from the elastic international capital market

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22 See Park, W. A., *op. cit*, Kang, and Ro., *Ibid.*

23 See Park, W. A., *op.cit*, p. 260.

in their bid to diversify their industrial capacities. The domestic banks often acted as the major conduit for the massive short-term ("hot") money inflows. But this excessive foreign borrowing since the first quarter of the 1990s particularly, proved to be disastrous for the Korean financial system as we shall see (in more detail) in the next Chapter.[24] Financial deregulation (liberalization)-cum-stabilization and real economic reform with OECD membership in prospect stimulated vast inflows of "hot money" into Korea. Such inflows caused a dramatic collapse in the banking system and generated an ultimately unsustainable credit-driven consumption boom that finally collapsed into a spate of bankruptcies, massive depreciation of the won and financial crisis in the second half of 1997. Thus, the vulnerability to the "over borrowing syndrome" of the Korean economy undertaking financial deregulation reforms was exposed.

THE INTERNATIONAL SETTING

Apart from the domestic factors like, pressures from the business community, demands of autonomy from the public financial institutions, several economic factors (as discussed earlier) and above all the increasing democratization of the Korean polity especially during the tenures of Presidents Roh Tae Woo and Kim Young Sam, certain international factors, too, played a very crucial role in the initiation and furtherance of financial deregulation amidst overall economy liberalization of the Korean economy.

The international or external sources of pressure to liberalize or open up the domestic economy in Korea can be said to have been emanating at three

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[24] See Chapter 4, ff.

levels - bilateral, regional, and global.

Bilateral pressure form the United States has been significant. In spite of the agreement of the Uruguay Round, the U.S. government did not relax its pressure on Korea and other East Asian countries to further liberalize their domestic markets and deregulate their financial systems. In the light of the long history of Korea-U.S. association[25] and the deterministic role of the latter in the former's economy and polity, continuous U.S. pressures have always proved extremely significant on Korean policy decisions and economic-cum-financial reforms, as we have seen earlier.[26]

Regional pressure has also been significant, driven by the accelerating trend of regional economic integration. Between 1990 and 1994, for example, a total of 33 regional agreements were reported to the GATT (now WTO), compared with 11 in the previous decade. Joining the regional integration meant that Korea had to adopt more open-door policies to those in the integration. Given that Korea had about 65 per cent of trade and 75 per cent of FDI with other member countries of Asia Pacific Economic Cooperation (APEC) (in 1996), the potential need for more open-door policies increased.

The GATT and subsequently, the WTO system after the Uruguay Round

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25 The distinct association between Korea and U.S., esp., since 1945, has led to the proposition of notions depicting Korea as being a "Client-state" (?) or a "vassal-state" of the U.S. (Manual Castles, "Four Asian Tigers With a Dragon Head: A Comparative Analysis of the State, Economy and Society in the Asian Pacific Rim", in R.P. Appelbaum and J. Henderson (ed.), *States and Development in the Asian Pacific Rim*, (California: Sage Publications, 1992), p./63.

26 The literature on Korea-US relations is voluminous. There is a genre of writing, that may be described as 'non-mainstream', which has sought to depict the nature of the special relations between Seoul and Washington.

implied enhanced pressures at the global level. Also, Korea's new membership of the Organization for Economic Cooperation and Development (OECD)[27] - the "club of the rich (countries)", and the preconditions of achieving this new status exerted much more immediate and substantial pressures on Korea to liberalize its economy including its several sectors. The financial sector, as expected suffered significantly from its lack of international competitiveness when opened to foreign competition.

Above all, the universal force of "globalization", particularly since the later half of the 1980s, has been acting as the all-encompassing factor, within which other factors have been functioning, for the liberalization of the Korean economy and deregulation of its financial system. Technological development has been enabling people to have an access to cheaper communication, and transportation. Multinationals have began seeking opportunities world-wide and brought consumers to so-called 'global products'. Internal demand for further growth, therefore, drove Korea to be more actively engaged in the global economy. Joining the global economy, however, invited external pressures to adopt more open-door policies and in the wake of it, Korea's vulnerabilities in the field of international experience came to light.[28]

Concluding Remarks. Korea's financial deregulation since the early 1980s brought about great changes in the financial market and in financial

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27 Korea finally and formally joined the OECD on December 12, 1996. The OECD requires its members to adhere to certain standards in the areas of finance, other services and agriculture. Thus, OECD membership demanded considerable burden on Korea, esp. in terms of short to megdium term impact on its economy.

28 For a critical discussion on the role of international forces in fanincial liberalization, see Prabhat Patnaik, "The real face of financial liberalisation", *Frontline*, vol. 16(4), February 26, 1998.

policies. This chapter has reviewed the deregulatory process and examined the effects of financial liberalization. Despite a series of deregulatory measures, Korea's financial market still had structural problems and was prone to face difficulties when the market liberalization progressed. Since domestic financial liberalization was mostly based on the deregulation of NBFIs, the reform of the banking sector still remained an urgent goal.[29]

It should be noted here that financial liberalisation is more likely to succeed if the pervailing system is generally sound. However, in Korea, reforms mostly took place in the context of the widespread distortions in the financial system, which were a consequences of the previous interventionist policies. These distortions rendered the banking systems generally unsound, with a large amount of non-performing assets. When, in such a milieu, interest rates were deregulated, the banking system became more fragile and ultimately reached a crisis situation. An unsound bank tends to offer higher interest rates or resort to casino ploys to drum up income to meet operating expenses or it may incur higher risk through adverse selection. When bank finds it difficult to openly declare loans in default lest it may hasten to translate illiquidity into insolvency, it may continue to lend to risky borrowers or to capitalise interest on loans to those borrowers. These consequences weaken banks as well as the real economy, thereby pushing them to the brink of financial and economic crisis.[30] Korea witnessed this very situation in 1997-98 owing to the shortcomings in its financial deregulation process.

In the context of the coming chapter on the financial crisis in Korea (1997-98) and as a prelude to it, it would be pertinent to mention that empirical

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29 This goal was undertaken with great (unprecedented) urgency in the wake/aftermath of the recent financial crisis in Korea. See Chapters 4 and 5, ff.

evidence shows that there are close linkages between financial sector reform and financial crises.[31] First of all, increased freedom of entry into the financial sectors and freedom to bid for funds through interest rates and other instruments often lead to excessive risk taking, especially in the absence of prudent regulatory control. One of the reasons for this is the lack of credit appraisal skills of bank managers. Second, the institutional structure of the banking system tends to have too much concentration of power, resulting in interlocking ownership and lending pattern. Such an environment is particularly vulnerable to market failures caused by factors such as moral hazard, adverse selection and the inherent oligopolistic pricing of loan. Third, deregulation of interest rates and other controls on bank operations make it possible for a sudden splurge in credit expansion which may even exceed deposit growth. Fourth, instability in the credit market could arise not only from an inelastic demand for credit and uncertainty but also from credit rationing. For instance, in tight credit conditions, real interest rates could rise sharply. The lending banks may consider higher loan rates as indicative of enlarging risks and hold back credit, thereby aggravating credit crunch further and causing bankruptcies of firms and banks. Finally, a spike in interest rates following their deregulation often affects banks severely, as their long-term loan portfolios which are financed by shorter-term liabilities carry fixed interest

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30 See Deena Khatkate, "Timing and Sequencing of Financial Sector Reforms: Evidence and Rationale", Economic and Political Weekly (EPW), July 11, 1978, p. 1833.

31 See V. Sundarajan and T. Balino, *Banking Crises: Causes and Issues*, IMF Washington, D.C., 1991.

rates. This situation could precipitate a crisis for certain segments of the industry[32] as it happened in the later half of the 1990s in Korea.

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[32] G. Caprio, I. Atiyas and J. Hanson, "Policy Issues in Reforming Finance: Lessons and Strategies", Chapter 12 in G. Caprio, I. Atiyas and J. Hanson (ed.), *Financial Reforms: Theory and Experience* (Cambridge: Cambridge University Press, 1994).

Table 3.10. SEQUENCING OF FINANCIAL REFORM IN KOREA, 1980-96.

Typeof Reforms	Prior to 1980	'81	'82	'83	'84	'85	'86	'87	'88	'89	'90	'91	'92	'93	'94	'95	'96	'97
(A) Interest Rate												o	o	o	o	o		
(B) Directed credit															o	o	o	
(C) Money market instruments		o	o	o	o	o	o	o	o	o	o	o	o	o	o	o	o	
(D) Exchange rate regime							o				o	#		o	o	o	o	
(E) Exchange market system current A/c					o	o	o	#										
capital A/c								#	o	o	o	o	o	o	o			
(F) Competition		o	o											o				
(G) Supervision and regulation					o	o	o	o	#	o	o	o	#		o	#	o	
(H) Capital Market					o	o	o	o	o	o	o	o	o	o	o	o	o	

Note: O represents change; # represents major change.

Sources: Cho and Khatkhate (1989); Pill and Pradhan (1997); Bisat, Johnston, and Sudarajan (1992); and Johnston; Darbar and Echeverrira (1997).[33]

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[33] Cited in Khatkhate, D., ibid., p. 1832.

CHAPTER 4

THE CRISIS OF 1997-98

> *"As financial markets expand and integration deepens, each episode of crisis comes with greater force, inflicting greater damage on the real economy. The cost of the crisis in East Asia is about 1 percent of global output this year alone, or some $260 billion, equivalent to the annual income of Sub-Saharan Africa. Prospects for the years ahead are extremely uncertain, but the risks are on the downside..."*
>
> \- Trade and Development Report, 1998[1]

The story of Korea's remarkable metamorphosis in about three decades is by now well clear – how it grew from one of the most impoverished agricultural economies in East Asia (rather, the world) to the 11th largest economy in the world. In its 1993 report[2], the World Bank cited Korea as an example of those developing countries that achieved rapid economic growth and industrial transformation. Korea's "compressed" economic growth until the 1980s was brought about by a state-led strategy of export-oriented industrialization that capitalized on the country's high-quality labour resources, of which Korea enjoyed an abundance during its early stages of economic development. By the 1990s, however, the currents of globalization and the era of the World Trade Organization (WTO) had started affecting the Korean economy, too. Globalization demanded that Korea alter its national economic strategy, transform its ways of doing business and carry out reforms, including deregulating its financial system, if it wanted to continue to maintain economic

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1 United Nations, *Trade and Development Report*, 1998, p.2.

2 World Bank, *The East Asia Miracle: Economic Growth and Public Policy,* (New York: Oxford University Press for the World Bank, 1993)

growth. Korea's failure to adequately respond to these demands mainly due to structural and functional shortcomings in its different institutions, led to the extraordinary situation of its having to seek bail-out funding from the International Monetary Fund (IMF) and being placed under its supervision[3].

Beginning in July 1997, the economies of East Asia[4], after decades of seemingly boundless growth, came to an abrupt standstill when clear manifestations of a fast developing, full-blown currency-cum-financial crisis started showing through the plummeting of different indicators of economic growth. What began as a local problem sparked by the rapid devaluation of the Thai baht (July 1997) quickly spread throughout the region including Indonesia and Korea. The crises undermined not only the viability of the regional economic order but also adversely affected the overall global economy. The ensuing economic meltdown forced Korea along with a series of countries to seek succour from the IMF. However, despite IMF "rescue" operations, everywhere there were cutbacks in investment, production and employment; sharp falls in stock prices and exchange rates; and bankruptcies or mounting losses in the banking sector. For Korea this crisis was its most serious one since the crude oil shocks in 1970s[5]. Though the crisis has been on the wane for quite some time now, the devastation it wrought on Korea has not yet been completely straightened out.

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3 Ahn Choong-Yong, "Economic and Political Reforms in Korea", *Korea Focus* (Seoul), vol. 6(5), Sept.-Oct. 1998.

4 'East Asia' is used in this chapter as inclusive of the region of ASEAN or South-East Asia.

5 Bill Mc Donough, the president of the New York Federal Reserve, described the recent East Asian crisis as the "most serious financial crisis since world war two" (sic). See *The Economist*, October 10, 1998, p.13. Goh Chok Tong, the Singapore PM, called it "Asia's worst crisis since the Second World War."

This chapter intends to analyze the characteristics and causes of Korea's financial crisis by looking at it in segregation from the whole East Asian crisis. Of course, the Korean crisis was not in isolation from the contagion-like spread of financial crisis across the East Asian region including countries in South East Asia and more or less South Asia, too. But the Korean crisis had its own distinctive elements which had their roots in the evolutionary process of Korea's financial system and the pattern of economic development adopted by the decision makers of the country. Thus, the structural and functional deficiencies of the Korean financial system would be examined along with the role of international agencies like the U.S., the IMF, the World Bank, etc.. Before closing, the post-crisis restructuring process, including the reforms already carried out and those still needed, would also be reviewed.

THE MEANING OF "FINANCIAL CRISIS"

Analysts have used the term "financial crisis" (or variants such as "liquidity crisis" or "currency crisis") to describe a variety of phenomena differing primarily in the degree of distress that is implied. Hyman Minsky[6] has emphasized the potential instability of the credit system. He has in mind a liquidation of assets, occasioned by an inability to raise cash through more conventional means, which precipitates a sharp drop in asset prices and leads inevitably to a depression. Alternatively, a (currency) crisis is defined as a situation in which an attack on the currency leads to a sharp depreciation of the currency, a large decline in international reserves, or a combination of the two. A crisis so defined includes both successful and unsuccessful attacks on the currency. The definition is also comprehensive enough to include not only

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6 Hyman Minsky, "A Theory of Systemic Fragility," in Edward I. Altman and Arnold W. Sametz (eds.), *Financial Crisis: Institutions and Markets in a Fragile Environment* (Wiley, 1977)

currency attacks under a fixed exchange rate but also attacks under other exchange rate regimes. For example, an attack could force a large devaluation beyond the established rules of a prevailing crawling-peg regime or exchange rate band[7].

According to Charles Kindleberger, in his classic work, *Manias, Panics and Crashes*[8], the crisis is the last phase of a cycle which begins with an initial boom. The upswing usually starts with some change, such as the new markets, new technologies or political transformations. It proceeds via credit expansion, rising prices, particularly of assets, and euphoria. Overtrading and then speculative mania emerge, "as a larger and larger group of people seeks to become rich without a real understanding of the processes involved". Ultimately, the markets cease rising and, as a consequence, some highly borrowed players find themselves outstretched. This is the "distress" stage. Distress generates other failures, including some unexpected ones, and this is followed by a stage of "revulsion" or "discredit". The final phase is a self-feeding panic, involving a downward free fall.

But then financial markets are notoriously prone to cycles; asset markets have always tended to go boom and bust. This in itself does not necessarily make for major real economic depression unless there are other deflationary forces operating, or unless the effects of the financial failures on the real economy are not counterbalanced by increased spending in some other way. Kindleberger recognized that major economic depressions do not result from

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7 Graciela Kaminsky, Saul Lizondo, and Carmen M. Reinhart, "Leading Indicators of Currency Crises", *IMF Staff Papers* (Washington, D.C.), vol.45(1), 1998, p.15.

8 Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: Basic Books, 1978).

credit cycles in themselves, but from a complex interplay of real and financial factors that reinforce each other[9].

In an emerging market financial crisis, like the one which was witnessed by East Asia, including Korea, an economy that has been the recipient of large-scale capital inflows stops receiving such inflows and instead faces sudden demands for the repayment of outstanding loans. This abrupt reversal of flows leads to financial embarrassment, as loans fall into default or at least are pushed to the brink of default. The outcome of the reversal of capital flows may be a period of out-right default, a rescheduling of debt payments or rescue by a lender who provides a new loan to finance the repayments of past loans that are falling due[10].

Before we look into the manifestation of different factors leading to the unfolding of the above-discussed phenomena (of financial crisis), let us first take a brief look at the broad characteristics of some recent financial crises.

SOME PRECEDENTS

There have been several dramatic international financial crises involving developing countries in this (twentieth) century. In fall 1929, the flow of bond financing from the United States to Latin America suddenly dried up, leading to widespread defaults by Latin American sovereign borrowers that took nearly a generation to resolve. In August 1982, Mexico was pushed to the brink of default when it was unable to roll over short-term debts that were falling due. The Mexican crisis was soon followed by a generalized withdrawal of credit from developing countries, which, in turn, led to debt rescheduling defaults,

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9 See Jayati Ghosh, "The coming crisis", *Frontline* (Chennai), vol.15(21), 1999, p.107.

10 *Ibid.*

and renegotiations, in a dozen debtor countries. Chile, Uruguay, and Argentina also experienced financial crises in the early 1980s, following financial deregulation in the late 1970s[11]. More recently, there have been several dramatic reversals in large-scale lending to emerging markets: Mexico, Turkey, and Venezuela in 1994; Argentina in early 1995; and the East Asian countries in 1997. In five of these recent cases - Mexico, Argentina, Indonesia, Korea and Thailand - extraordinary international loans were arranged to forestall defaults on debt servicing.

These episodes, according to Steven Radelet and Jeffrey D.Sachs[12], shared certain characteristics: they were marked by sudden shifts in financial flows; they were to some extent unanticipated; and they provoked deep economic contractions within the debtor countries, as well as losses to some of the foreign investors, especially equity investors. Most analysts have tried to explain these crises in terms of two categories of "fundamental" factors: (1) abrupt changes in international market conditions that affect the ability of debtors to repay outstanding loans, such as shifts in interest rates, commodity prices, or trade conditions; and (2) abrupt shifts in the debtor country that cause creditors to reassess that country's ability or willingness to service the foreign debt, including changes in political leadership or economic policy, or in the burden of the debt (for example, because of new information about the overall size of external debt obligations).

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11 See Sebastian Edwards, " A Tale of Two Crises: Chile and Mexico", *Working Paper 5794* (Cambridge, Mass: National Bureau of Economic Research, 1996) and Carlos F. Diaz-Alejandro, "Good-Bye Financial Repression, Hello Financial Crash", in Andres Velasco (ed.), *Trade, Development and the World Economy: Selected Essays of Carlos F. Daiz-Alejandro* (Oxford: Basil Blackwell, 1988).

12 Steven Radelet and Jeffrey D. Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects", *Brookings Papers on Economic Activity* (Washington, D.C.), 1: 1998, p.5.

In the 1929 crisis, the main factor behind the cessation of bond finance is alleged to have been the boom conditions in U.S. financial markets, which tightened the terms of new international bond issuances. In addition, falling international commodity prices called into question the ability of commodity-exporting countries in Latin America to service their debts. Soon after lending stopped, global economic conditions grew markedly worse, with the onset of the Great Depression and the rise of protectionism in countries throughout the world. In the 1982 debt crisis in Mexico, the most important shifts were the very steep rise in interest rates in the U.S. and the accompanying steep appreciation of the U.S. dollar which, in turn, caused the dollar prices of internationally traded commodities, including oil, to fall. This combination of soaring interest rates and falling commodity prices caused international investors to reassess the debt-servicing capacity of borrower countries, e.g., Mexico[13].

One striking feature of the recent crises in Asia and Latin America, Radelet and Sachs remark, is that the typical international factors have not been present. In the crisis of 1994 and 1995 (in Argentina, Mexico, Turkey and Venezuela), international financial conditions were stable, U.S. interest rates were moderate, and the global trading system was open. Indeed, Mexico had just entered the North American Free Trade Agreement (NAFTA) with Canada and the United States. And economic reforms in Mexico and Argentina had generally led to widespread enthusiasm for these economies. Rudiger Dornbusch, Ilan Goldfajn, and Rodrigo Valdes assign heavy responsibility for the Mexican crisis to poor macroeconomic management within the country. In their view, the Achilles heel of the Mexican and Argentine economies in 1994-95 was an overvalued exchange rate, a legacy of anti-inflation programmes that had been centred on nominal exchange rate stability. In an alternative

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13 *Ibid.*

interpretation, Sachs, Aaron Tornell, and Andres Velasco argue that the over-valuation of the exchange rate played only an indirect role; more important was creditor panic[14].

The East Asian crises of 1997 were even more remarkable. Not only were the international factors seemingly absent - with benign conditions in international financial markets, commodity markets, and the trading system - but the domestic factors that contributed to the crises in Mexico and Argentina did not apply either. None of the East Asian countries was in the aftermath of an anti-inflation programme. Their real exchange rates were only mildly overvalued. Their overall debt carrying capacities did not seem to present imminent risks of default. Yet the crises hit with a vengeance[15].

THE ONSET OF THE KOREAN CRISIS

Before going into the actual dynamics of the Korean crisis, let us take a short look at some of the events which had been working towards brewing up the recent crisis. Though this was not a clandestine process, still its seemingly harmless façade lent the allegedly 'unanticipated' nature to the crisis.

In 1985, under the Plaza Accord, the G7 nations intervened to stop the dollar's surge against the yen and the mark. Tokyo also cut interest rates to help boost Japanese demand for imports and thus cut the trade deficit with the U.S.. The yen straightened, making East Asian exports more competitive (most currencies were virtually pegged to the dollar). Japanese businesses built production bases in Asia. The region boomed consequently. "Hot money" -

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14 See R. Dornbusch, I. Goldfajn and R.O. Valdes, "Currency Crises and Collapses", *BPEA*, 2: 1995, pp.219-93; and J.D. Sachs, A. Tornell and A.Velasco, "The Collapse of the Mexican Peso: What Have We Learned?", *Economic Policy 1996,* no. 22, pp.13-56; and "Financial Crises in Emerging Markets: The Lessons from 1995" *BPEA*, 1:1996, pp.147-215.

15 Radelet. S. and Sachs. J.D., *op.cit.*, pp.5-6.

funds in stocks and short-term instruments - poured in as the world's banks and investor found the boom too enticing. The U.S. push for financial deregulation started getting results. Korea, as we saw earlier, liberalized its financial system starting in 1980[1]. But this regulation remained rudimentary, and cronyism and monopolies continued to distort the economy.

China devalued the renminbi in 1994, which meant it could undercut exports from East Asia. The dollar straightened the next year. Current-account balances deteriorated as spending on imports outpaced receipts from exports. Japan's bubble economy had burst, but its interest rates were kept super low. So Japanese banks lent to Asian companies for high returns. Western lenders joined the party. Easy money funded showcase infrastructure projects and property speculation. Thai finance companies borrowed low-interest U.S. dollars to re-lend in high-interest baht. Well-connected Indonesian corporates just needed to ask to get foreign-denominated loans. Korean conglomerates frittered borrowed money on grandiose expansion. Hedging one's bets was not a priority.

By the end of 1996, currency speculators seemed to have smelled blood. The skirmishes ended with the Thais giving up on July 2, 1997. Other Asian currencies, including the won, succumbed soon after. Hot money fled. Some politicians were paralyzed into inaction. Others reneged on promises to push reforms. Economies and their financial systems were under full-blown pressure. The crisis was on, and the IMF at the gates.

Indonesia liberalized its banking system in 1988 and Thailand allowed offshore banking in 1992.

Chronology of the Korean Crisis

January (23) 1997 - Hanbo Steel collapses under a $6 billion debt- the first bankruptcy of a major *chaebol* in a decade, later to be joined by other *chaebol*

March '97 - Sammi Steel fails, provoking fears of a corporate debt crisis.

July (2) '97 - Thai baht depreciation and peg system abandonment.

July '97 - Korea's third largest car maker, Kia, suffers credit crunch and asks for emergency loans.

August '97 - International credit ratings downgraded for banks with heavy exposure to troubled conglomerates (*chaebol*)

October '97 - Korea nationalises Kia after banks refuse to provide more loans. Standard and Poor's downgrades Korea's sovereign rating.

October (20-23) '97 - The Korean won is in free-fall.

November (6) '97 - The Korean won slides despite government intervention. Questions are raised about the financial systems health because at least 8 *chaebol*, recipient of huge bank loans, are dead or dying. Officials deny rumours that Korea will be calling on the IMF for assistance.

November (17) '97 - Seoul stops defending the won, which falls below the psychological 1,000-to-the-dollar level.

November (18) '97 - Parliament fails to pass 13 financial-reform bills because of strong protests from organised labour. Finance minister Kang Kyong Shik later resigns.

November (21) '97 - Korea says it will ask for IMF aid after all (of $20 billion) to ease debt crisis. The government holds out for easier terms, seriously delaying an agreement until December 3.

November (24) '97 - In Japan's largest financial failure ever, 100-year old stock brokerage Yamaichi folds.

December (3) '97 - Korea signs agreement with IMF for a $57 billion bailout that includes tough conditions on economic reforms.

December (8) '97 - Korea's short-term foreign debt is nearly twice as big as thought, at more than $100 billion.

December (18) '97 - Former dissident Kim Dae Jung wins the Presidential elections. the won which strengthened by 20% the previous week on expectations the IMF will speed up disbursement of emergency loans, gives back some of its gains.

December (22) '97 - Korean state and corporate bonds reduced to junk-bond status.

December (23) '97 - Won falls to near 2,000-to-the-dollar.

December (24) '97 - IMF and donors agree to advance $10 billion to Korea.

December (26) '97 - Won surges by nearly 23% to the dollar.

December (30) '97 - International banks agree in principle to roll over $15 billion in short-term loans- 2 days before they were to fall due Dec.31.

January (8) '98 - IMF and Korea agree ona 90-day deferment of Korean short-term credit repayment.

January (12) '98 - One of Asia's biggest homegrown investment banks, Hong-Kong's Peregrine Investment, fails.

January (29) '98 - Korea manages to reach an agreement with creditor foreign bank to reschedule debt, ending short-term liquidity problems ($25 billion of the $90 billion due for repayment in 1997), by 1 to 3 years at the annual interest of 8-8.5%.

January (30) '98 - Korean government closes 10 merchant banks.

February (25) '98 - Inauguration of President Kim Dae Jung.

February (26) '98 - The government closes 2 more merchant banks.

June (29) '98 - Korean Big Bang starts – closure of 5 shaky commercial banks.

Source: Compiled from various periodicals, including newspapers; journals and the Internet during the period of 1997-98 (for a list of them, refer to the Bibliography at the end of this dissertation).

Coming on to Korea exclusively, the Korean economy can be said to have had two aspects of fundamentals: one indicating normalcy of the economy, and the other showing the symptoms of the crisis[2].

Some of the key macroeconomic variables showed no sign of deterioration. The fiscal budget was balanced and inflation was under control. In 1996, the government budget was, from a deficit of 0.68 per cent of GDP in 1990 to a meagre 0.07 per cent. The inflation rate was tamed from 9.3 per cent in 1991 to 4.96 per cent in 1996. Also, the unemployment rate was steady around 2 per cent and the GDP growth rate was at an average of a respectable 7.64 per cent between 1990 and 1996. Thus, the Korean economy seemed fundamentally sound during the first half of the 1990s. (See table)

Table 4.1. <u>Pre-crisis Fundamentals</u>

GOVERNMENT FISCAL BALANCE as a per cent of GDP

Economic Indicators	Year						
	1990	1991	1992	1993	1994	1995	1996
Budget	-0.68	-1.63	-0.50	0.64	0.32	0.30	-0.07
Growth Rate	9.6	9.1	5.0	5.8	8.4	8.7	6.9
Unemployment Rate	2.4	2.3	2.4	2.8	2.4	2.0	2.0
Inflation rate	8.60	9.30	6.22	4.82	6.24	4.49	4.96

Source: Compiled from G.P. Corsetti, P.Pesenti and N.Roubini, "What caused the Asian currency and financial crisis?" (Mimeo) 1998[3]

Besides, the accession of Korea to the OECD as its twenty-ninth member on 12 December, 1996 represented the culmination of 35 years of

2 Kyoo H. Kim, "Korean Economic Crisis", *Korea Observer* (Seoul), vol. 29(3), 1998, p.469.

3 *Ibid.*

extraordinary growth that transformed it from one of the poorest nations in the world to the eleventh-largest economy and exporting country. Its rapid development was driven by very high rates of saving and investment and a strong emphasis on education. By 1996, its per capita income surpassed $ 10,000 and was relatively equally distributed, while life expectancy reached 72 years, not far short of the OECD average of 76[4].

But the above composition of the key economic indicators began to show the signs of the impending crisis. Beginning in 1990, public saving (government budget) did not change much till the end of 1996, though. But national saving went down from 35.69 per cent of GDP to 33.33 per cent (see Table 4.2). That is, national saving decreased by 2.39 per cent from 1990 to 1996. Much of this decrease was due to private saving decrease, which was by almost 4 per cent during the same period. The fall in private saving may be associated to an increase in taxes on private consumption, in part due to liberalization of trade. But the percentage of private consumption out of the GDP was in the range of about 53-54 throughout the 1990s. Thus, the increase in size of the government revenue explains the decrease in private saving (see Table 4.3). Despite the fiscal budget being in balance throughout the first half of 1990s, the size of government revenue increased substantially so that the receipts of the government as a percent of GDP increased from 19.2. in 1990 to 23.6 in 1997.

Table 4.2. Saving and Investment as a per cent of GDP

Year	1990	1991	1992	1993	1994	1995	1996
Public Saving	-0.68	-1.63	-0.50	0.64	0.32	0.30	-0.07
Private Saving	36.37	37.37	35.38	34.27	34.38	34.84	33.40
National saving	35.69	35.74	34.88	34.91	34.60	35.14	33.33
Domestic Investment	36.93	38.90	36.58	35.08	36.05	37.05	38.22
Net Foreign Investment	-1.24	-3.16	-1.70	-0.16	-1.45	-1.91	-4.89

Source: Complied from Corsetti, Pesenti, and Roubini (1998) and Bank of Korea.

OECD, *1997-98 Annual Review /Korea* (available on internet).

Table 4.3 Government Revenue and Private Consumption as a per cent of GDP

Year	1990	1991	1992	1993	1994	1995	1996	19
Revenue	19.2	18.2	19.3	19.9	20.5	20.9	21.7	23
Consumption	54	53	54	54	54	53	54	54

Source : Bank of Korea.

Table 4.4 Balance of Payment 1985-96 as a per cent of GDP

	Current Account	Reserve Assets	Capital Account	Direct Invest.	Portfolio Invest	Others
1985-89	4.3	-1.4	-2.5	-0.1	0.2	-2.4
1990-96	-1.7	-0.6	2.5	-0.3	1.9	1.0

Note: The capital account is the sum of the direct investment and portfolio investment and others.

Source: Radelet and Sachs (1998).

Table 4.5 Real Yield of Corporate Bonds (per cent)

Year	1990	1991	1992	1993	1994	1995	1996
Yield	7.9	9.6	9.98	7.78	6.66	9.31	6.94

Source: Korea Economic Research Institute for the nominal yields, then from them inflation rates subtracted for the real yields.

Table 4.6 Real Exchange Rate Index and Labor Cost Index

Year	1990	1991	1992	1993	1994	1995	1996
Exchange Rate	100	101	106	108	110	114	114

Source: Calculated from Radelet and Sachs (Based on WPI; Trade-weighted, 1990=100), the nominal exchange rate times the domestic-to-foreign price ratio.

Year	1975	1980	1985	1990	1992	1993	1994	1995
U.S.A.	100	100	100	100	100	100	100	100
Korea	5	10	9	25	32	34	38	43

Source: Foreign Labor Statistics, based on hourly compensation costs for production workers in manufacturing, United States = 100.

Table 4.7 Real Yield of Corporate Bonds (per cent)

	Total	Banks	Public Sector	Non-bank Private	Short-term	Reserves	Short/ term Reserves
End 1995	77.5	50.0	6.2	21.4	54.3	32.7	1.7
End 1996	100.0	65.9	5.7	28.3	67.5	34.1	2.0
Mid 1997	103.4	67.3	4.4	31.7	70.2	34.1	2.1

Source: Radelet and Sachs (1998).

Table 4.8 Net Foreign Assets of the Banking System (per cent of GDP)

Year	1990	1991	1992	1993	1994	1995	1996
Total	5.7	3.8	5.1	6.6	6.7	6.4	5.2
Monetary Auth.(net)	6.0	4.9	5.7	6.2	6.8	7.2	7.2
Foreign Assets	3.8	3.8	4.2	4.9	5.4	6.1	7.3
Foreign Liabilities	4.1	4.9	4.8	4.5	5.5	6.9	9.3

Source: Radelet and Sachs (1998).

Table 4.9. Debt Ratio (per cent)

Year	1990	1991	1992	1993	1994	1995
Debt Ratio	286	316	325	298	309	305

Source: Korea Development Bank, Analysis of Financial Data for 1995, 1996.
Note: The debt ratio is defined as a ratio of liabilities to stockholder's equity.

Looking at the demand side of the loanable funds market, the figures tell a similar story (see Table 4.2). Domestic investment demand increased by 1.27 per cent from 36.93 per cent in 1990 to 38.22 per cent in 1996. Such an increase in demand was financed by the inflow of foreign capital. Net foreign investment decreased from -1.24 per cent in 1990 to -4.98 per cent, which indicates a substantial increase in foreign capital inflow during the period. To see clearly the net foreign investment, we can go back to the earlier period that would show the change over a decade prior to the crisis. Over the period of 1985-96, the current account changed from surplus to deficit (see Table 4.4). During 1985-89, it was 4.3 per cent of GDP, but during the subsequent period of 1990-96, it became -1.7 per cent. The huge current account deficit of 1995 may be attributed to the slump in semi-conductor export market. But the composition of the capital account is also interesting. Not much change of direct investment happened from 1985-1996, but one can see a huge increase in portfolio investment from 0.2 per cent in the late 1980s, to 1.9 per cent in the early 1990s. A decrease in the reserve assets is also noteworthy[5].

Table 4.5 shows the real yield rate of corporate bonds as a proxy for the real interest rate in the loanable funds market. As one can see, the inflation adjusted real interest rate, on an average of 8.31 per cent did not show any systematic trend between 1990-1996, which may be explained by the simultaneous decrease in supply of loanable funds (national saving) and in demand (domestic investment and net foreign investment)[6].

The other remaining stylized facts about the Korean economy in the 1990s are in the foreign exchange market and labour market. If we look at Table 4.6, it shows that the real exchange rate index for Korea increased by 14 per cent from 1990 to 1996. The labour costs increase is more spectacular. In 1975, Korean wages were only 5 per cent of the U.S. But by the end of 1996, it increased to 46 per cent of the U.S., Korea no longer had a competitive edge in low labour cost in the world market[7]. The Korean wage index increased from 25 in 1990 to 46 in 1996, an 85 per cent increase during the period.

Summarizing the above figures, it can be said that the Korean economy, on the surface, showed a continual growth into the 1990s, with a balanced budget and moderate rise in prices. But domestic savings began to slow down without a decrease in domestic investment. In fact, it rose quite a bit. The

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5 *Ibid.*

6 *Ibid.*

7 Recently, the McKinsey Global Institute reported that in most manufacturing sectors, labour and capital productivity of Korea was at less than 50 per cent of the U.S. levels. (McKinsey Report, 1998).

government sector continued to grow. To finance domestic investment and government spending, Korea turned to foreign capital. Without an increase in foreign direct investment, foreign capital inflow took the form of portfolio investment. At the same time, the real exchange rate of won soared up and so did the labour costs[8]. Things were thus, already turning serious.

This brings us simultaneously, to Korea's debt problem: Korea's foreign debt began to explode starting from 1984 when the restrictions on overseas borrowing were abolished. However, for the following ten years, until 1995, both the government and most people were principally concerned over the overheating of the economy. 1995 was the year when the debt burden started showing signs of the looming crisis for the first time. After that, the foreign debt began to snowball, reaching $154 billion at the end of 1997 according to IMF measurements. (See Table 4.7)

Table 4.7. KOREA'S NET EXTERNAL DEBT (UNIT: $1 BILLION)

	End 1996	End Jan. 1998
Total External Debt	157.5	151.2
Public Sector debts	2.4	21.0
Financial Institution	119.5	89.5
Enterprises	35.6	40.6
Long-term	57.5	87.2
Short-term	100.0	64.0

Source: *Committee on Foreign Exchange and Other Transaction, Sub-Committee on Asian Financial and Capital Markets, under the Ministry of Finance, ROK, "Lessons of the Asian Monetary Crisis, "May 9, 1998, p.15.*

By mid-1998, with the devaluation of the won, the foreign debt made up nearly half of the country's GNP. This debt was not only caused by financial institutions, but by businesses in general.

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[8] Koyoo H. Kim, op.cit. pp.472-473.

In 1996, Korea experienced serious stagflation. Businesses failed subsequently, including in some cases, *chaebol* groups. In January 1997, for example, Hanbo Steel, and subsequently later in the year, Jinro, which was Korea's 19^{th} biggest *chaebol*, New Core, which was 25^{th} and finally Kia Motors Company, which was the 8^{th} biggest *chaebol*, gave way. Although Kia became insolvent in July, the problem was not solved until October, when it was put under court protection.[9]

As a result of the stagnation and these defaults, Korean banks and other financial institutions began to lose their solvency in 1996 and 1997. They responded by withdrawing their credit lines to the big business groups, leading to a vicious cycle of business default and bank insolvency. This downward spiral was one of the causes of the currency crisis. In particular, merchant banks competed to borrow short-term foreign funds and gave credit in the long-term to the big businesses. After the mid-1990s there had been a significant increase in short-term borrowings by the Korean banks and financial institutions. Within a short period of two and a half years, the borrowings by Korea nearly doubled from $56 billion in December 1994 to $103 billion in June 1997. An increase of $47 billion in two and a half years was very sharp indeed by international standards. European banks were the most aggressive leaders to Korea, with their share of lending rising from 30.5 per cent in mid-1996 to 35.5 per cent in 1997. During the same period, the Japanese banks cut their exposure from 24.3 per cent to 22.9 per cent. According to semi-annual report of the Bank of International Settlements (BIS), released in January 1988, almost 70 per cent of bank credits granted to Korea by mid-1997 were to be repaid within a year or less. Since the majority of these borrowings were short-

9 Kim Dae Hwan, "Behind the Economic Development", *AMPO: Japan Asia Quarterly Review*, vol. 28(3), 1998, pp. 17-18.

term, nearly $70 billion were due for payments between late 1997 and mid-1998. The BIS also estimated that at the end of 1996, foreign-currency debt of less than two years' maturity was about 200 per cent of foreign exchange reserves in Korea. Of the top 30 *chaebol*, 25 had debt-equity ratios of more than three-to-one, and ten of more than five-to-one, against the one-to-one usual in an ordinary economy.

International Bank Lending to Korea (in million US$)[10]

	June '97	Dec.'96	June'96	Dec.'95	Dec.'94
Korea	103,432	99,953	88,027	77,528	56,599
Asia	389,441	367,009	337,849	306,855	241,249

Source: Bank of International Settlements, 1998.

Faced with a situation of liquidity crunch and default, the then Korean President, Kim Young Sam, sacked his Finance Minister and replaced him with a former IMF official, Lim Chang-Yuel, on November 19, 1997. Soon after taking office Lim announced liberal policy measures to further open financial markets and remove restrictions on portfolio investments which were introduced in the early 1990s in the wake of surge in such flows. After announcing the removal of capital controls, the Korean authorities got involved in extensive discussions with the IMF to work out a mutually acceptable bail-out programme.

In the meantime, as already stated earlier, pressure had been increasing tremendously on merchant banks because they had been the intermediaries-cum-guarantors for foreign funds borrowed by over-debted *chaebol*. This created a possibility of default on the loan by the merchant banks. The won

10 For similar statistics of other East Asian countries, see Kavaljit Singh, *A Citizen's Guide to the Globalization of Finance* (Delhi: Madhayam Books, 1998) p.83.

began to depreciate moderately from late August 1997 and gathered momentum by October under attack from the fleeing foreign capital and international speculators. From about 900 won to the dollar in early August, the exchange rate jumped to about 1, 200 by the end of November. The sudden movements in the exchange rate were matched by swings in cross-border capital flows, which mostly included short-term portfolio movements. The impact was immediately felt on share prices in stock markets. The Korean stock prices fell by 44 per cent over the last three months of 1997. Efforts on part of the official monetary authorities to rescue the national currency led the central bank (BOK) in Korea to lose a sum of about $10 billion during the last few months. For Korea, its $23.9 billion official reserves in December were found inadequate, especially since $17.9 billion of it was blocked in overseas accounts and with short-term debt (to be repaid by January 1998) exceeding $20 billion. Short-term interest rate shot up to 15 per cent by the end of November because of a liquidity shortage, which resulted from the tapering off of foreign capital flows. Exports, which proved themselves as major source of expansion in Korea, fell from 30 per cent in 1995 to 3 per cent in 1996 in terms of export growth rate. As can be expected, the slower growth of exports led to decline in GDP growth, which caused decline in imports in the country. The GDP growth, which had slowed marginally from around 8 per cent during 1994-96 tom 6 per cent per annum over the first three quarters of 1997, fell sharply to 3.9 per cent at the height of the crisis during the last quarter of 1997[11]. Despite the decline in imports, trade balance also worsened, with trade deficit at $-17.8 billion in Korea. Moreover, the much vaunted saving rate

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[11] The GDP growth rate of Korea over some three decades since 1960s had been 8.6 per cent per annum on average.

slipped from 30 per cent in the early 1990s to 23 per cent and current account deficit also worsened to about $23 billion in 1996.

Finally, on 3 December , 1997, the record largest-ever $57 billion Stand-by IMF Agreement (rescue package) was successfully concluded by Korea. With its usable foreign exchange reserves nearly exhausted in November 1997, Korea had to request emergency assistance from the IMF to avoid a moratorium on its foreign debt. The IMF programme, however, did not provide a respite to the trough-seeking won. The exchange rate (won-dollar) plummeted from about $1.150 at the beginning of December 1997 to $ 2,000 at the end of the year and to the lowest value of about 2,100 in January 1998 at the peak of the crisis, while corporate bond rates soared from around 14 to almost 30 per cent in the wake of large-scale capital flight. Thus, the financial crisis wreaked havoc during 1997-98.

The impact of the financial crisis on the economy became apparent in the first quarter of 1998 as GDP dropped 3.8 per cent year-on-year, while the number of insolvencies jumped to three times the pre-crisis level. Almost 1.5 million jobs have been lost between the summer of 1997 and April 1998, boosting the unemployment rate from 2.2 per cent to 6.7 per cent despite a sharp decline in participation rates. Nominal wages appeared to have fallen dramatically as firms struggled to survive and workers preferred pay cuts to reductions in employment. The sharp rise in import prices due to the depreciation of the won temporarily boosted consumer price inflation to 9.5 per cent year-on-year in February. In the three months to May, however, the price level fell at a 1.4 per cent annual rate, reflecting weak domestic demand and declining oil prices. With imports plunging and export growth sustained by the large real depreciation of the won, the current account swung to a surplus equivalent of about 14 per cent of GDP in the first quarter of 1998. But falling wages and massive cuts in investment, while being essential to restore company balance sheets and Korea's external position, seriously depressed domestic demand. Moreover, in the first half of 1998, Korea's banks turned in their worst performance in memory. The country's 22 commercial banks ran up combined losses of 6.72 trillion won ($5.16 billion), thanks to huge provisioning against a mountain of soaring loans that had been made to what are now crisis - battered enterprises. Against this background, financial markets remained volatile in April and May, reflecting uncertainty over the near-term outlook, aggravated by slow progress in restructuring banks and the *chaebol*. Further, there was growing concern about a new wave of lay-offs and bankruptcies as corporate bond rates in early June remained at 18 per cent, even though wage costs were falling. Despite high interest rates and a successful flotation of $4 billion at the end of May, the won remained in the $1,320 to 1,440 per dollar range[12]. However, the crisis started subsiding since the second quarter of 1998 and the won stabilized at around 1,300 per dollar in mid-1998.

Nature and Characteristics of the Korean Crisis

The following features depict the nature and characteristics of the Korean crisis and the build-up to it:

1. *Financial institutions had accumulated large amounts of non-performing loans*; too much of the debt was in short-term foreign

[12] OECD, *Annual Review/Korea*, 1997-98.

currency liabilities, banks lacked liquidity and risked default on payments; there was no accurate information on total outstanding liabilities. Thus, the Korean crisis was to a significant extent triggered by the debt-crisis[13].

2. *Annual capital inflows into Korea increased substantially* during 1990-1996 at an average of over 6 per cent of GDP.
3. *Korean corporations were over leveraged* - debt-to-equity ratios were too high - and much of this debt was in foreign, short-term liabilities; consolidated corporate accounts were not available; accounting procedures did not conform to international standards.
4. *Production was concentrated in a few corporations*; these firms suffered from high costs of production, low profits and declining competitiveness.
5. *Political direction and government policies were going through a turbulent period*; it was unclear what the future and national policy would be because of the elections.
6. *The government maintained exchange rate with small, predictable changes*; in effect, the central bank absorbed the risks of exchange rate movements on behalf of investors, which helped to encourage capital inflows, especially with short maturity structures.
7. *The exchange rate appreciated in real terms*, as the capital inflows put upward pressure on the prices of non-tradable between 1990 and 1997.
8. *Domestic bank lending expanded rapidly in Korea* and throughout East Asia in the first half of the nineties - the foreign liabilities of the banking

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13 See pp.104-106, cf.

system more than doubled from 4.5 per cent of GDP in 1993 to 9.5 per cent of GDP in mid-1997.

9. *An alarmingly increasing share of domestic bank lending was being apparently used for indiscriminate diversification by the chaebol* - the top five were in an average of 140 different businesses apiece.

10. *Export growth, measured in current US $, began to slow in the mid-1990s and then dropped sharply in 1996* - exports increased by only 3.7 per cent in 1996 in Korea[14] - several factors contributed to this feature: the increasing over-valuation of the exchange rate, the appreciation of the Japanese yen against the dollar in 1994, the devaluation of the Chinese yuan in January 1994, the competitive effects of Mexico's participation in NAFTA and the devaluation of the Mexican peso, the world-wide glut in semi-conductor production, over-production of automobiles, etc.

11. *The unwinding of "carry trades"* (by which international commercial and investment banks borrowed foxed-rate funds in dollar and yen market sand on-lent them in higher-yielding Asian local currency instruments); *the rush by domestic banks and corporations to hedge their substantial on- and off-balance sheet exposures; and the thinness of foreign exchange market magnified the initial depreciations.*

12. *The won started depreciating modestly in August 1997 and then speedily from October onwards*, reaching the trough in January 1998.

13. *The bulk of outflows followed rather than led the initial currency depreciations*; the ensuing liquidity squeeze created a downward spiral of exchange rate depreciations and credit quality that fed one another,

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14 It was down by 30 per cent in 1995

magnifying price movements relatively long after the initial depreciations.

14. *International financial conditions had changed* - markets had become globalized, capital was mobile, South East Asia was in financial disarray, expectations for accountability and transparency were not being met. Korea had not adjusted to these demanding market standards.

15. *The form and structure of international finance had direct bearing on the dynamics of the crisis and its aggravation.* Leveraged positions on emerging market instruments - particularly debt and foreign exchange, and also equity - and the margin calls in response to price movements in emerging market instruments, the subsequent rapid deleveraging, and the substantial size of financial flows and linkages within Korean and other victim markets - all played critical roles in propagating and transmitting the crisis across markets. The "contagion" was thus not merely a manifestation of the souring of mature market investors' sentiment but also a direct result of the nature of financial linkages across markets.

16. *After four decades of economic success in Korea, strong vested interests sought to preserve past practices*, cronyism between government and business leaders and out-dated operational methods; these interests resisted calls for transparency, accountability and openness, improved financial institution supervision, and a separation of government from the market.

17. *The Korean crisis as well as the whole East Asian crisis can be characterized as "capital account crises"*, due to the sudden flight of short-term capital that had financed the current account

deficits.(Because they are brought on by the rapid flight of short-terms capital, capital account crises have three characteristics: they occur suddenly, they escalate easily, and they tend to spread easily to other countries.

18. *The problem of "moral hazard"* was to a large extent a catalyst in the build-up to the crises. *Coupled with it was the malady of "asymmetric information"*. Because banks failed as efficient information conduits between depositors and borrowers, excessively optimistic expectations about the success of the reform were created among domestic residents, international investors, and the policy authorities. Initially, improved economic performance and large inflows of foreign capital justified such optimism. Only later did the sustainability conditions bind so that the economy collapsed into a recession, financial crisis, and capital flight.

19. *The overly harsh reaction of the IMF and its "uniform" prescriptions* for all the victim economies, served to exacerbate the situation, when a different approach might have resolved the problems more efficiently.

20. Last, but most importantly, the Korean financial crisis was brought about by the *presence of different structural and financial shortcomings in its financial system* - ill managed and shoddy financial deregulation, poor exchange rate management, abandonment of investment coordination, lack of risk-assessment by the tender domestic banks, relative absence of avenues and fora for scrutiny and debate about the shape of the economy and economic policies in Seoul, absence of checks and balances, etc. were some of the greater faults in the economy.

THE CRISIS EXPLAINED

The Timing. The financial crisis in East Asia, including Korea, is often seen to have had a sudden and unpredicted nature. The severity and virulence experienced by the victim economies have often been tended to be explained on the basis of the unanticipated onset of the financial crisis. Thus, a lot has been made of the "unannounced" onslaught of the crisis. However, it should be asserted that the crisis did not occur in isolation. We have already seen some of the earlier crises in other developing regions of the world that should have been seen as exemplary precedents. Moreover, the Korean economy itself had started emitting some disturbing signals, which we saw in the preceding pages and would also be trying to understand in the following pages. It needs to be mentioned that the Korean crisis, though much more complex, was to a large extent similar to the Mexican crisis in being also a capital account crisis. The lessons learned in the aftermath of Mexico's experience have been widely known, and should have provided a warning to other developing countries that were trying to achieve economic growth through maintaining an unrealistic dollar peg and seeking inflows of short-term capital. The following few points could not have been overlooked:

a) when current account deficits are being financed with private capital, those funds should be invested efficiently and productively;

b) a currency should not be allowed to remain overvalued for a long period;

c) excessive dependence on short-term capital has to be avoided;

d) when the crisis emerges, the possibility of gaining support from investors diminishes (because it is easy for capital to take flight)[15].

In this sense, as Nobuyuki Ichikawa posits, the crisis in East Asia was never a matter of "if", it was a matter of "when". In the period from 1996 through 1997, for example, the IMF and the World Bank both released opinion papers, the former arguing that fluctuations in the real exchange rate beyond certain limits (either over-valuation or under-valuation) suggested the emergence of a currency crisis, while the latter stressed that rapid infusions of short-terms capital would bring about bubble-type conditions in developing countries, with a consequent increase in bad loans[16]. During the same period, the American credit-rating firm, Moody's, downgraded ASEAN external debt on the grounds of inherent weakness in the system of financing debt through dependence on foreign capital supported by inflows of short-term capital. If these warnings had been heeded seriously, the East Asian crisis would not have reached such critical proportions. In fact, the warnings were ignored both by the governments of the victim countries, who had profound confidence in the economic performance of their nations, and by private-sector investors, who overestimated that profits financial globalization would deliver to emerging markets and underestimated the risks involved[17]. The creditors as well as the debtors

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15 Edwin M.Truman, "The Mexican, Peso Crisis : Implications for international Finance, " *Federal Reserve Bulletin* (Washington, D.C.), March, 1996.

16 See Graciela Kaminisky et al, *Leading Indicators of Currency Crises*, IMF Working Paper 97/79, (Washington, D.C.: IMF July, 1997); *World Bank Private Capital Flows to Developing Countries*, A World Bank Policy Research Report (Washington, D.C.: World Bank, 1997).

17 Nobuyuki Ichikawa, "The Financial Crisis in East Asia," Asia-Pacific Review, vol.5(1), Spring/Summer 1998, p.166.

have to be blamed for their lack of prudence and sight. Thus, the timing of the 1997-98 financial crisis had an inherent imminency within.

The Causes. It was not long ago when Alwyn Young[18] had published the finding that growth in capital and labour inputs and not growth in total factor productivity has driven the relatively high rates of economic growth in the East Asian economies in the past three decades or so. This 'unexciting' technical finding, based on the approach of growth accounting with all its well known limitations, was supplemented by the much more popular argument by Paul Krugman[19] in 1994, which later (post-crisis) came to be cited extensively. In this article, Krugman has provocatively challenged the World Bank's findings regarding the "East Asian Miracle" and its causes/sources. He argues that East Asian economic growth was essentially input-driven, i.e., fuelled mostly by the mobilization of large amounts of labour and capital, rather than gains in efficiency. Since there is a natural limit to the accumulation of inputs, and hence a limit to their return under the law of diminishing returns, as economy that relies on the mobilization of inputs without realizing gains in the efficiency of these inputs would necessarily reach a limit to its growth. In this sense, the term "miracle" is misplaced, since there is nothing miraculous about economic growth based on the sweat of hard labour. Krugman, further says, and this

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18 See Alwyn Young,"A Tale of Two Cities: Factor Accumulation and Technical Change in Hong Kong and Singapore", *NBER Macro-economic Annual* (MIT Press), 1992; and "The Tyranny of Numbers: Confronting the Realities of the East Asian Growth Experience", *The Quarterly Journal of Economics*, 1995, pp.641-80.

19 Paul Krugman, "The Myth of Asia's Miracle", *Foreign Affairs*, vol.73(6), 1994, pp.62-78. Krugman refers to the NICs of Asia as "paper tigers" in the article.

proved to be premonitive to an extent:

> Popular enthusiasm about Asia's boom deserves to have some cold water thrown on it... the future prospects of that growth are more limited than almost anyone now imagines.[20]

An implication of the Young-Krugman thesis is that rapid growth in East Asia may not endure and once the economics begin to confront problems of tight labour markets and exhaustion of all the known production possibilities, the growth rates must slacken in the longer terms in the absence of technological improvements[21].

Though the above pre-crisis explanation would not go a long way when considered in an ex-post sense, however, it was one of the first studies that saw an inkling of an impending crisis in the East Asian economies and gave a lead to searching for the causes of the crisis.

The recent financial crisis in Korea was the immediate result of a foreign exchange crisis - a rapid and drastic depreciation of the won and a severe liquidity crunch. The currency crisis, in turn was precipitated by the confluence of a drastic increase in the demand for the dollar and an equally drastic decrease in its supply. This was a result of a massive disintermediation by foreign lenders, who had suddenly become very much concerned about the

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20 *Ibid.*, p. 64. Despite this prophetic comment, Krugman (1998) himself wrote: "It seems safe to say that nobody anticipated anything like the current crisis in Asia." In a recent speech in Hong Kong, Krugman (1998), referring to his Foreign Affairs article and the Asian crisis, pointed out that while he was 90 per cent wrong about what was going to happen to Asia, everyone else was 150 per cent wrong since they saw only the miracle and none of the risks.

21 V.V.Bhanoji Rao, "East Asian Economies: The Crisis of 1997-98", *Economic and Political Weekly*, June 6, 1998, p.1397.

business prospects in Korea. According to Young Back Choi[22], Korean foreign debt at the end of 1997 was very large, standing at $153 billion (of which $82 billion was short-term debts due within a year)[23]. Assuming that the average duration of the long-term loans was three years and that all the loans are evenly spread out and interest payments were duly made, Koreans had to refinance at the rate of roughly $9 billion a month ($7 billion for short-term and $2 billion for long term loans) to keep the debt from growing. Soon after the bankruptcy of the Hanbo group in January, there was no new medium- to long-term loans, i.e. 2 billion a month less supply of dollars compared to the earlier period. Moreover, since the announcement of the insolvency of the Kia Motors in August 1997, even short-term loans dried up completely. That is, an additional 7 billion a month reduction in supply of dollars[24]. In addition, the building up of the expectation for currency devaluation induced many Koreans to substitute the U.S. dollar for the won. For example, many Korean firms stopped converting their export earnings into local currency, preferring to hold them in dollars in anticipation of a devaluation, further reducing the supply of dollars.

A massive scramble for the dollar began with the disintermediation by foreign lenders. As loans came due, but not refinanced, the Korean banks and other financial institutions scrambled to purchase dollar to repay the loans. As

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22 Young Back Choi, "On Financial Crisis in Korea", *Korea Observer*, vol. 29(3), 1998, p.491.

23 The comparable figure at the end of 1996 was $157 billion (of which $100 billion was short-term) and at the end of 1998 it was $151 billion (of which $63.8 billion was short-term loans, thanks to the conversion of some short-term loans from foreign banks to long-term loans from IMF and ADB, etc.). *Ibid.*

24 This is assuming that interests on loans were being paid. However, there are evidences that many Korean firms borrowed short-term to cover interest payments. If this was a general practice, the above calculations should be revised upward by about $0.6 billion a month, assuming 5 per cent interest.

per earlier calculations the demand of dollars was adding up. The attempt on part of the BOK to prevent massive bank failures by providing emergency loans to the tune of W32 trillion, enabled the banks to sustain the demand for dollars. Moreover, a massive panic disinvestment from the Korean stock market by foreign investors[25], in reaction to the declining stock market, combined with a rapid depreciation of the won, created additional demand for the dollar.

The Korean government was not in a position to stabilize its currency without increasing interest rates in the face of such an increase in dollar demand. Official reserves standing at $30 billion at the end of 1996, stood at $22.3 billion at the end of October and $7.3 billion only at the end of November 1997. Thus the Korean government was not able to contain the radical depreciation of its currency.

A drastic depreciation of more than 100 per cent in two months created havoc and the impact was more serious because much of the massive foreign debts that were coming due was dollar-denominated and the Korean economy relied heavily on imports for its industrial production. Disintermediation by foreign lenders on a massive scale, setting off subsequent rounds of disintermediation by domestic banks and other financial institutions created a severe liquidity crisis. The fact that most of the Korean firms were highly leveraged made the impact of disintermediation and the liquidity crisis even worse[26].

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25 As of January 1997, the total foreign investment in Korean stock market stood at $ 18.7 billion.

26 The estimated domestic debt in January 1998 was around $300 billion, of which somewhere between $150 and $225 billion was in the form of *oum*, due usually in three months. See Stephanie Strom, "Korea's other Big Problems: $300 billion in

The massive disintermediation by foreign lenders, and the resulting currency-cum-liquidity crisis was a reaction to the worsening economic conditions in Korea in the preceding years, made worsening by the financial crises in South East Asia and the banking crisis in Japan. The worsening of Korean economic conditions was, in turn, caused by over-investment by Korean firms. It was also encouraged by some mistaken government policies and temptingly low interest rates in the international capital markets due to the expansionary monetary policies of the U.S.

The second quarter of the 1990s saw a new global glut in labour-intensive manufactured exports, precisely the kind of exports that had fueled Korea's growth in the past generation. Such a glut was reflected in slower export earnings for Korea in the field of electronics and semi-conductors, especially. Semi-conductor prices were hit the hardest, with prices estimated to have fallen by as much as 80 per cent in 1996. The rapid growth in electronics production in South East Asia, coupled with the addition of China and Mexico, created excess productive capacity and contributed to the decline in prices. Thus a spanner was thrown in Korean exports which were proving uncompetitive in relation to the new entrants. Moreover, the Korean firms became increasingly less competitive due to inefficiencies caused by over-investment and concessions made to militant unions, which secured a system of life-time employment with generous compensation. Additionally, the depreciation of the Japanese yen from about 90 to a dollar to 125 in 1997 magnified the problem for Korean exports.

Domestic Debt", NY Times, Feb. 10,1998. The rate of bounced *oum* reached over 10 per cent in January 1998, accounting for the mounting bankruptcies. Firms began to refuse to accept promissory notes as payments, demanding instead, cash, further driving firms under liquidity crunch over the brink.

The Korean recession was thus quite serious by mid-1996. The Korean government attempted to deal with the situation by introducing in December 1996, legislation intended to allow easier layoff. This resulted in general strikes in January 1997, creating much industrial dislocations. A series of subsequent bankruptcies of business firms, including the *chaebol* like the Hanbo, Sammi, Haitai, Kia etc., not only further depressed the economy but also exposed the weakness of Korean banks and set off a series of disintermediation by foreign lenders, making the situation worse[27]. The ground for a panic for the dollar was cleared further.

The earlier financial/ crises in South East Asia contributed to a degree by awakening the foreign lenders and investors to the possibility of a similar crisis in Korea. A series of bank failures in Japan (the major creditor to Korea with more than 30 per cent of Korea's external debt), resulted in higher costs of fund for Japanese banks (the so-called 'Japan premium') and brought about a turn to more conservative lending practices.

The heavily leveraged *chaebol*, which had played a crucial financial role in driving the export-led growth of Korea, proved very determinative in engendering and deepening the financial crisis. In fact, the Korean economy has been monopolized by the *chaebol* (especially the top five - Hyundai, Daewoo, LG, Samsung and Ssangyong) since the beginning of its

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27 This led the Korean government to announce a short-term financial stabilization package in August 1997, and prepare a proposal for a legislation to create a "Non-performing Asset Management Fund", fashioned after the American Resolution Trust Corporation. The proposal was defeated in the Parliament in November 1997.

developmental process. The *chaebol* - representing the business interests of the country, have also been enjoying a very cozy and cooperative relationship with the government beginning with the Park Chung Hee era of economic development initiation - thus the term "alliance capitalism". According to one measure, the top 10 *chaebol* have sales equal to 50 per cent of Korea's GDP. The privatization of the Korean banking and financial system by President Chun Doo Hwan in the early 1980s also led to an unhealthy nexus between the *chaebol* and the private banks. Although the government developed mechanism to prevent *chaebol* dominance of the banking sector, by the end of the 1980s, Korea's biggest conglomerates owned a sizeable chunk of the country's banks, insurers and NBFIs. The result: they were able to corner the lion's share of credit, a large proportion of which went into property speculation and mergers and acquisitions.

As Yoon Jin-ho[28] has argued, the country's top *chaebol* expanded vertically and horizontally but ended up severely over-leveraged. In the first nine months of 1997, the top 30 *Chaebol* were involved in 114 cases of mergers but this was at the cost of an average debt-to-equity ratio of 400 per cent compared to 167 per cent for US companies and 210 per cent for Japanese. Despite the difficulties experienced by their clients on the export front, the Korean banks were happy to lend, with many, using the benefits of a liberalized financial environment, borrowing a large volume of short-term money from the international system in order to make long-term money

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28 Yoon Jihn-ho, *IMF Bailout and Employment Crisis: The Labour Response* (Seoul: Korean Confederation of Trade Unions), December, 1997.

available to their conglomerate clients at higher rates. This unhealthy process continued until the crisis was precipitated.

Table 4.11. The Chaebol

	Long-term Debt Outstanding (U.S. $Billions)	Debt Equity Ratio
Hyundai	47.89	4.4
Samsung	40.95	2.7
LG	31.80	3.5
Daewoo	29.16	3.4
Sunkyung	19.94	3.9
Ssangyong	14.04	4.1
Hanjin	13.03	5.6
Kia	13.14	5.2
Hanwha	10.74	7.8

(Won 904.55 = U.S. $1)
Source: Office of Bank Supervision, The Bank of Korea.

The heavy debt burden in itself would not have been a problem if all investments of the *chaebol* were as successful as the Korean economy itself had been. In practice they were not, but in periods of high growth most *chaebol* were in a position to cross-subsidize their loss-making operations with revenues from their more profitable ones. Two developments had adversely affected this arrangement. First, a slowdown in international trade growth in general and in trade expansion in certain areas like semi-conductors, office automation equipment and consumer electronics undermined this ability of the hugely diversified *chaebol*[29] to cross subsidize their activities. Moreover, in spite of the existing sectors, which were already proving to be a liability, the *chaebol* started indulging in diversifying in sectors wherein many of them lacked the expertise, e.g., the automobile leaders, Hyundai, tried expanding into

29 A typical *chaebol* has business involvement in several unrelated areas, e.g. insurance, brokerage, steel, newspaper, refrigerators, shoes, conductor chip fabricating, etc. In each of the industries they are involved, the *chaebol* have raced to expand their market shares, with little respect for profitability. Such drives have often been ego-driven.

the field of electronics, while the electronics giant, Samsung, started diversifying into automobiles. Often, profitability of the new projects was not given proper consideration. Second, these over-diversification drives and lack of income-generation had been giving velocity to increasing accumulation of Korea's external liabilities, a major portion of which was in terms of short-term commercial borrowings fast approaching their due dates of repayment. Clearly, it was not merely Korea's banks that were not diligent about their exposure; the international financial system was also to blame.

It took a slowdown in export growth to spur international financial uncertainty about the prospects for repayment of short-term debt, which resulted in the growing unwillingness of banks to roll over short-term debt. The resulting surge in corporate insolvencies had a devastating impact on Korea's financial system. Non-performing loans (NPLs) of commercial banks rose from 4 per cent of total credit at the end of 1996 to 6 per cent at the end of 1997. The surge in problem loans in 1997 led to a number of credit distortions. Financial institutions, reluctant to see a further rise in NPLs, provided concessionary loans to prop up large firms in difficulty, while restricting credit to small and medium-seized enterprises. What ensued was a galore of insolvency-led closures of both business firms and banks.

In the liberalized financial environment, the first effect of the debt-crisis in banks was on the value of the domestic currency, won, which began to slide. This had two consequences, as already seen: it set off speculative attacks on the currency from traders looking for quick returns; and it encouraged domestic banks, that had to make dollar payments to service their short-term debts, to rush and purchase dollars. A collapse of won followed. Accompanying was the slump in stock markets where institutional investors who had made large portfolio investments lost confidence and booked profits and started withdrawing en masse. Massive capital flight followed. Over $45 billion left the Korean shores in the third and fourth quarters of 1997. The capital flight was underlined by dramatic swings in the creditor's expectations about the behaviour of other creditors, thereby creating a self-fulfilling - although possibly individually rational - financial panic[30] .

Besides the disastrous accumulation of short-term debt, the ensuing withdrawal of capital and financial panic, generated by the gradual and sudden shifts in international market conditions and the domestic financial market instability, the deficiencies in the financial market instability, the deficiencies in the financial system of Korea - some long-existing, as well as those caused or aggravated by the financial deregulation and overall economic liberalization moves since the early 1980s, have come to be attributed to as being a very major precursor of the recent financial crisis. The following views substantiate this approach. Radelet and Sachs : "...it was brought on by weaknesses in ...economic management...haphazard and partial financial liberalization...";[31] IMF: "...Korea paid little attention to management, supervision and regulation

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30 This argument depends on some underlying assumptions: (1) that fundamental conditions, though not perfect, were strong enough to sustain reliable debt servicing; (2) that needed adjustments in exchange rates could have been carried out in mid-1997 without financial collapse; and (3) that foreign exchange and financial markets in fact overshot in their initial reactions to the panic at the end of 1997. It is consistent with several major facts: the role of short-term debt in the onset of the crisis, the unexpected nature of the crisis, the continued rapid lending to Asia until the brink of the crisis and the initial overshooting, as indicated by the reversal of exchange rate and stock indices from January, 1998. See Radelet S. and Sachs, J.D. *op.cit.*, pp.1-90.

31 Radelet and Sachs, *op.cit.*, p. 35.

of financial institutions...";[32] Ahn Choong-yong: "...combined with inefficient financial systems and poor oversight of banks, the crisis seems almost inevitable in hindsight...";[33] Kamara and Traub: "Closer examination [of the crisis] however, reveals three things: the financial crisis was triggered by deep-rooted problems in the banking system; despite its dramatic manifestations the crisis had been building up for some time; and the financial problems underlying the crisis had, to a considerable extent, been engendered and prolonged by weaknesses in the regulatory environment...";[34] Yilmaz Akyuz (chief economist of the UNCTAD and the main author of its Trade and Development Report, 1998) : "If anything, it was the departure from the Asian model (state guidelines and controls for a private sector-driven economy) that set off the crisis. Rapid liberalization of capital flows is a major predictor of [East Asian] financial crisis.";[35] Ghosh: "...the Korean crisis is one of deregulation and not excessive regulation as was originally projected ...";[36] Patnaik: "...Financial liberalization, therefore, was at the root of the South-East Asian crisis..."[37]; Chang: "...the Korean crisis has been due to ill-managed financial liberalization, poor exchange rate management, and abandonment of

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32 IMF, *World Bank Economic Outlook : Interim Assessment*, December, 1997.

33 Ahn Choong-yong, "East Asia's Economic Growth : Can It Continue?", *Korea Focus* (Seoul) May-June, 1998, p.45.

34 Samura Kamara and Tony Traub, "The East Asian Currency Crisis : Emerging Conceptual and Practical Considerations", *International Capital Markets* (Commonwealth Secretariat), vol.17(4), December, 1997 p.22.

35 Yilmaz Akyuz, "1999 is going to be worse than 1988", *Interview conducted by Development Update* (UN, New York), no. 25, Sept.-Oct. 1998.

36 Jayati Ghosh, in her lecture on "The Korean Crisis and Its Management" in the Seminar on 50 Years of the Republic of Korea at SIS, JNU, Novemeber 30, 1998 (unpublished).

37 Prabhat Patnaik, "The real face of financial liberalization", *Frontline*, vol. 16(4), February 26, 1999, p.102.

investment coordination"[38]; Dallara: "...Another factor underlying the crises in East Asia was, poorly regulated domestic financial systems, with banks engaged in either connected lending or politically motivated activities that contributed to excess expansion of credit in a number of these economies."[39] Besides the above, a host of analysts have stressed the significance of the Korean financial liberalization process and the structural deficiencies in the system, on the recent crisis, in the ever-proliferating literature on the crisis in East Asia, Korea included. In the Korean financial system, new banks and finance companies were allowed to operate without supervision or adequate capitalization. Proper norms were not followed by the banks and they lacked an efficient risk-assessment while lending to the private business. The loans were often on the basis of cozy relationship between the state and business. Political and business connections determined the financial transactions. This phenomenon has come to be referred to as "crony capitalism"[40] or "alliance capitalism". Thus, high levels of corporate debt was buffered by long-term financial relations between the *chaebol* and banks, with the government standing ready to support both firms and banks in the event of shocks[41]. Another fault-line in the system was the failure to depreciate the exchange rate in time when the trade deficits were widening, and reliance instead on short-term funds to finance widening current account deficit.

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38 Ha-Joon Chang, "Korea: The Misunderstood Crisis" (unpublished draft), cited in Rao, V.V.B., *op.cit.*, p.1405.

39 C.H. Dallara, "Outlook for Emerging Markets and India following the Asian Currency Crisis", *13th Exim Bank Commencement Day Lecture* (30 march 1998); Exim Bank of India, Mumbai, 1998.

40 One of the observers of contemporary capitalism has remarked that it is generally overlooked that *all* capitalism is crony capitalism (Prabhat Pattnaik). *Op.cit.*, p.103.

41 In Korea, none of the *chaebol* had been allowed to fail for a decade before Hanbo Steel collapsed in early 1997.

The crisis-engendering problems in Korea had either been created or exacerbated by the "big-bang" financial liberalization measures including a more open capital account. The deregulation of the financial institution in an effort mainly to attract FDI inflows, due to lack of proper regulatory mechanisms (an evidence of shoddy and hasty deregulation) led it to develop, unfortunately, into a highly lubricated medium wherein international capital and portfolio could move freely, both inward and outward. It enabled the inflow of short-term funds to be more mobile, causing over-borrowing among the *chaebol* and banks. Indiscriminate speculation by global players was a very dangerous phenomenon to which Korea was exposed. The quick, speculative movements of capital could not be overtly realised, but the havoc they created within a matter of a few months - thus giving a "suddenness" to the onset of the crisis - could be felt only when the exodus of capital started[42]. Hence, the root of the crisis lay in financial liberalization which has ingrained in it the property of engendering speculation. Moreover, financial deregulation also signified a process of quick transmission of shocks from one market (say, currency) to others (say stocks, real estates, money)[43]. Efforts to reduce risks by devising derivative instruments to hedge/speculate in different markets increased the flow of financial transactions, without having a counterpart in the real sector. As the real sector performance slowed down, the real estate market as well as

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42 The recent financial crisis in East Asia has brought to the fore the existence of a class of decision makers, the hand picked global fund managers, who move billions of dollars across countries at the drop of an eyelid. While they are accountable to no international regulatory authority, the consequences of their decisions, as the recent experience shows, can be frightening for the international community. See D.N. Ghosh, "Global Fund Management: U.S. Hegemony and Bail-Out Strategies", *Economic and Political Weekly*, January, 31, 1998, p.202.

43 Financial liberalization in the different East Asian economies also worked in giving the contagion-dimension to the crisis.

the secondary stock and other financial derivative market with their high risk and high (speculative) returns attracted the financial flows, mostly of the portfolio variety. This also explains the large share of NPLs in the asset structure of banks. Financial deregulation also allowed an interlocking of the assets of banks and industries. Thus both banks and industrial units held securities, a part of which turned out to be illiquid and non-performing as the crisis broke out. Consequently, a number of *chaebol* went under, burdened by their heavy debts[44]. The bank-*chaebol* network proved too dear to the Korean financial system[45].

An additional explanation to the debt-driven liquidity crisis is the phenomenon of "moral hazard". The Korean banks and financial companies lent out on overly risky projects under the assumption that all the loans are implicity guaranteed by the government[46]. This, together with poor regulation, led the banks to base decisions not on a project's expected return, but on "Pangloss" values (the values that "variable would take on if it turns out that we live in what is (from their point of view) the best of all possible worlds")[47]. Then such moral hazard and thereby inflated prices of assets from risky investments create bubble under implicit government guarantee and the bubble bursts when the Pangloss value is realized and leading to a general fall in asset

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44 For example, one can mention Hanbo Steel and Kia Motors whose debt levels were respectively at $6.5 billion and $9.4 billion.

45 See Sunanda Sen, "Asia: Myth of a Miracle", *Economic and Political Weekly*, January 17, 1998, pp.118-114.

46 See Paul Krugman, "What happened to Asia?" (mimeo), 1998; Michael P. Dooley, "A Model of Crises in Emerging Markets", *Working Paper 6300* (Cambridge) Mass : National Bureau of Economic Research) December 1997, and Radelet, S. and Sachs, J.D., *op.cit*, pp.35-42.

47 Krugman, P. *Ibid.*

prices, then loans default and losses of the banks ensue with. This, according to Kyoo H.Kim, was found true with the Korean case too[48].

Finally, contrary to the tents of financial orthodoxy, the problems of Korea did not stem from resistance to a globalizing world and the discipline of global market forces. Rather, the crisis occurred because the government lacked the competence and the required expertise to manage integration into global capital markets - a situation into which it had already entered, willy nilly, with the initiation of its financial deregulation and liberalization process - with the same prudence and skill it had earlier shown in managing trade liberalization.[49].

Before concluding this section, it may, however, be mentioned that though the Korean financial system had been having enormous structural weaknesses and deficiencies[50], these had been tolerated by foreign investors and the IMF so long as the going was good.

THE IMF RESPONSE

The official international response to the Korean financial crisis, once the Korean authorities had decided to request a monetary bail-out instead of waiting until the country was on the verge of a debt moratorium, was led by the IMF. The landmark event was staged on December 3, 1997 when the bail-out

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48 Kyoo H. Kim, *op.cit*, pp.474-76.

49 UNCTAD, *Trade and Development Report 1998: Overview* (New York: United Nations), 1998, p.3.

50 e.g., The banks' NPAs net of reserve were almost equal to 70 per cent of their equity at the end of 1996. See Ashima Goyal and Shridhar Dayal, "Arbitrage: An Explanation for South-East Asian Crisis and Indian Immunity, *EPW*, August 1, 1998, p.2099.

Agreement was singed between IMF and Korea, after a pretty long drawn drama in Seoul about whether to take to this recourse. The IMF package consisted of a total amount of $57 billion worth of aid, the largest-ever monetary assistance to a single country in history[51]. This sum included $21 billion contributed by the IMF from its own coffers, $10 billion from the World Bank, $4 billion from the Asian Development Bank (ADB, Bangkok), and $22 billion from the industrialized countries - $10 billion by Japan and $4by the U.S.. Besides, the G7 countries and also Australia, Belgium, Holland, Sweden and Switzerland, declared themselves ready and willing to form a "second line of defence" and render more help to the IMF in supporting Korea's economy.

The IMF package included stringent economic restructuring policies intended to restore stability and confidence in the Korean economy. It involved the following main elements[52]:

- a package of loans to the central bank and the government that could be drawn on, directly or indirectly, to support the repayment of debts falling due to international creditors and to stabilize exchange rates;
- a macro economic framework based on budget balance or surplus, and high nominal interest rates and restrictive domestic credit targeted at exchange rate stability;
- a programme of drastic financial sector restructuring, based on immediate closure or suspension of several financial institutions and significant intensification of financial sector supervision in various forms;

51 Besides, $17 billion was agreed for Thailand (August 1997) and $35 billion for Indonesia (November 1997) by the IMF.

52 These elements were uniformly applied to all the three bailed out economies – a major point of criticism of the IMF prescriptions.

- other "good governance" and "structural" measures aimed at increasing the transparency and competitiveness of the economic system, including accelerated trade reform, demonopolization and privatization.

On the monetary policy[53] side, the key element for Korea was very high money-market rates, which jumped from 12 per cent prior to the crisis to 27 per cent at the end of 1997, to stem capital outflows and thereby stabilize the exchange rate at a more normal level. Moreover, these high interest rates were aimed at preventing a spillover of the currency depreciation onto domestic inflation and to encourage corporate restructuring. Money supply growth (M3) was to be slowed from 16 per cent in 1997 to 13 per cent in 1998. In addition, foreign exchange reserves were targeted to rise to $40 billion by the end of 1998.

The IMF programme also included significant fiscal restraint[54] in Korea, which has pursued very sound fiscal policies during the past few decades. Large general government financial surpluses have made Korea one of only three OECD countries where the government is a net creditor. The original agreement with the IMF targeted a balanced consolidated central government budget in 1998. As the economy slowed, the budget objective was eventually revised to a deficit of 1.75 per cent of GDP.

A unique aspect of the IMF programme with Korea was the wide range of structural reforms that accompanied the above macro economic policy prescriptions. These policies were consistent with the changes demanded during the country's accession process to the OECD. The structural reform plan was based on two fundamental principles - exposing the economy more

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53 The stated aim of the tight monetary policy was "to restore and sustain calm in the markets and contain the impact of the recent won depreciation on inflation".

54 The tight fiscal policy was proposed by the IMF to "alleviate the burden on monetary policy and to provide for the still uncertain costs of restructuring the financial sector". See IMF Stand-By Arrangement, 1997.

fully to world competition and introducing more effective governance structures into financial institutions and the corporate sector. Its implementation was to replace the dirigible approach of the past with a market-based paradigm. Establishing such a paradigm required first and foremost a rehabilitation of the financial sector and its mirror image - the highly indebted corporate sector. Such policies had to be accompanied by reforms in other areas, notably increasing labour market flexibility by reducing search employment through job training and match and unemployment insurance (the lay-offs were also expected to be more flexible) and opening of the capital account. Transparency of accounting standards and disclosure, no bail-out by the government of the troubled *chaebol*, reduction of the high debt-equity ratio, development of capital market and thus less reliance on bank financing, and elimination of the mutual guarantees within the *chaebol* were also directed.

The elimination of trade barriers and liberalization of foreign direct and portfolio investments in Korea set the tone of trade liberalization measures. For example, Korea's import diversification programme was to be eliminated. Elimination of the ceiling on the foreign ownership in the equity market and unrestricted participation of the foreign investors in the bond market were intended to liberalize the capital markets[55].

The basic goals of all the afore-mentioned IMF programmes, enunciated in Article 1 of its Articles of Agreement, included: "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to

55 All the prescribed measures were subject to review and revisions.

correct maladjustment in their balance of payments without resorting to measures destructive of national or international prosperity".[56]

The Programme in Action. The linkage between the loan package and the repayment of foreign debts was direct and fairly automatic in Korea. In early December 1997, the commercial banks simply notified the BOK of the daily foreign creditor demands for foreign exchange loan repayments. The BOK then credited these banks with the necessary foreign exchange. In this way, the foreign creditors were repaid out of the IMF loan package; the BOK became the creditor of the Korean commercial banks and the debtor of the IMF. The upside of this arrangement was that the original loans were repaid and default was avoided. The downside was that the original private loans were in effect socialized. If the original loans had been allowed to default, the foreign creditors and the owners of the Korean banks would have shared the bulk of the losses[57]. Instead, the foreign creditors were allowed to escape and the Korean government took over the burden of repaying the foreign debts - now owed to the IMF[58]

Moreover, the tight monetary policy framework, however, has proven problematic as the impact of very high interest rates on highly-indebted companies provoked a new wave of bankruptcies, thus boosting banks' problem loans and impinged on economic growth and exports. This increase, combined with the banks' efforts to meet the capital adequacy ratios by end-June 1998, have apparently obliged banks to curtail their lending. In May 1998, bank

56 IMF, "Korea-Request for Stand-By Arrangement", December 3, 1997 (Washington, D.C.).

57 The Korean government might still have borne some of the losses if the Korean banks had become fully solvent, since the repayment of the domestic deposits in the insolvent banks would probably have required public rescue funds.

58 Radelet and Sachs, *op.cit.*, pp.51-52.

loans actually fell. The fiscal policy's stance also became markedly contractional in 1998, thus compounding the effect on demand of high interest rates. It is unclear, beyond the immediate aftermath of the crisis, whether the overall tight stance of macroeconomic policy has achieved its goal of strengthening investor confidence, given the negative repercussions on the real economy and the exchange rate.

Further, since the launch of the programme, actual outcome on economic growth has been far worse than projected. The IMF was repeatedly forced to reduce its growth forecasts for 1998. And the much lower revised forecasts were still much more optimistic than those of private forecasters[59]. The IMF's own responses added to the risks of a sharply contractionary outcome. Overall, the IMF conditionalities made the economy stagnant, throwing it into zero or minus growth[60].

The management of the Korean crisis entered a new phase on December 24, 1997. With Korea on the brink of default, the US government (led by the Federal Reserve Board and the US Treasury) decided to press foreign commercial banks to roll over their short term credits to that country on an enforced basis, rather than waiting for market confidence to be restored. The banks and the Korean government initially announced a standstill on debt servicing, pending a formal agreement. On January 16, 1998, they agreed to a complete roll-over of all short-term debts falling due in the first quarter of 1998. On January 28, an agreement was reached to convert $24 billion in

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59 When pressed on this point, IMF officials answer that their original forecasts were built on best case assumptions. But there is much more to it than that. See Radelet and Sachs, *op.cit.*, pp..55-70.

60 See Kim Dai Hwan, "Behind the Economic Development", *AMPO: Japan Asia Quarterly Review* (Tokyo), vol.28(3), 1998, pp.18-19.

short-term debt to claims with maturities of between one and three years. The IMF, with the backing of the U.S., insisted on the comprehensive debt roll-over as a condition for further disbursements under the IMF lending package - in fact, those disbursements were accelerated as part of the new arrangement. In one sense, the new arrangement represented the failure of the conception embodied in the original loan programme and its recognition by the IMF. Rather than using a loan package in combination with economic reforms to restore market confidence, the new arrangement meant a non-market postponement of debts falling due, albeit ratified by market participants in a collective undertaking. The new arrangement finally put a brake on the fall of the won and also on the decline in stock market in Korea.

Shortcomings of the Programme. Ever since the IMF moved to the centre stage in the crisis, there has been growing criticism of its approach and typical demand-restraint programmes as well as the size, timing and flow of assistance. The fund has been criticized for associating its rescue package with onerous conditions for fiscal tightening, upward adjustment in interest rates, monetary and credit restraint, institutional reform and financial liberalization. As the situation continued to deteriorate, these standard prescriptive policies stirred considerable debate and were being considered inappropriate in many respects in the case of Asia, as against the earlier case of Latin America.

First, according to Jim Rowher[61], the IMF has grown used to working with a crisis-solving template that fitted Asia's situation only haphazardly. The

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[61] Jim Rowher, "Asia's Meltdown: The Risks Are Rising", *Fortune*, February 16, 1998, p.34.

IMF's medicine was normally aimed at countries with an inflation and a budget problem, whereas Asia's problems were ones of debt deflation, excessive private-sector leverage, and weak financial systems[62].

Second, and related to the first, was that the Fund failed to see the danger of fiscal restriction where budget had long been roughly in balance. More seriously, it also failed to see the danger of high real interest rates in the Korean economy with a high level of private indebtedness and low inflationary expectation. Under these circumstances, high real interest rate had disastrously deflationary consequences, which gave rise to capital outflows regardless of the attractions of high interest rates. Third, an insistence on budget surplus seemed inappropriate for a country where inflation - whatever the long-term threat - has heretofore been largely a non-issue and whose government has for years been running nearly balanced budget. In fact, deficit rather than surplus was the need of the hour.

Fourth, the Fund tried to strengthen weakened Korean financial structure by imposing western measures of financial restructuring[63]. This straitjacketed imposition had a constricting effect on the much different nature of Korean economy and its principles.

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62 *Ibid.*

63 Basle rules of capital adequacy were to be applied - named the Basle "Core Principles of Effective Banking Supervision".

Fifth, the IMF's insistence on further and faster liberalization of financial flows actually added to financial vulnerability and rendered the economy more prone to future crises.

Sixth, the IMF was rather poorly placed to rally market confidence in the short-term, under any circumstances. Its arrival gave all the confidence of seeing an ambulance at one's door.

Seventh, the Fund greatly amplified the jitters that it naturally creates by declaring - both for the purpose of negotiation and in reflection of the substantive beliefs of the institution - that "while the contagion effects of developments in South-East Asia contributed to the current crisis, the magnitude and speed of deterioration in the financial situation owed much to the fundamental weaknesses in Korea's financial and corporate sectors"[64].

Eighth, the IMF's approach to restoring market confidence was based on a very peculiar hypothesis: that tough action on restructuring financial markets - including closing financial institutions, tightening regulatory standards, and the like - would reassure creditors so much that they would roll-over their short-term claims as they fell due. But there is no reason to believe that these steps would in fact restore market confidence in the middle of a panic, in the sense of stemming demands of debt repayment. Indeed, the logic of creditor panics is the opposite: the sudden realization that a bank will not be bailed out by a lender of last resort can easily incite a panic that would not have arisen[65].

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64 IMF, "Korea - Request for stand-by Arrangement," Washington, D.C December, 3, 1997, p.38 (Annex.1).

65 Radelet and Sachs, *op.cit.*, p.61-62.

Charles Kindleberger points out that decisive regulatory actions have often triggered panics rather than calm[66].

Ninth, the loan package provided only a weak shadow of a lender of last resort facility as the large sum of money announced was not readily available for short term support. Thus running creditors were unlikely to stop[67].

Tenth, by imposing such a damaging squeeze, as it happened in Korea, on domestic economic activity, the IMF-determined policies effectively undermined investor confidence in rapid recovery and future growth, far from restoring it.

In two other regards, as per Radelet and Sachs, the IMF programme was far from optimal for restoring financial market confidence in the short term in Korea and other East Asian crisis-ridden economies. First, it covered a very wide range of policies beyond the immediate financial crisis, including trade liberalization, demonopolization, privatization and so on - however desirable such reforms may well have been. They took government expertise, negotiating time, and political capital away from the core issues of financial markets, exchange rate policy and the like[68]. Second, the initial loan programme was not released to the public. This secrecy proved a major

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66 Kindleberger, C.P., *op.cit.*, p.96.

67 Radelet and Sachs, *ibid.*

68 For a critique of IMF programmes along these lines, see Martin Feldstein, "Refocusing the IMF", *Foreign Affairs*, vol.77(2), 1998, pp.20-33. Cited in Radelet and Sachs, *ibid.*, pp.67-68.

liability in the Asian (read Korean) context, since the programme aimed in large part to restore public confidence in the short term.

Thus, we see that the victim economies of the East Asian crisis, instead of being given individual prescriptions, were fed the same medicines by the IMF resulting in aggravation of the problems and also jeopardizing the professed recovery process.

Consequences of the IMF Programme. Let's take a very brief point-wise look at the manifested consequences of the IMF programme: (i) forced devaluation; (ii) forced privatization; (iii) a free fall in the value of the won; (iv) lower purchasing power; (v) a fall in the standard of living; (vi) unemployment and retrenchment of workers (such that "IMF" even became an acronym for "I'M Fired"); (vii) inflation and the phenomenon of rising prices; (viii) social unrest/distress; (ix) challenges to trade unions and labour; (x) increased mortality with the mandatory removal of subsidies on health and education; (xi) rise in suicide rate; (xii) de-industrialization; (xiii) transfer of as much as 40 per cent of the domestic budget in debt repayment to the creditors/bankers of Euro-America; (xiv) *de facto* loss of sovereignty; (xv) take-over of firms by foreign MNCs; (xvi) political backlash; (xvii) psychological dysfunction/depression among the citizens; and so forth.

MANAGEMENT THROUGH RESTRUCTURING OF THE FIANNCIAL SYSTEM

The devastating consequences of the 1997-98 financial crisis and the subsequent IMF-led recovery programme have left the Korean financial system in shambles and needing urgently a sturdy, durable, long-term strategy to rectify the problems and cope with future crises, pressures or disturbances of any degree. While many positive steps have already been taken towards the management of the crisis and rebuilding of the staggering economy, especially the financial system, further progress is required.

Rehabilitating the financial system is essential. Modern, market-based economies do not function efficiently without vibrant, well-supervised financial institutions, more so, as they play a central role in monitoring and disciplining corporate performance. In particular, well-managed banks are essential to assist in the restructuring of the corporate sector and to achieve an efficient allocation of resources. In the wake of the crisis, the government has made a promising start in addressing the long-standing weaknesses in the financial system. A single, independent regulator, the Financial Supervisory Commission (FSC), has been given the mandate to supervise all financial services. The FSC's aim is to progressively apply international prudential standards in loan classification, loss provisioning, as well as in disclosure and accounting. Regulators will take a positive view towards financial innovation, allowing institutions with adequate capitalization and risk management to expand the range of their activities. They will be aided in this regard by the legislation in late 1997 that eliminated rigid functional segmentation between financial institutions. To strengthen governance in banking, prohibitions on ownership concentration have been eased, although the authorities reserve the power to block ownership linkages considered undesirable. Moreover, restrictions on foreign ownership of banks have been lifted. Also, 14 insolvent banks and several securities and trust companies have been closed[69].

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[69] As of May 1998. Among the unviable life insurance companies to be suspended by the FSC were Kukje, BYC, Taeyang and Coryo, which were soon to be liquidated or absorbed by healthier firms as was done with the banks (discussed on p.152).

The FSC targeted five banks in its first step in reforming a dozen undercapitalized banks. In June 1998, it shut down Chungchong, Daedong, Dongmam, Donghwa and Kyungki banks, forcing their absorption by five healthier counterparts : Hana, Kookmin, Housing and Commercial, Shinhan and Koram banks, respectively. The FSC also promised 17.5 trillion won in public money to make the mergers more palatable to the five banks taking over[70].

With a sound legal and regulatory framework in place, the most urgent task is to proceed expeditiously with the rehabilitation of the banking system under the direction of the FSC. They key task is to deal with the problem loans (NPLs plus loans on arrears by 3 to 6 months), which, for all financial institutions were estimated in march 1998 at 118 trillion won (about a fourth of GDP). In November 1997, the Korea Asset Management Corporation (KAMCO) was given the important mission of resolving problem loans. As part of the May package, KAMCO received 25 trillion won to purchase about half the NPLs, with the rest to be written off by financial institutions. To use its funds efficiently, KAMCO must continue to acquire impaired assets at realistic prices and later liquidate them efficiently, taking into account market conditions to maximize revenue. Asset sales have been minimal to date. (KAMCO had, by December end 1998, purchased more than $32 billion in NPLs from ailing banks). Other asset disposal techniques are being introduced.

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70 Brushing aside all kinds of moral hazard questions, none was allowed to fail. Notably, loans and deposits at the banks which have been absorbed represented only about 5 per cent of those for the entire industry. The four largest problem banks - Chohung, Commercial, Hanil and Korea Exchange Banks - were given extra time to dig themselves out of their difficulties - Commercial Bank of Korea and Hanil Bank have since announced a merger; their executives claim that the union will lead to the creation of the country's first "super-bank". CBK-Hanil will oversee combined assets of 102 trillion won, which would put it within a hair's breath of the world's top 100 banks. See Charles H.Lee, "South Korea: Cautious Reforms", *Far Eastern Economic Review*, October 1, 1998, pp.60-62.

Besides, the government has also announced that it will raise 50 trillion won in government funds by issuing public bonds - 25 trillion won for the Bad Loan Disposition Fund (BLDF) and another 25 trillion won for the Deposit Insurance Fund (DIF). But the reality is that even this amount will be insufficient to deal with all the bad loans expected in the future. Given the amount of bad loans till date and various other costs expected to rise hereafter, the government will need to substantially bolster its stake in its BLDF and DIF[71].

The authorities recapitalized the two weakest commercial banks - Korea First Bank and Seoul Bank - after writing off nearly all of the existing shareholders' capital, and nationalized them, in January 1998. Later, in the third quarter of 1998, the merged CBK-Hanil was also nationalized. Nationalization is an inevitable - and temporary - step towards revitalizing the moribund Korean banking industry as no one else has the necessary funds to replenish the banks' depleted coffers. Twelve banks with less than 8 per cent capital adequacy ratio were obliged to summit plans specifying how they will meet the new standards within two years, in the first half of 1998. The FSC has demanded fuller disclosure of asset quality, based on audits by internationally-recognized firms. In May 1998, the government announced a comprehensive 50 trillion won (12 per cent of GDP) plan[72] to address financial sector problems. In addition to the 25 trillion won for KAMCO, 16 trillion won will be used to recapitalize viable financial institutions, while the remaining 9 trillion won is earmarked to increase depositor protection. Moreover, in return for massive financial aid (as seen earlier), the government is insisting on consolidation in the over-crowded

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71 Ha Sung-Keun, *op.cit.*, pp.38-39.

72 Through the BLDF and DIF schemes discussed above.

banking industry. Following CBK-Hanil, Hana and Boram banks, in early September 1998, announced their merger followed within days by Kookwin and Korea Long Term Credit Banks[73]. Banks should be allowed to resolve their problems independently, to the extent possible, through asset sales, securities issues, strategic partnerships or mergers[74]. Banks are expected to increase capital by about 6 trillion won through asset revaluation and securities issues, which will depend on convincing investors that the government and banks are implementing effective restructuring plans. In short, use of public funds for recapitalization should be adequate but held to a minimum, with capital injections targeted to institutions with credible restructuring plans. Moreover, it should be clear that these injections are a one-time event and that any future requests will be met with severe sanctions.

Another major area for reform - corporate governance - is essential to improve the performance of the economy. The expansion of the *chaebol* into prestigious, but high-risk industries at the expense of shareholder value played a key role in the crisis[75]. The government has taken a number of steps in this area. On February 6, 1998, President Kim Dae Jung and the heads of the country's leading *chaebol* worked out a 5-point accord in which they agreed: to adopt consolidated financial statements and enhance the transparency and reliability of corporate accounting practices according to international

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73 The sudden merger mania among banks was apparently fanned by fears that delays might prompt the government to forcibly match them up with such unwanted partners as Chochung Bank and Korea Exchange Bank (KEB).

74 Forced bank mergers are cautioned against by analysts as mergers and consolidation only make sense if they bring about major cost reductions or synergy. Thus the now-scuttled proposal to merge Chohung and KEB, two equally beleaguered institutions, made little sense. Such moves would merely perpetuate a cycle of mediocrity.

75 For instance, Haitai, which makes lollipops, biscuits and soft drinks, went bankrupt in late 1997 after its reckless expansion into electronics and construction.

accounting standards, and to hold corporations accountable to shareholders by appointing independent outside directors to corporate boards and by strengthening shareholder rights;

- to rectify traditional practices of intra-group subsidization among subsidiaries, strengthen the financial independence of individual corporations, and abolish cross debt payment guarantees;
- to reduce dependence on debt-financing and strengthen the financial condition of corporations by improving their debt-equity ratios and promote profit-oriented management by liquidating unprofitable business lines and assets;
- to concentrate on core business areas, move away from diversified business portfolios, and strengthen cooperative ties with small and medium-sized corporations; and
- to specify the accountability and legal responsibility of controlling shareholders, who in most cases serve as group chairmen.

For its part, the government has enacted changes to pertinent laws and regulations to promote corporate restructuring, most of which were passed on February 24, 1998. The revisions include, among others:

- the External Audit Law was revised to mandate consolidated financial statements beginning in 1999. External auditors and corporate accounting officers are now subject to stiffer penalties while approval by the Auditor Nomination Committee is required in the appointment of internal auditors for listed companies and *chaebol* subsidiaries.
- the amended Securities Exchange Law abolished the requirement on the minimum number of shares to be tendered. It also significantly strengthened

minority shareholder rights by lowering the minimum number of shares[76]. It also raised the ceiling for buying back a company's own shares from 10 per cent to one-third, and the ceiling was soon to be abolished altogether. Finally, it simplified the procedures for merging listed and unlisted companies.

- the General Banking Act was revised to raise the ceiling on bank equity investment in individual corporations to 15 per cent of the corporation's outstanding stock from 10 per cent;
- the Foreign Capital Inducement Act was changed to liberalize hostile takeovers by international investors, with stock acquisition falling below one-third of outstanding shares of a corporation to be merged or acquired, effective April 16, 1998. Hostile takeovers are expected to be completely liberalized in the near future. The changes also abolished the requirement for prior approval by the Ministry of Finance and Economy for large scale M&As in all sectors except the defence industry;
- the Monopoly Regulation and Fair Trade Act was amended to abolish regulation on the ceiling of equity investments by *chaebol* subsidiaries and prohibit cross-debt payment guarantees among them, and to require that remaining debt guarantees be eliminated by the end of March 2000;

- the Corporate Reorganization Law adopted the economic criteria of comparing the scrap value of a company with its operating value when courts evaluate applications for reorganization. It also simplifies corporate reorganization procedures and reduces the grace period for debt repayment to 10 years from 20 years, while establishing the Reorganization Management

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76 See Yoo Seong-min, "Democracy, Efficiency, Equity and *Chaebol* Reform", *Korea Focus*, vol. 6(4), July-August 1998, p.12.

Committee to advise the court and major creditors in the process;

- The Corporate Commission Law was revised to restrict the conditions for mutual settlement between a corporation and its creditors by specifying those cases in which such a deal is undesirable. It also restricts unfeasible applications for composition and strengthens monitoring of the implementation of a mutual settlement. In addition, the revision simplifies the procedures involved and introduces procedural exemptions for small and medium-sized firms.[77]

Besides the above, several other restructuring and reforms measures have either been already or are being initiated in the areas of: increasing labour market flexibility, expansion of the unemployment insurance systems; industrial relations system; dismantling of barriers to capital inflows; suppression of red-tapism (to promote FDI); capital market liberalization; deregulation of imports; privatization of public corporations; identification of failing companies and business groups eligible for FSC's "workout programme"[78]; and so on.

However, what degree of success would the above reforms achieve is a matter of "wait and see". The measures undertaken, though quite comprehensive, cannot be said to be sufficient and fulfilling. There are many remaining fields and aspects of the Korean financial system which need to be restructured.

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77 *Ibid.*, pp. 12-13.

78 On June 18, 1997, the FSC identified 55 "non-viable" *chaebol* subsidiaries for its "workout programme" to enable them to survive without financial support. One June 24, 236 financial institutions entered into a so-called Corporate Restructuring Agreement for such identification. However, as of November 1998, only 22 of them were selected as prime candidates. As per the programme the banks swap up to 40 per cent of debts owed by the firms for equity and extend the maturities of short-term debts upto five years at a lower interest rate.

From the perspective of endogenous growth theory, improving the efficiency in the financial sector is the most critical task for the Korean economy at this crucial juncture. The nation's financial system can no longer be a tool for industrial targeting and instead must establish a new paradigm. Recent financial scandals, including that involving Hanbo Steel, revealed the undesirable non-market elements prevailing in Korea's financial system. The fact that a company like Hanbo, with limited collateral and technology, could borrow up to 20 times its own equity, characterizes the gross inadequacies of Korea's financial system, which led to the recent crisis[79].

Thus, one of the most important ways to strengthen the banking sector's health without jeopardizing its viability is to sever the collusive ties between political and business circles. Though the IMF agreement prohibits administrative intervention in bank management and decision-making, in order to root out the problem, the government needs to introduce systematic checks. First, it has to enact strict regulations with harsh penalties to deter irregularities and corruption as the Latin American countries did to recover from their own crises earlier. While moving to enact such measures, Korea must also reform its wasteful high-cost political system, which is at the root of "crony capitalism"[80].

Further, a top priority should be to improve the bankruptcy law which provides weak incentives for both creditors and debtors to initiate bankruptcy proceedings. Apart from formulating the afore-discussed reforms, the

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[79] Ahn Choong-Yong, *op.cit.*, p.49.

[80] Ha Sung-Keun, "Direction of Financial Sector Restructuring, "*Korea Focus*, July-August, 1998, p.40.

authorities need to guarantee that they gain permanency in the system so as to avoid future crises.

As a bottom-line to the above discussion it needs to be mentioned that the coming into power of the present President, Kim Dae Jung, amidst increasing democratization of the polity in Korea augurs well for the post-crisis economy. He arrived at a time when the shape of the Korean economy was in utter disorder and malaise was all pervasive therein. His responsibilities were clearly ordained. Being a very experienced and patient politician, President Kim has supervised over a complex and debilitating reconstruction of the economy. The result is that Korea has started biting into the kernel of recovery. It is today, the fastest recuperating economy among the worst affected victims of the 1997-1998 East Asian financial crisis. Moreover, the democratic and 'hard-nut' credentials of Kim has started bringing back investors and creditors to the Korean soil. The successful continuation of the evolutionary process towards the 'liberal' democratic system has reinforced the faith of the West in Korea under the leadership of President Kim.

Albeit long, this chapter has tried to draw a comprehensive analysis of the financial crisis in Korea during the period 1997-98. The dynamics of the crisis have been laid bare and in the latter half, we saw the changing shape of the financial system of Korea in the aftermath of the crisis. Thus, an attempt has been made to draw a complete picture of the Korean financial system from its early days through its evolution into a successful system, to the present post-crisis times, starting with Chapter 1 of this dissertation.

CHAPTER 5

SUMMARY AND CONCLUSION

"The ascendancy of finance over industry together with the globalization of finance have become underlying sources of instability and unpredictability in the world economic. Financial markets have for some time had an independent capacity to destabilize developing countries; there are now increasing indications of the vulnerability of all countries to financial crisis. The evidence indicates that the costs of financial liberalization and deregulation can be quite high... Overall, there appears to be a need for more collective control and guidance over international finance."

- Trade and Development Report, 1990[1]

Korea is the largest of the most troubled economies which were ravaged by the East Asian financial crisis of 1997-98. In 1955, it could have been "poor Asia's one of the likeliest future failures".[2] It had all the makings (indicators) of yet another underdeveloped country - so typical of the newly independent states of the early post-Second World War era - having been vaulted into the modern world following the chaos of the (Korean) peninsula's division immediately after its independence from Japan's vicious colonial rule, a bitter fratricidal war (Korean War, 1950-53) and the subsequent economic devastation and social trauma. Having spent the 1950s mostly fumbling its economic chances, in the following three-and-a-half decades it produced one of the best economic performances in Asia, and among the best in the world.

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1 UNCTAD, *Trade and Development Report, 1990*, United Nations, 1990. Though these words were written in 1990, they are still relevant, as we might have come to know by now. Such warnings have seemingly fallen on deaf ears.

2 See Jim Rowhrer, *Asia Rising*, (New York: Touchstone (Simon and Schuster), 1996), p. 61.

Consequent to its successful economic development often termed as a "miracle" or "miracle on the river Han", Korea became the 11th largest economy in the world and was granted the membership of OECD – the world's most developed nation's club. The search for an explanation of this fast-paced economic growth among the economists and academics all over the world has led Korea, for the last fifteen years or so, to be at the centre of the debate between the adherents of neoclassical economics and others, about the virtues of state intervention vs market guidance, financial regression vs market-determined allocation of credit, and choice of sectors and technologies for development on the basis of relative factor prices rather than strategic considerations.[3] As we have seen earlier, at the beginning of its drive towards industrialization, which is dated from around 1962, the year Park Chung Hee was firmly ensconced at the helm of the Korean state, it possessed a number of advantages, compared with other NIEs (of today): "(a) it had carried out thorough-going pro-peasant land reforms, and got rid of the landlords (b) it had a reasonably well-educated labour force by third world standards; and (c) despite its utter dependence on the US for very large volumes of economic and military aid, it was fiercely nationalist, with a linguistically homogeneous population, with few ascriptive status differences."[4]

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3 See A. K. Bagchi, "The Terror and the Squalor of East Asian Capitalism", *EPW*, vol. 19(1), January 7, 1984, pp. 21-22; *Public Intervention and Industrial Restructuring in China, India and Republic of Korea* (New Delhi: ILO-ARTEP, 1987); A. Amsden, "The Paradigm of Late Industrialisation" in Bagchi, Rosenberg and Torino (ed.), "Contributions on East Asian Capitalism", *Political Economy: Studies in the Surplus Approach*, Vol. 3(2), 1987, pp. 133-60; "Asia's Late...", *op.cit.*; R. Wade (1990), *op.cit.*; J. Woo, *Race to the Swift: State and Market in Korean Industrialisation* (New York: Columbia University Press, 1991; Chowdhury, A. and I. Islam, *op.cit.*

4 Amiya K. Bagchi, "Growth Miracle and its Unravelling in East and South-East Asia", EPW, May 2, 1998, p. 1035.

The remarkable transformation of the Korean economy initiated by President Park since the early 1960s resulted in a winning combination of characteristics which can be summarised in the following points.

(a) sustained high growth rate – at an average of 8.6% a year till the crisis broke out in 1997;

(b) a relatively equitable distribution of the product of development;

(c) a continuing capability to alter domestic economic structures in alignment with changing international circumstances; and

(d) a state capable of mobilizing and deploying domestic economic resources.[5]

Simultaneously, a variety of factors (theories) explaining the above phenomenon could be provided.:

1. The miracle growth was a result of embracing a market economy with a free trade policy. (Bela Belassa)

2. It was a consequence of "special circumstances"[6] unlikely to be easily duplicated. (Paul Streeten)

3. It can be attributable to a Confucian heritage emphasizing hard work, frugality, hierarchy, and harmony. (Hung-Chao Tai).

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[5] Vera Simone and A. T. Feraru, *The Asian Pacific: Political and Economic Development in a Global Context* (New York: Longman, 1995).

[6] "Special circumstances" – Korea received an annual average of $ 270 million in economic aid from the U.S. between 1953 and 1958 (military assistance was twice the amount). Besides, Korea acquired many of its infrastructure foundations under Japanese colonial rule: a modernized agricultural system, a network of roads and communication, high literacy rates, and linkages with the international economy.

4. It was the consequence of economic planning by a strong state in close cooperation with an industrialization-fed, market-driven, export-oriented economy. (Chalmers Johnson)

To summarise the causes, domestic investment, universal primary education and growth of secondary education and successful interventions combined with a result seeking leadership and a diligent work-force have been used to spur economic growth and development in Korea.[7]

A major component of the Korean economy which provided capital and incentives to the economic development process is its financial system the foundation of which, in its modern form, were laid during the early 1950s when the central and commercial banking systems were realigned under the new institutional bases provided by the Bank of Korea Act and the General Banking Act.

The financial edifice, including the informal and formal sectors, has since been enlarging with the addition of more and more institutions, especially in the formal sector, as the economy expanded and needs multiplied. The Korean financial system has grown considerably and achieved a more diversified structure since the mid-1960s. Between 1965 and 1970, the system grew rapidly in overall size.

Since the early 1970s, the system has responded to the evolution of the real economy through the introduction of many NBFIs in order to diversify financing sources, to promote the development of the money market and to

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7 The World Bank came out with a comprehensive study of the features and causes of the East Asian Miracle in its *The East Asian Miracle* (Washington, D.C., World Bank, 1993).

attract funds into the organized market. There have also been significant developments in direct types of financing, in the form of commercial paper, bonds and debentures. The development of the financial system has therefore been influenced by the pattern of growth in the real economy and by changing financial policies.

The financial system in Korea thus, having undergone substantial changes in terms of structure and magnitude since the early 1960s, continued to evolve by diversifying its assets and liability mix, offering more intermediaries, concurrent with the modernization and industrialization of the Korean economy. With improved financial techniques and closer links with international financial markets developed since the initiation of the economic liberalization and financial deregulation processes of the early 1980s, the financial sector in Korea seemed to have modernized and come of age. Several more commercial banks and non-bank financial institutions were added as a part of a series of broad measures to spur financial liberalization and internationalization. This coincided with a shift from a government-oriented stance on economic policy towards a market-oriented stance.

Recently, the Korean financial system had been undergoing substantial changes in the course of the implementation of a comprehensive financial reform program, which was a crucial element in the Five-Year Plan for the New Economy for the period of 1993 through 1997, under President Kim Young Sam's direction. But this financial development process suffered a serious setback with the outbreak of the Korean financial crisis amid the contagion-like spread of the East Asian financial crisis and the subsequent economic meltdown throughout the region. The crisis has exposed the flaws and weaknesses present in the financial system. The debate regarding the miracle of the last three-and-a-half decades shifted to that analyzing the "myth of the miracle."[8] However, since early 1998, the Korean government has been implementing a number of measures, initiated by the IMF, to restructure and rejuvenate the faltering financial system.

The State in Korea's Economy and Finance. The single most compelling factor in the economic development of Korea is the extensive and intensive ways in which the state (government) has pushed economic levers and pulled financial strings to accomplish economic success. Prominence of the state in promoting, financing, shaping and nudging the economy towards economic growth has been the most vital aspect of Korea's march toward becoming an Asian "tiger" and subsequently, the world's eleventh-largest economic giant. It had, for almost four decades, authoritarian regimes aware of the necessity of modern economic growth for their national strength and survival, controlling and directing the affairs. In fact, it was with the coming into power of the military government under President Park Chung Hee in 1961 which saw the state reinforce its proactive and aggressive role in shaping the economy of the country with added vigour. He made the state initiate a pattern of industrialization and sustain its momentum in changing domestic and international political and economic environment. So much so that the basic strategy of economic development remained more or less unchanged during the post-Park period too. Among the conditions provided by this 'developmental state' in Korea to promote economic growth have been: land reforms, a literate

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8 See Krugman, Sen, S., Ghosh, J., and others, *op.cit.*

labour, capital for investments, raw materials, a strong industrialization ideology on the part of the government, a well-trained, efficient and active bureaucracy, and institutions for linking the public and private sectors. Apart from these attributes. Korea has had a distinct pattern of political, economic and security relations with the world's two most developed states, the U.S. and Japan. The sate deliberately and abundantly granted tariff protection and subsidies, manipulated interest and exchange rates, managed investment, and controlled industry using both rewarding and punitive instruments. Relative prices were deliberately set "wrong", to generate and reap the benefits of evolving comparative advantage, instead of letting them adjust to the "right" levels by the free play of market forces. Korea's leaders judged that getting prices right would lead to short-run efficiency but long-run anaemia. Korea's rapid industrialization-led development was thus, the result less of the free market and more of command capitalism – in fact, the phrase "guided capitalism" was used to describe the mechanism during the First Five-Year Development Plan - which suborned the market.[9]

Korea's development strategy has been mainly one of pragmatic trial and error, based on a twofold commitment: to the growth of exports and to the nurturing of selected infant industries through protection. The encouragement of exports, particularly manufactured exports, became an active policy in the early 1960s, following unsuccessful attempts at import substitution in the 1950s. It involved the establishment of virtual free trade regimes for exporters through detailed systems of duty drawbacks for direct and indirect exporters.

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9 Robert Wade has, however, called this mechanism the "simulated free market" theory of East Asian industrial success. See. R. Wade, Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization (Princeton: Princeton University Press, 1990), pp. 23-24.

The incentives available to exporters included direct tax reductions, privileged access to import licenses, and preferential interest rates. At the same time, to develop discipline among the business enterprises, "targets" were set with rewards and sanctions attached to them for fulfilment and failure to reach them, respectively. In R. R. Krishnan's words the state's strategy and the resulting pattern of development was a fusion of three factors - the three f's, so as to say: *fear, favour, fervour.*[10] Fear of the state, fervour of the citizens cutting across social groupings for a tangible change in their lifestyle and favour by the state for the target-achievers and some select industrial sectors. Thus export promotion entailed substantial government involvement.

The Korean state chose to focus first on low technology products, in which the gap between the skills required and those available locally was not large. This had two effects: it encouraged learning-by-doing, and it made Korean firms less dependent on foreign expertise. In the early 1960s targeted industries included cement, fertilizers, and petroleum refining. In the late 1960s and early 1970s the focus shifted to steel and petrochemicals, and in the late 1970s shipbuilding, capital goods, durable consumer goods, and chemicals besides other heavy machinery were targeted – popularly known as the HCI drive of the seventies. More recently, electronic and other component industries, including micro/DRAM memory chips, liquid-crystal-display (LCD) panels, and other high-tech products, have been given preference. As a result of the success of the above interventionist strategy of state-led, export-oriented industrialization, a new 'model of economic growth came to be recognized, called the "Korean Model".

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[10] Krishnan, R.R. *op.cit.*,, p. 129.

Moving further, state control over finance has been a persistent feature of the politico-economic structure of Korea. The state successfully used an active and pervasive policy of intervening in financial markets and thus played a deterministic role in shaping the current financial system. What is no less significant, although less emphasized, is that the state control over finance has been an integral and important aspect of the Korean economy. From the early stage of economic development, the Korean government has been deeply involved in raising and allocating financial resources to carry out its ambitious development plans. In fact, the formal financial sector has tended to be highly regulated as the state has widely used financial policy as its major instrument to support economic growth. In the early stage of development, direct and selective intervention was very effective, and the growth and diversification of Korea's financial institutions contributed significantly to the development process starting in the 1960s.

In 1961, when Gen. Park took power, he distrusted financiers immensely, believing all of them to the speculators and many of them unscrupulous. His regime's goal seemed to be, not just insulation from private capital, but complete dominance over it. He seized control of the banks, and for the next thirty years the government ran a careful eye over bank budgets and exercised veto power over the appointment of top bank managers; until the early 1980s its approval was required for each loan for any substantial size.

Traditional roles of the state in Korea included resource allocation, differential regulation of lending rates directed at different activities, administration of deposit rates, entry and exit regulation, direct ownership of enterprises, price and wage controls, regulation of inflows and outflows of foreign exchange, credit allocation and large-scale subsidisation of favoured economic activities. Many of the targeted industries in the heavy and chemical sector were driven by scale economies. As a result, the government had a licensing system whereby it allowed only a small number of companies to enter an industry and prevented other firms from doing so. The state also channelled money to a targeted industry by allocating its own funds and by directing commercial banks to offer loans. The policy measures, further, consisted of both carrot and stick: positive measures to promote exports (e.g., hidden subsidies and allocation of foreign exchange) and negative policies to discourage imports.[11] Moreover, as capital was saved, the government ensured that it was not channelled into economically unproductive activities (such as property speculation) nor permitted to seek alternative investment in foreign industries overseas. Besides, when private companies with heavy government borrowings became insolvent due to mismanagement, the government or a bank will be directly involved in finding a new company, which can bail out/salvage or even take over the companies drifting towards insolvency, together with the debt. In so doing, the Korean government were guiding and supervising the industry and companies therein along with their individual sectors.

Several features of the state's role in Korea's financial system since the 1970s stand out. First, the SFIs have been active in attracting savings, unlike their counterparts in some other Asian countries. The funds, raised from deposits and sales of debentures, have provided over 50% of loans. Emphasis on deposit taking has favoured their expansion. Second, private local banks have been allowed to flourish, catering to the needs of local businesses; they

[11] For example, the banks charged 27% interest to finance imports but only 6.5% to finance exports.

have also been effective in attracting funds and in gaining a rising share of total deposits. Third, an active policy to incorporate traditional lending and saving into modern institutions. As early as 1972, mutual savings and finance companies were set up to attract funds from informal money markets into formal sector. These companies make small, unsecured loans and discount bills for holders of installment savings account. They also operate mutual credit "kyes" in the manner of the traditional rotating savings and loan societies.

However, in the 1970s efficient functioning of financial institutions was restricted by the administrative allocation of credit to HCIs selectively and the low interest rate policy. As a result, the government intervention hampered the development of financial markets and brought about less optimal allocation of funds. Compared with the real sector of the Korean economy, the volume of financial assets and the transaction level of the financial intermediaries were too low. Thus in the 1970s, in spite of considerable increase in savings, they could not be channelled into investments efficiently because of the relatively underdeveloped financial sector.

As the economy grew larger and more sophisticated, it became increasingly apparent that the government's heavy-handed intervention in the financial sector was no longer so viable. For this reason, Korea adopted extensive financial reforms to create a more competitive environment in the financial sector from the turn of the 1980s. Measures were taken to transfer the decision-making responsibility in the financial sector to the private sector. The new policy package aimed at achieving economic balance through economic liberalization-cum-financial deregulation. To correct the over-investment in

HCIs and distortions created by the strong protectionist policies in the 1970s, the state had respect for the market mechanisms and competition, as a result there was limited government intervention. The import liberalization ratio rose from 68.6% in 1979 to 91.6% in 1986.[12] The average nominal tariff rate for all commodities declined from 35.7% in 1978 to 18.1% in 1988. Financial deregulation commenced with the removal of various restrictions and bank management and the privatization of commercial bank ownership in the early 1980s. Regulations on commercial banks in the spheres of organizations, budget, branching, and business practices were greatly loosened.

Domestic financial deregulation since the early 1980s has been accompanied by a gradualist approach to financial opening. While deregulation in the domestic financial market proceeded faster in the later half of the 1980s because of the current account surpluses during 1986-89 after chronic deficits in the previous years. However, the reforms of the 1980s were not effective as had been hoped, because the measures taken were piecemeal and lacked an overall vision.

Drawing on the lessons of that experience, the government in July 1993 unveiled a 'Blueprint' for the five year period, 1993-97. This constituted a comprehensive and consistent plan designed to promote the efficiency of the financial market and the internationalization of the domestic financial industry – full interest rate deregulation, the granting of greater managerial autonomy to financial institutions, the easing of restrictions of business scope and new entry, foreign exchange liberalization, capital market opening, and so forth. The

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[12] The figure may not accurately reflect the impact of liberalization as it was a result of a change more in terms of quantum than range of the items liberalized for import.

1990s reforms have been largely driven by globalization forces, both inside and outside Korea. The IMF, World Bank, WTO and finally OECD – the membership conditionalities of which speeded up the liberalization process – have all played crucial roles in furthering the financial deregulation in Korea. Subsequent to the crisis in 1997-98, which revealed the lacunae in the deregulation process, further liberalization of the Korean economy and finance is underway through the restructuring package overseen by the IMF.

The *Chaebol's* Place and Role in the Korean Economy. Korea established an effective centralized administration which co-operated closely with business interests. From 1961 to 1979, Korea's planners kept interest rates below the market-clearing level and used their control over the banks to direct cheap loans to borrowers that were carrying out the government's strategic aims – the state's "favour" (R.R. Krishnan, 1993). The borrowers were export-oriented groups that quickly grew into gigantic family-owned business conglomerates called the *chaebol*. The Park regime saw them as a useful and necessary instrument for its objective of economic growth. This policy of relying on existing private firms instead of establishing new state enterprises (as the Kuomintang regime did in Taiwan) however, laid the foundation for the subsequent growth of the *chaebol's* power. The government supported their growth through a loose and erratic monetary policy and heavy foreign borrowing.

As the state has persistently relied on the *chaebol* (big business) for the success of its development strategy, credit allocation has been the major vehicle with which the government could induce them to invest in sectors that the government regarded as strategic or important. In the mid-1960s, for instance, the government instituted a system of export financing to make the *chaebol* turn their eyes to foreign market. To meet their rapid growing demand for capital, it opened a new avenue for foreign capital inflow via a mechanism of foreign loan guarantee intermediated by the specialized state-guided banks and commercial banks. And credit analysis on the part of the banks was not a mandatory and scrutinizing exercise.

In the 1970s, the government launched a massive program of HCI promotion which were undertaken mainly by the *chaebol*. To induce them to commit to invest in those unfamiliar industrial sectors, it needed to intensify intervention into the financial system. Due to the sheer size of heavy industrial projects, the credit allocation became even more direct and selective. The government's task was to give which amount of investment capital to whom. There was little space in which banks could exercise their discretion. Once a specific investment project was sanctioned by the government, it meant that the needed capital would be provided at the government's direction. Moreover, the companies owned by the different *chaebol* borrowed on the strength of personal relationships. The "cronies" at the helm in the government, *chaebol* and the banks acted as the media for negotiation of this unfair leverage to the companies. The government guaranteed the banks that they would be taken care of if a borrower went bankrupt. Favoured borrowers knew that they could get the credit they needed, often by running long-term overdrafts (known as "over borrowing") at the banks. It was thus in the financial sector that private and public interests merged almost completely.[13]

These government guarantees extended to foreign borrowing as well.

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[13] Lee-Jay Cho and Kim Yoon Hyung, quoted in Clifford, M., *op.cit.*, p. 61.

Companies could negotiate agreements with foreign banks and, after approval, they would be guaranteed by the Korean government. This cozy financial system was the heart of Korea, Inc. State and private interests needed one another, but it was the state that held far greater power.

By 1984 the ten largest *chaebol* absorbed a third of Korea's total domestic credit; the thirty largest, half of all domestic credit (much of which was, in fact, recycled foreign borrowings by Korean banks). The *chaebol*, as a consequence, were debt-laden, especially so, after the deregulation of the financial system : By the mid-1980s their ratio of debt to equity had risen to almost 5:1 and the figure did not change much in the next decade. And they were absurdly diversified: In 1985, Samsung, that year the biggest *chaebol* in terms of sales, had under its umbrella 39 companies operating in 26 distinct lines of business, including semiconductors, textiles, aerospace, and sugar processing. Yet, this diversity was apparently not enough for it and others too. With further financial liberalization in the 1990s at the prodding of the U.S., IMF, WTO, OECD, EU et al, the *chaebol* went for an over-diversification drive without regard for adequate returns and required expertise – e.g., Samsung started expanding into automobiles and Hyundai, the auto giants, into electronics. Subsequently, the top 5 went on to have an average of 140 businesses apiece by 1996.

The Korean economy has thus been one of the most concentrated in the world. Consequently, a "strategically interdependent" relationship has been forged between the state and the *chaebol*. As long as the former needed the active cooperation of big business, the later could influence the government's economic policymaking greatly, thus infringing on it autonomy. Under this relationship, it was only natural that the financial system under the complete control of government could not have an independent voice. It was simply forced to support and sustain this relationship of "alliance capitalism". In other words, the *chaebol* whose growth the state initiated and fostered, gradually became more and dominant (over the latter). At least during the tough, repressive Park regime, various kinds of state-controls - the fear of the state - kept the increasingly powerful *chaebol* under control. But with the eroding state supremacy since the 1980s as a result of incremental increase in the implementation of deregulation, privatization and liberalization, the state-enterprise (*chaebol*) relations have turned from discretionary governance to rule governance. In such circumstances, the *chaebol* kept on accumulating highly-leveraged debts and the related banks, bad loans. The repeated practice of bail-out (preferably termed restructuring) by the state of the bankrupt banks – in 1969-1970, 1972,1979-81, 1986-88 and more recently in 1997-98 has only encouraged the *chaebol* to rely on further indebted growth.

The matter came to head in 1997 when the debt-ridden *chaebol* and banks started shutting down resulting in panic among the foreign creditors and speculators, which in turn led to capital flight and more bankruptcies – the financial crisis of 1997-98.

In the aftermath of the crisis and the subsequent IMF-led restructuring programme, the government of has announced its much-awaited plans to cut down the country's overweening *chaebol* to size. But still, the top five *chaebol* are actually absorbing a bigger share of bank-credit and capital-market funds than they did before the crisis.

Thus, we have seen that the Korean state has failed to control undesirable activities by the *chaebol* and the decreasing autonomy of the state and resulting in policy failure. It is to be seen to what degree the self-perpetuating state-*chaebol*-bank nexus rectifies its wrongs and shortcomings. But it is for sure, that the post-crisis recovery of the Korean finance and economy as a whole will again require the *chaebol's* support. The *chaebol*, with cooperation from the state, have come to become synonymous with the direction of Korea's economic development, be it toward boom or bust.

The Financial Crisis of 1997-98. Within months after getting a formal recognition from the rich world (OECD) for its economic success, Korea was propelled viciously into the vortex of an economic meltdown resulting from the financial crisis of 1997-98. Just as a varying combination of ingredients went into the making of the miracle of this tiger economy, there are varying factors which led to the recent collapse. Among the most important of the individual factors are: (1) a week financial system that did not have either an adequate regulatory mechanism or prudent banking practices to cope with the inflow of huge amounts of foreign capital; (2) the herd mentality (antelopes theory) of international finance was equally evident in the way in which it indiscriminately flowed in the economy during the 1990s and the speed with which it fled from the scene it had helped to create, in the second half of 1997; (3) ego-driven over-diversification campaign by the *chaebol* into areas they had little expertise and with little concern for profitability, using highly leveraged finance which ultimately led to the problem of debt-forced illiqidity; and (4) paradoxical as it may seem, an underprepared and hasty deregulation almost certainly precipitated the crisis in Korea. There are other causes as well. But some, like keeping the exchange rate pegged to the dollar even as the latter appreciated, current account deficit in the form of "hot money" (short-term credit), precipitated the crisis

Paul Krugman, one of the first to initiate the debate on the unsustainability of East Asian economic growth, including the Korean Miracle, has described the recent crisis as an "off the books" crisis (as against the "first generation" crisis[14]) which is not a result of what the government spent on its budget, but the implicit or perceived guarantees that the government gave for bad investment and bad lending. And the weakness that got revealed in the crisis were "not weaknesses in the government's budget, but in the banking system and corporate finance." All the weaknesses that have now become apparent were not in those books.

Financial Deregulation and the Crisis. As mentioned earlier, the financial crisis in Korea was not a result of regulation (by the state), but of financial deregulation - its thrust, timing and sequence. Prodded on by the Washington Consensus in the 1980s and the early '90s to open up its economy and finance and more recently, the demand for selective financial deregulation as the price for admission to the OECD led Korea into the turbulent. waters of international finance which is dominated mostly by unscrupulous, profit-seeking speculators. As a result of the liberalization measures, global banks and portfolio investors flooded in, with international speculators on constant watch for any profit-affecting signals. After 1995 the

14 By a 'first generation "crisis Krugman means the traditional balance of payment crisis which is driven by irresponsible monetary expansion and often, behind that, an out-of-control budget deficit, which leads governments to print money to pay their bills. Russia today, is a near example of such a crisis. See "Q and A\Paul Krugman: Boom to bust and beyond", Interview in *The Times of India* (New Delhi), September 23, 1998.

rise of the dollar and depreciation of the yen and the yuan led to a loss of export competitiveness for the dollar-pegged-won economy in Korea. The capital inflows exacerbated the real appreciation of the exchange rate and the loss of export competitiveness, resulted in large, and out-of-character current account deficits in Korea and more so, in Thailand and Malaysia). The inflows generated by the banks borrowing recklessly abroad and financing huge diversification programmes of the *chaebol* also contributed to domestic asset bubbles, credit excesses, and a growing fringe of bad investments - the fatal combination. Of course, there was always a problem with the country's financial system. But sudden deregulation under persistent external pressure without first creating a proper regulatory apparatus was the recipe for the recent disaster.

Lessons from the Crisis. Some of the significant lessons that could be derived form the recent crisis in Korea and other East Asian economies are:

(1) the worst time to "reform" a financial system is in the middle of a crisis;

(2) when currency turmoil is associated with financial difficulties, raising interest rates over an extended period may simply worsen the situation by bringing about widespread corporate and bank insolvencies;

(3) currencies should not be left to sink while funds are used to bail out the international creditors;

(4) an emerging panic should be suppressed at the earliest as top priority;

(5) asymmetric information between the debtors and creditors should be minimised through transparent disclosure of capacity, so that a panic-

situation is avoided;

(6) short-term capital flows should be restrained, particularly those intermediated through the domestic banking system

(7) "direct" investment as against portfolio investment should be promoted for, the former involves not only financial capital but also technological, managerial and intellectual capital that jointly represents a stock of assets for the production of goods and services. While the latter is motivated primarily by a search for immediate financial gain and the time horizon for many bank lending is also short-term which may make these investment flows quite volatile at times;

(8) currency instability and current account deficits should be taken care of before deregulating finance;

(9) loans should be sanctioned on the basis of market value of the firm, not on its non-market leverage value;

(10) non-viable business should not be encouraged through bail-outs; and so forth as taught by the causes.[15]

Globalization, Finance and the Korean State. Globalization is crucial to understanding international political economy, for it directs attention to fundamental changes underway in the post-Cold War era. The

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[15] An important lesson thet India needs to learn from the Korean crisis is: Investments need to go to areas where they are most needed. In other words, too much overseas capital is going into the stock market and consumer durable for other rich, and not enough into infrastructure and high-tech industries. Little wonder that since reforms were accelerated in 1991, India has attracted less than $3.5 billion is foreign investment.

manifestations of globalization include the spatial reorganization of production, the interpenetration of industries across borders, the spread of financial markets, the diffusion of population within the South as well as from the South and East to the West, resultant conflicts between immigrant and established communities in formerly tight-knit neighbourhoods, and an emerging world-wide preference for democracy. A rubric for varied phenomena, the concept of globalization interrelates multiple levels of analysis - economics, politics, culture and ideology.[16]

The globalization of financial relations has been proceeding apace for well over a century already. However, the depth, reach, speed and core character of financial flows across national boundaries has altered dramatically in the closing decades of the millennium. Throughout the 1990s, finance has increasingly become global. Some of the factors that are driving this process of globalization are: First, there are astounding advancements in technology. Second, there is the similarly breathtaking progress in communications, enabling corporations to manage their business on a global scale and individuals to partake ever more easily and quickly of the world across distant horizons. Third, there is the force of free trade, which has enabled many countries and corporations around the world to enhance their efficiency and to find new markets. The fourth and final factor in globalization is capital mobility. A force that has become an especially powerful one during this decade, is net private flows to emerging markets, which have grown from US $50 billion to about US $300 billion in 1996, a six-fold increase in less than a decade.

16 James J. Mittleman, "The globalisastion challenge: surviving at the margins", *Third World Quarterly*, vol. 15(3), 1994, p. 427.

Technology, communication, free trade, and capital mobility - they all bring substantial potential benefits to the emerging markets of the world. If utilised properly, they can provide a framework for accelerating development and dramatic growth. But they also bring new challenges and risks. And if these risks are not understood and those challenges are not managed carefully, then they can breed the seeds of destruction and setback as we have recently seen in Korea and South-East Asia. This is especially the case with regard to capital mobility because capital can move so quickly and, in some circumstances, with such volatility. The East Asian crisis cannot be separated from the excessive borrowings of foreign short-term capital as East Asian economies loosened up their capital account controls and enabled their banks and firms to (over-) borrowed abroad. In 1996, total private inflows to the East Asian economies[17] were $93 billion, up from $41 billion in 1994. In 1997, that suddenly changed to an outflow of $12 billion. Hence it has become apparent that crises attendant on capital mobility cannot be ignored.[18] The sweep, scale and size of the present process of globalization of finance has made it gain a life of its own, no longer complementary to international trade and investment.[19]

In December 1997, when Korea's crisis was at its peak, it was revealed - a fact that contributed to this crisis - that Korea's reserves were only $6 billion and its short-term foreign debt obligations were $100 billion. Figures of this kind perpetrated the subsequent panic and capital flight. Virtually all of the

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17 They comprise Korea, Indonesia, Malaysia, Thailand and Philippines.

18 Jagdish Bhagwati, "The Capital Myth: The Difference between Trade in Widgets and Dollars", *Foreign Affairs*, vol. 77(3), May/June 1998, p.8.

19 International trade now, accounts for only 2% of the global currency movements.

factors that lay behind the crisis in Korea (and South East Asia), reflected some fundamental misunderstandings of what globalisation is all about. If the seeds of the crisis were planted by the local businessmen and government officials, then they were certainly watered and fertilised by the global financial community. Of course, there were fundamental factors in the economy (ies) that encouraged and supported some of these flows, but because of the seemingly endless Asian miracle, banks, fund managers, and investors were also complacent, especially European banks that were building their exposure just at the time when the overheated nature of the East Asian economies was becoming visibly less sustainable. Thus, we can say that the Korean (read East Asian) crisis was a direct but inevitable outcome of not only of globalization but also of the country's extraordinary success in taking advantage of it to achieve miraculous rates of growth.

With the growing degree of globalization, especially in the past decade, the bargaining power of finance capital has been enhanced and the relative autonomy of states is being increasingly reduced. In fact, in the globalized division of labour, the state no longer serves primarily as a buffer or shield against the world economy. Rather, the state seeks material gains from globalization. Put differently, the state increasingly facilitates globalization, acting as an agent in the process. Significantly, the state's creditors have become the depositories of real political power operating discretely in the background as has been seen in Korea. Surrounded by impersonal and unaccountable forces beyond their control, political leadership's capacity to lead has been diminished. Faced with the power of globalized production and international finance, including debt structures, the leadership is constrained to concentrate on enhancing national conditions for competing forms of capitalism. Statecraft, tested as it is by non-state actors, has been reduced in efficacy relative to transnational forces. Moreover, the state is at risk because of challenges to sovereignty.

Globalization has encompassed contradictory trends in Korea. The state has responded by becoming a transmission belt in the globalization process, more fully integrating the domestic economy in the world system. This has been the trend more so, gradually since the 1980s and speedily since the 1990s - at the instance of the major international agents of globalization comprising primarily of the IMF, World Bank, the U.S. (Washington Consensus); WTO (formerly, GATT); G7; EU; and lately OECD, who set the agenda of deregulation, privatization and liberalization of the economy of Korea along with other developing countries. On the other hand, the state has pulled in the opposite direction by using a variety of government interventions to create a competitive edge. Industrializing late, starting in the 1960s, Korea relied on large-scale interventions, most importantly, direct involvement in the production process, establishment of social and economic infrastructure, and generous terms of credit and material support for shifting from imitative to indigenous technological capacity. In the process, it has evolved its own brand of alliance capitalism (infamously, crony capitalism) wherein the state has fostered more than a cooperative relationship with big business (private enterprise) through its control of the finance in the course of its economic development strategy. However, even today the Korean state has considerable power in shaping the economy. In the aftermath of the crisis and the subsequent IMF-prescribed recovery course, the state is assigned with an onerous and unequivocal responsibility of restructuring the economy. Thus, the state has been allowed to retain much of its determinative role over the economic system of Korea - albeit it may have to gradually deprive itself of its past "glory" in the not-so-distant future under pressure from the same globalization forces which caused Korea's recent crisis and then came forward to resurrect the fallen economy. And yet it needs to be stressed that the socio-political support base of the state has been changing due to years of struggle by the civilian-democratic forces.

It would not be incongruous here to mention an ironical aspect of the recent happenings in Korea: The 'beneficiaries' of the bail-out (the foreign creditors-mostly from the G7 countries) are also the underwriters of the public debt operation required to finance the bail-out under the IMF auspices (once again the G7 countries being in majority).

To conclude, the 1997-98 crisis has shown that liberalization without appropriate institutional infrastructure and without concern for political and business confidence is unlikely to be sustainable. Liberalization must therefore be underpinned with a carefully targeted set of adjustment policies to facilitate the process of change. Key to this is sound economic governance based on transparency and competition principles and the development of institutions and expertise.

As the Crisis bit deeper, capitalism in the whole region struggled to reconcile its free market aspirations with the reality of increasing and indispensable state intervention. Korea, along with other victim economies, is already adopting more and more measures utilizing state power to revive the economy, if not to tame the markets. The wholesale takeover of banks and finance companies is probably the biggest boost to the state's power over the economy, giving it the potential to influence the amount, direction and terms of loans, given the trajectory and pattern of Korea's economic development for almost four decades having a similar combination. Thus, a combination of basic liberalization principles with selective and efficient types of state intervention should be the recipe for recovery. Moreover, the need to set aside ideological structures and devise pragmatic, workable polices is key to sustainable reform.[20]

As regards the phenomenon of globalization it is a reality, not a choice. "You can run but you can't hide", might serve as the mantra for the age. The real choice for governments is not how best to fight globalization but how to manage it.[21]

Meanwhile, Korea has already embarked on the steady road to recovery. A rebound is expected in the economy and it is expected to grow by 2% this year (after contracting by 6% in 1998). International investors have begun reassuring their faith in the recuperating/restructuring economy. Overall, foreign direct investment in Korea increased tenfold during the first six months of 1998 to $3.4 billion and in January, this year, it reached $1 billion – the biggest amount for any single mouth on record. The won has stabilized at around 1,200 per dollar and the reserves have increased to $50.1 billion (as of February 1999). The foreign usable reserves also rose to $50 billion in

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20 Having Post $2 billion in Russia, even financier and master capitalist, George Soros, now sees the need for financial discipline in the markets. See Asia week, September 25, 1998, p. 23.

21 Richard N. Haas and Roberty E. Litan, "Globalization and its Discontents: Navigating the Dangers of a Tangled World", *Foreign Affairs*, vol. 77 (3), May/June 1998, p. 6.

January 1999 – sufficient to cover three months of imports – from just $3 million when crisis hit in 1997. However, the basic factor in the recovery of Korea from its recent economic crash is and would be more of the **fervour** (than fear and favour – the other ingredients of Korea's economic success, in the words of R.R. Krishnan) of the Koreans to sustain the changing state-*chaebol*- citizen equation.

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