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We don’t know whether we would go bankrupt tomorrow or the day after tomorrow. I can’t sleep since I was briefed. I am totally flabbergasted . . . This is the bottom. It’s a matter of one month, no, even one day. I just can’t understand how the situation came to this (President-elect Kim Dae-Jung, December 23, 1997).1

In the 1950s, Korea was among the poorest countries in the world, with a per capita income of under US$100. In per capita terms, this placed the country below Haiti, Ethiopia, Peru, Honduras and India, among others. Ravaged by a brutal war between 1950 and 1953, a divided Korea was predicted to remain a “basket-case” for the foreseeable future. However, South Korea (hereafter Korea), defied the dire predictions – becoming in less than a generation the quintessential developmental success story, and a model for other developing countries to emulate. With the exception of a relatively short-lived recession in 1979–80, Korea enjoyed continuous economic growth between 1960 and 1997. With a well-educated population of 42 million in 1996, and an economy expanding at an annual rate of over 8 per cent, Korea’s per capita income had grown to US$10,973 by mid-1997.2 This earned the country its coveted membership of the exclusive OECD (Organization for Economic Cooperation and Development) group of nations.3 Already the world’s eleventh largest economy in 1996, Korea’s publicly stated ambition was to outperform Japan technologically in the new millennium. Indeed, the “miracle on the Han” seemed to know no bounds. As the world’s top producer of the dynamic random access memory (D-RAM) computer chips, the second largest shipbuilder, the third largest producer of semiconductors, the fourth largest electronics manufacturer, the fifth largest automobile maker, the sixth largest steel producer, and the seventh largest textile producer, Korea’s aspiration was hardly an empty threat.4
When the financial crisis unexpectedly hit Southeast Asia following the devaluation of the Thai baht on July 2, 1997, it was widely believed that the contagion would not spread to Korea. Not only was the Korean economy the second largest in East Asia, with a gross domestic product of 376 trillion won (or US$454 billion); all the key macroeconomic fundamentals looked sound (Ariff and Khalid 2000, 63). First, since the early 1990s, the Korean economy had grown at an impressive rate. Though not as high as the double-digit growth rate of the late 1980s, the growth rate still exceeded 8 per cent in 1995, and 6 per cent during the first three quarters just prior to the crisis. Second, inflation was not only under control – since 1993 it had remained relatively low, fluctuating between 4 per cent and 5 per cent. Price stability and expectations of low inflation also led to a gradual decline in nominal interest rates. Third, the real exchange rate was not significantly overvalued. In fact, in the three years prior to the crisis, the real exchange rate was essentially flat. Fourth, the gross domestic savings remained high, exceeding 30 per cent in 1995–96. Fifth, the fiscal deficit, which was about 2.5 per cent of GDP in the early 1980s, was turned into a surplus in 1993 – a position it maintained on the eve of the crisis. Sixth, the government budget was close to being in balance, and between 1990 and 1995, Korea’s current account deficit averaged 1.9 per cent of GDP. It increased significantly in 1996 to US$24 billion (4.9 per cent of GDP), because the Korean monetary authority decided to adhere to a strong won policy, despite market pressures for devaluation, because they were concerned about price stability. However, as the Japanese yen became strong again by early 1997, the current account deficit fell to 2.5 per cent of GDP, and by mid-1997 to US$8.2 billion, or 1.9 per cent of GDP. Thus, on the eve of the crisis, Korea’s external position was fairly sustainable. After all, its current-account deficits were used to finance investment rather than consumption. Seventh, although Korea’s foreign debt had grown significantly in the 1990s, it was not unsustainable. That is, the Korean debt/GNP ratio in 1996 was still only 22 per cent – well under the critical level of 48 per cent specified by the World Bank. Moreover, the debt-service ratio of Korea was low, at only 5.8 per cent (Chang 1998). Finally, unlike the other crisis-hit economies, Korea was blessed with a 99 per cent literacy rate (Ariff and Khalid 2000, 62). From a macroeconomic perspective, the Korean economy seemed well managed and sound.

In November 1997, when Thailand, Indonesia, Malaysia and the Philippines were in the throes of a deepening financial turmoil, the headlines in the Korean media consisted mainly of stories dealing with the upcoming presidential election. Thus, on November 19, when President Kim Young Sam announced his decision to fire several key economic policy-makers on the grounds of gross economic mismanagement, most Koreans were surprised at the news. However, two days later, on the morning of November 21, the Korean public, and also many outside observers, were shocked to
learn that the Korean government had formally requested the IMF (International Monetary Fund) for emergency standby loans because Korea's own foreign reserve level was very low (at US$7.3 billion) and most foreign financial institutions were unwilling to roll over their short-term loans to Korea.8

On December 3, 1997, in order to calm the financial markets, the IMF and the Korean government announced that they had agreed to a loan package totaling an unprecedented US$57 billion to assist Korea overcome a mounting foreign-exchange problem and stop the rapid deterioration of the nation's credit standing. Of this, US$21 billion would come from the IMF, US$10 billion from the World Bank, US$4 billion from the Asian Development Bank, and the remainder from bilateral sources, including US$10 billion from Japan and US$5 billion from the United States. Owing to Korea’s desperate situation, the IMF’s part of the package was to be released quickly under the Fund’s accelerated emergency financing mechanism.9 However, the Korean government had to accept virtually all the IMF’s conditions. On December 4, the IMF released US$5.56 billion to the Korean government. An additional US$3.58 billion was to be made available following the first review on December 18, and an additional US$2 billion on January 8, 1998 following the second review. The sheer magnitude of the bailout package and the acceptance of the IMF’s many conditions led most Koreans to the same conclusion as their President, that “we have lost our economic sovereignty.” The Korean media designated December 3 as the “second day of national disgrace” (che iui kukchiil), and President Kim Young Sam in a televised address warned his fellow-citizens to prepare for an indefinite period of humiliating “bone-carving pain.”10

What went wrong? Competing explanations

Why did an economy with such seemingly sound fundamentals succumb so quickly to the economic shock? Two general interpretations have informed the discussion. According to the “fundamentalist” view, the Asian crisis was caused by poor economic fundamentals and policy inconsistencies. Proponents of this view argue that apparently sound macroeconomic indicators masked systemic structural problems. For example, Korea, like many other Asian economies, provided implicit guarantees to the banking system. This meant that banks were often engaged in lending practices that favored financially connected (and not always unqualified) borrowers – in particular, the chaebols or big family-controlled conglomerates. These implicit guarantees led banks to lend recklessly. This, in conjunction with poor corporate governance, created a stock of non-performing loans, thereby risking bank collapses (Corsetti, Pesenti and Roubini 1998). The Economist (1997, November 15, 33) is more blunt: “Most of the financial mess is of Asia’s
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own making, and nowhere is this clearer than in South Korea. For years, the government has treated the banks as tools of state industrial policy, ordering them to make loans to un-creditworthy companies and industries.”

By contrast, the “panic” interpretation views the “asymmetric information and self-fulfilling pessimism of international lenders” as the root cause of the crisis (Hahm and Mishkin 2000). Highlighting the fact that between October and December 1997 capital outflows from Korea amounted to about US$9.8 billion, the more sophisticated version of this argument interprets the crisis as a classic liquidity crisis – where Korean banks had insufficient reserves and insufficient access to funds, and where investors, suddenly seized with panic, refused to roll over short-term debt, besides demanding immediate payment (Radelet and Sachs 1998).

From the perspective of actual experience, analytical distinctions between the “fundamentalist” and the “panic” perspectives are less sharp than they are made in the literature. Indeed, it is impossible to point to any emerging market economy that experienced a financial crisis, but did not have significant fundamental weaknesses that called into question the sustainability of its policies. Indeed, in the case of Korea, as the currency crisis began to unfold it became clear that the Korean economy possessed a number of serious structural weaknesses, most notably weak financial sectors and over-indebted corporate sectors. Yet, it is also impossible to ignore the fact that “reputational externalities” were almost certainly at work. That is, a crisis in one country affected investors’ expectations and perceptions about common structural conditions and vulnerabilities in other countries. Yet, even while acknowledging the impact of structural problems in the Korean financial and corporate sectors, it is hard to avoid the judgement that Korea’s punishment was disproportionate to the crime – because there is no doubt that panic withdrawal of capital and poor policy responses greatly exacerbated the crisis.

This chapter, while building on the insights of the “fundamentalist” and “panic” interpretations, provides a third perspective. It argues that Korea’s financial crisis had both long-term and short-term causes. Weaknesses in both the financial and corporate sectors, especially inefficient management and imprudent lending among financial institutions, coupled with over-investment and low profitability in the corporate sector, made them vulnerable to external turbulence. In fact, it will be argued that poor corporate governance was a major destabilizing factor for the Korean economy. Because the chaebols (a conglomerate group of firms, linked by indirect cross-shareholdings), were highly interdependent financially through cross-shareholdings and cross-loan guarantees, the financial trouble of one chaebol could easily lead to a disaster for the whole group, including the banking system. Indeed, six of the thirty largest chaebols (Hanbo, Sammi, Jinro, Kia, Haitai and New Core) had already filed for court protection in bankruptcy proceedings in early 1997 – several months before the collapse of the
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won. Compounding this was poorly sequenced capital account liberalization – or liberalization that was not accompanied by prudential supervision of the financial system and concurrent measures to discourage excessive capital inflow. These oversights only increased the economy’s vulnerability to financial panic and economic collapse. Despite a relatively low overall external debt level and a moderate and sustainable current-account deficit, Korea had high short-term debt relative to its international reserves – which made it vulnerable to a balance-of-payments crisis. The sharp deterioration in terms of trade in 1996, the bankruptcy of a number of important chaebols, and a change in international market sentiment following the collapse of the Thai baht in mid-1997 were the proximate causes.

Specifically, starting in the early 1990s, the Korean government embarked on an ambitious drive towards globalization, or segyehwa. To this effect, the government began to relax its control over the financial sector, especially its restrictions on foreign borrowing. As a result, the number of financial institutions engaged in foreign-currency-denominated activities increased sharply. This process was greatly accelerated (partly in order to meet OECD requirements) under the first civilian government in thirty years – the Kim Young Sam administration, which came to power on February 23, 1993. As Samuel Kim (2000, 2) notes, “indeed, no state in the post-Cold War cast its lot with globalization as decisively or as publicly as Korea did under the Kim Young Sam administration, which viewed it as the most expedient way for Korea to become a world-class, advanced country. Segyehwa has been touted as no longer a matter of choice but one of necessity – globalize or perish.”

Thus, during the Kim Young Sam administration (February 1993–February 1998), controls on short-term external borrowings by banks were greatly eased, while the government maintained quantity restrictions on medium- and long-term foreign borrowing as a means of capital flow management. In fact, in what became known as window guidance, the authorities drove the banks to rely heavily on short-term financing by limiting the amounts that it was permissible to borrow on a medium- and long-term basis from international sources. That is, the Korean government provided financial institutions with real incentives to borrow for the short term by making it mandatory for them to notify authorities of long-term foreign debts, whereas short-term loans, regarded as trade-related financing, were hardly regulated. Similarly, for non-financial borrowers, it was the short-term trade and other credits that were liberalized, while long-term suppliers’ credit and foreign access to bond markets remained restricted. Moreover, the authorities retained de facto control of many bank interest rates and corporate bond yields, while completely deregulating interest rates for short-term securities such as commercial paper. Finally, the government allowed the entry of many new merchant banking companies during 1994–96. From 1994 to 1996, a total of 24 finance companies were made into merchant
banking corporations, which meant a corresponding increase in the number of participants in international financial markets, because merchant banks were allowed to engage in foreign-exchange transactions, while finance companies were not. During the same period, Korean banks opened 28 foreign branches, which gave them greater access to foreign funds. These banks borrowed heavily in the short term, but invested in long-term assets. These policies would ultimately have dire consequences. For example, the shortening of the maturity of the financial liabilities of Korean corporate borrowers and of the foreign liabilities of Korean banks and non-bank financial intermediaries made the economy extremely vulnerable to external shocks. Moreover, the increasing mismatch in maturity between foreign liabilities and assets in merchant banks, including the fact that these financial institutions were not properly monitored or supervised, made the economy vulnerable to a foreign-exchange crisis.

The following sections will show that because of the eased control on short-term external borrowing, Korea’s big businesses, in particular the chaebols, undertook an aggressive investment drive. This investment drive was financed mainly by large increases in borrowing from domestic banks, in particular merchant banks. As a result the number of merchant banks and the volume of their foreign-currency business expanded rapidly. These changes in the institutional framework contributed greatly to the rapid growth in foreign-currency borrowing. Moreover, financial liberalization and tight monetary policy (which kept domestic interest rates above world interest rates) only encouraged commercial and merchant banks to rely heavily on cheaper foreign credit – perceived to be cheaper because of the pegged exchange rate. As Sylvia Maxfield (2000, 99) aptly notes, “after the financial market was deregulated, newly licensed Korean merchant banks and chaebols began to borrow internationally with all the self-restraint of children let loose in a candy store.”

However, the excessive investments in capacity expansion during the boom years of the early 1990s soon caught up with the chaebols. The high leverage ratios of the chaebols and their low profitability made them extremely vulnerable to any shock to their cash flow. In turn, the health of the banking system was highly dependent on the viability of the chaebols, as the banks were exposed to the chaebols, both directly through loans and discounts, and indirectly through the guarantee of corporate bonds and commercial paper. Financial liberalization also played a major role in producing the deterioration in financial sector balance-sheets. Specifically, while regulations on financial institutions were being relaxed in order to enable them to engage in a wider set of activities, an implicit government safety-net for financial institutions along with weak prudential supervision led to excessive risk-taking. Inevitably, the result was growing bad loan problems and deterioration of financial institutions’ balance-sheets. It is now recognized that the source of moral hazard that helped produce a deterioration in both
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financial and non-financial balance-sheets was the tradition of the government’s coming to the rescue of troubled corporations and financial institutions, not to mention government involvement in the credit market, which created the impression that the chaebols were simply “too big to fail.” These conglomerates had huge leverage, and lending to them increased in the 1990s despite the weakness of their profitability. Banks and other financial institutions kept lending because they expected that the government would not allow the chaebols to go bankrupt – thus in effect guaranteeing their loans. Moral hazard was a bigger problem for the non-bank financial institutions, many of which were owned by the chaebols. Since these institutions were largely independent of the government, supervisory standards and monitoring of prudential regulations were extremely lax. They soon developed major maturity mismatch problems.

When the domestic recession and a disruption in the terms of trade aggravated the cash-flow problems of highly indebted firms, corporate insolvency became widespread. During 1996–97, several highly leveraged chaebols failed and went into bankruptcy. The slowing domestic demand coupled with a deteriorating movement in Korea’s terms of trade could not support an economy burdened with an excessive build-up in capacity. The resulting bankruptcies of a number of major companies, in addition to increasing failures of medium and small businesses, resulted in a deterioration in the balance-sheets of Korea’s financial institutions – resulting in a rapid decline in their international creditworthiness. As the structural weaknesses and the government’s inability to cope with them became exposed following the string of large corporate defaults in early 1997, foreign investors began to take a fresh look at Korea. Arguably, the deepening crisis in Southeast Asia was the last straw. The collapse of the Thai baht in July 1997 increased the concerns of foreign creditors about the strength of Korea’s corporate sector and the soundness of its financial system, despite the Korean government’s repeated attempts to calm foreign creditors. The Hong Kong stock market turmoil in late October 1997 triggered a sudden loss of market confidence. The capital inflows that had helped to finance Korea’s rapid economic growth were sharply reversed. Jittery foreign investors, many reeling from losses in other East and Southeast Asian economies, decided to lower their exposure to Korea and pulled their funds en masse, contributing to the severity and duration of the crisis.

Korea’s economic crisis erupted as a speculative attack on the won in a context of very low foreign-exchange reserves. Because the government had allowed foreign finance to enter through the banking system while continuing to limit inward FDI and foreign purchases of Korean securities, it ended up with liabilities that were owed to foreigners and denominated in foreign currency. Under these circumstances, the capacity of the government and the central bank to lend in the last resort was limited by the stock of international reserves. By the end of 1996, short-term external liabilities
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As a share of foreign-exchange reserves had risen to some 300 per cent (Balino and Ubide 1999). Thus the Korean crisis was not a current account, but a capital account crisis. Conventional current-account crises are caused by the deterioration of domestic macroeconomic fundamentals, manifested as price inflation, fiscal deficits and low rates of saving. A capital account crisis is characterized by massive international capital inflows, usually large enough to surpass the underlying current-account deficit and composed mainly of short-term borrowings denominated in foreign currencies. This leads to currency and maturity mismatches, which adversely affect the balance-sheets of domestic financial institutions. There is thus a dual financial crisis – a currency crisis due to currency mismatch that leads to international liquidity problems, and a domestic banking crisis resulting in credit contraction. Moreover, currency depreciation further adversely affects the balance-sheets of corporations by inflating the value of liabilities in domestic currency terms, thereby precipitating a currency and banking crisis. The Korean crisis also illustrates the fact that, although the alliance between the government, the chaebols and the banks had been in place since the 1960s, it was no longer compatible with Korea’s integration into the global financial market. In sum, the Korean crisis reflected a fundamental structural misallocation of resources to which investors suddenly awoke when financial turmoil engulfed Asia. The withdrawal of funds from Korean banks and the ensuing crisis were simply triggers for a long-overdue process of industrial and financial restructuring.

The rise of the chaebols

Most accounts of Korean economic development depict the 1960s as the pivotal decade (Amsden 1989; E-M. Kim 1997). As the key protagonist of the era, General Park Chung Hee himself, noted, “in the 1960s Korea changed from a pre-modern, underdeveloped society to a modern, productive, constantly growing society.” Indeed, following the successful coup on May 16, 1961, the military government of General Park Chung Hee embarked on an ambitious plan for national economic development through the strategy of suchul ipguk, or “nation-building through exports” (Kim and Leipziger 1997, 155). This meant that in practice the government’s “external economic policies were marked by mercantilistic trade that encouraged exports and suppressed imports” (Dobson 1998, 162). But, first, as a prerequisite, “Park proposed two important strategies: (1) restructuring the government to become a comprehensive developmental state, and (2) elimination of corruption in the political and economic systems” (E-M. Kim 1997, 100). After ruling the country for two and a half years as coup leader, Park was elected president. This served to increase further the institutional coherence and capacity of the state. Park “quickly converted the ‘corrupt soft’ state he had
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inherited into a ‘developmental hard’ state . . . He then proceeded to execute an industrial policy, using a large battery of targeted and un-targeted interventions to implement his detailed vision of the public interest” (Adelman and Yeldan 2000, 97). Among the first items on the new regime’s agenda was purging the bureaucracy of sloth and corruption. Lie (1998, 53) states that, to extirpate corruption, the Park regime fired nearly one-sixth of South Korea’s 240,000 civil servants, besides arresting leading businessmen on charges of illicit profiteering. Similarly, Campos and Root (1996, 166) note that:

Under Park the link between leadership and bureaucratic accountability was cemented. Park granted the economic bureaucracy wide-ranging authority while guarding against its capture by the private sector. Viewing bureaucratic competency as essential to economic performance, Park introduced features modeled upon the Japanese bureaucracy, such as competition in the recruitment and promotion of personnel and control over foreign exchange. He exercised a strong and direct role over the promotion and firing of bureaucrats. His close surveillance of the bureaucracy allegedly included allowing the Korean Central Intelligence Agency to monitor bureaucrats.

Moreover, just two months after the coup, a new “super-ministry,” the Economic Planning Board (EPB), was created to serve as an apex body for economic policy and planning. The EPB enjoyed a broad mandate and was granted extensive administrative powers to supervise and coordinate the work of other ministries that had any bearing on the economy. For example, planning was taken over from the Ministry of Reconstruction, budget preparation and coordination was shifted from the Ministry of Finance, and the collection and analysis of statistics was removed from the Ministry of Internal Affairs. In July 1962, the EPB was given the power to extend government guarantees to loans and to audit and oversee the activities of the borrowing firms. Finally, the EPB was given the power to select those capital goods imports and importers that qualified for government-aided deferred payment privileges. These powers gave the EPB a strong say with regard to the economy. As Cumings (1984, 29) notes, “The EPB . . . took over from a previous ministry the entire budgeting functions: it decides which industries and firms to promote, which to phase out; it closely supervises both the development and the implementation of planning, along with an official trade promotion agency . . . it surveys the world for needed markets, capital and technology.” In effect, throughout the 1960s and 1970s, the EPB “remained as the most prestigious ministry within the government bureaucracy” (E-M. Kim 1997, 102). The EPB articulated the nation’s developmental blueprint in the first five-year plan (1962–66), and the six other five-year plans up to 1994 – when the EPB was formally disbanded.

The EPB gave the Korean state a commanding role in the economy. In late 1961, the Park administration nationalized most of Korea’s commercial banks by repossessing the shares held by large stockholders. Thus, as
Park and Kim (1994, 215) note, “it is not an exaggeration to say that the commercial banks were little more than government agencies delegated the task of mobilizing savings and allocating them according to directives and guidelines issued by the government.” Further, in May 1962 the government amended the Bank of Korea Act, thereby bringing Korea’s central bank, the Bank of Korea (BOK), under the direct control of the Ministry of Finance (MOF). This meant that the BOK functioned as the executor of government policies. Its role was to assist the policy-makers to bring about desired levels of economic activities through interventionist policies. Thus, the BOK provided financing for strategic sectors at preferential lending rates through direct loans programs and re-discounting of bills presented by commercial banks. In fact, the central bank was not independent of the government until it was restructured in 1997–98 following the IMF intervention. In addition, the government assumed the power to appoint the heads of all commercial banks. A government-directed credit-rationing program obliged commercial banks to extend so-called “policy loans” to strategic industries. These measures more clearly signaled that it was the government, not the central bank, that was ultimately responsible for monetary and financial policy. Indeed, the government’s new powers enabled it to influence the sectoral allocation of credit, both directly through the appointment of bank management and credit controls, and indirectly through various regulations and incentives. The government also established several special-purpose banks such as the Korea Development Bank (1961), Kukmin Bank (1963), and the Foreign Exchange Bank (1967), the Small and Medium Industry Bank, the Korean Reconstruction Bank, and the Central Federation of Agricultural Cooperatives to administer generous subsidized loans called “policy loans” on behalf of the government to favored industries. “Policy loans” were distributed to beneficiaries through direct deposit, preferential “rediscounting” for lending to priority sectors at the central bank, credit floors and credit ceilings. Interest rates on loans varied considerably across categories of borrowers, even among preferential credit recipients. These mechanisms not only allowed the Korean state to allocate scarce monetary resources directly to preferred industries, but the monopoly the government exercised over financial institutions gave it important leverage to direct the private sector. In addition, interest rates were administered and competition in the banking system was limited. It is no exaggeration to say that the banks in Korea were hardly market-based, but an arm of the government for allocating financial resources. Because access to funds was crucial to corporate growth, the fact that private enterprises, and in particular the chaebols, had to rely on government-backed financing, only served to enhance the state’s control over the private sector.

This quintessentially cozy “synergistic” and cooperative relationship between the Korean state and the private sector have led some to dub it “the Korean development model” (Amsden 1989; Kim and Leipziger 1997;
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Wade 1990). This model, which essentially refers to a strategy of government-led outward oriented economic development through the promotion of industries using government directed or government influenced subsidized credit allocations as its main means, can be divided into roughly four phases. According to B. Lee (1998), these include (1) export-oriented industrialization via labor-intensive manufactures from 1961 to 1972, (2) export-oriented industrialization via heavy and chemical industries (HCI) from 1973 to 1981, (3) industrial adjustment from 1982 to 1987, and (4) economic liberalization from 1988 to the present.

In the first phase, the Park regime favored light industries as the main beneficiaries of government support – with manufacturing industries that produced for export markets receiving special treatment. Specifically, cognizant of the fact that Korea lacked a large domestic market and natural resources, the state promoted labor-intensive manufactured goods for export by providing preferential financing to export manufacturers, including unrestricted access to tariff-free import of raw materials and intermediate products used for the production of exports. Moreover, the Korea Trade Promotion Corporation (KOTRA) was established in 1962 to help exporters create overseas marketing networks by providing administrative services and serving as a conduit for information between Korean producers, traders and foreign buyers. During the second five-year plan (1967–71), Korea’s economic policy became even more interventionist as the government made a big push towards the promotion of heavy and chemical industries. The HCI strategy placed special emphasis on seven “strategic” industries: machinery, shipbuilding, textiles, consumer electronics, petrochemicals, iron and steel and non-ferrous metals. These strategic industries were subject to industrial targeting – for example, the promotion of basic industries such as steel and petrochemicals was required for developing the defense industry and ensuring a more stable supply of these key materials. The selection of electronic and shipbuilding industries was motivated by another strategic consideration, namely, that these relatively labor-intensive industries could gain competitiveness within a short period.

However, in the early 1970s, as the new climate of protectionism spread, along with the worldwide stagflation caused by the first oil crisis, it reduced the demand for Korean exports. Moreover, Korea’s labor-intensive light industries were losing their competitiveness as a result of rapid wage increases and fierce competition from other developing countries. It soon became clear to policy-makers that Korea needed to move to higher value-added manufacturing to avoid becoming uncompetitive with the new entrants in the consumer light manufacturing industries. These changing circumstances led the Korean government to introduce *Yushin* (or “revitalizing reforms”) – and thereby greatly to accelerate the HCI strategy under the third five-year plan (1972–76). Indeed, the urgency seemed so great that, in order to expedite HCI expansion, the government did not even put HCI projects
for bids. Rather, strategically placed large enterprises and conglomerates (chaebols) – including those already involved in heavy industry and some in light manufactures – were assigned to carry out each project in the steel, petrochemical, shipbuilding, machinery and electronics industries. Fields (1995, 97) argues that even the largest chaebols “were reluctant to assume the risks entailed in these projects, and participated only when the state provided a combination of guarantees, equity participation and increasingly distorted incentives in the form of tax concessions and preferential low-interest credit.” Over the course of the third plan, almost 60 per cent of the total bank loans and more than 75 per cent of total manufacturing investment went to these sectors (H. Smith 2000, 60). The main tool of promotion was preferential access to bank credit. As Wontack Hong (1998, 146) notes, “the success of Korea’s export-oriented growth owes very much to the late President Park’s effort to establish an automatic loan allocation system for exporters . . . Under Park’s regime (1961–1979), any entrepreneur could automatically attain access to short-term bank credits at subsidized interest rates without collateral by undertaking export-related activities . . . The efficiency of credit rationing was maintained by the efficiency of Korea’s export sector.” Overall, the state support for the HCI drive was massive, as the Korean Development Bank provided long-term loans, underwrote corporate bonds and stocks and guaranteed foreign loans. In addition to preferential access to subsidized credit (the so-called “policy loans”), the chaebols were granted favored access to import licenses, tax exemptions and tariff rebates, monopoly or oligopoly market positions, protection and restrictions on competing foreign investment, fiscal incentives, and guaranteed sales through government procurement.21

However, the chaebols had to perform – after all, the state had the ability to reward export success and penalize poor performance. The chaebols knew that they were only to receive subsidized credit and other benefits as long as they were successful in exporting their products. Indeed, firms seeking credit and licenses had to meet Park’s basic criterion: “How much have you exported for me lately?”22 Export performance was used to allocate preferential credit and to determine who would get valuable licenses from the government to produce promoted products. The determined HCI drive proved highly successful, producing several spectacular successes in the development of automotive, shipbuilding and semi-conductor industries. Not surprisingly, exports as a proportion of GNP rose from 7.4 per cent in 1967 to 27.2 per cent in 1997 and 36.7 per cent in 1987 (Kim and Leipziger 1997, 158). However, the export orientation also strengthened the chaebols. Thus, if in 1973 the top fifty chaebols accounted for 32 per cent of GDP, by 1980 the chaebols dominated the economy, accounting for 49 per cent of GDP, 24 per cent of total sales, 18 per cent of manufacturing employment, and over half of Korea’s total exports.23 As Woo-Cumings (1999, 120) notes:
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The Korean chaebol grew as fast as they did because of the steady and massive provision of investment capital from the banks. Almost all of the chaebol groups began when Korea was in the phase of export-led, light industrial production. Lucky made toothpaste, Goldstar made radios, Samsung made clothes, and Hyundai began with U.S. military contracts during the Korean war. . . . Daewoo was founded only in 1967. They acquired their typical large and diversified structure even more recently, during the Third Five-Year Plan in the early 1970s, which developed heavy industries: steel, chemicals, machine tools, automobiles, shipbuilding, and power generation. By the 1980s, electronics had also become a huge part of the chaebol repertoire. The expansion of these firms was stupendous: between 1970 and 1975, the three fastest-growing chaebol (Hyundai, Daewoo and Ssangyong) grew at annual rates of 33 per cent, 35 per cent and 34 per cent, respectively.

Nevertheless, the Korean government’s ambitious expansionist policies had some unintended consequences. First, by the late 1970s there was the problem of growing industrial concentration and sectoral imbalance in favor of the chaebols. H. Smith (2000, 60–1) notes that “by 1977, 93 per cent of all commodities were produced under monopoly, duopoly or oligopoly conditions in which the top three producers accounted for more than 60 per cent of market share. Between 1973 and 1982, the share of manufacturing output of the twenty largest groups increased from 7 per cent to 29 per cent.” Small and medium-sized industries – the very backbone of Korea’s successful export of labor-intensive manufactures – faced a credit squeeze, as more and more of the resources were channeled to the chaebols, and the large enterprises that “grew and became chaebol during the 1970s” (E-M. Kim 1997, 152). Second, the cross-subsidization of chaebol subsidiaries compounded the difficulty of identifying whether capital was being used profitably. In fact, the complex pattern of cross-subsidization within the chaebols enabled unprofitable companies to survive. Soon the chaebols became a serious threat to fair competition between affiliates of the chaebols and non-affiliates, including small and medium-sized businesses. As Kang (2000, 89) notes, “the chaebol presented formidable entry barriers that discouraged competition from newcomers. In short, behaving in an oligopolistic manner, they skewed the economy to favor their own interests and impeded free competition.”

Third, the years of a politicized policy environment and the resultant easy availability of cheap credit via the “policy loans” created problems. In particular, the socialization of bankruptcy risk that accompanied the plan, combined with the low interest-rate ceilings, made the cost of debt financing very cheap for firms in targeted sectors – encouraging firms to take on excessively high levels of debt and to increase market share rather than profitability and shareholder value. In addition, not only was there much waste, but the chaebols also made excessive and redundant investments in heavy and chemical industries. Cho and Kim (1995) aptly observe that the use of directed credit by the Korean government over an extended period of
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time proved to be fundamentally damaging. Most notably, in an oligopolistic market environment, the implicit co-insurance of bank lending by the government induced banks to lend and encouraged firms to invest in risky projects. Commercial banks in Korea functioned almost like development banks, and ended up being saddled with huge non-performing loans equal to almost 20 per cent of GDP. Problems faced by banks were mirrored in deteriorating industrial performance – an important cause of the economic downturn of 1979–80.

Fourth, in their rush to expand and diversify their activities, the chaebols took excessive risks, and as a result the financial structures of some of the largest chaebols became increasingly fragile owing to the heavy debt contracted through the state-owned banking system. Mathews (2001, 159) notes that “across the board, Korea’s top 30 chaebol were leveraged to the extent of debt exceeding shareholders’ equity by nearly 4 times (actually, a ratio of 3.87) – compared with the situation in other countries, such as Taiwan (0.85), Japan (2.0) and the US (1.6).” However, as we noted, the growing debt burdens did not seem to concern the chaebols, as they remained confident in the knowledge that the state would bail them out if they got into difficulty.

Fifth, as economic power accumulated in the hands of the chaebols, they gained greater influence over how preferential credit was to be allocated. By the 1970s, selective credit policy was highly politicized, and it was no longer possible to specify whether the chaebols or the government actually controlled Korea’s credit-allocation policy. Furthermore, the growing diversification in chaebols’ businesses, especially in non-bank financial services, gave the chaebols a degree of autonomy from the state. That is, the considerable economic and political weight of the chaebols made it extremely difficult for the government and the banks to impose fiscal discipline or to disengage completely from supporting the chaebols. Indeed, “the lack of transparency in privately owned companies, facilitated by chaebols’ control of non-bank financial institutions, stymied government efforts to restrict cross-subsidization. And banks, which had high volumes of loans to individual chaebol, had powerful incentives to continue lending rather than to force companies into liquidation” (Noble and Ravenhill 2000, 86–7). The nation’s economy had become so dependent on the chaebols that their collapse could pull down the entire economy. Thus a “too big to fail syndrome” developed, “with governments concerned about the effects on employment, economic stability and the financial system should one of the larger corporate groupings or commercial banks be permitted to go bankrupt” (Noble and Ravenhill 2000, 87).

Finally, not only had the chaebols become economically “too big to fail,” but it was well known that a clientelistic relationship had developed between the government and the chaebols – whereby big business routinely paid the so-called “political taxes” that financed the ruling party in return for favorable
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treatment on a range of discretionary policies from credit allocation to taxation (Haggard and Moon 1990, 227). Thus the politicization of credit policies also meant that recipients of preferential credit made jun jo-seh or contributions to political parties or individual politicians as a sign of appreciation. As will be discussed, by the early 1980s several corruption scandals involving high-ranking politicians and chaebols had been made public.

As was noted earlier, between 1979 and 1980, the Korean economy faced significant external and domestic shocks. Economic growth-rates that had averaged almost 10 per cent a year between 1962 and 1978 fell to just over 2 per cent between 1979 and 1981. Inflation rose to 26 per cent from an annual average of 16 per cent between 1962 and 1978. Exports fell from a 27 per cent average annual rate of real growth between 1962 and 1978 to 7.5 per cent between 1979 and 1982. The current-account deficit widened from US$1.1 billion in 1978 to US$4.4 billion in 1981. Compounding the situation was the second oil shock, which worsened Korea’s terms of trade and balance of payments, while rising interest rates increased the country’s debt-service burden. Faced with mounting challenges, the EPB hurriedly devised an economic stabilization plan. However, before the plan could be implemented, President Park was assassinated on October 26, 1979. Following a period of increasing uncertainty, the military seized power in May 1980 under the leadership of Chun Doo-Hwan. The economic subcommittee of the interim National Security Council was now to dictate the economic policy of the Fifth Republic – inaugurated by the passage of the September 1980 constitution.

The Chun regime introduced financial liberalization as part of its overall structural adjustment program. In its effort to channel curb market funds into formal financial institutions and mobilize savings, interest rates were partially liberalized. Notable developments in capital markets during the period include the establishment of an over-the-counter stock market in 1987, providing a market for small and medium companies and venture businesses not eligible for listing on the Korea Stock Exchange. The Securities and Exchange Act was further amended in 1987, strengthening regulations against insider trading and for the disclosure of information. Various measures for opening capital markets were also taken, including allowing foreign securities companies to operate, and the domestic stock market was partially opened to foreign investors. In addition, the government sold off the government-held shares in commercial banks and imposed an 8 per cent limit on the number of shares of a bank that an individual or chaebol could own. The introduction of the Fair Trade Act of 1980 included the prohibition of cartel practices and cross-investment among affiliated companies, a ceiling on credit to the larger chaebols, and restrictions on their vertical and horizontal integration. The Korean government also directed the thirty largest chaebols to restructure their businesses around fewer core sectors. Further, the government removed a number of entry restrictions, thereby
making possible the establishment of foreign joint-venture banks, non-bank financial institutions (NBFI), insurance companies, regional banks and security companies. Starting in the mid-1980s, commercial banks were privatized and given the right to set interest rates on regular deposits and loans. Finally, banks were allowed to underwrite privately placed corporate bonds and issue CDs (certificates of deposit), which were not subject to legal reserve requirements.

However, these measures hardly had any negative impact on the chaebols. There are several reasons for this. First, high-ranking politicians, including President Chun, were dependent on the chaebols for funds. In fact, Chun had built up a huge slush fund totaling some US$1.8 billion by demanding contributions from chaebols, threatening to cut off credit to firms that did not comply (Oberdorfer 1997, 376). Second, and more importantly, Heather Smith (2000, 62) notes that “a significant gap existed between policy pronouncements and implementation, as the chaebol continued to grow.” Likewise, Byung-Sun Choi (1993, 42) notes that, “big business saw financial liberalization as a means of limiting the government’s intervention in economic decision making . . . businesspeople abhorred the situation in which their fate was at the disposal of government policymakers’ fickle political judgements. In addition, to meet its rapidly increasing capital needs more flexibly, big business felt a need to own and control financial institutions.” Indeed, the change in corporate financing only further increased the autonomy of the chaebols from the Korean state, as they became less dependent on the government-controlled commercial banks for financing. Third, the privatization of commercial banks only enabled the large chaebols to acquire controlling shares in these banks indirectly through the holding of shares by the non-bank financial intermediaries under their control, while the large state-owned banks such as the Korea Development Bank (KDB) and the Korea Export–Import Bank (KEXIM) continued to remain important sources of financing for the chaebols. Fourth, the chaebols as owners of NBFI s (in 1998 the top 30 chaebols owned 12 security companies out of a total of 25; 18 insurance companies out of a total of 35; and 18 investment trust companies out of a total of 38), had easy access to funds from the NBFI s. The NBFI s’ share in total deposits increased from less than 30 per cent in 1980 to more than 60 per cent by the early 1990s. Their share of NBFI loans and direct financing increased from 38.1 per cent in 1980 to 67.5 per cent in 1988 and to 69.3 per cent in 1990. Moreover, foreign bank loans to large firms decreased significantly in the 1980s, as the chaebols began to raise funds directly from the foreign bond markets.26

By the early 1980s, the formidable presence of the chaebols in the Korean economy could not be denied. According to Oh (1999, 211), the chaebols had evolved from being “servants of the state” to “partners” as they gained control of the financial system. For Eun-Mee Kim (1997), the dramatic rise of the chaebols led to a simultaneous “decline of Korea’s developmental
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state.” Thus, although the semi-authoritarian regimes of Chun Doo Hwan (1980–88) and Roh Tae Woo (February 1988–February 1993) attempted to restructure chaebol–state relations, both regimes’ efforts were structurally constrained by the former’s very considerable weight in overall economic activity.27 For example, the Chun regime devised the Credit Administrative System for Big Business, requiring the chaebols to sell off certain subsidiaries and to liquidate “unproductive” real-estate investments that were unrelated to their main line of business. The measure was specifically directed at 26 groups that held a total of 631 subsidiaries. Further availability of credit was made contingent on compliance. Similarly, the enactment of the Anti-Monopoly Regulation and Fair Trade Law in April 1981 (to be enforced by the newly created Korean Fair Trade Commission, KFTC) was designed to reduce the dominant position of the chaebols in the domestic market, besides improving their performance. Although the state was somewhat successful in reducing the subsidies to the chaebols in the Chun regime’s initial years, overall the regime (and its successors) failed to tame the chaebols. As Yoo and Moon (1999, 269) note, the anti-monopoly “law in itself contained numerous exemptions to ensure that competition would remain subordinate to industrial policy goals.” Until 1994 there were few actions in number that were taken against the chaebol by the KFTC, and those that were initiated seemed to be based more on political than economic considerations. In essence, the Korean state quickly relented and acceded to the demands and imperatives of the private sector. As Kang (2000, 91) notes:

Even under the semi-authoritarian governments of Chun Doo Hwan and Roh Tae Woo, the balance of power between the state and the chaebol was slipping in favor of the latter. When Chun and Roh attempted, each in his own way, to check the abuses of the chaebol in response to public resentment, they found it difficult to do. For instance, when Roh launched an anti-big business campaign, Koo Ja-kyung, chairman of the Lucky-Goldstar Group and of the Federation of Korean Industries (FKI), “warned politicians – both ruling and opposition – of potential retaliation through the discretionary use of political contribution” and “declared that the FKI would henceforth provide donations only to politicians willing to support and protect business freedom.” Eventually, Roh had to abandon the anti-chaebol campaign.

Indeed, the number of subsidiaries under each chaebol had increased dramatically since 1970. Pyo (2000, 18) notes that “the Kia Group expanded its car production capacity drastically and, at the same time, pursued both unchecked vertical integration (Kia Special Metals Co.) and unconventional horizontal diversification into construction and financing business . . . the Hyundai group announced its intention to enter steel manufacturing, which had been monopolized by the Pohang Steel Co.” Overall, the top 30 chaebol had on average 4.2 subsidiaries in 1970, 17.8 in 1989 and 26.8 at the end of 1997 (Beck 1998, 1022). The ten largest chaebols continued to grow rapidly during the 1980s. Kia, for example, grew by 30.5 per cent average annual
growth rate, followed by Samsung with a 25 per cent growth rate. Oh (1999, 65) notes that “ten of twenty-seven private concerns in developing countries that made the Fortune 500 list in 1982, for instance, were Korean chaebols.” Also, by 1987, sales from the five largest chaebols comprised 75.2 per cent of manufacturing GDP (E-M. Kim 1997, 183–4). It was clear that by the mid-1980s, the ubiquitous chaebols had come to occupy an extremely powerful position in the economy, and their demands were proving difficult to ignore. Powerful family patriarchs were able to dominate their chaebols with little or no oversight on the part of board of directors, minority shareholders, or even outside auditors (S-N. Choi 1996). By the early 1990s, the level of economic concentration had deepened substantially, and the chaebols enjoyed an even more protected monopolistic position in the domestic market. In 1991, the top five chaebols had revenues of US$116 billion, equivalent to just under half Korea’s 1991 GNP, while the combined revenue of the top ten conglomerates equaled three-quarters of the country’s GNP (Fields 1995, 35; E. C. S. Kang 2000, 89). Not surprisingly, Korea’s media soon cynically began to refer to their nation as the “chaebol Republic” (E-M. Kim 1997, 167).

Democracy and the chaebols

The Korean form of democratization most closely follows what Samuel Huntington has called “transplacement” – where the sitting government makes a concession and opposition groups accept the compromise in order to avoid political gridlock or civil disorder. This type of democratic transition is different from “replacement,” under which “democratization results from the opposition gaining strength and the government losing strength until the government collapses or is overthrown” (Huntington 1991, 142). In Korea, after weeks of massive demonstrations demanding democratization and reform, the autocratic Chun regime agreed to allow a direct, popular election to choose Chun’s successor. However, wishing to have a say in the future government, Chun invited some thirty top lieutenants of the ruling Democratic Justice Party (DJP) to the presidential mansion on June 2, 1987 and revealed his decision to anoint Roh Tae-Woo his successor, to be elected by the electoral college that Chun controlled. Roh Tae-Woo took a dramatic step towards democratization with his June 29, 1987 declaration of an eight-point program – accepting the opposition Reunification Democratic Party’s key demands. Roh’s declaration called for direct presidential elections, amendment of the constitution (to be approved by national referendum), freedom of the press, freedom for political prisoners and restoration of their civil rights, local autonomy, guaranteed protection of all “sound” political parties and an end to corruption. The December 1987 presidential elections were acknowledged (despite some irregularities) to be free and democratic,
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with voter turnout in excess of 89 per cent (Oh 1999). The opposition had a chance to defeat Roh, but because of divisions among themselves, the “three Kims” (Kim Dae-Jung, Kim Young-Sam and Kim Jong-Pil) were unable to agree on a unified opposition ticket, splitting the vote and allowing Roh to win the election. Roh’s inauguration on February 25, 1988 marked the first peaceful transfer of presidential power in Korea since 1948, and the voters directly elected the president for the first time in sixteen years.

While Roh Tae-Woo won the presidency, he only obtained 36.6 per cent of the total vote, because (as noted above) the opposition failed to agree on a unified candidacy and ran two candidates. Kim Young Sam garnered 28.1 per cent and Kim Dae-Jung 27.1 per cent. During the general election for the National Assembly held in April 1988, the ruling DJP failed to win a working majority, raising the specter of political gridlock. However, in February 1990, in an unprecedented merger of three parties, Kim Young Sam’s Reunification Democratic Party and Kim Jong-Pil’s New Republican Party joined the DJP to form a new party, the Democratic Liberal Party (DLP) – giving the DLP a comfortable majority in the National Assembly. More importantly, the merger gave Roh Tae-Woo’s regime political legitimacy.

The Roh interregnum made some important changes in the political life of the nation. First, the constitution of the Sixth Republic was made more democratic. Second, the role of the National Assembly was strengthened. Third, the judicial system was made more independent of executive control; and finally the presidency was limited to a single five-year term. However, despite this new-found autonomy, and despite the fact that president Roh tried to initiate a number of measures to reform the chaebols, the Roh regime (1988–93) was ultimately unsuccessful in its efforts.

Kim Young-Sam became the DLP’s presidential nominee, and he won the December 1992 presidential election by securing 42 per cent of the vote over the 34 per cent received by Kim Dae-Jung of the Democratic Party. When Kim Young-Sam took the presidential oath for a single five-year term on February 25, 1993, this marked an important political milestone for Korea, as Kim was the first civilian to be democratically elected in thirty-two years. No doubt, the Kim regime (February 1993 to February 1998), was in a far stronger position than that of his immediate predecessor to implement political and economic reforms. Indeed, in the political arena, the Kim government introduced a number of measures to eradicate further authoritarian legacies of the past. For example, the government tried to reduce the military’s involvement in politics by reshuffling key military leaders and purging those generals associated with the past military-backed governments. Further, the Kim regime tried to de-politicize the nation’s intelligence agencies, including banning the much disliked Agency for National Security Planning and Defense Security Command from political activities, besides reducing their investigative authority. Kim also ordered public investigations into corruption in the military and civilian bureaucracies – which

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led to the dismissal of scores of politicians, senior bureaucrats, prosecutors and judges guilty of improprieties. In keeping with his promise of clean politics, Kim declared that he would not accept any political contribution, and voluntarily made public his family’s financial assets. The regime also revised the Public Officials Ethics Act in the National Assembly, thereby requiring all high public officials to disclose their assets for public scrutiny. Finally, in August 1993, under a presidential decree, Kim passed the Real Name Financial Transaction System (which outlawed the practice of holding bank accounts under assumed names) and the Real Name Real Estate Ownership System, designed to prevent property monopoly and block the illegal flow of political donations.

Important as these measures were, the new democratic government (like its authoritarian predecessors) failed to break the complex relations between power and money in Korean politics, let alone to tame the chaebols. As Noble and Ravenhill (2000, 100) note, “governments in the democratic era before the 1997 crisis were no more successful than their predecessors in constraining the chaebol.” On the contrary, democratization further strengthened the political power of big business in Korea. Why was this the case? Two complementary explanations have been advanced. First, some lay the blame on “Korea’s democratic deficit” – in particular, the growing “role of business money in electoral politics” (Kong 2000, 374). Likewise, Heo and Kim (2000, 493–4) argue that “South Korea was in the middle of a transition from the government-led economy to a more market-oriented one, and from a government based on dictatorship to a more democratic system. During this transition, both the government and the business sector needed time to implement structural changes. When the financial crisis hit the Korean economy, the relevant institutional mechanisms to deal with such a crisis were not yet in place. Neither the government nor the market economy were sufficiently institutionalized to cope with the sudden shock to the foreign-exchange market that produced the severe economic downfall.” In a similar vein, some stress the pervasive “political gridlock” – the direct result of the “immaturity of Korean democracy” (Mo 2001). Specifically Jongryn Mo and Chung-In Moon (1999, 173–4) note:

In many ways, however, Korean democracy is still maturing. In the context of the economic crisis, it was particularly costly that the formal and informal rules required for or compatible with the effective functioning of democracy were not fully developed, especially such behavioral requisites as tolerance, willingness to negotiate and compromise, and respect for the rule of law. The immaturity of Korean democracy has produced many negative effects . . . But the greatest damage to the Korean economy came from ten years of policy gridlock under an immature Korean democracy. The Korean government under democracy made numerous attempts to reform the very features of the economic system that caused the economic crisis, such as rigid labor markets, business practices of chaebol, and the backward banking and financial sector.
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But in almost every case, reform debate continued without a lasting resolution, which resulted in increased uncertainty and confusion. The government’s handling of the crisis has also been hampered by its inability to resolve policy conflicts.

And second, it has been argued that since Korean national elections are very expensive, and the political parties have no independent sources of funding, the Federation of Korean Industries (FKI), the chaebols’ principal lobby group, has been the largest source of political funding in Korea since its establishment in 1961. As Kong (2000, 376) notes, “democracy transformed the government–chaebol relationship in the latter’s favor. Given the cost of fighting elections . . . aspiring politicians of all colors needed to attract business support. It was therefore advantageous for politicians to cultivate smooth relations with big business and seek its financial support . . . Having grown in economic power through three decades of state nurture, the chaebol had become more resilient to state sanctions.” In fact, under the democratic regime, the pervasive “government–business nexus” (jeong–kyeong yuchak) not only became rife with patronage and corruption, but was fundamentally transformed. Kong (2000, 376) adds that “by the late 1980s, government–business relations had developed beyond the mutual exchange of favors by interdependent parties. Relationships had become more personalized as families of business leaders and senior government officials became closely interconnected through the marriage of their children.”

Not surprisingly, as Chang, Park and Yoo (1998, 741) note, under the Kim government, “for the first time in post-1960s Korean history, we heard the names of particular chaebols, such as Samsung, talked about as being close to the regime.” Certainly, chaebols as a group enjoyed preferential treatment under previous regimes — but they were all treated equally, with no one particular chaebol enjoying an advantage over the others. However, under the Kim government there was a fundamental change in state–business relations — “which meant the major manufacturing sectors became less insulated from the corrupt political exchanges than they had been previously” (Chang, Park and Yoo 1998, 741). For example, close associates of President Kim, including his son Kim Hyun Chul and the former Construction Minister Kim Woo Suk, were accused (and eventually convicted) of money-laundering, influence-peddling and accepting bribes from the steel manufacturer, Hanbo (then the eleventh largest chaebol). Despite having a poor record in manufacturing and a low ratio of self-owned capital (about 300 billion won), Hanbo Steel was able to borrow 5 trillion won for investment in a steel plant — through political connections. Also, through connections, Hanbo Steel instead of Hyundai was granted the license to enter the steel industry. To make its bid successful, Hanbo had its loans rolled over, despite experiencing acute financial problems. Similarly, the government’s decision to grant Samsung a permit to build an automobile factory was largely “political.” Yeon-ho Lee (2000, 121) notes that “economic elucidation
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can account for only a part of its hidden motivations. A crucial motivation lay in the owner-chairman’s ambition to become the largest chaebol owner in Korea.” Chang, Park and Yoo (1998, 740–1) state more bluntly:

The Kim government also licensed Samsung to enter the already overcrowded car industry in 1993. What is fascinating about this entry is that it destabilized the industry before it produced a single car – Samsung’s cars did not come on the market until 1998. Relatively lacking in strength in machine-related industries and having deliberately located the factory in the president’s hometown, Pusan, despite the fact that the (reclaimed) site needed massive fortification, Samsung’s venture looked questionable from the beginning.

Thus, although the Kim Young Sam government “promised a new revitalized economy as one of the regime’s primary goals, including reforming the chaebols complex system of cross-shareholdings, its economic measures ostensibly served the interests of the chaebols” (Oh 1999, 136). For example, in March 1993, a month after his inauguration, the Kim Young Sam government abolished the practice of five-year planning (which had provided an overarching policy coordination framework since its inception in 1962), in favor of a 100-day new economic development plan. Such measures, while impressive on paper, made for hasty and uncoordinated policy formulation. In the end, besides reducing public utility fees such as charges for water and electricity and lower prices on twenty basic consumer items such as rice, beef, sugar and milk, the government’s new plan “accelerated the kinds of deregulation demanded by the chaebol without promoting real competition and efficiency” (Kang 2000, 92). Specifically, Kims “new economy” plan outlined an immediate deregulation of the Korean economy, including liberalization of capital market and securities businesses to align Korea with the growing “globalization trends” (Oh 1999, 137). By early 1994, the impetus for chaebol reform began to wane because of concern that restrictions on the activities of the chaebol could impact adversely on growth and employment – given the chaebols’ large presence in the domestic economy. As the following sections illustrate, the hastily implemented liberalization plan, biased towards short-term borrowing, and without effective prudential regulation and supervision in place, was hardly designed to rein in the chaebols. Indeed, these “mostly half-baked measures, often not backed up by improvements in the supervisory and disclosure framework would have a profoundly negative impact on the economy” (Claessens, Ghosh and Scott 1999, 83). In short, they made Korea vulnerable to the financial firestorm that eventually swept East Asia in 1997.

Liberalization without regulation

The Korean financial system comprises three main types of institutions: (a) commercial banks, (b) the specialized and development banks, and
The commercial banks account for over half the assets of the financial system. They are owned by small shareholders (prior to the crisis, no shareholder could own more than 4 per cent of a nationwide commercial bank or more than 15 per cent of a regional bank), and engage in both traditional short-term banking operations and long-term financing of the corporate sector, including leasing. The commercial banks consist of 16 nationwide banks, 10 regional banks, and numerous (52 as of September 1997) foreign banks. Commercial banking is highly concentrated, with the top eight banks accounting for about two-thirds of commercial bank assets (Balino and Ubide 1999, 7–9). The specialized and development banks (which are partly or wholly owned by government) were established in the 1950s and 1960s to provide funds to specific strategic sectors. They account for roughly 17 per cent of financial system assets.

In an effort to bring the unregulated money markets under control, the MOF enacted the Short-Term Financing Business Act in 1972. The Act was designed to encourage the establishment of a variety of non-bank financial intermediaries, including investment and finance companies, mutual savings firms, and general finance companies. Permitted to offer higher deposit interest rates, these NBFIs expanded their market share rapidly. As institutional investors and underwriters, they also played an important role in the stock market. Not surprisingly, many chaebols came to acquire controlling shares of NBFIs by the late 1970s. The non-bank financial institutions comprised 30 per cent of financial system assets at the end of 1997. They consisted of three types of institutions: investment institutions; savings institutions; and insurance companies. Of these, investment institutions, which consist of merchant banks, investment trust companies and securities companies, are the largest in terms of assets, followed by savings institutions. As Balino and Ubide (1999, 10) note, “NBFIs have been directly or indirectly owned mainly by chaebols and other large shareholders. They are used to finance activities within the chaebol group and have become an increasingly significant source for intermediating chaebol notes and other paper. For example, most of the 30 merchant banks in operation in mid-1997 were owned by the chaebols, while the securities companies acted as their underwriters and brokers.”

Prior to the post-1993 liberalization, the Korean government controlled all the internal and especially cross-border financial flows very tightly. Although there were a series of financial liberalization measures introduced in the 1980s, these were limited in scope. For example, the fact that no shareholder was permitted to own more than 4 per cent of a bank’s equity resulted in fragmented ownership. In practice, this meant that the managements of banks were not accountable to anyone, except to the government. Also, up until the 1990s, decisions regarding credit allocations that commercial banks could make were dominated by the government’s policy of favoring (c) non-bank financial institutions (NBFIs). In addition, there also exists an informal and unregulated financial market known as the “curb market.”
investment loans to large corporations engaged in export activities. Foreign-exchange transfers were heavily regulated – Korean nationals were not allowed to borrow freely on the international market and the ability of foreign residents to buy, own and sell domestic assets was limited. However, from the early 1990s, the Korean government began to relax its control over the financial sector and “under the Kim Young Sam government the liberalization process was greatly accelerated (H-J. Chang 1998, 1557). The Kim government’s ambitious liberalization agenda was outlined in its *Blueprint for Financial Liberalization and Market Opening* (July 1993) and *Foreign Exchange Reform Plan* (December 1994). Figure 4.1 briefly outlines some of the major financial liberalization measures in Korea during the 1990s.

As Figure 4.1 shows, the liberalization program was wide-ranging in its scope. By mid-1997, many restrictions on the financial markets and foreign-exchange transactions were relaxed or abolished. By July 1997, most interest rates had been liberalized, while entry barriers to the banking and non-banking sector had been significantly relaxed. Restrictions on foreign capital flows were substantially removed. Furthermore, to expedite liberalization, the government merged the Economic Planning Board (EPB) and the Ministry of Finance (MOF) into the Ministry of Finance and Economy (MOFE). However, this only made policy coherence and accountability very difficult. Similarly, the Foreign Exchange Reform Plan of 1995, in liberalizing interest rates (and reducing the government’s monitoring role), only allowed for faster portfolio than direct investment inflows – thereby making the country more vulnerable to mass international capital movements.

Why did the Korean government pursue such far-reaching (and poorly sequenced) liberalization measures? There are several interrelated explanations. According to Ilpyong Kim and Uk Heon Hong (2000, 70–71), the Kim Young-Sam administration, determined to create “a New Korea” (*sin Hankuk ch’angjo*) and enamored with *segyehwa* (or globalization) “believed that only a full-blown market economy could build an economy competitive at the world level.” Administrators therefore worked to increase the role of the private sector, to loosen the concentration of the *chaebols*, and to deregulate further the financial markets. Also, Chang, Park and Yoo (1998, 740) compellingly note that, by the early 1990s, the increased credit ratings of Korean corporations and banks in the international financial markets meant that the private sector began to regard government involvement in their foreign-exchange transactions as a burden – and the “*chaebols* now hankered for greater freedom in their investment decision-making.” Similarly, Lee (2000, 10) notes that “the 1990s saw an increasing demand from *chaebols* for deregulation such as lifting the ceiling on their ownership of bank shares, financial opening for greater freedom in foreign borrowing, raising the aggregate credit ceiling, and so on.” Furthermore, the decision by the Kim government to apply for Korea’s membership in the OECD meant that Korea had to liberalize substantially the country’s financial
Major financial liberalization measures in Korea

1 **Interest rates deregulation** (in four stages: 1991 to July 1997)
   - by 1997, all lending and borrowing rates, except demand deposit rates, were liberalized

2 **More managerial autonomy for the banks and lower entry barriers to financial activities**
   - freedom for banks to increase capital, to establish branches and to determine dividend payments (1994)
   - enlargement of business scope for financial institutions (1993), which included (a) continuous expansion of the securities business of deposit money banks (1990, 1993, 1994, 1995), (b) freedom for banks and life insurance companies to sell government and public bonds over-the-counter (1995) and (c) permission for securities companies to handle foreign exchange business (1995)
   - abolition of the limits on maximum maturities for loans and deposits of banks (1996)

3 **Foreign exchange liberalization**
   - introduction of “free won” accounts for non-residents (1993)
   - allowance of partial won settlements for the export or import of visible items (1993)
   - Foreign Exchange Reform Plan (1994), which included a detailed schedule for the reform of the foreign-exchange market structure
   - a very significant relaxation of the Foreign Exchange Concentration System (1995)

4 **Capital market opening**
   - foreign investors are allowed to invest directly in Korean stock markets with ownership ceilings (1992)
   - foreigners are allowed to purchase government and public bonds issued at international interest rates (1994), equity-linked bonds issued by small and medium-sized firms (1994), non-guaranteed long-term bonds issued by small and medium-sized firms (January 1997), and non-guaranteed convertible bonds issued by large companies (January 1997)
   - residents are allowed to invest in overseas securities via beneficiary certificates (1993)
   - abolition of the ceiling on the domestic institutional investors’ overseas portfolio investment (1995)
   - foreign commercial loans are allowed without government approval insofar as they meet the guideline established in May 1995
   - private companies engaged in major infrastructure projects are allowed to borrow overseas to pay for domestic construction cost (January 1997)
   - liberalization of borrowings related to foreign direct investments (January 1997)

5 **Policy loans and credit control**
   - simplifying and slimming down the controls on the share of a bank’s loans to major conglomerates in its total loans

*Source: Chang, Park and Yoo (1998, 737).*
markets, in particular, both the current and the capital accounts. Beyond these domestic structural explanations are the external factors, in particular, the continued pressure from the US government for Korea to deregulate and open her financial markets. Yet, whatever the explanation, there is general consensus that the liberalization program was accompanied by extremely lax supervision and prudential regulation.

For example, a history of government involvement in bank lending decisions had hampered the development of a commercially-oriented and sound banking system, besides creating moral hazard. Within banks, lending decisions tended to be highly centralized, and the internal risk-control structures as well as credit analysis skills and procedures did not mature fully. As a result, credit decisions tended to rely on collateral and inter-company guarantees, as well as informal government guidance, rather than projected cash flows. Loan review processes and management information systems were rudimentary. Thus Balino and Ubide (1999, 16) succinctly note that “although government involvement in bank lending decisions was gradually withdrawn, banks developed few skills in credit analysis or risk management. Lending decisions were still largely based on the availability of collateral rather than on an assessment of risk or future repayment capacity. Because of their large exposures and inadequate capitalization, banks were generally in a weak position relative to their chaebol clients. Reflecting the history of directed lending, banks did not insist on, or receive, full financial information from chaebols.” In addition, basic accounting, auditing and disclosure practices were significantly below international best practice. Commercial banks were under the direct authority of the Monetary Board (the governing body of the Bank of Korea) and the Office of Banking Supervision (OBS). However, specialized banks and NBFIs were under the authority of the Ministry of Finance and Economy (MOFE). This lack of a unified system of supervision and regulation comprising both bank and non-bank financial institutions created conditions for regulatory arbitrage and the development of risky practices.

Similarly, the standards for loan classification and provisioning were significantly laxer in Korea than in the other OECD countries. Non-performing loans were defined as loans that had been in arrears for six months or more, compared to a standard definition of three months or more. Bad loans were defined as the portion of non-performing loans not covered by collateral. The classification system was based on the loans’s servicing record and the availability of collateral without regard to the borrower’s future capacity to repay. Banks also lacked good internal liquidity-management controls, and regulations were not sufficiently stringent, especially in regard to foreign exchange. In order to ensure the liquidity of banks, the OBS required that long-term loans (defined as those with a maturity between one and ten years) should be financed with funds with maturities of at least a year. However, banks were not expected to invest an amount equivalent to
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more than 100 per cent of their equity capital in securities with maturities over three years. Moreover, all these calculations included only domestic liquidity positions, not taking into account positions of overseas branches and offshore funds – which accounted for more than 60 per cent of domestic financial institutions’ short-term external liabilities in 1996. Yet, despite the growing maturity mismatches in banks’ balance sheets that resulted from the capital account liberalization, no special consideration was given to the prudential regulation of liquidity-management in foreign exchange (Chopra et al. 2001). Finally, Korean banks were subject to considerable restrictions on product innovation, while controls on interest rates limited price competition. Labor laws made it difficult to reduce excess personnel. With little control over their credit policy or costs, and with relatively little concern about insolveny, the banks were usually more concerned with achieving profits through asset growth than in maintaining asset quality.

Another consequence of the deregulation was the rapid growth of merchant banks. As was noted earlier, many of these newly established merchant banks were previously (in the 1970s and 1980s) small-scale investment finance companies created to reduce the importance of the informal curb markets. However, with deregulation they simply changed their names and became merchant banks. In 1994, nine such merchant banks were established, and by 1996, sixteen more were added to the group. At the end of 1996, there were 30 merchant banks in the country. Merchant banks as wholesale financial institutions engaged aggressively in underwriting, leasing and short-term lending. Soon they began to cut into the profitability of the banking sector. The merchant banks (which were the dominant lenders in the issuance and discounting of commercial paper) funded themselves by issuing notes and short-term bonds to overseas investors, by inter-bank deposits and by borrowing in foreign markets. As was also noted earlier, most of these newly established merchant banks were either owned or controlled by the chaebols. Similarly, the significant relaxation of restrictions on chaebol ownership of other non-bank financial institutions such as life insurance companies and investment-trust companies enabled the chaebols to further expand and concentrate their financial operations. Indeed, there were no effective laws to prevent excess concentration of lending. Korea did not have laws to restrict lending to multiple borrowers belonging to the same group. That is, different firms that belonged to the same chaebol family were treated independently. The result was heavy concentration of lending. Finally, although the merchant banks often competed directly with commercial banks, they were subject to different regulatory regimes. In fact, the merchant banks faced far fewer regulatory restraints than the commercial banks, and therefore quickly developed some distinct vulnerabilities. For example, owing to the relatively lax regulatory regime, merchant banks assumed much higher interest rate and currency risk than the commercial banks. Their lending concentration inside affiliated groups was greater, and
merchant banks usually lent without collateral – and thus had less protection in case of default.

Compounding this problem was the maintenance of tight monetary policy and a regulatory framework that was explicitly biased towards short-term borrowing. That is, short-term loans regarded as trade-related financing were hardly regulated, whereas long-term borrowing was subject to much stricter restrictions, requiring one to provide detailed information, besides obtaining permission from the MOFE.37 Also, since the government expected that the credit rating on bank loans of Korean companies would improve in the international financial market, it further induced financial institutions to transform long-term external debts into short-term debts (MOFE 1998). However, other “borrowers seem to have taken a ‘wait and see’ approach by continuously rolling over short-term loans rather than taking out long-term ones, an approach supported by the international lenders who were perfectly willing to roll over Korean loans until the eve of the crisis” (Chang, Park and Yoo 1998, 739). Overall, the bias towards short-term foreign borrowing only encouraged the development of large maturity mismatches in the banks’ balance sheets.

Moreover, financial liberalization and tight monetary policy (which kept domestic interest rates above world interest rates) only encouraged commercial and merchant banks to rely heavily on cheaper foreign credit. Korean banks borrowed on the overseas interbank market, taking advantage of lower interest rates and passing the funds on to their domestic customers. This strategy was fraught with problems, since it meant that Korea was borrowing short-term money abroad (money that had to be repaid in hard currency) and lending it long-term to their chaebol and other customers. Secondly, foreign credit was perceived to be cheaper because of the pegged exchange rate. No doubt, a pegged exchange rate in normal circumstances would eliminate the foreign-exchange risk associated with foreign loans for domestic borrowers. However, Korea’s exchange-rate policies contributed to reckless foreign borrowing. Prior to the crisis, the Korean won was effectively tied to the US dollar, with very little or predictable variation. Specifically, in March 1990, Korea adopted an approach to exchange-rate management known as the Market Average Exchange Rate System (MAR). Under this system, the daily won/dollar rate was allowed to fluctuate each day within a band centered around the preceding day’s weighted average spot rate. The band width was initially set at plus or minus 0.2 per cent. Between 1990 and 1996, the exchange rate was tightly managed – with the won depreciating fairly steadily by an annual average rate of 2 per cent.38 The daily fluctuation band was gradually widened in the period before the crisis, reaching plus or minus 2.25 per cent in 1996. In maintaining such a tight exchange rate, the Bank of Korea, in effect, absorbed the exchange-rate risks on behalf of market participants. With little variation of exchange rates and high domestic interest rates, it is not surprising that chaebols and financial institutions...
increased their offshore borrowing, especially with short-term maturity loans. Moreover, although the exchange rate was not fixed, its undervaluation in a managed float system and relatively high interest rates at home had substantially increased the attraction of foreign borrowing. Yen-denominated loans became especially attractive in the couple of years before the crisis, because the continuing decline in the value of the yen against the US dollar lowered the real cost of yen loans to domestic borrowers.

The resultant wave of excessive short-term foreign borrowing was intensified by ineffective policy response and poor prudential supervision. Specifically, the mounting balance of payments surplus due to the increasing exports and the inflow of capital forced the monetary authority to engage in a massive sterilization operation by issuing Monetary Stabilization Bonds (MSBs) on a large scale, leading to a circle of higher interest rates and larger inflows of foreign capital. Second, lax regulation of banks, in particular, merchant banks (for example, there were no asset classification, capital or provisioning rules for merchant banks) and the regulatory distortions that favored short-term borrowing contributed heavily to the accumulation of short-term foreign debt, increasing the banks’ vulnerability to maturity mismatch. As Chang, Park and Yoo (1998, 738) note, “leading this rapid build-up of short-term foreign debt were the inexperienced merchant banks.” For example, in a period of almost three years, merchant banks managed to acquire US$20 billion in foreign debt – 64 per cent of which was short-term debt, while 85 per cent of their lendings were long-term. Overall, foreign debt jumped from US$44 billion in 1993 to US$120 billion in September 1997 (a 33.6 per cent per annum increase between 1994 and 1996), while the share of short-term debt (or debt with less than a year’s maturity) in total debt rose from an already high 43.7 per cent in 1993 to 58.3 per cent at the end of 1996 (Chang, Park and Yoo 1998, 738–9). However, these figures underestimate the actual size of the debt, since they do not include offshore borrowing of domestic enterprises and Korean banks and their overseas branches and subsidiaries. By the mid-1990s, low profits and soft lending combined to make the chaebols highly leveraged in terms of their debt/equity ratios. As Table 4.1 shows, at the end of 1997, the top 30 chaebols had an unprecedented debt/equity ratio average of 519 per cent – which was more than twice the international banking norm of 200 per cent.

Economic vulnerabilities: the road to the crisis

High as the foreign debt figure was, it was not necessarily at an unsustainable level. As was noted earlier, in 1996, Korea’s debt/GNP ratio stood at 22 per cent, far below the World Bank’s definition of “less indebted,” at 48 per cent. Similarly, Korea’s debt-service ratio of 5.8 per cent was well below the critical 18 per cent specified by the World Bank. Also, the current account,
### Table 4.1 Debt/equity ratio of the top 20 chaebols

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
<th>1996</th>
<th>1997</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Hyundai</td>
<td>376</td>
<td>579</td>
</tr>
<tr>
<td>2</td>
<td>Samsung</td>
<td>206</td>
<td>371</td>
</tr>
<tr>
<td>3</td>
<td>Daewoo</td>
<td>337</td>
<td>472</td>
</tr>
<tr>
<td>4</td>
<td>LG</td>
<td>313</td>
<td>506</td>
</tr>
<tr>
<td>5</td>
<td>Sunkyong</td>
<td>320</td>
<td>468</td>
</tr>
<tr>
<td>6</td>
<td>Hanjin</td>
<td>619</td>
<td>908</td>
</tr>
<tr>
<td>7</td>
<td>Ssangyong</td>
<td>297</td>
<td>400</td>
</tr>
<tr>
<td>8</td>
<td>Hanwha</td>
<td>619</td>
<td>1,215</td>
</tr>
<tr>
<td>9</td>
<td>Kumho</td>
<td>465</td>
<td>944</td>
</tr>
<tr>
<td>10</td>
<td>Dong-Ah</td>
<td>320</td>
<td>360</td>
</tr>
<tr>
<td>11</td>
<td>Lotte</td>
<td>179</td>
<td>216</td>
</tr>
<tr>
<td>12</td>
<td>Halla</td>
<td>2,930</td>
<td>N/A</td>
</tr>
<tr>
<td>13</td>
<td>Daelim</td>
<td>344</td>
<td>514</td>
</tr>
<tr>
<td>14</td>
<td>Doosan</td>
<td>625</td>
<td>590</td>
</tr>
<tr>
<td>15</td>
<td>Hansol</td>
<td>290</td>
<td>400</td>
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<tr>
<td>16</td>
<td>Hyosung</td>
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<tr>
<td>17</td>
<td>Kohap</td>
<td>472</td>
<td>472</td>
</tr>
<tr>
<td>18</td>
<td>Kolon</td>
<td>350</td>
<td>434</td>
</tr>
<tr>
<td>19</td>
<td>Dongkuk Steel</td>
<td>323</td>
<td>324</td>
</tr>
<tr>
<td>20</td>
<td>Dongbu</td>
<td>338</td>
<td>338</td>
</tr>
<tr>
<td></td>
<td>Top 30 chaebols</td>
<td>387</td>
<td>519</td>
</tr>
</tbody>
</table>


which had recorded a deficit of US$23.7 billion (4.9 per cent of GDP) in 1996, had decreased to US$8.8 billion by April 1997. It is important to note that (unlike what happened in Mexico), the current-account deficit was used to finance investment rather than consumption, and it was thought that the trend of increasing deficits would be reversed quickly as soon as the falling international prices of major export items such as semiconductors, steel and petrochemical products rebounded. Moreover, private corporate sector profligacy was not as widespread in Korea as it was in Indonesia or Thailand, nor was Korea highly exposed to real-estate and property inflation. In fact, much of the foreign borrowing went into the tradeable sector, and not to fuel speculative asset bubbles in the non-tradeable sector. Land prices, which had risen at a rapid pace in the second half of the 1980s, were basically stable in the 1990s. Instead, foreign borrowing primarily financed an expansion of industrial capacity. That is, the chaebols were investing in export industries...
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with stable returns, and in which they were particularly well represented – namely petrochemicals, petroleum refining, iron and steel, automobiles, electrical equipment, electronics and communications and shipbuilding. Yet, these only reflected part of the economic picture. Looming alongside were growing economic vulnerabilities, which the history of impressive macro-economic performance had served to cover up.

Specifically, the heavy indebtedness of the chaebols (and their subsequent insolvency) are to be found in the investment boom of the early to mid-1990s. During 1994–96, facility investment in manufacturing rose by 38.5 per cent per year. However, the investment boom was not uniform across sectors, but concentrated in manufacturing. Within manufacturing, the bulk of the investments (65.7 per cent) went to expand existing production lines, while a relatively small amount was allocated to corporate restructuring (15.5 per cent). Moreover, investments in heavy and chemical industries grew at an annual rate of 43.1 per cent, while the rate of growth for light industries was only 15 per cent (OECD 1998a). Also, investments by large firms grew 45.7 per cent, while small and medium-size enterprises increased their investments by 17.7 per cent. In sum, the boom was dominated by the large chaebols investing in heavy industries such as steel, automobiles, petrochemicals and electronics. However, this boom soon resulted in gross over-investment. Blustein (2001, 121–2), for example, vividly illustrates the fact that “from 1994 to 1996, spending on new plants and equipment rose by nearly 40 per cent a year . . . these expansion programs reeked not only of excessive ambition but even megalomania. The Ssangyong Group, whose chairman, M. P. Kim, was a car buff . . . invested $4 billion to enter the Korean automobile market, where three giants (Hyundai, Daewoo and Kia) already dominated. Samsung, whose chairman also cherished a personal car collection, insisted on following its rivals into the crowded automotive industry as well – and reportedly got permission from the administration of President Kim Young Sam by locating its plant in Pusan, Kim’s home base.”

Thus, in an environment marked by zealous expansion and the near-complete absence of investment coordination, it was only a matter of time before investments would lead to overcapacity and declining profitability. Indeed, the profit rates (return on assets) in the manufacturing sector had fallen continuously from over 4 per cent in 1988 to 0.9 per cent in 1996. The decline of rates of return to capital during this period was caused at least partly by excessive and misallocated investment. In addition, using firm-level data in eight major industries, Bailey and Zitzewitz (1998) have shown that much of the rapid growth in the Korean economy could be accounted for by input growth rather than by productivity increase, and that the returns to capital (or profit rates) of Korean firms were lower than those of American and Japanese firms. They find that many chaebols recorded little or no profit even as their sales were expanding at a rate of 30 per cent per year in 1996.40 Similarly, studies by Borensztein and Lee (1999) and Choi, Jen and
Shin (2000) have found that many chaebols recorded little or no profit in 1996. Corsetti, Pesenti and Roubini (1998, 6), note that in 1996, 20 of the largest 30 chaebols showed a rate of return below the cost of capital. Hence, by 1996, Korea’s corporate sector was characterized by low levels of profitability and high levels of debt – reflecting the tendency of the chaebols to diversify into capital-intensive industries using short-term bank loans. Hong and Lee (2000, 209), citing World Bank figures, note that “by 1996 the average debt-equity ratio of firms was over 300 per cent and it reached 620 per cent for a median firm. The ratio exceeded 500 per cent for the 30 largest chaebols and reached even 3,000 per cent for some chaebols.”

The aggressive borrowing, especially of short-term foreign loans, had dire consequences. While there is nothing intrinsically wrong in borrowing from abroad to finance rapid industrialization, it is necessary to apply risk-management to those foreign loans. First, in Korea, banks were exposed to large maturity mismatches in their foreign-currency operations because they relied on foreign-currency-denominated short-term borrowing to fund long-term domestic-currency-denominated loans. Hahm and Mishkin (2000, 29) note that “gross external liabilities had been growing at rates exceeding 30 per cent from 1994 to 1996. . . . the amount of external liabilities relative to GDP was also rising rapidly over the same period, rising from the 20 per cent level prior to 1994 to above 30 per cent by 1996 and 1997.” It is estimated that, prior to the crisis, corporate debt totaled some US$75 billion, and the ratio of short-term external debt to total external debt was over 50 per cent (Lee and Orr 1999, 97). Moreover, there was a sharp mismatch between the short-term debts and official foreign reserves. In fact, the ratio of short-term external debt to official foreign reserves increased continuously in the 1990s (from 34 per cent in 1992 to 63 per cent by the end of 1996), reaching an unprecedented high of 252 per cent in 1997 (H. Smith 1998, 67). By June 1997, Korea’s short-term debt was more than three times the size of its reserves, a higher ratio than for any other country in the region. As Dongchul Cho (1998, 105–6) notes, “at the end of November 1997, [Korea’s] short-term debt comprised almost 60 per cent of the approximately $110 billion total foreign debt.” It was asserted that Korea was protected from “hot money” because liquid asset markets were not open to foreigners; but once the country’s credibility was lost, short-term debt became virtually hot money.

Second, much of the foreign loans (which were short-term debts denominated in foreign currencies) was without an appropriate hedge. Third, the continued government support of industrialization through foreign debt was
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not accompanied by any improvement in the transparency of accounting standards in the leveraged chaebols. In fact, prudential regulation and supervision simply failed to keep up with the increasing concentration of risk in the domestic financial system. Not only were the banks lax in examining the large-scale investment project loans for which bank credits were requested by chaebols, but formal feasibility studies and risk analysis were also lacking. More often than not, bank managers decided on credit extension according to the size of borrowing firms, swayed by the charms of the “too big to fail” argument. That is, because chaebols were considered to be “too big to fail” financial institutions believed that the government would protect them from any harm. Further, the banks did not bother to check into possible misuse of loans by borrowers in the form of financial contributions to politicians and political parties, while foreign investors provided funds to domestic financial institutions without due vigilance, since they were perceived as having implicit government guarantees. In fact, this reflected a long-established tacit understanding among Korean banks that if their chaebol clients got into trouble, the government would step in to protect everyone against a major loss.

Reflecting this lack of consolidated supervision, the increasingly risky activities of the merchant banks and other non-bank financial institutions, as well as the overseas subsidiaries and foreign branches of domestic financial institutions, were largely overlooked. The ill-experienced managers in merchant banks and financial companies were prone to allowing high-risk exposure owing to their inability at managing short-term foreign capital. Without effective supervisory regulations, the merchant banks engaged in increasingly risky business – for example, investing in high-yield foreign junk bonds with funds borrowed cheaply using Korea’s high credit rating in international financial markets. Thus they exposed themselves to significant interest-rate, currency and credit risks. Indeed, when foreign lenders started to recall loans in late 1997, these assets turned out to be illiquid. Finally, the liberalization of foreign-exchange transactions on the current account allowed exporters to avoid depositing their foreign-exchange revenues with the Central Bank. As a result, foreign-exchange deposits in the commercial banks declined sharply – the build-up of short-term foreign debt far exceeding Korea’s foreign-exchange reserves.

The economic boom began to slow down by the mid-1990s. Industrial output growth slowed down from an annual growth rate of 14 per cent in 1995 to 10 per cent in 1996. Growth in manufacturing sales declined from 20 per cent in 1995 to 10 per cent in 1996. More troubling, Korea’s export engine slowed down significantly owing to its deteriorating international competitiveness, and to the currency devaluation by China and Japan – Korea’s major competitors in the export market. In addition, with wage increases rapidly outstripping productivity increases, Korea simply could not effectively compete against Japan for high-valued products, and against
China for low-value goods. As the world export demand receded, the \textit{chaebols} suffered heavy losses. In particular, the slowdown in international trade in semiconductors (especially the memory chips market), office automation equipment, and consumer electronics, which began to slow down imperceptibly in 1995, but reached crisis proportions by mid-1996, severely hurt the Korean economy, which had invested heavily in it. In fact, the terms of trade deteriorated by approximately 20 per cent in 1996 – the largest external shock since the first oil shock of 1974. However, as Noble and Ravenhill (2000, 90) note: “Korean companies ignored the softening demand for 4 MB and 16 MB chips in the mid-1990s and continued to expand production capacity.” The 16-megabit memory chip, which accounted for approximately 20 per cent of Korean exports, saw its price tumble from a high of more than US$50 to under US$7 by mid-1997 owing to a worldwide glut, declining demand, and the entrance of new competitors (in particular, Taiwan and Singapore) in the marketplace. By mid-1996, the unit price of semiconductors had fallen by more than 70 per cent, which alone was estimated to have decreased the value of Korean exports by more than US$10 billion, or over 2 per cent of GDP, severely affecting the top three semiconductor companies: Samsung Electronics, Hyundai Electronics and LG Semiconductors. In addition, international prices of many of Korea’s other export items, such as steel and chemical products, fell in 1996. As a result, the terms of trade deteriorated by more than 20 per cent in 1996. Since the \textit{chaebols} financed the construction and expansion of costly multi-billion-dollar chip-fabrication factories known as “fabs” with massive doses of short-term dollar-denominated loans, they now faced an impending financial disaster as the huge losses in this critical sector mounted. Compounding the problem was the weakening profitability associated with cyclical downturns in sectors such as autos, shipbuilding, and the labor-intensive textiles and steel. All this not only resulted in deteriorating terms of trade (during 1996–97, Korea’s terms of trade deteriorated by more than 20 per cent cumulatively), but also severely constrained the \textit{chaebols’} ability to cross-subsidize their investments.

As the new year began in 1997, foreign investors began to take a closer look at Korea – not only because of the unexpectedly sharp economic slowdown, but also because Korea’s current-account deficit of 5 per cent in 1996 (the largest in five years) raised concerns. Then, on 23 January, the 14th largest \textit{chaebol}, Hanbo Steel and Construction, declared bankruptcy, with a total estimated debt of US$6 billion spread across 61 banks and non-bank financial institutions. Other affiliates of the Hanbo group, which had been forced to act as guarantors of Hanbo Steel’s debts, also collapsed, effectively bringing down the entire group. On February 19, Moody’s lowered the long-term ratings of three Korean banks (Korea Exchange Bank, Korea First Bank and Cho Hung Bank), all of which had substantial exposure to the Hanbo Group. However, this was just the beginning. Hanbo’s...
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collapse was followed by four more large chaebol: Sammi Steel on March 19 (with a 2.3 trillion won debt, 33 times its capital base), Korea’s largest distillery, the Jinro Group (with a 3 trillion won debt) on April 21, the retail chain Dainong in May and the 6th largest chaebol, Ssangyoung, in June. Each went into bankruptcy, dragged down by excessive investment, declining profits and a substantial debt burden. As noted earlier, because of the cross-guarantee of debts among the affiliated firms of a chaebol group, the bankruptcy of one affiliate firm led to the bankruptcy of other affiliated firms. Moreover, these large corporate insolvencies inevitably undermined the health of the financial institutions with large exposure to these conglomerates.

By mid-1997, it became clear to investors that Korea’s corporate sector difficulties would have significant repercussions on the financial sector. The growing economic turmoil in the region, especially the collapse of the Thai baht on July 2, 1997, and the subsequent contagion to other regional currencies pegged against the US dollar, brought Korea’s growing financial and corporate sector problems into sharper focus. When, on July 15, Kia Motors, Korea’s third-largest car-maker and eighth-largest chaebol, asked for emergency loans to avoid bankruptcy, the credit agencies immediately began downgrading ratings for several major Korean banks, as they estimated that the fiscal bailout for the banking system would cost as much as 20 per cent of GDP (D. Park and Rhee 1998, 170). In the face of the growing crisis, the Kim Young Sam government remained indecisive – if not paralyzed. Although the Bank of Korea had alerted President Kim to the danger of a foreign-exchange crisis as early as July 1997, “the Ministry of Finance and Economy (MOFE) and the presidential economic secretary downplayed it by emphasizing the ‘healthy fundamentals’ of the macro-economy. Kim’s aides thought they could put off the IMF bailout until Kim’s tenure was over. His poor monitoring and mismanagement aggravated the crisis by mis-timing effective intervention.” Thus an indecisive and discredited president (as a result of the Hanbo scandal), coupled with a divided ruling party, pervasive intra-bureaucratic fragmentation, and an opposition resistant to reform legislation, produced political gridlock and policy incoherence.

Finally, after weeks of sending mixed signals, the government began to take action. In early August, the government announced a set of measures aimed at increasing confidence in the Korean financial market. First, official support was provided by the Bank of Korea in the form of special loans and a capital injection in exchange for government bonds to Korea First Bank. However, the government’s response of guaranteeing the foreign liabilities of financial institutions only called into question the Bank of Korea’s ability to act as the lender of last resort. In addition, a special funding facility was created to assist 21 merchant banks (out of the 30) whose exposure to bankrupt companies exceeded 50 per cent of their equity. Second, the
government announced guarantees covering the foreign liabilities of Korean financial institutions, including both commercial and merchant banks. And, third, for the disposal of non-performing assets at financial institutions, an Act on the Efficient Disposal of Non-performing Assets of Financial Institutions and for the establishment of the Korea Asset Management Corporation (KAMCO) was passed in November 1997. Under this Act, the Non-performing Loans Management Fund was set up under the umbrella of KAMCO in order to help financial institutions dispose of their non-performing assets at the earliest date possible. In exchange, banks would receive KAMCO bonds, which they could liquidate at any time.

It is now clear that the markets perceived these measures as insufficient. On October 24, 1997, Standard and Poor downgraded Korea’s sovereign status, citing corporate and financial problems and the government’s weak response. This struck a major blow to market confidence, making it difficult for Korea’s private sector to obtain foreign-currency funds. Indeed, by October 1997, the balance-sheets of Korean financial institutions had deteriorated severely. The share of non-performing loans in total assets of commercial banks had increased by about 70 per cent between December 1996 and September 1997 – and amounted to about 80 per cent of banks’ capital. As a result, the net worth of many financial institutions fell perilously low, and a significant shortfall in capital adequacy emerged. Of the 26 commercial banks, 14 had capital adequacy ratios below 8 per cent, of which two were deemed to be technically insolvent. In addition, 28 of the 30 merchant banks had capital adequacy ratios below 8 per cent and 12 were deemed technically insolvent (Balino and Ubide 1999, 30). Daekeun Park and Rhee (1998, 171) point out that the Korean government “made a critical mistake when it decided to bail out the near-bankrupt Kia group on October 22, 1997.” Immediately after the Kia decision, foreign banks refused to roll over loans, forcing Korean banks and corporations to buy dollars in the foreign-exchange market to service their obligations – adding to the pressures on the exchange rate. Indeed, “this was the moment that Korea’s private banking crisis officially turned into a sovereign one.” Standard and Poor harshly criticized the Korean government’s decision to bail out Kia, stating that “the bailout might alleviate short-term pressures but the long run economic consequences are unambiguously negative” (D. Park and Rhee 1998, 171). Cha (2001, 43) more bluntly notes: “the government’s decision to ‘nationalize’ Kia was interpreted by international capital markets as a signal that the Korean government had neither the will nor the courage to correct the economy’s structural problems. Foreign investors lost their confidence completely.” In this environment, capital flight picked up speed as foreign investors began to pull out of Korea and domestic residents shifted funds to foreign-currency deposits. The once-solid Korean bonds tumbled to junk levels as investors became nervous that the world’s eleventh largest economy was heading for a Mexican-style crisis.
By late October 1997, it was clear that not only were the foreign banks reluctant to roll over short-term loans, but the massive outflow of capital continued unabated. The Bank of Korea tried to intervene in the exchange market with its foreign reserves in order to restore confidence. This meant that now a part of the current-account deficit had to be financed from central bank reserves – and soon the central bank reserves began to fall rapidly, as private capital inflows virtually vanished. Even before the collapse of Yamaichi Securities (Japan’s fourth-largest securities company), and the bankruptcy of Japan’s Takushoku Bank on November 15, Japanese banks began to call in their loans from Korea, thereby precipitating a liquidity crunch for the Korean banks. As Yanagita (2000, 21–22) notes, “already facing their own crisis as the economy bubble burst in the early 1990s, Japanese banks began to collect maturing debts in the region. Once the Japanese banks, which were most familiar with the Korean economic situation as the largest Korean creditors, started to collect matured short-term debts, other countries’ banks followed suit in short order, abruptly prompting the liquidity squeeze on the Korean foreign exchange. As a result, US$34.2 billion in private capital flowed out of Korea in a few short months, including US$9.2 billion collected by international banks and US$25 billion of short-term capital.” As the merchant banks’ weakest borrowers began going bankrupt, foreign and Korean commercial banks further curtailed their lending. To stay afloat, the merchant banks were forced to call in loans – causing more bankruptcies. They bought up dollars or yen with won to pay their foreign-currency debts, and these won sales contributed to the drastic decline in the won’s value. The won dropped sharply from 915 won per dollar on October 21, 1997 to 965 won per dollar on October 31, 1997.

A sharp export slowdown and a growing current-account deficit in 1996 led many to suspect the possibility of an overvalued exchange rate. In spite of the perception that the won had been overvalued since the second quarter of 1996, when the price of semiconductors collapsed, the Bank of Korea nevertheless actively intervened in the foreign-exchange market to uphold the value of the won. However, this intervention contributed to the rapid depletion of foreign reserves. For example, the government sold off more than US$7 billion in official foreign reserves between June 1996 and the end of March 1997, reducing reserves from US$37 billion to US$29 billion. Why did the Korean government try to uphold the value of the won despite a growing current-account deficit? In large part because the authorities expected the current-account balance to improve soon, and worried that a devaluation would trigger inflation and increase the debt-service burden of the private sector. After October, domestic financial institutions found it extremely difficult to roll over their loans. As a result, Korean banks and corporations had to buy dollars in the domestic exchange market to service their external obligations. This situation also meant that the central bank had to supply foreign exchange to banks in the form of deposits at overseas
branches. However, the supply of foreign exchange declined sharply with the expectation of a won depreciation. In this fast-deteriorating environment, the Korean authorities made another fatal mistake by wasting a substantial part of the country’s foreign reserves in this futile foreign-exchange market intervention. That is, instead of letting the won float, the Korean government tried to defend it by spending approximately US$15.1 billion in October and November 1997.

Korea’s liquid foreign reserve, which was US$22.4 billion in early October, dropped to a paltry US$7.3 billion by mid-November. According to an IMF study, Korea’s usable foreign exchange reserves fell dramatically in November, at a rate of US$1 billion to US$2 billion daily, bottoming out at around US$5 billion by the end of the month. Although the central bank of Korea tried to calm the financial markets by announcing that its reserves were around US$30 billion, the strategy backfired. Specifically, as Daesik Kim and Park (2000, 89) note, “confidence was eroded further when it became apparent that monetary authorities had lied about foreign exchange reserve levels. The government insisted that the Bank of Korea held about US$30 billion in reserves in November. However, simple calculations revealed that this claim could not be true, and only about US$15 billion remained.” Similarly, Daekeun Park and Rhee (1998, 172) observe that “the market ridiculed the government’s denial attitude.” Likewise Dongchul Cho (1998, 105) adds that “given the public knowledge of the heavy government intervention in the exchange market, this statement did not make sense at all.” This incident decisively destroyed the credibility of the Korean government, and foreign investors began to distrust even official statistics unless they were endorsed by the IMF. Foreign investors estimated that the actual reserves were as low as US$15 billion – which totaled about five weeks’ worth of imports and only a fifth of Korea’s short-term debt. With the markets cognizant of the fact that the announced reserves did not include dollars borrowed through forward market intervention (contracted by offshore entities), and recalling that Thailand had committed as much as two-thirds of its reserves in this way, the Korean government’s lack of candor cost it its credibility, besides fueling rumors among international financial investors regarding the actual amount of Korea’s usable foreign-exchange reserves. By the end of October 1997, 6 out of the top 30 chaebols had filed for court protection or court-ordered receivership, and a seventh went into bankruptcy in December. These large bankruptcies, together with rising bankruptcies among small and medium-sized enterprises significantly damaged the asset position of financial institutions (MOFE 1998).

By early November, Korea was confronted with a “twin crisis” – a banking and currency crisis. Specifically, the wave of corporate bankruptcies and rising non-performing loans created doubts about the overall health of the financial system and drove foreign banks to withdraw their credit lines to Korea. In turn, this drying up of foreign credit lines made it extremely
difficult for Korean banks to roll over their large volume of short-term external debt – creating the potential for a currency crisis and contributing to capital flight and further decline in the value of the won. In response, the Korean authorities widened the won’s daily fluctuation band to plus or minus 10 per cent. However, on November 16 Korea finally abandoned its defense of the battered won and allowed the exchange rate to float freely. This sent the currency crashing through the psychological 1,000/dollar level, with shock waves hitting the baht, the rupiah, the ringgit and other regional currencies, which fell even further relative to the dollar. On November 18, the affable reform-oriented deputy prime minister and minister of finance and economy, Kang Kyung Shik, announced Korea’s intention to seek IMF support. However, Kang’s “economic recovery plan” was voted down by the National Assembly. On November 19, Kang took responsibility for the crisis, and was abruptly dismissed from both his official positions. The newly appointed finance and economy minister, Lim Chang-Yuel, downplayed the gravity of the situation, referring to Korea’s problems as a “temporary funding shortage” and the “idea of IMF aid” as “unthinkable.”56 Lim immediately pressed the United States and Japan for assistance, asserting bluntly that “it is in their national interests to help . . . if the Korean currency depreciates beyond its value, it will seriously affect the Japanese economy” (Blustein 2001, 131). Moreover, he announced that the government would form an emergency economic presidential advisory committee to solve the nation’s financial problems. In the late evening of November 19, Lim unveiled an emergency financial bailout package. However, seen as “too little to late,” these last-minute attempts failed to restore market confidence. On November 20 the won fell by another 10 per cent to 1,139 won per dollar. With some US$158 billion in external debt (US$90 billion of which was in short-term debts with maturity of less than one year, mostly held by the chaebols), the country now teetered on the brink of defaulting on its debt repayments. Following marathon all-night negotiations with the IMF team led by the Fund’s number two man, Stanley Fischer, the weary and somber-looking finance minister, in a nationally televised press conference (on November 21) reluctantly announced that Korea would seek emergency financial assistance from the IMF.

However, with Korea’s presidential elections due to be held later in December 1997, the IMF made it clear that its support would be contingent upon all presidential candidates’ approving (in writing) the terms of the IMF agreement. This was done because two of the leading candidates, the populist Kim Dae-Jung and Rhee In Je, had made it public that if they were elected they would renegotiate the terms of the IMF rescue package if the level of unemployment and corporate bankruptcies turned out to be too high. In this climate of uncertainty the won dropped to 1,800 won to the US dollar in late November. Finally, President Kim Young Sam had to seek written commitments from all the major contenders they would uphold the
IMF agreement if elected. After some ten days of tense negotiations, on the late evening of December 3, 1997, it was announced that the IMF and the South Korean government had finally reached an agreement. On December 4 Michel Camdessus, Managing Director of the IMF, and finance minister Lim signed a three-year standby arrangement under which the IMF agreed to provide a record-breaking US$57 billion rescue package to South Korea. The US$21 billion IMF portion was the largest the Fund had ever lent to a single country, and it was more than six times the amount Korea would normally be allowed to borrow (IMF 1997d). About US$10 billion was lent by the World Bank and US$4 billion came from the Asian Development Bank. The remaining US$22 billion was to be provided on a bilateral basis from governments of the G-7 countries. This portion was earmarked as the “second line of defense funds” – to be provided only if the multilateral loans proved insufficient. Under the agreement, Seoul would receive the first payment of US$5.6 billion immediately, and the second tranche after December 17, following review of Korea’s adherence to the comprehensive economic reform program underpinning the loan. After signing the agreement, President Kim Young Sam publicly conceded that “we have lost our economic sovereignty” and apologized for “capitulation to IMF trusteeship.” Nevertheless, he stated with unusual candor that his government would honor the stringent IMF conditionality, and pleaded with the nation to endure “humiliating and bone-carving pain.”

The December 3 program was based on the expectation that a large financing package, comprehensive structural reform measures, and firm monetary and fiscal policies would be sufficient to restore market confidence. In the first couple of days after the signing of the agreement, the won began to stabilize. The IMF claimed that its program was now starting to work (Blustein 2001, 180–81). However, beginning on December 8 and continuing for the next five days, the won plummeted by the 10 per cent limit each day, ending at 1,712 per dollar on December 12. On December 23 it reached 1,962 won per dollar, while usable reserves had fallen to US$4 billion. The proximate causes for this loss of confidence were several. First, Kim Dae-Jung’s announcement on December 6 that if elected he would renegotiate the agreement (despite having signed a pledge to support it) unsettled the markets. Moreover, the fact that his campaign took out ads in major newspapers attacking the deal only worsened matters. Second, the government’s decision (on December 9) that it would invest US$1 billion in two large ailing commercial banks, rather than shutting them down as the agreement had stipulated, served to convince the markets that Korea was not serious about implementing the program. Third, when Chosun Ilbo, a leading Korean daily, published a leaked version of the December 3 IMF staff report, showing that Korea’s foreign debt falling due over the coming year (1998) was over US$116 billion, instead of the officially reported US$65 billion, market confidence was shattered (Blustein 2001, 180–83). It now
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began to sink in that, large as the IMF bailout was, it did not provide Korea with sufficient hard currency to deal with its debt or to meet its short-term financial obligations.

As panic set in, foreign banks refused to roll over short-term loans to Korean borrowers. Korea’s central bank became besieged as it “scrambled to respond to the flood of requests for hard currency that were coming in from Korean commercial bank branches around the world” (Blustein 2001, 183). In this difficult environment, the once unthinkable – allowing Korea to default – was now being contemplated by the IMF and the US Treasury. Yet, recognizing that the potential consequences of default were simply too great to risk, the IMF made one final attempt to rescue Korea. The first order of business was to get Kim Dae-Jung on board. As Blustein (2001, 190–98) documents, this proved much easier than expected. Elected president of Korea on December 18, 1997, Kim Dae-Jung dramatically reversed his policy stance.58 On accepting his electoral victory in an address to the nation on December 19, 1997, Kim Dae-Jung delivered a ringing endorsement of economic reforms and promised to implement the conditions attached to the IMF program expeditiously. The president-elect noted: “I shall state once more with utmost clarity and emphasis, we shall cooperate with the IMF fully and completely. We shall also faithfully abide by the agreement between the IMF and the present government of this Republic. For that, we shall try our best to legislate the necessary laws in the National Assembly” (Sohn and Yang 1998, 206).

The second IMF plan (coupled with the moral suasion of the United States Treasury, the US Federal Reserve’s Alan Greenspan and G-7 governments) was to get Japanese, European and American banks to agree to roll over their maturing short-term loans (with the intent of converting them subsequently into long-term bonds) until March 1998. Again, as Blustein (2001, 190–200) documents, this proved easier than expected. The roll-over, or the “bail-in,” as it was called, gave the Korean government the much-needed breathing space to negotiate a more comprehensive restructuring package – albeit it should be noted that the rolled-over debt was owed by domestic private entities to foreign private entities. The Korean government took a central role in the debt negotiations, including providing financial guarantees for the rescheduled loans, because it placed a priority on preserving the access of domestic banks to international credit – even at the risk of fostering moral hazard. On January 16, 1998, the Korean government and the foreign banks reached agreement on the rescheduling of some US$24 billion in short-term debt owed by Korean companies. The debts were converted into new obligations with a maturity of one to three years, backed by government guarantees. To secure foreign-currency liquidity, the government also floated a total of US$4.1 billion worth of foreign-currency-denominated Foreign Exchange Stabilization Fund guaranteed bonds in April 1998.59 Although the agreement was criticized by some for being too
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favorable to foreign lenders, it nevertheless, enabled the country to avoid defaulting on the repayment of its short-term foreign debts. In return, the IMF agreed to speed disbursement of US$2 billion on December 30 – well ahead of schedule. The World Bank and the Asian Development Bank also agreed to disburse a combine US$5 billion ahead of schedule. On their part, the Korean authorities agreed to accelerate many of their promised reforms, as well as undertake new ones.

Under the “IMF Shidae” (Era)

The financial crisis had a devastating impact on the Korean economy, causing Korea’s worst recession in the post-war period. As has been noted earlier, real GDP growth fell from levels that had been running in the positive 7–12 per cent range before the crisis to a negative 5.8 per cent in 1998. The won had lost 60 per cent of its value against the dollar, and the Korean stock market dropped 50 per cent in 1997. Worse still, per capita income declined from US$10,543 in 1996 to US$9,511 in 1997. More than 17,000 companies (mostly SMEs, or small and medium enterprises) went bankrupt, including eight conglomerates. SMEs were hit particularly hard. Since more than half the SMEs had subcontracting relationships with the larger chaebols, their access to credit contracted sharply as banks (the primary source of external finance for SMEs) refused to transact with SMEs without established credit records or collateral. During the first half of 1998, the losses of Korean listed companies reached new historical heights (about 14 trillion won in the first half of 1998), and unemployment rose from pre-crisis levels of 2 per cent to 6 per cent in 1998 and to 8.7 per cent in March 1999 – the highest in thirty years. Real wages also saw a substantial decline of 20.7 per cent during the same period (World Bank 1999, 34). In the midst of all this, a leaked confidential IMF document further spooked the market by revealing that Korea’s short-term debt was nearly twice as large as had been previously declared by the government. It was estimated to be more than US$100 billion once offshore borrowing by Korean banks, enterprises, and their overseas branches and subsidiaries were accounted for (World Bank 1999).

It should be noted that, even before the ink was dry on the agreement the Korean government had reached with the IMF, criticism of the program had begun to mount. As Daekeun Park and Rhee (1998, 173) note, “the public’s reaction to the IMF arrangement was unreasonably negative. Local news media portrayed the IMF not as a counterpart for cooperation but as an invading army. Many believed that Korea had lost its economic sovereignty as it was now under a neo-colonial ‘IMF shidae.’” However, to halt the spiraling economic decline and jump-start the faltering economy, the Kim Dae-Jung administration (which took office in February 1998) committed itself to the IMF’s program of macroeconomic adjustment and structural
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reform. In fact, in its February 7, 1998 “Letter of Intent” to the IMF, the Kim Dae-Jung government did more than accept the “steadfast implement-
ation of the very tight monetary and fiscal policy stance proposed by the IMF” (IMF 1998e). The government also closely worked with the IMF and the World Bank to devise a wide-ranging and politically challenging struc-
tural adjustment program designed to address outstanding problems in the financial and corporate sectors.62

Although the IMF-sponsored program underwent several revisions, it consisted of three basic elements: macroeconomic stabilization, financial and corporate sector reforms, including comprehensive dismantling of the old financial system, and further measures related to trade liberalization, capital account liberalization and labor market reform. This reflected the IMF’s view that the crisis originated from structural weaknesses in the Korean economy, especially from its financial system (IMF 1997d). However, the IMF believed that the immediate challenge was to achieve macroeconomic stability and restore confidence in the currency. To achieve this the IMF program required that: (1) money supply be squeezed, or at least be limited to a rate consistent with containing inflation at 5 per cent or less; (2) the government maintain a balanced budget by reducing its spending level to match its tax revenue – which was expected to decline; (3) the exchange rate be determined by market forces; (4) interest rates be allowed to rise to the highest possible level to stem capital outflows and discourage speculation (On December 1, 1997, the statutory ceiling on interest rates was raised to 12.3 per cent. However, it was increased to 20.7 per cent on December 3, and to 30.1 per cent on December 23. The high interest-rate policy con-
tinued throughout the first two quarters of 1998.); (5) the government work hard to accumulate foreign exchange; and (6) a tight fiscal stance be main-
tained for 1998 to alleviate the burden on monetary policy and to provide for the interest costs of restructuring the financial sector.

In the area of financial sector reforms, the program was designed to: (1) restructure and recapitalize the banking system to address the problem of the stock of bad loans and the weak capital base This meant decisively dealing with problem institutions and problem loans by closing down the former and by selling off the latter, and substantially improving the health of the remaining financial institutions by injecting additional capital. Indeed, at the outset of the program, in order to maintain public confidence, the government guaranteed all deposits of financial institutions until the year 2000 and suspended the operation of fourteen insolvent merchant banks. In addition, two commercial banks were placed under supervision, while all remaining financial institutions were required to submit plans for capital restorations needed to meet the Basle standards; and (2) strengthen the disclosure rules, enforcing transparency requirements and establishing a prudential regulatory framework in order to prevent the recurrence of sim-
ilar problems.
On December 29, 1997, the Korean National Assembly passed a package of thirteen financial reform bills designed to facilitate financial restructuring, improve prudential regulation and speed up capital market liberalization. Specifically, the new Bank of Korea Act provided for the independence of the central bank, the Bank of Korea. Taking effect immediately, the Act placed the Monetary Board, the supreme policy-making body of the Bank of Korea, under the direct authority of the Governor of the Bank instead of the Minister of Finance and Economy. The aim was to consolidate the Bank of Korea as the principal instrument of the country’s monetary policy, in charge of setting prime interest rates. The responsibility of the central bank was also narrowed to maintenance of price stability, whereas earlier it had also been responsible for the maintenance of exchange-rate stability and regulation of the financial system. The Ministry of Finance and Economy (MOFE) was to retain the authority over macroeconomic and broad financial policy and license the establishment of financial institutions. Indeed, such a restructuring was seen to be critical to breaking the nexus between monetary policy and supervision of financial institutions – which was one of the factors allowing situations like the Hanbo scandal to persist for so long.63

The reform bills further consolidated all financial sector supervision (for banks, non-bank financial institutions, insurance and securities markets) in a single and independent (albeit interim) Financial Supervisory Commission (FSC) established in April 1998.64 The FSC, separate from the government, was established to function as a neutral and independent supervisory and policy-making body, besides playing a central role in financial restructuring (World Bank 1999). The FSC’s immediate priority was to ensure capital adequacy guidelines were met and risk management and accounting standards improved. To perform its duties effectively, the FSC was given considerable powers to impose civil and criminal liabilities on directors of financial institutions, including the powers to impose sanctions on external auditors and examiners of supervisory authorities for neglect of duties. Also, under the FSC supervision, a sub-committee called the Securities and Futures Commission (SFC) was created to provide for the orderly functioning of the financial market. The reform bills also strengthened the deposit insurance system. In April 1998, the FSC merged all deposit insurance protection agencies into a newly established body: the Korea Deposit Insurance Corporation (KDIC).65 The KDIC not only authorized funds for capital injection and deposit loss coverage for ailing financial institutions, but also required the submission of rehabilitation plans by 12 commercial banks that did not meet the 8 per cent capital adequacy ratios. Mathews (2001, 164) notes that the FSC “revealed that it had teeth when in July 1998, only three months after its establishment, it ordered the closure of five non-viable commercial banks, and gave seven further banks ‘conditional approvals’ requiring them to undergo substantial restructuring, including replacement of senior management.”
Corporate sector reforms were explicitly designed to reform the chaebols by (1) reducing their high debt/equity ratios, (2) ending intra-group debt guarantees, (3) requiring chaebols to divest themselves of non-profitable activities, and (4) requiring transparency of balance-sheets through the enforcement of independent external audits, full disclosure and consolidated statements for all conglomerates, including the publication and dissemination of key economic and financial data – giving them until 2000 to comply.

In the area of economic liberalization, the IMF urged Korea to open up the economy rapidly and completely – with open trade in commodities, services, intellectual property rights and foreign exchange. In fact, under the arrangement trade was to be liberalized by setting a timetable in line with World Trade Organization commitments to eliminate trade-related subsidies. Capital flows were to be completely opened and the capital account transactions substantially liberalized. Specifically, the capital account was to be liberalized by opening up the Korean money, bond and equity markets to capital inflows and liberalizing foreign direct investment. Labor-market reform, including wage-cuts and flexible layoffs, was also required to facilitate the redeployment of labor.

However, the IMF-mandated program, in simultaneously pursuing structural reform and foreign-exchange market stabilization, posed a fundamental dilemma. Specifically, in order to stabilize the foreign-exchange market in the short run, contractionary fiscal and monetary policies were needed. On the other hand, expansionary policies were required to alleviate the pains from the credit crunch that inevitably accompanied structural reform.

As it turned out, although the IMF program helped to restore some measure of international investor confidence, it also produced severe negative economic shocks. In particular, the very tight macroeconomic policies (designed to restore stability in the financial and exchange markets), contributed to the substantial contraction of bank credit and extreme stress in the corporate sector. Further, devaluation and high interest rates produced recession and inflation. Consumer prices rose from an annual rate of 4.5 per cent in 1997 to roughly 20 per cent during the first two months of 1998; unemployment increased sharply from 0.5 million to 1.3 million; and the exchange rate, which had dropped to near 2,000 won per US dollar on December 24, 1997, improved only modestly, fluctuating around 1,600 to 1,700 won per dollar in mid-January 1998. Moreover, as banks became reluctant to provide new loans to firms in order to meet their Basle requirements, the number of bankrupt firms jumped from one thousand per month in September 1997 to three thousand per month by December 1997 – taking an indiscriminate toll on both weak and healthy firms alike (Suh 1998, 5). In turn, company bankruptcies led to the insolvency of financial institutions and scared off foreign investors, decreasing the inflow of foreign capital.

Even as the IMF program was being implemented, Jeffrey Sachs (1997a) pointed out (and in hindsight, correctly) that, in the case of Korea, there
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was no need for such excessively tight monetary and fiscal policy, since Korea’s macroeconomic policy was sound, with “the budget in balance, inflation is low, the savings rate is high, and the economy is poised for export growth.” According to Sachs, the IMF gravely misjudged the Korean crisis by equating it with the Mexican peso crisis. However, while Korea and Mexico suffered from the same liquidity crisis, the causes of the crisis were not the same. In the case of Mexico, it was profligate spending and consumption, while in Korea it was highly leveraged investment burdened with short-term debts. By applying the same prescriptions as it did during the peso crisis, the IMF severely aggravated the Korean crisis. Because of this miscalculation, the sharp increases in interest rates failed to stabilize the exchange rate – which quickly depreciated far below the targets set in the IMF program. In agreement with Sachs, Kihwan Kim (2000, 204), also adds that the IMF’s decision to release its funds in small increments was shortsighted “as foreign banks judged these amounts to be altogether inadequate, particularly for Korea’s need to meet its short-term obligations.” No wonder, then, the foreign banks “accelerated the withdrawals of their funds from Korea, thus pushing the country to the verge of a sovereign default in less than 10 days after the initial agreement was signed” (Kihwan Kim 2000, 204). Both Sachs and Kihwan Kim note that the IMF’s excessively high interest-rate policy had disastrous consequences (also see Yoo and Moon 1999, In-June Kim and Rhee 1998). The high interest rates were recommended on the rationale that they would serve to bring in foreign capital and discourage the outflow of funds – thereby stabilizing the exchange rate. However, coupled with the sharp devaluation of the won, the immediate effect of the high interest-rate policy was to increase the debt burden carried by Korean businesses. Given the fact that Korean companies were highly leveraged, the high interest rates drove an unusually large number of firms into bankruptcy. Kihwan Kim (2000, 205) points out that the IMF’s demand that Korean financial institutions meet their BIS capital adequacy ratio in a very short period of time “resulted in a credit crunch of unprecedented proportions. As all banks and financial institutions were preoccupied with the need to improve their BIS ratios, they not only ceased to make new loans but hurriedly recalled their outstanding loans as well. This, more than anything else, was responsible for the sharp contraction of economic activities during the first three quarters of 1998.”

Martin Feldstein (1998, 26–7) also severely criticized the IMF program, arguing that the traditional prescription of budget-deficit reduction and a tighter monetary policy (which together depress growth and raise unemployment) was inappropriate for Korea given the country’s balanced budget and a national savings rate that was already one of the highest in the world. He aptly states that Korea was “a case of temporary illiquidity rather than fundamental insolvency . . . what Korea needed was coordinated action by creditor banks to restructure its short-term debts, lengthening their maturity
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and providing additional temporary credits to help meet the interest
obligations... Although many of the structural reforms that the IMF in-
cluded in its early-December program for Korea would probably improve
the long-term performance of the Korean economy, they are not needed for
Korea to gain access to capital markets.” Rather, the IMF’s primary task
should have been to persuade foreign creditors to continue to lend by roll-
ing over existing loans as they came due. Given the fact that Korea had the
advantage of a relatively strong economy, this arguably would not have
been very difficult. By highlighting the fact that Korea’s lack of adequate
foreign-exchange reserves was a temporary shortage, not permanent insolv-
ency, the IMF might have been able to persuade creditors to exercise
forbearance.

As was noted earlier, the IMF was able to get the creditors to roll over
Korea’s debt until March of 1998, including getting banks to reschedule
US$21.8 billion of short-term debt into one- to three-year loans. As a result,
the share of short-term debt dropped to 30 per cent of the total external
debt, and, by the end of March, the level of usable foreign reserves had
increased to US$24 billion (Lee and Orr 1999, 100). Moreover, from the
IMF’s perspective tight monetary policy was needed to restore investor con-
fidence, and high interest rates were necessary (particularly at the outset) to
stabilize the exchange rates and restructure the corporate sector. That is, the
IMF reasoned that high interest rates were necessary to reduce the excessive
financing that was the main culprit for excessive investment by the chaebols,
and to improve the current-account balance by reducing investment and
increasing savings. Indeed, considering the need at the time to stabilize the
foreign-exchange market and strengthen the weak won through the intro-
duction of foreign capital and a general improvement in the current-account
balance, there seemed little choice other than to follow a high interest-rate
policy. Arguably, the high interest rates that the Korean authorities were
forced to maintain to encourage the markets to take up the sovereign-
guaranteed bonds helped avoid default. Moreover, they also facilitated the
stabilization of the foreign-exchange market and the rapid restoration of the
country’s creditworthiness.66 Regarding monetary policy, the IMF arrange-
ment did achieve its basic objective in curbing the depreciation–inflation
spiral.

However, in retrospect, there is little doubt that the IMF’s program
was too contractionary in the short run, thereby making it very costly to
implement structural reform. The IMF, in pursuing tight monetary policies,
while simultaneously requesting Korean banks to observe, within a short
period of time, the capital adequacy ratio set by the BIS, unleashed prob-
lems. Fearful of the penalty they would receive if they could not meet the
ratio, banks rushed to withdraw loans from companies, thereby deepening
the credit crunch and pushing interest rates up even further. This drove
many, including profitable, but highly leveraged, firms into bankruptcy.
Indeed, the increase in the cost of credit raised the firms’ debt-service burden so severely that many firms, including some that would have been financially viable under normal circumstances, were driven into bankruptcy.67 The most severely affected were the medium and small firms. The credit squeeze and excess capacity in industry negatively hit medium and small establishments, as most were heavily dependent on the chaebols for business. With the economy rapidly contracting as their big business customers cut back on production and investment, these establishments faced plummeting sales and bankruptcies. As Kwan Kim (2001, 40) notes, “during the first five months of 1998 all but 18 of the 5,239 bankrupted corporations were small firms with fewer than 300 employees. In Korea, small firms employ three times the work force of large companies.”

The economic contraction and resultant bankruptcies, in turn, lowered the capital base of banks owing to the losses – which only speeded up foreign banks’ collection of loans from the Korean banks, since they became fearful of the growing insolvency of the Korean banks.68 Moreover, the decision to permit the exchange rate to continue to float, rather than readjusting the pegs to rates deemed defensible, only opened the door to continued market depreciation. No wonder the high interest rates failed to attract foreign capital, as the credit risk involved in the payment of principal was too high, not to mention the fact that it diminished investors’ confidence in the economy, as they were concerned that the excessively high rates could push Korea’s corporate sector into insolvency. Finally, the high interest-rates policy negatively affected exports – the locomotive of the Korean economy. Kwan Kim (2001, 38) notes that “exports fell over the first seven months under the IMF regime, a decline by 13.9 per cent to $10.1 billion in July 1998 for the third consecutive month. Shipments dipped 3.5 per cent in May and 6.6 per cent in June of the same year.” The Korean case vividly highlighted the fact that the gap between domestic and international interest rates is not in itself a sufficient condition for stabilization of the exchange rate through interest arbitrage. Finally, as Sachs has noted, in Korea the budget was balanced, with a slight surplus. Therefore, the IMF prescription of budget cuts (which is the standard way to deal with irresponsible governments running large deficits in their current accounts) was not only inappropriate for Korea, but it also aggravated the crisis. Given this, it is difficult not to agree with the critics that the IMF’s fiscal austerity program for Korea was fatally misguided.

Alarmed by the sharp continuous downturn of the economy, the IMF began to rethink its program. It can be argued that the IMF even recognized its mistakes. Hubert Neiss (1998, 22), Director of the IMF’s Asia and Pacific Department, argues that the Fund’s major macroeconomic projections proved incorrect in the case of Korea because “important decisions in several complex and painful areas had to be made almost overnight and without full information.” In any case, the IMF began to soften the stringency
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of its program. Beginning with the second quarterly review of the standby arrangement, on February 17, 1998, monetary policy was eased. The fiscal target for 1998 was lowered from a surplus of 0.2 per cent of GDP in the original program (including bank restructuring costs) to a deficit of 0.8 per cent of GDP. Although monetary policy was expected to remain tight as long as the exchange-market situation remained fragile, the program, nevertheless, allowed for a gradual decrease in the interest rate and a slight increase in the growth of reserve money. As the won stabilized to the level of 1,350–1,400 won per dollar by the end of April 1998, this enabled the Korean government to lower interest rates below the 20 per cent level – after consultation with the IMF. The program was also broadened to include measures to strengthen the sahoe anjonmang (“social safety net”) by expanding the unemployment insurance system and increasing labor-market flexibility through public works and other programs, including vocational training, job placement and social protection for the unemployed. As Kang and his co-authors note (2001, 108–9), “to implement these unemployment policy measures, the government spent almost 10 trillion won in 1998... and total labor market-related expenditures expanded to 2.2 per cent of GDP in 1998.” In the third quarterly review on the standby arrangement on May 28, 1998, the conditionality of the macroeconomic policies was adjusted in order to counter the recession and to strengthen the structural reform agenda. There was agreement on easing the restrictive monetary and fiscal policy by increasing the target for the budget deficit to 4.0 per cent of GDP. In effect, the high interest-rate policy was terminated, and the real interest rate was left to find its own level. In the fourth review signed on July 28, 1998, the Korean government and the IMF agreed to ease fiscal policy further. In September 1998, in a bold move, the Korean government lowered interest rates, extended more credits to small and medium-sized enterprises, and widened the fiscal deficit to revive the economy – despite criticisms from the IMF that a premature stimulus of the economy might undermine the restructuring process. In the fifth program review, signed on November 18, 1998, the deficit target was further increased to 5 per cent of GDP.

Economic reforms under Kim Dae-Jung

As has been noted earlier, Korea’s three-year standby agreement with the IMF, approved on December 4, 1997, was for a total of US$21 billion, or 950 per cent of Korea’s IMF quota. Korea made ten drawings, totaling US$19.5 billion, under the arrangement. The last drawing was made in May 1999, and Korea was eligible to make six further drawings totaling US$1.5 billion. On August 23, 2000, the IMF completed the seventh and eighth reviews under the standby credit for Korea. The IMF’s executive board announced that, given the economic recovery, Korea did not intend to draw
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the funds still available to it (IMF 2000e). In keeping with its intent, Korea’s three-year standby arrangement with the IMF expired on December 4, 2000. By then Korea’s macroeconomic fundamentals had improved considerably, especially the current-account balances.

The sharp turnaround in current-account balances contributed towards a rapid accumulation of foreign-exchange reserves (from US$20.4 billion in December 1997 to US$52.3 billion on December 15, 1998, and US$65 billion in July 1999), thereby making the Korean economy more resilient to external shocks. Also, by August 1999, the won had appreciated nearly 30 per cent against the US dollar (in nominal terms) since bottoming out in January 1998. Just as impressive, the ratio of short-term debt dropped to 20 per cent of the total debt from more than 40 per cent in 1997, and the won–dollar exchange rate significantly declined from a high of 1,962 won on December 23, 1997 to around 1,200 for most of 1999. By March 1999, interest rates had dropped significantly from above 20 per cent to single-digit rates, and in the first quarter of 1999, total FDI was about US$2 billion – a 250 per cent increase over the first quarter of 1998. By mid-1999, unemployment had been reduced to 8 per cent (still high by Korean standards) and inflation contained. Finally, a wide range of structural reforms have made Korea’s economy more competitive and open. Significant progress has been made in stabilizing the financial system, addressing corporate distress, strengthening the institutional framework for corporate governance and financial sector supervision, liberalizing foreign investment, and improving transparency. Korea’s V-shaped recovery and reform achievements surpass those in other crisis-affected economies.

Korea’s impressive achievements are the result of a combination of factors, including the early resolution of creditor panic, the export-oriented industrial structure, the favorable external economic environment, the expeditious implementation of the IMF-mandated structural reforms – in particular, the implementation of a wide range of structural reforms that addressed the weaknesses that contributed to the crisis, the Korean government’s expansionary macroeconomic policies, and Kim Dae-Jung’s personal commitment to democracy and economic reform.

Yet Korea’s achievements have been seen by some as a vindication of the IMF policies (Chopra et al. 2001). No doubt, the Kim Dae-Jung government did more than accept the very tight monetary and fiscal policy measures requested by the IMF to defend the exchange rate. The Kim administration also collaborated with the IMF and the World Bank to devise a wide-ranging and politically difficult structural adjustment program to address the outstanding problems in the financial and corporate sectors and labor markets. Yet such claims only tell part of the story. What is not well known is that Kim Dae-Jung, along with senior government policy-makers, was actively involved in all the eight formal meetings Korean officials held with the IMF during 1998 to review the progress of the programs. They
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were hardly passive participants, but were actively involved in questioning and shaping the content of the programs. Furthermore, once the policies were agreed to, Kim Dae-Jung took an active interest to see to their effective implementation. Suffice it to note, if policies are to be effectively implemented, this requires commitment from the political leadership. Kim Dae-Jung’s unequivocal anti-chaebol world-view and strong belief that “the economic crisis in South Korea was due to the collusive relationship between the government and business, the state-controlled financial sector, and the octopus-like overexpansion of the big business conglomerates” explains the zeal and determination with which his administration has attempted to reform the Korean economy.70 Moreover, the fact that Kim Dae-Jung brought to his administration a number of key advisors with strong anti-establishment views greatly strengthened his capacity to move ahead with difficult reform measures.

The Kim Dae-Jung administration’s achievements are all the more impressive in light of the fact that the conditions surrounding Kim Dae-Jung’s electoral victory did not appear particularly auspicious for effective crisis management or for the formulation and implementation of reformist macroeconomic policies. Kim Dae-Jung ran as an unsuccessful presidential candidate three times, in 1971, 1987 and 1992, before he finally won the office of president on December 18, 1997. However, the margin of his victory was paper-thin. With 80.7 per cent of all qualified voters participating, Kim Dae-Jung received 40.3 per cent, Lee Hoi Chang 38.7 per cent, Rhee In-Je 19.2 per cent, and the labor leader Kwon Young-Gil 1.2 per cent of the votes. Thus, Kim Dae-Jung’s victory over Lee Hoi Chang was only about 391,000 votes out of the over 26 million votes cast (Oh 1999, 231). Moreover, Kim Dae-Jung’s party, the National Conference for New Politics (NCNP), remained essentially a minor party in the National Assembly, with only 78 of the institution’s 299 seats. On the other hand, Lee Hoi Chang’s Grand National Party (GNP) controlled a comfortable majority in the parliament, with 161 seats. However, Kim’s victory was possible because of a split within the ruling party and an unlikely alliance between Kim Dae-Jung’s NCNP and the conservative Kim Jong Pil and his United Liberal Democrats (ULD).71 However, the ULD delegation held only 42 seats, “and so to further buttress the coalition’s parliamentary standing the Kim government also engaged in efforts to get members of the GNP to defect” (Hong Nack Kim 2000, 895). Such actions, coupled with the NCNP’s marriage of convenience, raised the possibility of intra-coalitional conflict and gridlock. Indeed, from his first day in office, Kim Dae-Jung’s ruling coalition faced a divided government, with the former ruling Grand National Party (GNP) holding a legislative majority. It was only in September 1998 that the ruling coalition secured a majority in the National Assembly “by enticing a large number of opposition lawmakers to defect” (Hong Nack Kim 2000, 895).
Given these formidable challenges, what explains why the Kim Dae-Jung administration was relatively successful in implementing measures to reform the Korean economy and the chaebols, where his predecessors had failed? No doubt, while economic crises coupled with externally-driven pressures (such as the IMF mandates) provide opportunities to implement major reforms, in the case of Korea, there is consensus that Kim Dae-Jung skillfully used every opportunity to pursue reforms. As Haggard (2000, 101) notes, “Kim Dae-Jung was able to make substantial progress on his program by exploiting the crisis and his political assets wisely at the outset of his administration.” For a start, as the perennial political outsider Kim Dae-Jung had little problem in portraying himself as a man of the common people, who was above the fray of partisan politics, and who represented the aspirations and interests of the working people against the sectarianism and self-interested machinations of traditional politicians. In fact, of the key party leaders, only Kim Dae-Jung could completely distance himself from the discredited Kim Young-Sam, and indeed, from earlier governments. This he did with great deftness. Second, Kim Dae-Jung’s international reputation as a champion of human rights and democracy served him well. As Bridges (2001, 41) notes, Kim Dae-Jung’s warm relations with world leaders, including President Clinton, the Japanese prime minister Hashimoto Ryutaro and the financier George Soros “worked wonders in transforming international perceptions of Kim Dae-Jung in a favorable direction.”

Perhaps more importantly, Kim Dae-Jung’s robust in-charge approach and decisive actions during the interim period between his election (December 18, 1997) and inauguration (February 25, 1998), inspired confidence and greatly diminished the perception that there was a power vacuum at the center during the transition period. For example, just two days after the election, Kim Young Sam and Kim Dae-Jung met and formed a joint 12-member Emergency Economic Committee (ECC). Haggard (2000, 101) notes that “For the two months before the inauguration, this body made up of six members from the outgoing and incoming governments but effectively under the president-elect’s control, served as the de facto economic cabinet.” Kim’s coalition (NCNP and ULD) and the majority GNP also agreed to convene a special session of the National Assembly to deal with a series of reform bills required under both the original IMF program and its December 24 revision. Not only did these institutional arrangements provide effective leadership during the immediate crisis period, but Kim Dae-Jung also used this transition period to push through important financial reform legislation that had been stalled under the previous government.

Moreover, the president-elect cooperated with the outgoing government and ruling party to get legislative backing for several important reform measures. In particular, the delegation of substantial powers to the newly-created Financial Supervisory Commission (FSC) greatly enhanced the government’s powers. The FSC, in exercising de facto control over the entire
banking system, including control over the allocation of credit, provided the government with substantial leverage over the chaebols. Finally, unlike his immediate predecessor, Kim Dae-Jung turned out to be decisive, and with a clear grasp of the causes of the crisis. His apt observation that “past government failures” and the “collusive links between companies and politicians” lay at the heart of Korea’s crisis resonated with the Korean public (Dae-Jung 1998, 280). Fully cognizant of this, Kim Dae-Jung shrewdly exploited the intense unpopularity of the chaebol management and the chaebols’ financial weakness to formulate and implement an ambitious agenda of corporate restructuring. In fact, well before his inauguration, Kim Dae-Jung reached an agreement with chaebol leaders regarding plans to restructure and reform their companies. He outlined an ambitious program to achieve his desired goals. As Mathews (2001, 166) notes, Kim Dae-Jung “showed that he meant business by calling a meeting of the country’s top five business leaders – the heads of the leading chaebol – in January 1998, only three weeks after his election and six weeks before his inauguration, to secure their agreement to a binding five-point undertaking.” The agreement committed the chaebols to: (1) producing consolidated balance sheets, prepared according to international accounting standards, (2) terminating the cross-divisional payment guarantee system for raising loans, (3) requiring affiliates to perform profitably, and merging or divesting those that are not profitable, (4) promoting partnerships between the chaebol and small and medium-sized enterprises, (5) committing the chaebol leaders to place their personal wealth into their companies to improve their equity base. Thus, Tan (2000, 197) notes that “much of the improvement in South Korea’s economic performance was due to the dogged determination of President Kim Dae-Jung to force economic reforms on the chaebols and the country’s ailing banks.”

Bridges (2001, 73–81), has noted that Kim Dae-Jung used both the “carrot” and the “stick” strategies to reform the chaebols. Immediately following inauguration, the Kim Dae-Jung government pushed for revision of the Outside Auditor Law to facilitate the adoption of consolidated financial statements and to require that all firms establish an “outside auditor selection committee” and report combined financial statements in accordance with international standards, beginning in 1999 (Sunhyuk Kim 2000, 167). Furthermore, since cross-guarantees allowed loss-making affiliates and subsidiaries with chaebol groups to continue to borrow from banks and drain financial resources from healthier firms, on April 1, 1998 the government (1) prohibited any new intra-chaebol mutual payment guarantees and ordered the phasing-out of the existing guarantees by March 2000, and (2) directed banks to negotiate financial restructuring agreements with chaebol groups to reduce any outstanding debts, including closing insolvent firms. No doubt, the government’s commitment to introduce internationally accepted accounting practices, including independent external audits, full disclosure, and
submission of consolidated statements by conglomerates, will help to improve the transparency of corporate balance-sheets.

Despite the various attempts by chaebols to undermine, if not sabotage, the reform efforts, the administration’s steadfast commitment to reform did not falter. On the contrary, the government, both symbolically and literally also played hard-ball by “using the stick.” For example, since the restructuring of the top 5 chaebols was viewed as too complex for either the courts or the banks by themselves, the government required them to restructure “on their own” through “voluntary capital structure improvement plans” (CSIPs) that were agreed by the banks, the government and the chaebols. However, by September 1998 – after several rounds of delays by the top 5 chaebols in submitting their revised CSIPs – the government issued an ultimatum. Failure to move on their restructuring plans would result in credit sanctions. Moreover, the government began to “increase pressure on the top 5 chaebols to engage in what became known as the ‘big deals’ – or the idea that the chaebol should reduce their level of horizontal diversification and concentrate on their ‘core businesses’” (World Bank 1999, 103). Under this program, the five largest chaebols agreed to swap major lines of business among themselves to consolidate excessive and duplicative investments while simultaneously achieving greater economies of scale and “industrial rationalization.” As Meredith Woo-Cumings (2001, 367–8) observes, “the democratic government of Kim Dae Jung did not shy away from using strong-arm tactics to bring about the desired results. When LG Group decided to pull out in the midst of merger negotiations, objecting to Hyundai taking the controlling share, the Financial Supervisory Commission immediately called in LG Group’s creditors to discuss punitive measures, including immediate suspension of credit and recall of existing loans. On top of that, the government threatened to conduct a tax probe.”

In the end, LG Group agreed to the merger, relinquishing management control and selling its semiconductor business to Hyundai. Similarly, Samsung was encouraged to sell its automotive operations to Daewoo. Other “big deals” included the sale of Hyundai and Samsung power-generation businesses and Samsung’s ship-engine operations to Korea Heavy Industries, the acquisition of Hanwha’s oil-refining operations by Hyundai, the merger of Samsung, Daewoo and Hyundai’s aerospace operations, and the merger of Samsung General Chemicals and Hyundai petrochemicals. Some of these deals were accomplished at the cost of some of the chaebols’ (in particular, Hyundai and Daewoo) taking on substantial additional debt to finance the acquisition.

While there have been improvements in the area of transparency, and debt-reduction and the cross-debt guarantees among chaebol affiliates in unrelated industries have been reduced, it remains to be seen if the “big deal” concept reduces the surplus capacity or improves competitiveness. Negotiations have been plagued by sharp differences over the valuation of assets, problems about how the different operations can be
effectively integrated, and uncertainty over the final corporate form the new entities would take. Also, the proposed swaps will require huge public funds to enable creditor banks to swap debt for equity, and therefore have the potential of “giving the chaebols back door access to public funds to reduce their large debts” (Tan 2000, 195). Despite these challenges, the government has been modestly successful in getting the chaebols to change their ownership structure by separating ownership from management. Furthermore, there has been reform in chaebol corporate governance through consolidated financial statements, independent external audits and reduction of intra-group mutual payment guarantees. Chaebols have also streamlined their operations by reducing their excessive leverage and consolidating their many operations in a few core competencies. Some have also reduced their debt burden and increased their profitability.

In December 1998, the top 5 chaebols finally submitted their revised CSIPs. These were approved by the government and the lead banks in January 1999. The top 5 chaebols agreed to: (1) reduce the debt-to-equity ratio to 200 per cent by the end of 2000; (2) be subject to sanctions if they failed to meet the deadline; (3) reduce the number of subsidiaries and affiliates and remove existing cross-guarantees between subsidiaries engaged in different lines of business; and (4) raise new equity and sell off affiliates. While the implementation of these measures is to be spread over the next several years, the government, to its credit, has been aggressively following up on them. By the end of 1998, the top 5 chaebols reduced their combined debt-to-equity ratio to 386 per cent, down from 470 per cent at the end of 1997. Overall, the CSIP implementation review (released in the first quarterly review for January–March 1999) reported that while the top 5 made satisfactory progress in reducing cross-debt guarantees and improving corporate governance standards, they were still lagging behind in meeting their pledges on asset sales, divestitures, foreign capital inducement and debt reduction. The review also noted that while LG and SK (formerly Sunkyung) made important progress in improving their capital structure and debt–equity ratios via asset sales and strategic alliances with foreign investors, Daewoo (Korea’s second largest chaebol) and Hyundai had not. Rather, Hyundai increased its debt to 79 trillion won (US$66 billion) in 1998, and its debt/equity ratio at the end of 1998 rose to 769 per cent – excluding asset revaluations (World Bank 1999, 106).

At the end of 1998, the Daewoo group had 37 affiliates and 253 overseas units. Among the affiliates, Daewoo Corporation, Daewoo Heavy Industry, Daewoo Motor and Daewoo Electronics accounted for 82 per cent of the group’s total assets. The 37 affiliates employed over 96,000 people. However, Daewoo imprudently assumed some 17 trillion won in additional debt in 1998. Thus, Daewoo’s debt-to-equity ratio increased sharply from 474 per cent at the end of 1997 to 527 per cent at the end of 1998 and to 588 per cent at the end of June 1999. By July 1999 it became clear that Daewoo...
could no longer continue to roll over its considerable short-term debt burden. Clearly, the prolonged and ultimately unsuccessful negotiations with both foreign and domestic groups regarding restructuring led Daewoo to near bankruptcy in mid-1999. Compounding this, Daewoo’s failure to address core problems, including acquiring debt-laden Ssangyong, further increased its debt to equity ratio. No doubt, Daewoo presented the government with the substantial dilemma of being “too big to fail.” Fearing that systemic risk from a Daewoo bankruptcy could undermine financial stability, the government urged creditors to roll over Daewoo’s short-term debt. However, the urging proved insufficient. Finally, under growing pressure to save Daewoo, the government stepped in to work with creditors to prepare an emergency financing package (worth US$14 billion) predicated on a substantial restructuring plan. As part of the package, Daewoo was required to adopt an accelerated restructuring program, including asset sales, raising of more equity, debt-for-equity swaps and a break-up of the chaebol into several independent corporate entities. Daewoo was also required to put up new collateral of 10 trillion won, including 1.3 trillion won of Daewoo Chairman Kim Woo-Chung’s personal shareholdings – which creditors would be free to sell if Daewoo failed to live up to its commitments under the agreed restructuring and financing plan. In spite of all this assistance, Daewoo could not be saved. With roughly US$80 billion in debt, Daewoo went bust in late 1999 – resulting in the largest corporate bankruptcy in South Korea’s history. No doubt, the decision by the Kim Dae-Jung government to let Daewoo fail emphatically demonstrated that the government was prepared to make difficult decisions and that no chaebol now was “too big to fail.”

The ability of creditors to force a number of large chaebol into receivership and to take control of Daewoo should help deter imprudent corporate investments in the future.

Arguably, with the Daewoo mess on his mind, President Kim made a forceful address to the nation on the 54th anniversary of National Liberation on 15 August 1999. He stated that “without restructuring the corporate giants, the chaebol, the most problematic element in our economy, the economic reforms cannot be completed . . . I am determined to go down in Korea’s history as a President who first accomplished corporate reforms” (Kim Dae-Jung, 1999, 533). Soon after, a second agreement was reached between the top five chaebols, the government and the creditor banks. Under the terms, the chaebols agreed to a series of potentially far-reaching reforms, including increased transparency, greater accountability and independent subsidiaries with professional managers in control. The agreement also poses a real threat to founding family control of the chaebols by requiring enforcement on inheritance tax, among other things.

As for the sixth to the sixty-fourth chaebols (or the so-called 6–64 chaebols), restructuring has been carried forward through the “voluntary workout program.” These workouts have been nominally organized around the
so-called London rules, a voluntary extra-judicial process under which banks reschedule debt obligations in return for restructuring plans that include asset sales, closure of business lines, and other operational and organizational restructuring measures. To address the debt overhang problem of the most troubled chaebols, a Corporate Restructuring Agreement (CRA) was signed in June 1998 by some 200 Korean banks and non-bank financial institutions which committed them to follow agreed workout procedures. These procedures included the appointment of eight lead banks to negotiate the workouts with the major corporate groups, and the establishment of an arbitration and quality-control body in the form of the Corporate Restructuring Coordination Committee (CRCC). The CRCC, besides helping resolve disputes among creditors or between creditors and debtors, also has the authority to act as an arbitration committee in the case that the banks cannot agree on a workout strategy among themselves, or when the lead bank and the debtor fail to come to an agreement. The FSC monitors the workouts agreed under the CRA to ensure consistency with the guidelines issued for the workouts. If a CRA signatory fails to comply with an approved workout agreement or a CRCC arbitration decision, the CRCC can impose penalties. Between June 1998 and mid-1999, some 90 companies had applied to the formal workout program within the CRCC (Lieberman 1999). Despite these accomplishments, a large number of companies are still in deep distress, and several are close to insolvency. Much of the corporate sector remains highly leveraged by international standards and continues to suffer from low profitability.

Unlike what happened in Indonesia or Thailand, bank closures in Korea did not result in a massive flight of depositors. In January 1997, the authorities introduced a deposit insurance scheme funded by low-premium contributions from banks. The scheme provided for full coverage of all deposits not exceeding 20 million won per individual depositor. In mid-November 1997, the government announced that it would guarantee all deposits of financial institutions until the end of 2000. The blanket deposit guarantee succeeded in reassuring depositors – despite the delays in repaying depositors at the start of the process. Nevertheless, since one of the main sources of corporate failure in Korea was the weak financial system, financial institutions have assumed a leading role in corporate restructuring.

In early 1998 the Kim Dae-Jung administration amended the bankruptcy laws simplifying legal proceedings for corporate rehabilitation and bankruptcy filing, streamlining provisions for non-viable firms to exit markets, and improving credit bank representation during resolution. In the first round of financial sector restructuring, the government committed 64 trillion won (roughly US$53 billion) in April 1998 to recapitalize financial institutions, pay deposit and credit claims of bankrupt institutions, and reduce the level of non-performing loans. When most of this fund had been exhausted by the end of 1999, the government’s commitments for financial
sector restructuring had reached 74 trillion won. In early December 2000, an additional 40 trillion won (US$33 billion) of public funds was approved to complete the second round of financial sector restructuring (IMF 2000f).

Second, in December 1997, following portfolio reviews of merchant banks and their rehabilitation programs, the government closed 14 merchant banks and required the other 16 to follow a timetable to achieve capital adequacy ratios of at least 6 per cent by the end of June 1998 and 8 per cent by the end of June 1999. Of the 26 commercial banks, two institutions (Korea First Bank and Seoul First), accounting for 40 per cent of commercial bank assets, were quickly sold off. In January 1998, in a dramatic show of its commitment, the Kim government nationalized Korea First and Seoul and sold them to foreign investors. The 12 banks that failed to meet the capital requirements were either merged into healthier banks or recapitalized with government fiscal support (World Bank 1999, 17). In May 1998, it was agreed that the restructuring of non-bank financial institutions (NBFIs) such as securities houses, investment trust companies, leasing companies and insurance companies were to be carried out under the responsibility of the major shareholders. However, if the institution’s liabilities exceeded its assets, the institution is to be ordered to reinstate its financial strength through measures such as recapitalization or merger. However, if it still fails to meet the minimum capital adequacy requirements, then the Financial Supervisory Commission (FSC) – which succeeded the bank supervisory function from the Bank of Korea – could decide to suspend its operation and transfer assets and liabilities to another institution. The FSC can do this, since it has operational autonomy and can license and de-license financial institutions.

In May 1998, a group of creditor banks established a formal review committee to assess the viability of 313 client firms with weak capital structure. The committee have agreed no longer to extend credit to insolvent firms, and to prevent bailouts from affiliated companies. Further, in June 1998, 5 out of the 33 commercial banks deemed non-viable were allowed to be acquired by 5 stronger banks, while 7 undercapitalized banks were required either to merge with healthy banks or to arrange mergers among the undercapitalized banks with government assistance. The FSC ordered the five non-viable banks to undergo a “transfer of businesses” under a purchase and assumption (P&A) arrangement. That is, the government offered incentives for acquiring banks. Under the P&A arrangement, a closed bank could transfer only performing assets to an acquiring bank, and non-performing loans to the newly established KAMCO or the Korea Asset Management Corporation (to be discussed later). However, if the failed bank’s total liabilities exceeded total performing assets, the Korea Deposit Insurance Corporation (KDIC) would pay the difference. In addition, the acquiring bank would be allowed to exercise a put-back option that permitted the bank to resell to KAMCO the non-performing loans that occurred within six months of the P&A transaction. By the end of 1998, the
Kim Dae-Jung administration had committed almost US$50 billion in additional public funds to bank recapitalization, deposit protection and the purchase of non-performing assets. As most merchant banking corporations were forced to exit the market, their number plunged to just four at the end of June 2001 from 30 at the end of 1997. Also, seven securities companies, seven investment trust management companies, 11 insurance companies, and 118 mutual savings and finance companies were also liquidated or merged during the same period.

While these measures have brought a modicum of stability to the financial markets, the banking system remains fragile. Many financial institutions are still effectively owned by the government – which is desperately trying to consolidate weak banks under a financial holding company or to merge them with healthier institutions. Further, Korea’s financial system remains vulnerable, as an estimated 20 per cent of bank loans are non-performing. As Noland (2001, 2) notes, “on a scale of A to E, with A indicating a system of exceptional financial strength and E indicating a system with very weak intrinsic financial strength and in which many banks will likely require outside support such as from the government, at the end of 2000 the ratings agency Moody’s assigned the South Korean banking system an E+, worse than Mexico’s and on the same level as China’s. Over the long term, since much of the banks’ portfolios are tied up in credits to large chaebols, viable and profitable companies are critical for the banks’ full recovery”.

Nevertheless, the Korean government’s financial sector restructuring efforts have strengthened banking supervision and regulation and created an environment where market discipline plays an increasingly important role. Notable progress has been made in raising banks’ capital ratios – which in a number of cases now exceed the minimum standards recommended by the Bank of International Settlements. Korea is now close to meeting international best practice. In addition, measures have been adopted to strengthen prudential regulations in the areas of loan classification and provisioning, foreign-exchange liquidity, large exposures and connected lending. Recognizing that foreign ownership and management of banks can play an important role in recapitalizing banks, increasing competition in financial markets and improving the overall management of banks, the government approved (in December 1997), full foreign ownership of merchant banks, besides allowing non-resident purchases of equity in banks and other financial institutions.

To deal with the non-performing loans problems, and in particular to minimize the impact on creditors (i.e. companies that borrowed from these banks), the government established a “bridge merchant bank,” Hanareum Banking Corporation (HMBC) in December 1997 to assume all deposits and selected liabilities and to accept in payment the “good” financial assets of the suspended merchant banks. The HMBC was only temporarily to assume some of the debt held by the suspended banks, until they could be
liquidated, merged or sold. Moreover, the Korean government did not directly commit resources to recapitalize merchant banks in view of their small size and the fact that many are owned by chaebols. Rather, any assets and liabilities remaining after the transfer to HMBC were sent for bankruptcy.

To deal specifically with the problem of increasing non-performing loans, the government established a special institution in November 1997, the Korea Asset Management Corporation (KAMCO), modeled after the Resolution Trust Corporation in the United States. Like the Resolution Trust Corporation during the US savings and loans crisis, KAMCO is designed to deal with the resolution of bad loans of commercial banks and merchant banking corporations. Specifically, KAMCO operates by purchasing non-performing assets from banks and merchant-banking corporations. KAMCO buys bad loans according to a rough estimate of the discount price – which varies from 30 per cent for loans with collateral to 80 per cent for those without. After a thorough assessment of the market value of the loans, KAMCO settles with the bank to account for the differences between the initial purchasing price and the new assessment price, if any. Also, KAMCO is empowered to purchase impaired assets (such as collateralized non-performing loans) from all financial institutions covered by the deposit guarantee and sell them off to domestic and foreign bidders. By December 12, 1997, the funds initially available to KAMCO amounted to 20 trillion won, with 3 trillion won provided by the Bank of Korea and other financial institutions, and the remainder obtained by bond-issuance. In order to enhance transparency, KAMCO is required to audit and publish its accounts on a semi-annual basis.

By June 1999 KAMCO had purchased non-performing loans with a face value of 46 trillion won for 20.3 trillion won. It also moved away from its fairly easy stance concerning asset purchases, and, in accordance with the agreement with the IMF, announced that any future asset purchases and disposal of non-performing loans by KAMCO would be made only for those financial institutions whose rehabilitation plans are approved by the FSC. KAMCO injects new capital into the banks in the form of interest-bearing government-backed securities. Its resources are financed by issuing its own bonds of 32.5 trillion won and by disposing of purchased assets through direct sale or asset-backed securities. The KAMCO bailout funds, along with the Korea Deposit Insurance Corporation (KDIC) constitute the fiscal support base of the financial sector restructuring process.

To facilitate liberalization, in April 1999 Korea abolished the regulatory Foreign Exchange Management Act and introduced instead the Foreign Investment and Foreign Capital Inducement Act. The new act effectively eliminated most restrictions on foreign-exchange transactions and on domestic transactions in foreign currencies for businesses and financial institutions. Overall, the new act has greatly improved the business environment for foreign direct investment. For example, under the act, most restrictions on
foreign-exchange transactions and on domestic transactions in foreign currencies for businesses and financial institutions have been eliminated. Domestic businesses now have more financing options, such as credit transactions for exports and imports or medium- and long-term foreign borrowing. Korean exporters are now able to establish their own trade-finance corporations, and payments for goods and services within Korea can be made with foreign currency. Beginning in 2001, all remaining foreign-exchange transactions have been liberalized, allowing individuals to deposit their money into foreign-based banks and to buy foreign securities or real estate. In addition, new regions are to be developed and opened to foreign investors. For large investments that entail “significant development benefits for underdeveloped areas,” the Korean government will provide infrastructure and basic facilities. FDI in such areas will enjoy tax exemptions. By the end of 1998, restrictions on foreign investment in the equity of domestic companies, foreign takeovers of management, and foreign land ownership had mostly been eliminated. Also, to facilitate investment and prevent selective treatment, the remaining restrictive regulations related to foreign investment have been streamlined and unified into a single legal framework under the Foreign Investment Promotion Act. Indeed, the investment procedures have been greatly simplified. Foreign investors will need to notify only Korean banks or the Korea Trade-Investment Promotion Agency (KOTRA). The Korea Investment Service Center (KISC), set up within KOTRA, will provide a one-stop service for foreign investors. KISC, which has close links with both the central and regional governments, will provide both pre-investment consulting services and post-investment follow-up services.

Finally, increasing flexibility in the labor market is necessary to solve Korea’s economic inefficiency. Thus, enhancing labor-market flexibility has been a key goal of Korea’s structural reform. Kim Dae-Jung was instrumental in forging corporatist agreements with business, labor and the government in order to get them to work together to resolve the country’s financial woes. Arguably, it was Kim Dae-Jung’s long history in the opposition, his well-known pro-labor views and his overall populist credentials that enabled him to get Korea’s mobilized and militant working-class constituency to accept the austerity requirements of fiscal stabilization. However, once in place, these agreements placed public pressure on both business and labor to make concessions and provided the basis for subsequent legislation. As Yong Cheol Kim and Moon (2000, 62) note, “in order to persuade labor to join the talks, Kim Dae Jung urged big business to share the burden and pain through corporate restructuring and downsizing. Public pressure made it impossible for labor to refuse to join the council. On 14 January [1998] the Labor–Employer–Government Consultative Council was formally launched to ensure a fair burden sharing in coping with the economic crisis.” On February 9, 1998 the council announced a “Social Agreement for the Overcoming of the Economic Crisis,” reflecting the grand compromise between
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labor and business on difficult issues concerning layoffs and restructuring. After the successful tripartite consultative negotiations between labor, business and government, the Labor Standards Act was amended by the National Assembly on February 13, 1998. Under the new accord, business promised to ensure transparency in its management and to take prudent measures in laying off its employees. Specifically, the law now provides legal grounds for employment adjustment. The law permits layoffs if a company has duly considered the interests of its workers. Labor, on the other hand, agreed to the implementation of flexible worker layoffs for the purposes of restructuring, and pledged to make every effort to enhance productivity and cooperate with business on wages and working hours. In return, the government has committed itself to strengthening its support programs by providing vocational training and information on re-employment. To adjust labor supply in accordance with changing market environments, new employment options such as temporary work, part-time employment and work at home are being developed. For example, in order to deal with the expected large-scale layoffs from the restructuring process, the government pledged to strengthen and expand the coverage of unemployment insurance.

The government responded by more than tripling its expenditure on social protection. Outlays on social protection were increased from 2.6 trillion won (0.6 per cent of GDP) in 1997 to 9.1 trillion won (2.0 per cent of GDP) in 1999 (World Bank 1999, 35). The budget allocation for the employment insurance fund, including funds for more training and employment stabilization, tripled from 0.7 trillion won to 2 trillion won (Yong Cheol Kim and Moon 2000, 64). Overall, the government committed some 8.4 trillion won in 1998 to fund public work programs and the extended unemployment insurance coverage. In 1999 a total budget of 16 trillion won was allocated for unemployment policies, of which 6.5 trillion won went to create jobs in the private sector, 2.5 trillion won to create public works jobs for 300,000 people, 0.5 trillion won to support firms that retained employees, 1.1 trillion won to support vocational training and job placement, and 5.4 trillion won to support the social safety net (Kang et al. 2001, 109). This caused the government budget for social safety nets to increase sharply. However, what is important to note is that the government did not simply throw money at the social programs, but took precautions to design a social safety-net program that was effective. Specifically, the government used three main instruments of social protection to help the most vulnerable sectors of society: the unemployed, the poor and the elderly. First, it expanded its nascent unemployment insurance program by including all firms (from the original firms with more than 30 employees), shortened the contribution period required for eligibility, and extended the duration of unemployment benefits. This expanded the eligible workforce from 5.7 million workers at the beginning of 1998 to 8.7 million at the end of the year. Beneficiaries increased tenfold, from around 18,000 in January 1998 to
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174,000 in March 1999. Yet this still only constituted 10 per cent of the unemployed workforce. Second, since most of Korea’s jobless did not benefit from the expansion of unemployment insurance, the government introduced a temporary public work program in May 1998, enrolling 76,000 workers. By January 1999, the program was providing 437,000 jobs. By the first quarter of 1999, the public work program was benefiting around 2.5 times as many people as the unemployment insurance program. Third, in May 1998 the authorities introduced a temporary livelihood protection program with funding to cover 750,000 beneficiaries. It also introduced a means-tested non-contributory social pension for 600,000 elderly people (World Bank 2000d, 167–77). The Korean case shows that the worst-hit victims of the crisis can be sheltered without compromising macroeconomic reforms.

Concluding observations

In hindsight, a number of lessons can be drawn from the Korean financial crisis. First, it is clear that a well-functioning financial sector and an effective financial supervisory apparatus is critical – especially in this era of capital mobility. Second, prudence is necessary when opening the capital account. As Mexico before it, Korea opened its capital accounts without having in place the necessary supervisory and prudential structures. Third, Korea’s experience illustrates the negative consequences of short-term foreign debts and relying heavily on short-term foreign borrowing to finance long-term domestic projects. Fourth, Korean policy-makers and the chaebols bear much responsibility for failing to respond to the economic challenges the country was facing. Instead of making massive investments in redundant projects, they should have first made more efforts to upgrade their firms’ economic structure through investments in technology and human resource development – and most importantly, to improve their firms’ productivity and profitability. Thus the Korean case underscores the proposition that the private sector can make mistakes in its investment decisions. Indeed, the Korean crisis was as much a case of market failure as of government failure. However, this should mean that in their efforts to reform the chaebols, the authorities significantly constrict the chaebols’ freedom of operation. In this era of globalization, the chaebols with their international networks, brand names and marketing expertise have the potential to contribute greatly to the Korean economy. Finally, and as noted earlier, the Korean case suggests that the gap between domestic and international interest rates is not in itself sufficient condition for stabilization of the exchange rate through interest arbitrage. In addition, in a country like Korea, where savings rates are already very high, seeking currency stability through high interest rates with the intention of curtailing consumption and boosting savings is subject to severe limits.
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Despite the severity of the crisis in Korea, there was little nostalgia for a return to authoritarian rule. The Korean case illustrates the fact that even weak democracies have the capacity to provide critical leadership and deal with major socioeconomic and political challenges. Indeed, as Mo and Moon (1999a, 158) note, "democracy provided unexpected opportunities for economic reform." Because of his longstanding commitment to democracy, Kim Dae-Jung has enjoyed a great deal of goodwill and support from foreign investors and allies (especially the US government), who wanted him to succeed. Domestically, too, democracy gave legitimacy and credibility to the government’s reform efforts. Kim Dae-Jung’s apparent success in reforming the Korean economy shows that democracy can be compatible with economic reform.

Yet over the long term Korea will need to forge stable political coalitions in favor of reform. This prospect does not seem likely any time soon. The parliamentary elections held on April 13, 2000 once again resulted in a deeply divided parliament, as no party won a majority. The opposition Grand National Party (GNP) won 133 seats – which gave it a plurality in the 273-member National Assembly, but left it 4 seats short of an absolute legislative majority. Kim Dae-Jung’s NCNP – whose name was now changed to Millennium Democratic Party (MDP) – came second, with 115 seats and 35.9 per cent of the popular vote. Kim Jong-pil’s United Liberal Party (ULD) came third, winning 17 seats. In such an environment, getting working coalitions committed to reform will be difficult. Moreover, the various corruption scandals (although neither Kim Dae-Jung nor his family members have been implicated in any) have certainly diminished the presidency, and the popular disillusionment with politics will make it difficult to maintain the public pressure for reform. Yet economic reforms in Korea will remain (for the foreseeable future) a work in progress. Kim Dae-Jung started the progress. As his term runs out in February 2003, it will be up to others to carry on the work his administration embarked on with such determination.

Notes

1 Kim Dae-Jung as quoted in Chosun Ilbo (cited in DeRosa 2001, 133).
2 In Korea, the distribution of total income has been fairly equitable. This has led to a dramatic improvement in living standards. According to the World Bank (2000a), “life expectancy at birth increased from 53.9 years in 1960 to 71.5 years in 1994. The adult literacy rate, already high by Third World standards in 1970 (88 per cent) reached 98 per cent in 1994. The percentage of total population with access to safe water grew from 66 per cent in 1975–80 to 93 per cent in 1990–96. The infant mortality rate (per 1,000 live births) was reduced from 85 in 1960 to 10 in 1994.”
3 South Korea became the twenty-ninth member of OECD on December 12, 1996.
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4 For details, see World Bank (2000a) and Bustelo (1999, 163). DeRosa (2001, 129–30) aptly notes that “by the middle of the 1990s, South Korea had established a serious competitive foothold against Japan’s export-oriented industries, examples being steel milling, shipbuilding, automobile manufacturing, and consumer electronics. South Korean construction companies had a presence everywhere that development was taking place; somehow it seemed that South Korean companies always managed to be the winning bidder for the big projects like airports, hospitals, and public housing. South Korea was beating Japan and the rest of the industrialized countries at their own game.”

5 For example, the 3-year corporate bond yield (the benchmark interest rate) declined from an average of 15 per cent during 1990–95 to 12 per cent in 1996. For details, see World Bank (1999).

6 Data are compiled from the Bank of Korea (1998) and Hahn (1999).

7 In the World Bank classification, a country is “less indebted” when the debt/GNP ratio is less than 48 per cent; “moderately indebted” when the ratio is between 48 per cent and 80 per cent; and “severely indebted” when it is over 80 per cent.

8 Jay Choi (2000, 4) notes that “in Korea, the economic planning minister pronounced, as late as November 1997 – several months after Southeast Asia had already fallen and less than a month before Korea had to seek assistance from the IMF – that Korea would not fall because of strong macroeconomic fundamentals.”

9 The emergency financing mechanism (EFM) was established in September 1995. The EFM strengthened the IMF’s ability to respond quickly in support of a member country facing an external financial crisis and seeking financial assistance from the IMF in support of a strong economic adjustment program.

10 The “first national shame day” was Korea’s annexation by Japan in 1910. The quotations are from Nicholas Kristof, The New York Times, November 22, 1997, p. B2. It is important to note that all the three political parties and presidential candidates, Rhee In Je, Lee Hoi-Chang (the ruling party candidate) and the long-time dissident, Kim Dae-Jung (who was slow to embrace the IMF package), all finally acceded to the IMF demands. In fact, because the crisis occurred in the middle of the presidential election campaign, the IMF made a very unusual request for a written endorsement of the IMF program from the three major presidential candidates. All three endorsed the program. Kim Dae-Jung was elected president for a five-year term on December 18, 1997.

11 The concept of “reputational externalities” was developed by Richard Zeckhauser (1986).

12 Chaebols are conglomerates of many companies clustered around one holding company. The parent company is usually controlled by one family. That is, the company founder and his family on average own about 10 per cent, and through cross-shareholdings control another 30 per cent to 40 per cent, of the group member firms in the top thirty chaebols. In 1998, the top 40 chaebols grouped a total of 671 companies.

13 In a televised speech given on 6 January 1995, President Kim Young-Sam stated, “Fellow citizens, globalization is the shortcut which will lead us to building a first-class country in the 21st century. This is why I revealed my plan for globalization and the government has concentrated all of its energy in forging
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ahead with it. It is aimed at realizing globalization in all sectors – politics, foreign affairs, economy, society, education, culture and sports. To this end, it is necessary to enhance our viewpoints, way of thinking, system and practices to the world class level... we have no choice other than this.” (Cited in Samuel S. Kim 2000, 1.)

15 The large stockholders were mostly big business owners who had been accused of illicit wealth-accumulation.
16 The profitability of commercial banks has been low because the “policy loans” they were obliged to extend were at rates that were lower than prime rates.
17 It is important to note that while “there were a large number of foreign banks – about 80 in the 1990s – they operated under restrictions on branching at least until the late 1980s. This meant that the government-owned commercial banks tended to dominate domestic financial transactions” (Ariff and Khalid 2000, 62).
18 The so-called “policy loans” were offered to private businesses at an interest rate substantially lower (by one-half to one-third) than regular bank loans.
19 Kihwan Kim and Leipziger (1997, 158) note that “the interesting fact about KOTRA is that it was not government financed. It was supported by the exporters themselves, although it was clearly an instrument designed to achieve government objectives.”
20 Under Yushin Honbop (Yushin meaning “revitalizing reforms”), under which the Korean constitution was amended by Park-Chung Hee (in 1972) to strengthen his presidential powers and abolish the limit on presidential tenure.
21 Indeed, the National Investment Fund (NIF) was created in 1974 for the purpose of raising funds. The NIF was funded by the compulsory deposit of savings from pensions, savings and postal savings accounts, and by other purchasers of NIF bonds, such as life insurers.
22 The quotation is from Campos and Root (1996, 91). Also, Amsden (1989, 16) notes that “the sternest discipline imposed by the Korean government on virtually all large size firms – no matter how politically well connected – related to export targets. There was constant pressure from government bureaucrats on corporate leaders to sell more abroad – with obvious implications for efficiency. Pressure to meet ambitious export targets gave the Big Push into heavy industry its frenetic character.”
23 Figures are from Haggard and Moon (1990, 218).
24 Figures are from Haggard and Moon (1990, 216).
25 Curb market loans were from outside the legal financial institutions, and were considered illegal by the Korean government. Curb market loans were popular among businesses when regular financing was unavailable or when businesses wanted a quick loan without extensive paperwork and a quick turnaround time. Curb market loans could come from commercial capital, loan sharks or individuals (Yeon-ho Lee 1997, 147).
26 Although there was a ceiling on the number of shares that could be held by a chaebol group, the top 30 chaebol owned about 30 per cent of the total outstanding shares in the banking sector in 1988. For details see Chung H. Lee (2000).
27 In its effort to distance itself from the Park regime, the Chun government attacked the chaebols for gross inefficiency and corruption, and made reforming economic rules more conducive to the development of the private sector.
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the chaebols a top priority (Haggard and Moon 1990, 226). However, as Beck (1998, 1019) notes, “when Chun Doo-hwan seized power in 1980, he threatened to prosecute the chaebols’ owners for illicit wealth accumulation. A few groups were forcibly restructured or dissolved, but in the end the effort failed. Chun’s democratically elected successors, Roh Tae-Woo and Kim Young-sam, also pledged to take on the chaebol, only to experience similar results.”

28 The DLP now controlled 217 of the 299 seats in the National Assembly.
29 President Kim not only won a convincing victory over his principal opponent, Kim Dae-Jung; he was also less indebted for his power to the various factions of the party. Not surprisingly, the twenty-five-member Kim cabinet had new faces who were “progressive outsiders” and “reform-oriented men and women” (Oh 1999, 131).
30 The NBFIs were established in the 1970s to reduce the importance of the informal credit markets. They were allowed greater freedom in their management of assets and liabilities and could apply higher interest rates on deposits and loans than could banking institutions.
31 Although an accurate measurement of the size of the Curb market is difficult, estimates suggest that in the mid-1990s the total lending in the Curb market was between 2 and 5 per cent of the total loans of the formal financial sector. In contrast, in the mid-1970s, the Curb market was estimated to account for more than one-third of all credit extended in the economy. As was noted earlier, Curb market loans are characterized by high interest rates and risks – to satisfy the credit demands of individual households and small and medium-size firms that have been excluded from the formal credit market (Balino and Ubide 1999, 11).
32 Although specialized banks can borrow from the government, deposits constitute their main source of funding. Funding for development banks, which are wholly government-owned, comes mainly from government-guaranteed bonds (Balino and Ubide 1999, 9).
33 The market share of banking institutions for Korean won deposits fell from 71 per cent in 1980 to 32 per cent in 1996, while that of NBFIs increased from 29 per cent to 68 per cent (H. Smith 1998, 73).
34 Specifically, Kim Young Sam’s merger of the Economic Planning Board (EPB) and the Ministry of Finance (MOF) into a super-ministry, the MOFE, did not bring policy coherence. While the “MOF segment within the MOFE consistently warned of the danger of foreign exchange and financial crises and urged immediate counter-measures including IMF rescue financing . . . the EPB segment, which dominated the MOFE decision-making machinery, ignored MOF warnings by pointing out the ‘fundamental health’ of macroeconomic indicators. If the MOF had remained as a separate bureaucratic agency, the liquidity crisis could have been avoided” (Moon and Rhyu 2000, 94).
35 Joining the OECD requires, as a precondition, free capital markets.
36 Before the deregulation, the top 15 chaebols were not allowed to own and control life insurance companies, while the next top 15 chaebols were allowed to have only up to a 50 per cent ownership of life insurance companies. However, by May 1996, all chaebol but the top 5 were allowed to own or control life insurance companies. Also, before the deregulation only the commercial banks could own investment trust companies. However, in early 1996 the restriction was lifted.
It is important to note that short-term borrowing rates were lower than long-term rates, and short-term funds could be raised relatively easily through the international money markets. This resulted in domestic banks channeling external short-term funds to long-term loans financing investments by domestic corporations.

The economic policy that put the first priority on the competitiveness of the export sector forced the monetary authority to intervene frequently in the market and to maintain stable exchange rates. During the first half of the 1990s, the real effective exchange rate of the Korean won had depreciated, unlike the currencies of the other crisis countries, partly owing to the appreciation of the Japanese yen during the period and the government’s policy of supporting the export sector.

Kyung-Hwan Kim (2000, 107), notes that “unlike those in Japan, Thailand, or Indonesia, Korean financial institutions had been prohibited from lending to finance real estate purchases except for land for new housing. This regulation was repealed in January 1998, right after the economic crisis began. Due to this and other regulations, Korea’s exposure to real estate was relatively small.” However, this does not mean that the chaebols did not engage in land speculation. E. C. S. Kang (2000, 89) notes that “in the period 1985–95, land prices increased by 250 per cent, with industrial land prices increasing even more, by 310 per cent. This rapid increase in prices was driven largely by investments by the chaebol, which could not find a more productive use for their money, much of it borrowed. The chaebol bought land to use as collateral and a hedge against inflation. Indeed, they bid up the land prices to offset the interest rates on their bank loans.”

According to a recent report by the Korea International Trade Association, the foreign-exchange earnings ratio of Korean exports, which is defined as the ratio of value-added created net of export-induced import to the total value added, started to decline continuously from the peak of 67.9 per cent in 1989 to the level of 55.9 per cent in 1997 (Pyo 2000, 20).

Bustelo (1999, 167) notes that in Korea, “total labor costs increased at an average annual rate of 8.2 per cent between 1985 and 1995, a period in which labor productivity grew substantially less, at 6.5 per cent.”

Until the mid-1980s, Korea had enjoyed cheap labor costs compared with competing countries such as Hong Kong, Singapore and Taiwan. However, the rapid rise in wages after 1987 increased unit labor costs, and Korea could no longer count on cheap labor to give the country an edge in international competition. After the democratization of 1987, trade unions were often successful in getting relatively advantageous collective bargaining contracts – and real wages came close to doubling between 1987 and 1997 (Kang et al. 2001, 97). During the period 1985–95, unit labor cost in manufacturing increased by 46.0 per cent in Korea, while the corresponding figures were 22.1 per cent in Japan, 25.1 per cent in Taiwan and 4.4 per cent in the United States. The situation became even worse when other countries such as China, Thailand, Malaysia and Indonesia adopted an export-oriented economic strategy. In the process, Korea was sandwiched between the developed countries (with their superior technological base) and the newly-industrializing countries, with their very low wages (Suh 1998, 13). As the dollar became stronger, particularly against the yen,
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Korea’s export competitiveness suffered, and the country experienced an accelerated increase in its trade deficit. The electronics exports declined from US$43.6 billion in 1995 to US$41.2 billion in 1996, an annual decrease of 5.5 per cent, after 30.4 per cent and 41.1 per cent annual increases in 1994 and 1995 (Yoon 1999, 412).

For example, Samsung spent 4 trillion won building a car-manufacturing plant in Pusan when there was already an excess supply of cars, not only in South Korea, but in the world. With a capacity of 240,000 units per year, it sold only 60,000 units in 1998. Not surprisingly, Samsung Motors lost 156 billion won in the first six months of 1998. Its debt rose to nearly 4 billion won, taking its debt/equity ratio to 555 per cent (Tan 2000, 130–31).

Mathews (2001, 161) notes, “why the banks had continued to lend to such a poor risk subsequently became clear: they were being bribed by Hanbo’s founder, Chung Tae Soo, to do so. Chung, it turned out, had been indicted twice before for bribery, but somehow had managed to stay in business. Eventually he was forced to default because even the banks, despite the bribes, refused to go on lending to him, and demanded his removal from the company’s management. Eventually, the bribery scandals spread, reaching even into the President’s office, thus effectively tying the hands of the government at the very moment when strong leadership was called for to stem the mounting crisis.”

On April 21, the Jinro group faced near-collapse, but was saved from bankruptcy owing to an Anti-Bankruptcy Accord hastily imposed on the creditor institutions by the Korean government to prevent a ripple effect in the economy.

Chae-Jin Lee (2000, 190) notes that “the government’s crisis management capability during Kim Young Sam’s presidency was lacking: when he replaced the chief economic planner (the deputy prime minister) seven times and the senior economic secretary to the president six times in five years, confusion, inconsistency and unpredictability ensued. And rampant corruption, particularly government–business collusion, undermined rational economic decisions.”

The quotation is from Moon and Rhyu 2000, 91. Also Doowon Lee (2000, 11) notes: “at first, the Korean government repeatedly denied the existence of a crisis. For example, the prime minister assured the National Assembly that the economy was not in trouble. Deputy Prime Minister Kyong-sik Kang mentioned many times that the economy’s fundamentals were sufficiently strong and there should be no worry about an economic crisis. In addition, the government refused to reveal the true situation of the economy to the public. A government report inflated the amount of available foreign exchange reserves.”

Moon and Rhyu (2000, 92) note that “Kim Young Sam failed to ensure bureaucratic and policy stability. Macroeconomic policy instability and the subsequent economic crisis were in fact aggravated by frequent reshuffles of the economic cabinet. During the Kim Young Sam government, deputy prime ministers in charge of finance and the economy were reshuffled seven times for reasons of policy failures such as price instability, current-account deficits and the Hanbo scandal, and their average tenure was less than eight months. It was virtually impossible for the Ministry of Finance and Economy to formulate and implement consistent and coherent economic policy with such a short tenures.”
KAMCO was first established in 1962 to manage and dispose of bad loans of the state-run Korea Development Bank. Its function has been increasingly expanded over the years, and in November 1997 legislation was passed to entrust KAMCO with the administration of a Non-Performing Asset Management Fund (NPA Fund). The objective of the NPA Fund is to purchase and dispose of non-performing loans of all financial institutions covered by a deposit guarantee as efficiently as possible. In August 1998 the reorganization of KAMCO as a “bad bank” was completed and KAMCO adopted a structure similar to the US Resolution Trust Company.

Doowon Lee (2000, 10) notes that “when the Hong Kong stock market collapsed in October 1997, many foreigners thought that Korea would be next.”

With the collapse of the Thai and Indonesian currencies, a large volume of loans made by Japanese banks to these countries became non-performing. This led the Japanese banks to collect their mature loans from Korea. According to In-June Kim and Rhee (1998, 363), Japanese banks collected short-term lending of some US$9 billion from Korea between October 1997 and December 3, 1997.

These deposits were not usable as foreign reserves.

See Lindgren et al. (1999, 71).


The change in Kim Dae Jung’s policy should not be surprising. As Blustein (2001, 197) notes, “there were some powerful advisers within the president-elect’s camp who favored breaking the power of the chaebol. Indeed, DJ’s [Kim Dae Jung’s] main economic adviser, You Long Kuen, a provincial governor and former Rutgers’s economics professor, had been trying since the election to convince the Treasury and IMF that the populist DJ would prove far more willing than the existing government to endorse those kinds of reforms.” Second, as Samuel S. Kim (2000, 245) notes: “faced with a likely financial meltdown in late 1997, President-Elect Kim Dae Jung quickly reversed his earlier stand against the International Monetary Fund (IMF), becoming perhaps the world’s most outspoken champion of the controversial institution.”

That is, in exchange for the interbank loans they held, the foreign banks received equal amounts of bonds, fully guaranteed by the Korean government. In addition, these bonds paid attractive yields, at an average interest rate of 8.2 per cent, which was 2.25 per cent over the London Interbank Offered Rate (LIBOR) for one-year bonds, 2.50 per cent over LIBOR for two-year bonds, and 2.75 per cent over LIBOR for three-year bonds.

In Korea, SMEs are defined as companies with fewer than 300 persons and assets of less than 80 billion won. As of 1996, there were 2.64 million SMEs – which accounted for more than 98 per cent of enterprises and 78 per cent of
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employment. Of these, nearly 100,000 were in the manufacturing sector, representing 47 per cent of total value added and 42 per cent of total exports. However, the overwhelming majority of manufacturing SMEs employ between 5 and 50 workers (World Bank 1999, 5).

61 Figures from Balino and Ubide (1999, 58). However, it is important to note that since a large number of people gave up searching for another job upon becoming unemployed and thus became part of the economically inactive population, the unemployment rate was a significant understatement of the actual degree of unemployment.

62 Lister (2001, 3) notes that “the incoming administration of President Kim Dae-Jung had no difficulty, in conjunction with the IMF adjustment program and emergency World Bank loans, in articulating sensible reforms to the financial and corporate sectors, the labor market, and state-owned enterprises. The authorities readily adopted principles that had become basic tenets in most of the industrialized world, even though these principles clashed in many respects with traditional way of doing business in South Korea.”

63 Mathews (2001, 165) aptly notes that “the clarification of the role of the Bank of Korea, and its separation from any supervisory function, is likely to diminish the scope for bribery and corruption.”

64 Until new institutions consisting of a Financial Supervisory Board (FSB) and Financial Supervisory Agency (FSA), together with a Securities and Futures Trade Commission are established, the FSC will act as financial watchdog and to direct reforms of the industrial conglomerates.

65 Deposit protection was amended and, with effect from August 1998, interest on deposits over 20 million won was no longer protected (World Bank 1999, 17).

66 Korea was able to re-enter international capital markets as early as May 1998.

67 Kwan S. Kim (2001, 40), notes that “the rapid rise in unemployment in the first half of 1998 was largely attributable to the bankruptcies of small and medium-sized firms which were hit disproportionately severely by the IMF’s high interest rate policy.”

68 As the economic recession grew worse and corporate bankruptcy multiplied, the IMF, it seems, finally realized its mistake, and in May 1998 granted permission to the Korean authorities to lower interest rates and to ease the money supply. However, the damage was done.

69 Even with the end of the IMF-supported program, the IMF will continue to have close relations with Korea. Regular consultations under Article IV of the IMF Articles of Agreement will continue to be held on an annual basis. IMF staff missions will also visit Korea because of the annual consultation discussions to maintain a close policy dialogue, and Korea will be subject to the IMF’s new policy on post-program monitoring.

70 The quotation is from Sunhyuk Kim (2000, 167). Also Beck (1998, 1030) notes that: “shortly after taking office, President Kim told one reporter, ‘if the chaebols reform, they will be given incentives; if they don’t, they will be at a disadvantage.’ ”

71 Oh (1999, 231) notes that if Rhee had not split the ruling camp, Lee would probably have been the winner.

72 Faizul M. Islam (2000, 136) asks “how did the South Korean economy recover so quickly? It was due primarily to the newly elected President Kim Dae Jung in December 1997 who introduced and implemented the reforms from the outset.
Chaebol and the labor unions who vehemently opposed those changes are surely but slowly yielding to President Jung’s reform plans.”

Mathews (2001, 166) notes that the top five have generally been responsible in their behavior.

More specifically, under the “big deals” it was hoped that each of the major chaebols would concentrate on only three or four core businesses, swapping other businesses with each other in order to achieve industrial rationalization.

Based on an exchange rate of 1,200 won per dollar.

Daewoo narrowly averted a default after its domestic creditor banks agreed to restructure its short-term debt.

The council was composed of eleven members (two from labor, two from business, two from government, four from political parties and the chairperson).

Despite this, Yong Cheol Kim and Moon (2000, 66) note that “the economic crisis penalized every sector of Korean society, but the hardest hit were the workers.”