

# **Restructuring Korea Inc.**

**Jang-Sup Shin and  
Ha-Joon Chang**

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# Restructuring Korea Inc.

The 1997 South Korean financial crisis not only shook the country itself but also sent shock waves through the financial world at large. This impressive book critically assesses the conventional wisdom surrounding the Korean crisis and the performance of the IMF-sponsored reform programme.

Looking first at the strengths and weaknesses of 'Korea Inc.' in comparison with other East Asian countries, the authors describe the challenges faced by Korea in the 1990s due to the acceleration of globalisation. By arguing that the transition attempted by Korea was badly conceived and ill designed, *Restructuring Korea Inc.* focuses on corporate reform after the crisis that has led to the running up of huge 'transition costs'.

This snappy, informative and readable book has a broad historical overview and, with its suggestions for structural change for Korea, is an important contribution not only to Asian studies, but also to the study of financial crises and the economics of structural reform.

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**Restructuring Korea Inc.**

*Jang-Sup Shin and Ha-Joon Chang*



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## Advance reviews of ‘Restructuring Korea Inc.’

This is without doubt the best book yet written on the crisis that hit Korea in late 1997 and the IMF-led restructuring process that followed the crisis.

A basic premise of this book, one that distinguishes it from 99 percent of the analyses of the crisis offered by Western authors, is that it is not possible to understand what went wrong with Korea’s economy in the 1990s unless you first understand the institutions and policies that generated Korea’s economic ‘miracle’ in the three decades that led up to the crisis. In this book, the authors carefully explain the roles played by the government, the large conglomerates known as *chaebols*, and markets in the construction of the Korean version of the East Asian economic model. With this material as background, they make a convincing case that the crisis was caused not by too much government interference in the economy as neoclassical economists claim; rather, it occurred because the government stopped performing crucial economic functions – such as the coordination of *chaebol* investment decisions, the regulation of financial markets, and control over cross-border financial flows – that were central to the success of Korea’s economy in previous decades.

The authors show that the radical neoliberal restructuring of the economy after 1997 was ill conceived and destructive, in large part because it was based on one-size-fits-all neoclassical economic models that bear little resemblance to the institutional structure of Korea’s economy. They evaluate every important aspect of the restructuring program, showing how each one failed to achieve its stated objectives because it failed to take into account existing economic and political institutions and totally misunderstood the key economic roles they played. The authors offer a pessimistic assessment of Korea’s intermediate economic future if the radical neoliberal restructuring process continues, an assessment which seems to me to be quite realistic.

If you only have time to read one book on this important subject, this is the one you should read.

JAMES CROTTY

*Professor of Economics, University of Massachusetts, Amherst*

An important and timely book. Was the Korean 'bounce-back' after the 1997 crisis thanks to all those reforms urged on Korea by the IMF and eagerly embraced by Korea's own economic managers? No, rather in spite of them. So Jang-Sup Shin and Ha-Joon Chang argue, closely, succinctly and persuasively. The reforms may have enhanced financial stability – of great concern to the foreign investors who cleaned up large chunks of Korean equity in one of the biggest fire sales in history. But they also reduced the system's ability to take entrepreneurial (as opposed to speculative) risk. And hence its capacity in future to grow.

RONALD DORE

*Professor, Centre for Economic Performance  
London School of Economics and Politics*

This refreshingly dissenting analysis of Korea's corporate reform program deserves a broad audience. It convincingly demonstrates that there are alternatives to the American economic model – restructuring will be of little value without a focus on knowledge and innovation as major sources of industrial upgrading.

DIETER ERNST

*Senior Fellow & Theme Leader, Economic Studies  
East–West Center, Honolulu  
and Research Professor, Center for Technology &  
Innovation (TIK), University of Oslo, Norway*

This is an impressive book, analyzing critically the conventional wisdom on how Korea had achieved a phenomenal growth before the Asian crisis in 1997, what caused the crisis in Korea and how Korea has bounced back so soon. This book is a must for all those interested in development economics, government policy, corporate restructuring, East Asia, and Korea

LINSU KIM

*Chairman and CEO of Humanities and  
Social Research Council in Korea and  
Professor of Business Administration, Korea University*

Jang-Sup Shin and Ha-Joon Chang have written an insightful and well-documented book that explains the origins of the Korean financial crisis of 1997 and the implications for the nation's economic progress. They show how in the years before the crisis a withdrawal of state support for Korea's 'catch-up' process rendered the *chaebol* vulnerable to international capital movements as well as the ideology and politics of the 'market economy'. The result was thwarted development. They argue convincingly that the resumption of Korea's economic advance requires the support of a developmental state, with the financial sector as its servant, and business enterprise – both the *chaebol* and SMEs – as agents of change.

William Lazonick  
*University Professor, UMass Lowell, and  
Distinguished Research Professor, INSEAD  
(the European Institute of Business Administration)*

Shin and Chang's *Restructuring Korea Inc.* is a brilliant and timely book which provides a trenchant critique of the IMF-inspired reform programme in South Korea following the financial crisis of 1997. The book rightly concentrates on the reform of the critical corporate sector and convincingly exposes the failure of the IMF programme both in intellectual and policy terms. The author's alternative second-stage catching up system is original and carefully thought through. These ideas will be of wide interest to economists, NGOs and policy makers around the world, many of whom confront similar restructuring challenges in their own economies.

AJIT SINGH  
*Professor of Economics  
University of Cambridge*



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Jang-Sup Shin  
Ha-Joon Chang

# 1 Restructuring Korea Inc.

## The 1997 financial crisis and structural reform

In the winter of 1997, Korea was plunged into the biggest financial crisis in its modern history. Unbeknownst to most outsiders, Korea had actually experienced three major financial crises since the beginning of its economic ‘miracle’ in the 1960s.<sup>1</sup> The first was a relatively mild and protracted affair happening over 1969–72 – during this period, the economy was still growing, although not as fast as it had been. There was another rather more severe crisis in 1980, when the economy contracted for the first time since the 1960s. However, even the 1980 crisis pales when compared to the 1997 one.

By the spring of 1998, the economy was in free-fall and many feared that the economy would not recover for another couple of years. In the event, such prediction proved far too pessimistic – although it contracted by 6.7 per cent in 1998, the economy started recovering quickly from 1999. However, it was by far the severest financial crisis that the country has ever experienced in its modern economic history.

In a way befitting its scale, the crisis has resulted in the most thorough restructuring of the country’s economic system, which was created by General Park Chung Hee’s military government that came to power in 1961 through a military coup and propelled the country’s economic development for the next few decades. This system was based on a close collaboration between the state, banks, and the *chaebols*, with the state as the dominant player, and was therefore often known (somewhat misleadingly) as ‘Korea Inc.’.

Needless to say, the Korean economic system has of course gone through various changes over time. Slowly from the 1980s, and in particular from the mid-1990s, there have been moves to rewire the system by reducing the role of the state, deregulating finance, and reining in the *chaebols*. However, after the 1997 crisis, the International Monetary Fund (IMF) and the Kim Dae Jung government, which

## 2 The 1997 financial crisis and structural reform

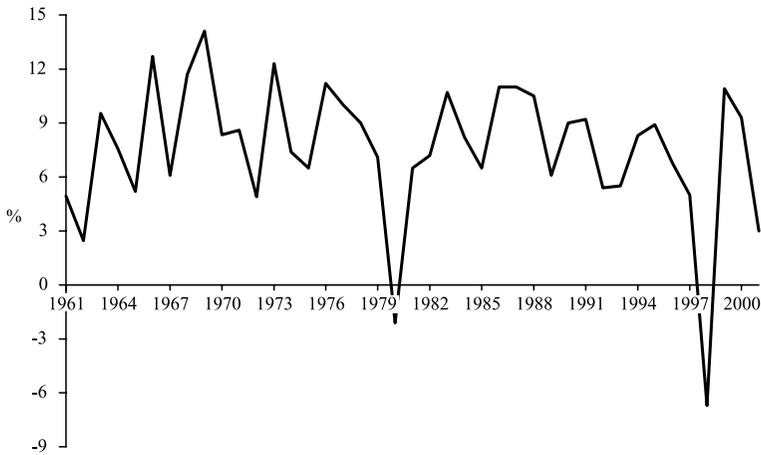


Figure 1.1 40 years' economic growth in Korea (%).

Sources: BOK website, World Bank (2001).

Note: The annual growth rates of real GDP.

came to power right after Korea signed the bail-out agreement with the IMF, carried out a wholesale restructuring of the system in the belief that the country's previous economic system was the root cause of the crisis. As a result, the system was, at least at the formal level, remoulded into an essentially Anglo-American one based on minimal state, arm's-length contractual relationships, and focus on short-term financial profitability.

What is notable about the post-1997 restructuring in the international context was that, for the first time, the private corporate sector became the focus of the IMF programme. It is well known that until the Korean crisis the IMF had blamed the 'profligate' public sector for just about every financial crises in developing countries – and still continues to do so, as seen in its dealings with the Argentine crisis that broke out in 2001. However, in the Korean case, it identified the private corporate sector, and in particular the *chaebols* – family-owned conglomerates – as a main maker of the crisis.

The *chaebols* were condemned as overly diversified groups of inefficient firms surviving on low profit only because they can borrow more than they deserve on the basis of their collusion with the state and banks, and 'unfair' intra-group transactions. It was argued that such inefficiency was possible only because Korea had a primitive corporate governance system. According to this view, the external corporate governance by the state and public was too loose in supervising

financial institutions' lending to the *chaebols* and regulating the *chaebols*' internal transactions. And the internal corporate governance system lacked transparency and was biased against minority shareholders, resulting in the 'dictatorship' of the dominant shareholders, or the 'owners' as they are known in Korea.

On the basis of such analysis, a 'broad' and 'deep' corporate reform programme was implemented. It had to be 'broad', because the close links between the state, banks, and the *chaebols* that had existed meant that a radical corporate reform requires reforms in many other areas. It was 'deep' in the sense that it virtually dismantled the group structure of the *chaebols*, although it fell short of forcefully disbanding them. The measures included the ban on intra-group transactions, the imposition of a *de facto* numerical cap on debt-equity ratios, strengthening of minority shareholder rights, improvement in accounting transparency, introduction of outside directorship, and so on.

Given its breadth and depth, it is impossible to fully understand the post-crisis reform programme in Korea without adequately understanding the corporate reform programme. By saying this, we are of course not implying that corporate reform was the only important element in the post-crisis structural reform programme in Korea. The public sector and the labour market were also subject to big changes, and financial sector reform was given as much weight as the corporate sector reform. However, special attention needs to be paid to the corporate reform programme, given that it provided the key 'organising theme' in the country's overall structural reform after 1997.

For instance, the success or otherwise of the financial reform programme depends critically on that of the corporate reform programme because a large part of the assets managed by financial institutions are corporate-related. Moreover, financial sector reform was seen as a way to reform the corporate sector. For instance, the introduction of new regulatory rules such as the Bank for International Settlements (BIS) capital adequacy ratio and the forward-looking criteria (FLC), which aimed at maintaining the 'soundness' of the financial sector, was also designed to make the aggressive corporate expansion more difficult by changing the incentives for the financial sector in relation to corporate lending.

In the same vein, the redefinition of the role of the state along the Neo-Liberal ideal also restructured the relation between the state, banks, and the corporate sector, and thereby significantly affected the operation of the corporate sector. On the one hand, the declaration of a complete end to traditional industrial policy made it difficult, though not impossible, for the state to underwrite large-scale risk-

taking in the private sector. On the other hand, the greater emphasis given to the role of the state in maintaining financial sector stability brought about new stringent financial regulations on corporate lending, as mentioned above.

Thus seen, the post-1997 structural reform practically destroyed all the elements in the country's economic system that are believed to have propped up the 'undesirable' corporate sector. And it may be reasonable to say that the scale of the corporate reform implemented in Korea since 1997 is the largest in the world since the forceful break-up of Japanese and German firms by the Allied occupation forces after the Second World War. Given this, it is essential to correctly understand the post-1997 corporate restructuring programme, if we are to correctly understand the 1997 Korean crisis and its aftermath – a task that we take up in this book.

### **Structure of the book**

The central thesis of the book is that the logic behind the corporate reform programme implemented by the IMF and the Korean government is fundamentally flawed and therefore it has incurred huge costs in the national economy without bringing about noticeable benefits. In the longer term, the reform will bring about a significant reduction in the growth dynamism of the Korean economy. We support our thesis with detailed theoretical criticisms of the conventional explanation behind the Korean crisis and various empirical evidence which suggest that the conventional view is largely unfounded.

We start the main part of the book with a discussion of the logic behind the 'traditional' Korean economic model (Chapter 2), as we believe that many of the flaws in the current reform programme in Korea derive from the flaws in the understanding of the traditional Korean model. We develop the historical, but also consciously comparative, framework first proposed by Alexander Gerschenkron, the Russian-born American economic historian. We characterise the traditional Korean economic system as a catching-up system pursuing the Gerschenkronian 'substituting strategy' – or as a system geared to pursuing an 'independent' developmental path by finding functional substitutes for the institutions used for industrial development by the forerunners. In the Korean case, such an institutional substitute was obviously 'the state–banks–*chaebols* nexus'. We discuss the strengths and the weaknesses of the traditional Korean system by contrasting it with those of Taiwan and Singapore, which pursued 'complementing strategies', where a late-developing country tries to

develop through a strategic (though not passive) alliance with the advanced countries.

In Chapter 3, we advance a detailed account of Korea's 1997 financial crisis and its aftermath, to provide the background to our analysis of the corporate sector reform programme. After a chronological charting of the evolution of the crisis, we critically examine the supposed causes of the crisis that are found in the conventional analyses. We show how these flawed analyses of the causes of the crisis have resulted in counter-productive short-term crisis management strategy and mistaken long-term restructuring programmes devised by the IMF and the Korean government. Then we analyse the unexpectedly rapid recovery of the Korean economy since 1999. We argue that, contrary to what the IMF and its supporters claim, the recovery was not the result of macroeconomic retrenchment and structural reform implemented by the IMF programme. Rather, it was the result of a very Keynesian policy package, involving interest cuts and the injection of public money into the banking system, which the IMF allowed in the face of economic collapse up to mid-1998. Then we advance our own interpretation of the Korean crisis as a case of 'transition failure' – a failure of moving to an economic system that would properly deal with economic maturity and the acceleration of globalisation in the 1990s in the context of the country's growth path.

In Chapter 4, we move on to the central focus of the book, namely, an evaluation of the corporate reform programme since 1997. The reform contained a number of elements – forced reduction in the debt-equity ratio of the *chaebols*, the 'big deals', the workout programme, and various measures intended to improve the corporate governance system. The last element in turn involved changes in fair-trading regulations, changes in accounting standards, changes in financial regulations, the liberalisation of the mergers and acquisitions, and reforms of internal governance system. After detailed documentation of these changes, we argue that, at least up to now, the reform has failed to achieve even its stated aim of reducing financial risks in the corporate sector, while running up huge 'transition costs'. We also point out that the attempt to seek new 'engines of growth' in increased foreign direct investment (FDI) and small and medium-sized venture business was also far from successful.

Drawing on the analyses in the previous chapters, the final chapter (Chapter 5) discusses the future prospect of the Korean economy. We argue that, unless Korea reverses and modifies many of the institutional changes implemented through the reform programme since

6 *The 1997 financial crisis and structural reform*

1997, it will find it difficult to sustain its growth dynamism. We then suggest the kinds of changes that we believe are necessary if Korea is to launch itself on to what we call the second-stage catching-up phase in a way that maintains its traditional strengths while reducing their weaknesses. We argue for a reinvigorated state and a modified *chaebol* system, and not a pale copy of the Anglo-American economic system.

## 2 The Korean model in historical perspective

If we are to correctly analyse the events leading up to the 1997 crisis and its aftermath, it is necessary to correctly understand the ‘traditional’ Korean economic model – or what is commonly known as Korea Inc. This is a critical exercise because how we understand this system is obviously going to influence how we understand the crisis and how we evaluate the recent ‘reforms’ intended to restructure it. Therefore in this chapter we discuss the key features of this system and explain its logic.

Our understanding of the Korean model is based on the framework of Alexander Gerschenkron (1962, 1963, 1968, 1970).<sup>1</sup> He provided the first systematic framework to view the catching-up process in historical and comparative perspectives, and therefore has been the key reference point for many scholars who study late-industrialisation.<sup>2</sup> Through a historical, but also consciously comparative, framework, he allows us to understand the changing roles of the state and of the private sector institutions in response to changing conditions for industrialisation, such as technology and international political economy.

In this chapter, we outline Gerschenkron’s theoretical framework (section 2.1) and then discuss the catching-up strategies pursued by the East Asian NICs. We first discuss the case of Korea, which is a classic case of Gerschenkronian ‘substituting strategy’ – or a strategy where late-developing countries pursue an ‘independent’ developmental path by finding functional substitutes for the institutions used for industrial financing by the forerunners. We argue that ‘the state–banks–*chaebol* nexus’ in the Korean model – often characterised as Korea Inc. – was such an institutional substitute (section 2.2.1). We go on to contrast the Korean model with the ‘complementing strategy’ pursued by Singapore and Taiwan, where a late-developing country deliberately forges a strategic (though not passive) alliance with the advanced countries rather than pursuing a fully ‘independent’ path of development. Then

we discuss the role of the state in these three countries and see how the differences in the catching-up strategies pursued affected the role of the state (section 2.3). The following section (section 2.4) discusses the *chaebols* – or the family-owned, diversified conglomerates – as the distinctive and critical element in the Korean model, before we summarise the discussion in the chapter and provide some concluding remarks (section 2.5).

## 2.1 Gerschenkron's 'patterns of industrialisation' and the Korean model

Gerschenkron's 'patterns of industrialisation' is a three-country paradigm mainly derived from the experiences of Britain, Germany, and Russia in the nineteenth century. From the three countries, he identifies distinctive institutions spearheading industrialisation as follows: (1) in Britain, the first country to experience the Industrial Revolution, the accumulated private wealth was a major source of industrial finance and individual entrepreneurs played a central role in driving industrialisation; (2) in Germany, a 'moderately backward' country, the universal banks played a major role in financing industrialisation and organising the private sector; (3) in Russia, an 'extremely backward' country, the state directly mobilised financial resources and created new industries. From these patterns, Gerschenkron makes a sweeping generalisation: 'The more backward a country's economy, the greater was the part played by special institutional factors . . . [and] the more pronounced was the coerciveness and comprehensiveness of those factors' (1962: 354).

According to Gerschenkron, this pattern was a combined consequence of the differences in: (1) the technological trend of the day; (2) the 'degree of backwardness'; and (3) the necessity and willingness on the side of the latecomers to directly compete with forerunners. He observes another pattern, that is, '[t]he more backward a country's economy, the more pronounced was the stress in its industrialization on bigness of both plant and enterprise . . . [and] the greater was the stress upon producers' goods as against consumer goods' (1962: 354). This was because, during the latter half of the nineteenth century when Germany and Russia embarked on industrial catching-up, technological progress was most rapid in heavy industry and the 'evolution of technology and changing composition of industrial output induced growing capital–output ratios and made for increases in the optimal size of plant' (1970: 113). And 'it was largely by application of the most modern and efficient techniques that backward

countries could hope to achieve success, particularly if their industrialization proceeded in the face of competition from the advanced country' (1962: 9). In a nutshell, the catching-up strategy of the latecomers in Europe was to focus on heavy industries and leapfrog the forerunners in size of plants and enterprises (Figure 2.1).

Different institutional patterns across countries were a direct result of this catching-up strategy. British industrialists were forerunners in industrialisation and did not face strong international competition. British industrialisation was therefore more of an unorganised and autonomous process.<sup>3</sup> The technological trend during the First Industrial Revolution was also not so much towards the increasing capital-output ratios as that during the Second Industrial Revolution when Germany and Russia earnestly began their catching-up efforts. It was thus enough for the British commercial banks to provide industrialists with only operating capitals.

However, Germany and Russia required special institutions to mobilise resources to realise their catching-up strategies. The universal banks carried out this role in Germany, because the banking sector had already developed to a certain level although the country was far behind Britain in industrialisation. The universal banks combined investment banking, which was pioneered by *Crédit Mobilier* of

	Britain	Germany	Russia
Timing of entry	– late-18c – forerunner	– mid-19c – moderately backward	– late-19c – extremely backward
Spearheading institutions	– individual entrepreneurs – banks providing operating capital	– universal banks	– state
Functional patterns	– gradual accumulation of capital – less organised	– mobilising resources through banking system and concentrate them on heavy industries – 'bigger and bigger' plants	– coercive mobilisation of resources and focus on heavy industries – still 'bigger and bigger' plants

Figure 2.1 Gerschenkron's 'patterns of industrialisation'.

France, with the short-term activities of the commercial banks. As a result, according to Gerschenkron (1962: 15), they were ‘from the vantage point of centralized control, . . . at all times quick to perceive profitable opportunities of cartelization and amalgamation of industrial enterprises’.

In Russia, an extremely backward country where ‘the standards of honesty in business were so disastrously low . . . [and] fraudulent bankruptcy had been almost elevated to the rank of a general business practice’ (1962: 19–20), there was little to expect from the private sector. The Russian state took over the entire role of devising a catching-up strategy and implementing it. ‘Not only in their origins but also in their effect, the policies pursued by the Russian government in the [eighteen] nineties resembled closely those of the banks in Central Europe’, Gerschenkron (1962: 20) thus points out.

It should be noted that a main driver in Gerschenkron’s scheme is competition among nations. If Germany and Russia had been content to remain in their dependent status, they would not have needed to adopt this strategy, which was certain to exert great strains in their societies. The strategy was taken because they wanted and needed to compete with Britain in terms of industrial and military might. Gerschenkron’s central concept of ‘substitutes’ was derived from this competition for supremacy among the European powers. Those different strategies and institutions adopted by the latecomers were substitutes for the lack of the supposed ‘prerequisites’ of development like capital, technologies, or well-functioning financial intermediaries, which were present in the forerunners. In this respect, we may name this Gerschenkronian-type catching-up strategy as a ‘substituting strategy’.

Since Gerschenkron’s pattern is a historical model developed on the basis of the experience of a specific set of countries in a specific time period, i.e., the large European countries in the nineteenth century, it needs to be modified if we are to apply it to the East Asian countries in the twentieth century.<sup>4</sup> Two points are especially important in this regard.

First, the technological trends or institutional forms that feature in Gerschenkron’s pattern may not be applicable to other time periods and other localities. For example, by the latter half of the twentieth century, the heavy industry was, although still important, no longer the new and technologically most dynamic industry as it was in the nineteenth century. For another example, in the late-twentieth century, it was business groups, such as Japan’s *zaibatsu* or the *keiretsu* or Korea’s *chaebols*, and not the universal banks as in nineteenth-century Europe, that played a key role in entrepreneurial decisions

and investment mobilisation. Changes in technological and institutional environment should be carefully taken into account when we apply a historical model to another historical setting.

Second, because he conceived economic development in terms of competition among major countries in major industries, Gerschenkron does not give enough attention to the nineteenth-century small European countries, which underwent industrialisation mainly through exploiting complementary relations with bigger forerunner countries rather than attempting to directly compete with them. He acknowledges the Danish case as a clear exception to his model, but he does not delve on it much further.<sup>5</sup> However, a pronounced trend in the second half of the twentieth century was the ever-increasing process of globalisation, which has enlarged room for latecomers to grow through utilising international specialisation in the manufacturing sector. In this milieu, some East Asian countries deliberately pursued a ‘complementing strategy’, which primarily exploits complementary relations between the forerunners and the latecomers. Bigger countries like Japan and Korea still employed Gerschenkronian substituting strategy, but smaller countries like Singapore and, to a lesser degree, Taiwan developed mainly through complementing the forerunners’ industrial needs by participating in increasingly global subcontracting networks. And currently many commentators are even treating it as the ‘normal’, if not necessarily the only viable, strategy for late industrialisation in an age of increasing ‘globalisation’ (Dunning and Hamdani 1997; Dunning and Narula 1996; Lipsey 1997; World Bank 1999).

With these points in mind, we shall below employ Gerschenkron’s framework as a broad interpretative tool for comparing the East Asian catching-up models.

## **2.2 East Asian catching-up models**

### ***2.2.1 Substituting strategy: South Korea***

The US, Japan, and Korea are ideal countries to which to apply Gerschenkron’s three-country paradigm in the twentieth century.<sup>6</sup> The US was the clear technological leader in most industries after World War II. Japan was substantially behind the US, but far ahead of Korea, making it plausible to designate Japan as a ‘moderately backward’ country and Korea as an ‘extremely backward’ country. Japan and Korea also adopted the Gerschenkronian substituting strategies.

Their substituting strategy was basically of ‘nationalistic’ or ‘mercantilistic’ character, focusing on building internationally competitive

'local' industries. Although they heavily imported foreign technologies, foreign direct investment (FDI) was generally discouraged. The control of major industries was firmly in the hands of locals in the two countries. Japan financed its industrialisation mostly through domestic resource mobilisation, with FDI and foreign debts negligible in its overall industrial financing. Japan's foreign debt was equivalent to only 0.35 per cent of GDP in 1975, even lower than those of even the financially open US (4.07 per cent) and the U.K. (6.33 per cent), not to speak of France (0.53 per cent) and Germany (0.40 per cent) (IMF 2000). The ratio of FDI to gross capital formation in Japan was only 0.1 per cent during 1970–90 (Table 2.1). Korea financed its industrialisation partly through domestic resource mobilisation, and, reflecting its relative backwardness as compared with Japan, through foreign loans. The share of FDI to gross fixed capital formation in Korea remained the lowest among the East Asian NICs with just over 1 per cent during 1970–90. On the other hand, Korea's reliance on foreign debt was the highest among the East Asian NICs, as shall be discussed below.

Japan and Korea also pursued unbalanced growth strategies by periodically concentrating their national resources on some strategic industries targeted for import substitution (and often exports too). Similarly to the European experience in the nineteenth century, they stressed capital-intensive industries in their catching-up process. The Japanese catching-up was led by heavy and chemical industries, and by the electronics industry, a new key industry of the twentieth century. Korea's catching-up was focused on even narrower segments of the

*Table 2.1* Ratio of FDI inflows to gross fixed capital formation in selected East Asian countries, 1971–1997 (%)

<i>Country</i>	<i>1971–1980</i>	<i>1981–1990</i>	<i>1991–1997</i>
Japan	0.1	0.1	0.2
Hong Kong	5.1	9.9	8.7
Republic of Korea	1.2	0.9	1.0
Singapore	15.8	26.2	25.9
Taiwan	1.3	1.3	2.7
Indonesia	3.5	1.5	5.5
Malaysia	13.6	11.3	17.2
Philippines	1.0	3.8	7.3
Thailand	2.3	4.8	4.1
China	0.0	1.5	12.0

*Sources:* Akyuz *et al.* (1998) and UNCTAD (1999, 2000).

above-mentioned industries, pursuing a more unbalanced growth reflecting its relative backwardness as compared with that of Japan. In both countries, import substitution in the heavy and chemical industries, and later in the 'high-tech' industries, was regarded as crucial in building an independent national economy.

The patterns of institutional solutions to the problems of backwardness in Japan and Korea were also similar to Gerschenkron's schemes for Germany and Russia, respectively. In Japan, the *keiretsu* was a functional substitute for the German universal banks. With commercial banks and general trading companies at the centre of their operation, the *keiretsu* was a major vehicle for financing and organising industrial expansion. For instance, the steel industry and the automobile industry became major exporters mainly as a result of fierce domestic competition among the *keiretsu*, despite the fact that the government was initially reluctant to regard them as key export industries.<sup>7</sup> It is certainly true that the Japanese state, as a 'developmental state', undertook some important entrepreneurial roles in the Japanese industrial development (Johnson 1982; Allen 1981; Dore 1986). But its role was more of a supporter than of an initiator and organiser of catching-up, when compared with that in its later-comers in East Asia.<sup>8</sup>

In contrast, the Korean state had to undertake a much greater role because of the relative underdevelopment of its private sector. It nationalised commercial banks and totally subordinated their lending decisions to industrial policy. The *chaebols*, the Korean version of family-owned conglomerates, were the children of the state-led heavy and chemical industrialisation (henceforth HCI) in the 1970s. The state designated strategic industries and picked up companies or business groups to undertake the task of building these new industries whilst providing them with subsidies and protections.<sup>9</sup> The state-banks-*chaebol* nexus thus became the central feature of the Korean economic system (Figure 2.2).

A consequence of this nationalistic development supported through bank financing was a heavy reliance on debts by industrial firms. The debt-equity ratio of the manufacturing sector in Japan reached nearly 500 per cent at the height of its heavy and chemical industrialisation in the 1970s. Korea's comparable figure also shot up to nearly 500 per cent in the early 1980s (Figure 2.3). The two countries were able to substantially reduce the debt-equity ratios of their corporations thereafter mainly thanks to their successes in the HCI, though the level remained relatively high when compared to those of other countries (further on this in sections 3.2.4 and 4.1).

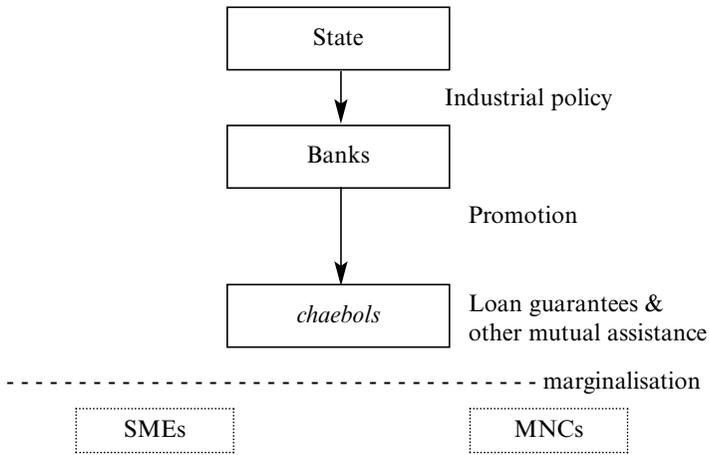


Figure 2.2 Korea's nationalistic model.

In anticipation of our comparison between the three East Asian NICs later in the book (sections 2.2.2 and 4.1), the following features of the Korean economy should be noted in particular.

The first is the reliance on foreign debt in industrial financing. Japan, with its relatively developed machinery and material industries that had been already developed to a certain level before the end of

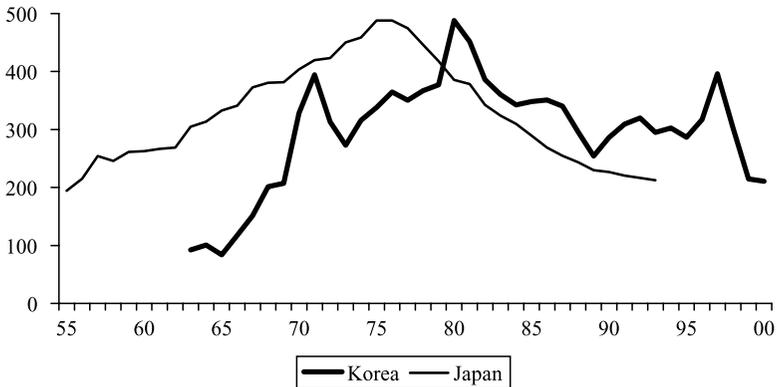


Figure 2.3 Trend of debt–equity ratio in Japanese and Korean manufacturing firms.

Sources: BOK website, Bureau of Statistics (Japan).

World War II, was able to finance its heavy and chemical industries mainly with its own domestic resources and export earnings. Taiwan and Singapore had less need of foreign loans because they did not participate in the HCI on as large a scale as Korea did, on the one hand, and because they were more willing to attract equity investments from multinational companies (MNCs), on the other hand. However, Korea had to rely on foreign debts heavily because it had to import a lot of capital equipment and advanced technologies in building the heavy and chemical industries, whilst securing that these industries remain under local ownership. Therefore, the period of the HCI was characterised not only by a jump in the corporate debt–equity ratio but also by a sharp increase in foreign debt (refer to Table 2.3 on page 22).

Second, the growth of the *chaebols* should be given particular attention. As noted above, they were products of the state-led HCI in the 1970s. But they rapidly began to take initiatives of new large-scale projects from the 1980s, similar to the development of St Petersburg banks in the early twentieth century, the Russian counterpart of the German universal banks.<sup>10</sup> For instance, the *chaebols*' foray into the semiconductor industry in the 1980s can be better understood as a result of oligopolistic competition among them in spite of the initial reluctance of the government to support it (Yoon 1990; Shin 1996).

The pace of the *chaebols*' expansion was partly reflected in the phenomenal growth of research and development (R&D) expenditure by the private sector, which increased 128 times in nominal terms from 21.7 billion won (\$24.6 million, 1\$=850 won) in 1976 to 2,698.8 billion won (\$3,175.0 million) in 1990. During this period, despite the rapid growth in absolute amount of over 16 times from 39.2 billion won in 1976 to 651.0 billion won, the R&D expenditure by the public sector fell as a proportion of total R&D – it fell from 64 per cent in 1976 to 19 per cent in 1990, similar to that of Japan in the 1990s (Table 2.2 and Figure 2.4).

Table 2.2 Major R&D indicators in Korea (billion won, %)

	1976	1981	1986	1988	1990
R&D expenditures	60.90	293.13	1,606.9	2,454.1	3,349.8
Funds from government	39.18	121.71	374.3	522.9	651.0
Funds from private sources	21.72	171.40	1,232.5	1,931.2	2698.8
Gov't: private (%)	64:36	42:58	23:77	20:80	19:81
R&D/sales (%)	0.36	0.67	n.a.	1.61	n.a.
R&D/GNP (%)	0.44	0.65	1.77	1.94	1.95

Source: Shin (1996, Table 4.3).

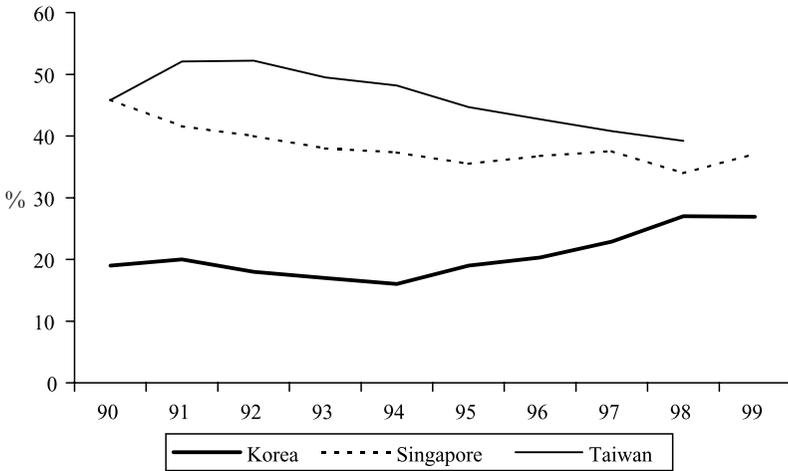


Figure 2.4 Public share of R&D in total R&D investment in Korea, Taiwan and Singapore.

Sources: STEPI website, NSTB, Bureau of Statistics of Taiwan website.

In this way, *chaebols* were securely established as the main bearer of high-risk projects in Korea since the 1980s. This pattern is quite different from those of Taiwan and Singapore, where their governments still play a central role in R&D activities and high-risk projects, as we can see from Figure 2.3 and as shall be discussed below (sections 2.2.2 and 2.3).

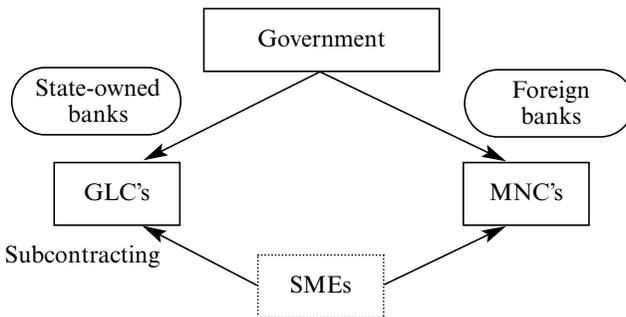
Third, the Korean economy was characterised by the continuing weakness of the small and medium-sized enterprises (SMEs). This was mainly because the *chaebols* were engaged in international competition in assembly industries. With Japan as a close but an advanced neighbour, it was more convenient for the Korean manufacturers to import parts and intermediate goods from Japan, rather than to rely on the underdeveloped local SMEs, in securing export competitiveness of their assembled products. Along with the marginalisation of foreign companies, the relative weakness of SMEs was the flip side of the *chaebol* dominance in the Korean economy.

### 2.2.2 *Complementing strategy: Singapore and Taiwan*

Singapore and Taiwan were also ‘extremely backward’ countries from the Gerschenkronian point of view. They were, like Korea, far behind Japan in their industrial development. Reflecting their levels of relative backwardness similar to that of Korea, the state was the prime agent

to initiate and organise industrialisation in both countries. Their states employed a broad range of industrial policy measures and continually led structural changes of their economies (Wade 1990; World Bank 1993; Lall 1994; Rodrik 1996; Champonniere and Lautier 1998; Low 1998; Wong 2001). However, catching-up patterns of Singapore and Taiwan were somewhat different from what Gerschenkron's schema envisaged for 'extremely backward' countries, reflecting new technological and international environment in the twentieth century.

Singapore developed mainly through attracting and upgrading FDIs by providing the MNCs with competitive and continuously upgraded 'complementary assets' like infrastructure, human capital, fiscal incentives, and so on. The Singaporean policy-makers were not interested in competing with its forerunners.<sup>11</sup> Instead, they attempted to directly connect the economy to the 'First World' (Lee 2000; Mirza 1986; Huff 1994; Low 1998). Since its industrialisation was spear-headed by MNCs, which already had their own technical and financial resources, Singapore did not face a pressing need to invest in local innovative capacity and to mobilise the necessary financial resources. Attracting MNCs itself was intended to solve the problems of accessing advanced technologies and of financing industrialisation at the same time. Government-linked companies (GLCs), i.e., what the public enterprises are called in Singapore, filled the areas in which MNCs were not interested but which the Singaporean government regarded as strategic to the country's development, such as shipbuilding, steel-making and so on. As a city-state depending its survival on trading, Singapore hardly could afford to protect domestic industries. Among the East Asian countries, Singapore developed through the most internationalist route for industrialisation (Figure 2.5).



*Figure 2.5* Singapore's internationalist model.

Taiwan initially took a nationalistic path of development relying on three pillars, i.e., the public enterprises, the *guangxiqiye* (local business groups), and the SMEs. It underwent a short period of import-substituting industrialisation and imposed heavy regulations on foreign direct investment. But it soon shifted to reducing protections and attracting MNCs in order to compensate for the lack of big local companies. The Taiwanese industrial structure is currently based on a complex relationship between four major players, i.e., the public enterprises, the *guangxiqiye*, the MNCs, and the SMEs (Wade 1990; Whitley 1992; Fields 1995; Hou and Gee 1993). It can be said that Taiwan developed through a semi-internationalist path of catching-up (Figure 2.6).

The Taiwanese private companies, the *guangxiqiye* or the SMEs, have seldom attempted to directly compete with their forerunners in Japan or in the US. Taiwanese public enterprises also focused on domestic industries, mostly related to military industries or upstream industries for local companies. The Taiwanese state encouraged and even arranged alliances with MNCs when it felt it necessary to venture into high-cost and high-risk areas like semiconductors.<sup>12</sup> The dominance of the SMEs and partnering with MNCs in high-risk projects reduced the need for external funding in the course of its industrialisation. As a result, and partly affected by the Taiwanese government's entrenched anti-inflation policy, Taiwanese firms maintained low debt-equity ratios, as we shall see below.

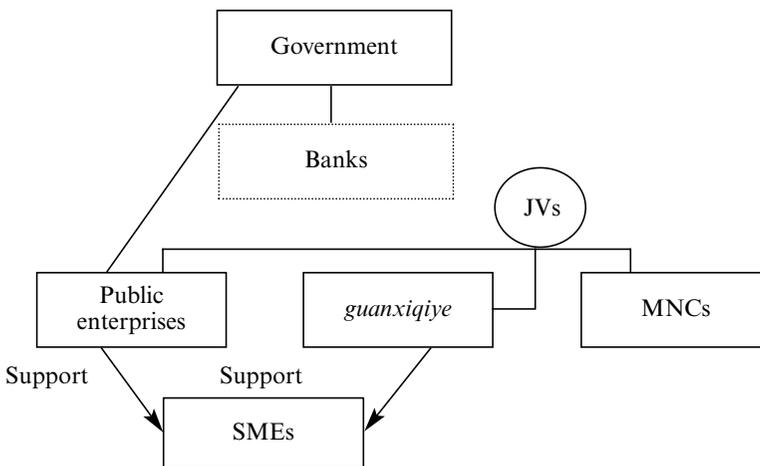


Figure 2.6 Taiwan's semi-international model.

A major factor behind the emergence of the Taiwanese or Singaporean 'complementing strategy', which had few precedents in the nineteenth century, was the acceleration of globalisation in the latter half of the twentieth century.<sup>13</sup> MNCs took off in the 1960s with FDI flows increasing at twice the rate of the growth of the world output and 40 per cent faster than world exports during the decade. After a short period of deceleration in the 1970s, FDI flows quadrupled in the 1980s, growing three times faster than trade flows, and almost four times faster than GDP (Dicken 1992; Julius 1990; Ernst 2002; UNCTAD 2000). The beginning of the electronics industry in Taiwan and Singapore in the 1960s, which later became the largest manufacturing industry in the two countries, can be attributed to MNCs' relocation of labour-intensive production segments to developing countries (Henderson 1989; Chen *et al.* 2000). At the beginning, the countries provided MNCs mainly with low-wage labour as a complementary asset. However, as MNCs continued to deepen and broaden their global production networks, they upgraded and diversified their complementary assets so that MNCs could remain and expand in their territories.<sup>14</sup>

In comparison with the substituting strategy pursued by Japan and Korea, one weakness of the complementing strategy lies in its relative underdevelopment of R&D and marketing capabilities. Mainly as parts-suppliers to the more advanced companies, those adopting complementary strategies have relatively less incentive in investing in R&D and marketing. For, in setting up complementary relations, MNCs normally supply R&D capability, higher-end production capability, brand names, marketing networks, and so on. Needless to say, this does not exclude the possibility that the latecomers can move up to higher-end production capabilities. In fact, the successes of Singapore and Taiwan have hinged on their abilities to continuously climb up the technology ladder. However, in comparison with countries adopting substituting strategies, the pace of accumulation of those high-end capabilities tends to be slower in countries adopting complementing strategies.

This explains why the pattern of R&D financing began diverging between Singapore and Taiwan, on the one hand, and Korea, on the other hand, from the 1980s, when they all seriously started investing in 'high-tech' industries. As noted before, the private sector, especially the *chaebols*, rapidly took over the leading role in R&D investment in Korea. In Taiwan and Singapore, however, the overall growth of R&D expenditure was far slower than that in Korea. The gross expenditure on R&D (GERD) to GDP in Korea was increased from 0.65 per cent

in 1981, to 1.77 per cent in 1986 and further to 2.69 per cent in 1997, while it increased from 0.94 per cent in 1983 to 1.01 per cent in 1986 and to 1.88 per cent in 1997 in Taiwan, and from 0.26 per cent in 1981 to 0.86 per cent in 1987 and to 1.47 per cent in 1997 in Singapore (see Table 2.2. and Figure 2.7; also see Hou and Gee 1993). Moreover, in the absence of large private sector firms that can assume a large role in R&D, the public share of R&D investment remained much higher in Taiwan and Singapore than in Korea. The ratios of private-sector R&D expenditure to GDP in Taiwan and Singapore were 1.11 per cent and 0.92 per cent, respectively, in 1997, whilst the corresponding figures for Korea was 2.07 per cent.

On the marketing front, the complementing strategies also resulted in the relative underdevelopment of large local trading companies in Taiwan and Singapore. This contrasts with the pivotal role that the general trading companies (GTCs), as the *chaebols'* trading arms, played in export expansion in Korea.<sup>15</sup> In contrast, Singapore's exports depended predominantly on MNCs' marketing networks reflecting its reliance on MNCs for production activities. The Taiwanese government briefly and half-heartedly attempted to nurture local large trading companies, but it was not successful – local trading companies accounted for only around 20 per cent of Taiwan's total trade in the 1980s whilst the Japanese *sogo shosha* accounted for 50 per cent of the total trade (Fields 1995; Whitley 1992).<sup>16</sup>

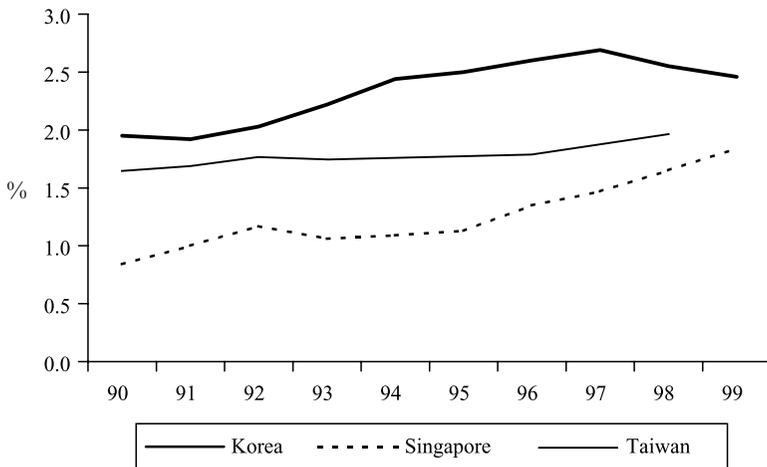


Figure 2.7 Trend of GERD/GDP among Korea, Taiwan and Singapore.  
Sources: STEPI website, NSTB, Bureau of Statistics of Taiwan (2000).

In entering the high-tech industries, Taiwan used a method that can be named an 'orderly spin-off strategy'. Public research institutes like the Industrial Technology Research Institute (ITRI) (especially ERSO, a division of ITRI specialising in the electronics industry) and the Institute for the Information Industry (III), developed major technologies. Based on those technologies, they then set up venture companies with combined investments from the government, the private sector, and sometimes from foreign companies (Hou and Gee 1993; Chen *et al.* 2000). Major high-tech venture companies were therefore in fact half-public enterprises, despite being formally private companies, because original technologies were endowed from public research institutes and 30–40 per cent of the initial funding came from the government. In this sense, it can be even argued that the state's involvement increased in Taiwan when the country ventured into high-risk sectors, thus compensating for the relative lack of the strong private sector. Reflecting this, the public share of R&D investment in Taiwan was maintained at almost the same level at around 60 per cent in most of the 1980s, when Korea saw a drastic increase the relative share of R&D investment by the private sector (Hou and Gee 1993, table 2.2).

In Singapore, where industrialisation was led by MNCs, R&D investment was also spearheaded by MNCs. Foreign companies' share of industry R&D remained well over 60 per cent of total industry R&D expenditure in the 1990s (Wong 2001), and local private sector's capability was far underdeveloped compared to those of Taiwan or Korea. Therefore, when Singapore increasingly needed to complement MNCs' operations with high-end assets, it was the state that initiated investments in upgrading local technological capabilities. The state set up and enlarged various research institutes, and launched programmes to nurture local venture firms, for example, the Technopreneurship 2000, and to develop local venture capital markets. In the semiconductor industry, following the Taiwanese model, the Singaporean government established new companies like Chartered Semiconductor as (half-) public enterprises with MNCs' equity participation.

The complementing strategy has one definite advantage over the substituting strategy. It is less risky, as it avoids direct competition with the forerunners and as it spreads financial risks among equity owners. Therefore, Taiwan and Singapore faced much less urgency to build domestic institutional mechanisms for large-scale mobilisation of financial resources. Their banks were less mobilised for industrial financing than their Korean counterparts, though the governments of both countries were active in investing in some areas which they

regarded strategically important.<sup>17</sup> One result of this, especially when combined with their greater openness to FDI that we discussed earlier, was that Taiwan and Singapore relied much less on foreign debts than Korea did (Table 2.3).

Their complementing strategies also resulted in relatively low corporate debt-equity ratios in Taiwan and Singapore *vis-à-vis* that in Korea. The debt-equity ratio for the Taiwanese manufacturing sector was 95.1 per cent on average during 1974–5, while that of its Korean counterpart was 342.20 per cent during the same period (Figure 2.8). According to Demigruc-Kunt and Maksimovic's (1996) study covering the period of 1980–91, the debt-equity ratio of Singapore firms was 123.3 per cent while that of Korean firms was 366.2 per cent.

### 2.3 The role of the state

The role of the state was critically important in the catching-up processes of the three East Asian countries, reflecting their similar level of economic backwardness at the beginning of industrialisation. The state was the only agent that could break the inertia in society and was able to design and manage the catching-up system in these 'extremely backward' countries, as Gerschenkron saw in the case of Russia in the nineteenth century. The state was 'developmental' in the sense that economic growth was 'enshrined near the top of the regime's value hierarchy' (Jones and Sakong 1980: 41), and this developmental objective was supported by 'hardness' of the state in the three countries. Korea's catching-up earnestly began with the formation of an authoritarian regime led by President Park Chung Hee (1961–79). Taiwan maintained the most explicitly authoritarian regime by governing the country under martial law until 1987.

*Table 2.3* External debt to GDP ratios of Korea, Taiwan and Singapore (% , selected years)

	1976	1982	1985	1993	1996	1997
Korea	36.7	52.0	52.1	12.7	20.2	25.5
Taiwan	13.6	12.8	14.5	7.6	8.0	9.3
Singapore		22.0	22.8	9.5	10.7	16.5

*Sources:* Table 3.1 for the Korean figures. The Taiwanese figures are calculated from OECD's External Debt of Developing Countries and the Joint BIS-IMF-OECD-World Bank statistics on External Debt. The Singaporean figures are calculated by combining the GDP figures from the IMF's International Financial Statistics, with the external debt figures from OECD's External Debt Statistics, and the exchange rates from the Statistics of Singapore website.

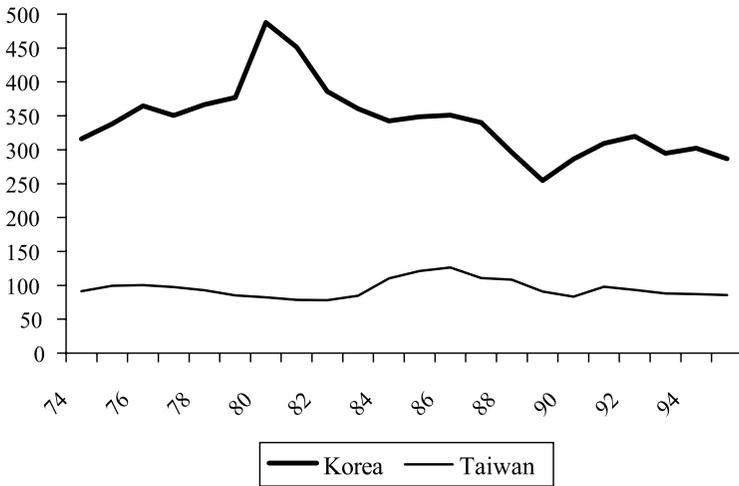


Figure 2.8 Debt-equity ratio of Korean and Taiwanese manufacturing firms (%).

Sources: BOK website, Fields (1995: 108, Table 4-5), Bank of China in Taiwan, quoted in BOK (1999a).

Singapore's economic spurt started with the formation of a new country in 1965 after the city-state was separated from the Malaysian Federation, and it has been supported by People's Action Party's (PAP) one-party domination.

Despite these commonalities, there were considerable differences in the relationship between the state and the private sector among the three East Asian NICs according to their different catching-up strategies and historical background.

Taiwan was a heterogeneous country with a deep divide between the 'mainlanders' and the 'local Taiwanese',<sup>18</sup> with the Kuomintang (the Nationalist Party) seizing the former Formosa Island after the defeat by the Communist Party and with the mainlanders dominating over the local Taiwanese. The Kuomintang government did not entrust the heavy and chemical industries, which were seen as crucial to national security, to the local Taiwanese businessmen, and developed them instead through public enterprises, the top echelon of whose management almost invariably constituted by mainlanders. The result was the relative underdevelopment of large-scale private enterprises. The extent of state domination in the Taiwanese economy is reflected in

the extremely high share of capital formation accounted for by the public sector in the country (Figure 2.9).<sup>19</sup>

However, the Kuomintang government allowed relative freedom to the ‘Taiwanese’ in pursuing economic gains through SMEs and provided them with wide-ranging supports. Reflecting its bitter experience with hyper-inflation in the mainland, it also maintained a strong anti-inflationary policy. Consequently, its support to the industry thus relied less on monetary than on fiscal policies like tax breaks and high depreciation allowances. It of course allocated policy loans, but they ‘were broadly targeted to support exports or anti-inflationary import package . . . and industry-specific loans were rare’, as Cheng (1993: 56) points out. In addition, the Taiwanese state heavily invested in R&D through public research institutes (e.g., ERSO ), spun off start-ups, which it supported in a number of ways (e.g., technology transfer, arranging alliances with foreign partners) (section 2.2.2).

Singapore developed mainly through MNCs, leveraging on its advantages as a city-state located at a historically important port in South East Asia and having a large pool of English-speaking population. The strategy was also a way to ensure its national security from its then hostile neighbours, Malaysia and Indonesia, by connecting the country directly to the advanced countries.

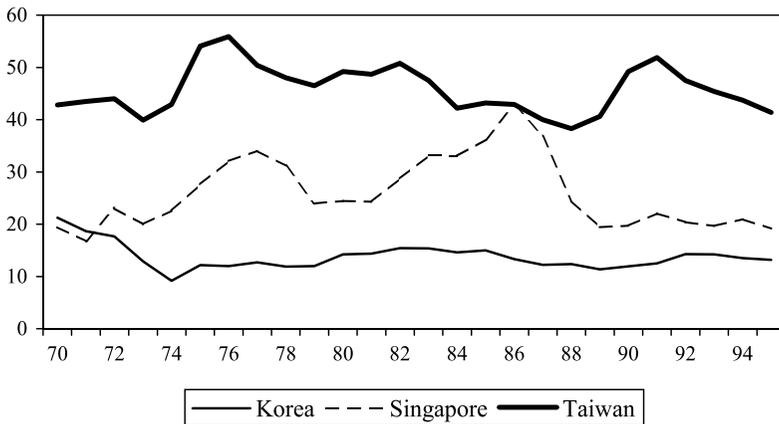


Figure 2.9 Public share to gross fixed capital formation in Korea, Taiwan and Singapore (%).

Sources: National Statistical Office (Korea) website, Singapore Department of Statistics website, Bureau of Statistics of Taiwan (2000).

The role of the state in industrialisation was therefore directed at attracting and upgrading MNCs' investment by providing them with complementary assets like infrastructure, human capital, fiscal incentives, and so on. The Economic Development Board (EDB) was particularly important. Since MNCs brought capital and technologies with them, fiscal policies were more important than monetary policies in influencing the path of economic development. The Singaporean state also supported SMEs, though on a much smaller scale than did its Taiwanese counterpart, by encouraging MNCs to transfer their technologies to local subcontractors and providing incentive to upgrade skills in SMEs, as, for example, reflected in Local Industry Upgrading Program (LIUP). In some industries like shipbuilding and steel-making, in which MNCs were not interested, the Singaporean state directly developed them through GLCs (Wong 2000).

The experiences of Taiwan and Singapore contrasts with that of Korea. The Korean state entrusted the *chaebols* as a major undertaker of industrialisation, although it developed some basic inputs industries like steel, petro-chemical, and fertiliser through public enterprises in the earlier stage of economic development in the 1960s. The state set up an overarching framework of industrial policy for import substitution whilst promoting exports generally. It pushed for upgrading of local industries through industry-specific, sometimes firm-specific, policy measures, including subsidies, protections, restriction of the number of firms in strategic industries, and so on. It also guaranteed foreign borrowings of the private sector, which until recently had very low international creditworthiness. Commercial banks kept providing the *chaebols* with 'patient' money under the guidance of industrial policy. In contrast to Taiwan and Singapore but in line with Gerschenkron's catching-up model, the financial system was extensively mobilised for industrial expansion, resulting in a very high portion of policy loans in the total loans from commercial banks.<sup>20</sup>

One important observation is that, although initially in many ways much more pervasive than in Taiwan or Singapore, state intervention in Korea subsequently shrank much more quickly than in the two other countries. This was because the very success of the Korean system resulted in the growth of very strong private sector agents, namely the *chaebols*, which made state intervention less necessary and which had the political clout to resist continuing state intervention. In Taiwan and Singapore, in contrast, private sector firms remained relatively weak, and, as a result, the state has maintained or even strengthened the leading role in initiating high-risk projects until the 1990s (section 2.2). This is why the issue of regulating the private

sector has been such a contentious issue in Korea for the last two decades (see section 3.4), whereas such issue has received virtually no attention in Taiwan and Singapore. And it is why the responses to the challenges of globalisation and pressure for market opening in the 1990s were very different in the two sets of countries.

## 2.4 The role of the *chaebols*

As we discussed earlier, the *chaebol* was a key institution that defined the Korean catching-up system. In some ways, it is what uniquely defines the traditional Korean model. However, it is important to note that business grouping is more a general feature of industrial structure in developing countries and is not unique to Korea, although the size and dominance of business groups in the economy may vary greatly across countries (Hirschman 1968, 1986; Strachan 1976; Leff 1978; Yasuoka 1984; Granovetter 1994; Ghemawat and Khanna 1998).<sup>21,22</sup>

Business group can be defined as 'a set of firms which act in different product markets under common entrepreneurial and financial control', if we slightly modify Leff's (1978: 663) definition.<sup>23</sup> In contrast with a diversified firm in which its different business units are not independent legal entities, member firms of a business group are legally independent. In contrast with independent individual firms, which normally transact with each other through market mechanism, member firms in a business group usually transact with each other through a non-market mechanism, i.e., hierarchy. *Diversification among member firms under centralised coordination* is a major characteristic of business group.

The widespread existence of business groups in developing countries can be explained by their greater abilities to exploit the economies of scope, accorded by the following three factors – the first two relating to the use of financial resources and the last relating to the use of non-financial resources.

First, the business group is a mechanism to increase the amount of capital as much as the universal banks were in the nineteenth century. A universal bank lends money to a company on the basis of holding the company's shares as its assets and it can therefore increase the lending to the company more than when it does not hold the company's shares. Likewise, business groups increase their capital through 'mutual shareholding', or 'circular shareholding' without actually putting real money, as we shall elaborate below in discussing 'fictitious' capital of the *chaebols*. This is a way of utilising leverage based on interlocked shareholdings: the more interlocked are shareholdings, the

more assets can be created on the same initial paid-in capital. Diversification through independent firms is also a better way to exploit the leverage of borrowings from financial institutions than diversifying within existing firms, as in the former case leverage can be spread across the new firms without increasing the leverage of the existing firms.

Second, the structure of business group works as a mini-capital market for member firms. Financial resources can be mobilised across member firms through direct subsidy, corporate lending, loan guarantees, and so on, and can be directed to projects the group considers strategically important. In this respect, Leff (1978: 672) argues that 'to some extent the groups approximate the functioning of a capital market in the less developed countries'. If capital market is underdeveloped, it may be more efficient to rely on intra-group mobilisation of capital than to rely on capital markets. If a business group has financial institutions as its member firms, the intra-group capital market can be even more effective.

Third, the centralised decision-making at the group level may save entrepreneurial resources. This is so-called the 'central office effect'. As Leff (1978: 670) points out, 'the group *structure* itself reduces the amount of entrepreneurial capacity which is required per unit of innovative decision making'. The same applies to other non-financial resources such as technologies, engineering skills, marketing capabilities, and so on. The group structure reduces the amount of those resources required per unit of economic activities though intra-group transfer.

These advantages also mean that business groups may be more suitable in sustaining long-term projects which require a long gestation period for learning and creating new technologies. Continuous stream of profits from existing businesses may be directly mobilised for or guarantee new uncertain projects. Member firms can provide various indirect financial supports through purchasing products at higher-than-market price, and supplying inputs at lower-than-market price. The intra-group transfer of managers and skilled workers often makes it easier to solve problems arising in the process of carrying out new projects. In this regard, Freeman (1987: 51) stresses that the oligopolistic competition resulting from the formation of business groups 'permits and encourages a long-term view with respect to research, training and investment'.

In terms of international competition, the business group can be understood as an 'institutional innovation' that has allowed the late-comers in the late-twentieth century to compete with their forerunners

on a more equal footing – in the same way the universal bank allowed Germany to compete more effectively with Britain.

The German universal bank in the nineteenth century allowed German firms to mobilise scarce resources and concentrate them on some strategic industries in competing with the British forerunner firms, as Gerschenkron emphasised. At the time, individual firms in Germany did not possess sufficient technological, managerial, and financial strengths to directly compete with the British firms. However, greater resource mobilisation and better managerial guidance that the universal banks provided compensated for their weaknesses.

Likewise, the business group has compensated for the lack of resources in the latecomer firms of the late-twentieth century in their competition with superior forerunner firms in developed countries. It is difficult for them to win the competition if they compete individually, but they can increase their chances by grouping. The Japanese *keiretsu* provided an exemplary case of gaining edge in international competition through grouping during the postwar period.<sup>24</sup> The Korean *chaebols* likewise showed their strengths in international competition by utilising their group structure. Let us elaborate more on the case of the *chaebols* below.

As we pointed out in section 2.2, the main impetus for the *chaebols*' rise was provided by the HCI programme. Origins of some of the *chaebols* can be traced back to the early 1950s, but they experienced substantial expansion during the period of HCI drive in the 1970s. The share of the top ten *chaebols*' value-added to GDP more than doubled from 5.1 per cent in 1973 to 10.9 per cent in 1978 (Table 2.4). The average number of affiliated firms of the top ten *chaebol* increased from 7.5 in 1972 to 25.4 in 1979 (Cho 1991: 184–5).

A characteristic feature of the *chaebols*' expansion was the correlation between group size, growth rate, and specialisation in the heavy and chemical industries (henceforth HC industries). In the 1970s, 'the largest groups grew much more rapidly than the smaller groups' (Jones 1987: 102), with the *chaebols* on the whole growing

Table 2.4 Trend in the *chaebol* share of GDP, 1973–1978 (%)

Groups	1973	1974	1975	1976	1977	1978
Top 5	3.5	3.8	4.7	5.1	8.2	8.1
Top 10	5.1	5.6	7.1	7.2	10.6	10.9
Top 20	7.1	7.8	9.8	9.4	13.3	14.0
Top 46	9.8	0.3	2.3	12.3	16.3	17.1

Source: Jones (1987), Table 3.

much faster than the overall economy. As we can see in Table 2.5, the top five groups' average growth rate was 31.6 per cent during 1973–8, and the growth rate falls as the group size becomes smaller. This size–growth relationship is closely associated with differing degrees of specialisation on the HC industries across groups of different sizes, with the larger groups relying more in the HC industries than the smaller ones. The top five *chaebols* accounted for 31.7 per cent of total valued-added in the HC industries in 1978 but only 5.7 per cent in light industry, with the share in light industry tending to increase as the group size becomes smaller.

This correlation between group size, pattern of specialisation, and growth rate is consistent with our previous discussion on the business group's structural advantages in developing countries. The HC industries were 'new' industries for Korea and required a large-scale capital mobilisation and a long gestation period for investment. The *chaebol* structure, with a high degree of diversification and centralised control, was critical in determining the success in these industries.

The Hyundai Heavy Industries (HHI), currently the largest shipbuilder in the world, is a case in point.<sup>25</sup> Shipbuilding was a new business for the Hyundai Group when HHI was set up in 1971. HHI ambitiously started by constructing the then largest shipyard in the world but it suffered from lack of demand from the outset. The initial level of technological capability of HHI was so low that it could not even meet the delivery date of simple replication of ships with the tested designs and proven capital equipment of an experienced European shipbuilder. In these adverse conditions, intra-group resource mobilisation was decisive in sustaining this long-term project, as the following documentation testifies:

Table 2.5 The *chaebol* growth rates and the share of the HC industries (%)

Groups	Growth rates (1973–7)	Shares of industries (1978)	
		HC industries	Light industries
Top 1–5	31.6	31.7	5.7
Top 6–10	24.2	9.0	1.2
Top 11–20	21.2	11.6	8.2
Top 21–46	14.1	7.4	11.9
Top 1–46	24.2	59.7	27.0
Economy	9.9		
Manufacturing	17.2	48.9	51.5

Source: Adapted from Jones (1987), Tables 4 and 12.

The top-ranking Korean manager of HHI was formerly a high-level manager of the Hyundai Construction Company (HC), and when HHI ran into problems keeping to schedule, engineers from HC were mobilised. In addition, Hyundai Construction provided HHI with many of its front-line supervisors, managed the construction of the Mipo dockyard, and helped supervise feasibility studies. Hyundai Motors dispatched engineers to help in the struggle to reduce throughput time and also provided technical assistance in assembly line and training techniques. Hyundai Cement sent people to work in production control. All in all, as HHI managers pointed out, 'a lot of people joined'. *The possibility of mobilizing such personnel enabled HHI to act quickly and to avoid delays of recruiting fresh talent in the market.*

(Amsden 1989: 286–7)

In addition, HHI could pick up the shipbuilding designs of Govan, a Scottish shipyard, at a bargain price, because the representative of the Hyundai Group in London read in a British newspaper that Govan was going bankrupt. Even more interestingly, when HHI faced problems in its upstream or downstream industries, the Hyundai Group dealt with them by establishing new firms in those very industries. So it founded Hyundai Merchant Marine Company (HMMC) to buy ships from HHI when foreign buyers refused the delivery of vessels constructed by HHI. Hyundai Engine and Heavy Machinery Manufacturing Company (HEMCO) was established in order to provide HHI with an alternative to high-priced Japanese engines.

Similar stories abound in relation to other *chaebols*, but another important example is the Samsung Group's entry into the semiconductor industry through Samsung Electronics Co. (SEC), which became the largest producer of memory chips in the world by 1992. Samsung's foray into semiconductors would not have been possible without the intra-group resource mobilisation. The group started the semiconductor business by acquiring a venture firm, Korea Semiconductor Inc. (KSI) in 1974, whose name was changed to Samsung Semiconductor Co. (SSC) in 1978, and later to Samsung Semiconductor and Telecommunication Company (SST) in 1982. This semiconductor firm was 'notorious within the Samsung Group as a symbol of low productivity' (Choi 1994: 87). According to Jun and Han (1994), the cumulative deficit of the firm was about 200 billion won (US\$227 million when US\$1=881.33 won, the annual average of exchange rate in 1986) by the end of 1986 from its inception, which far exceeded the ordinary profits of the whole Samsung Group in that

year, 120 billion won. But the company maintained an over 50 per cent investment-to-sales ratio all through the 1980s, which was sustained by the group's strategic concern and financial support from member firms. SEC on its own was much smaller than its key competitors such as Toshiba or Hitachi, but the Samsung Group was comparable to them in size.<sup>26</sup> SEC compensated for its relative lack of resources as compared to Japanese forerunners by group-level resource mobilisation and more narrowly focusing its catching-up effort on DRAM manufacturing (Shin 1996: Ch. 8).

The group structure has been maintained largely by inter-subsidary shareholding.<sup>27</sup> As Table 2.6 shows, the ownership control mechanism of the *chaebols* is in fact twofold: owner families control the 'key' member firms (these firms are *de facto* holding companies of the group) and the other member firms are interlocked through circular shareholding. The overall control of the groups has been maintained through relatively stable, *albeit* decreasing, inter-subsidary ownership, while the share of family ownership has decreased rather quickly.

As we pointed out above, this interlocked shareholding was itself a way of enlarging investment funds through creating 'fictitious capital'.<sup>28</sup> If the *chaebols* were to maintain their business grouping without interlocked shareholdings being thus created, the owner families would have had to raise additional capital from their own pockets, which would have been impossible – they were unable to maintain their ownership shares over time even with the help of interlocked share-

Table 2.6 Changes in the share of 'insider' ownership of the *chaebols* (%)

	1983	1987	1989	1990	1991	1992	1993	1994	1995	1996
Top 30	57.2	56.2	46.2	45.4	46.9	46.1	43.4	42.7	43.3	44.1
Family	17.2	15.8	14.7	13.7	13.9	12.6	10.3	9.7	10.5	10.3
Subsidiaries	40.0	40.4	32.5	31.7	33.0	33.5	33.1	33.0	32.8	33.8
Top 5	–	60.3	49.4	49.6	51.6	51.9	49.0	47.5	48.1	45.2
Family	–	15.6	13.7	13.3	13.2	13.3	11.8	12.5	9.4	8.6
Subsidiaries	–	44.7	35.7	36.3	38.4	38.6	37.2	35.0	38.7	36.6
Hyundai	81.4	79.9	–	60.2	67.8	65.7	57.8	61.3	60.4	56.2
Samsung	59.5	56.5	–	51.4	53.2	58.3	52.9	48.9	49.3	46.7
Daewoo	70.6	56.2	–	49.1	50.4	48.8	46.9	42.4	41.4	40.1
LG	30.2	41.5	–	35.2	38.3	39.7	38.8	37.7	39.7	38.3

Source: Chang and Park (1999).

Note: The figures for the top thirty and the top five *chaebols* are the weighted average of individual *chaebols* (according to the size of their capital base) in the respective grouping.

holding. And without such fictitious capital, the *chaebols* would not have been able to invest as much as they have done, given that, even with interlocked shareholding, they had to rely on the stock market much more heavily than the large firms in the developed countries (see section 3.2.4). Thus seen, both from the point of view of the *chaebols* and from that of the overall economy, interlocked shareholding provided investment funds which otherwise would not have been available during the country's high-growth period.

Interlocked shareholding was not the only thing that the group structure allowed the *chaebols* to use in raising new investments. When a member company applies for loans to commercial banks, loan guarantees and other implicit or explicit promises of assistance from its sister firms functioned as major collaterals the banks could count on. Likewise, other things being equal, *chaebol* affiliates could raise more money from the capital market than could independent firms, as they were seen as having lower risk due to their group affiliation. And, as we pointed out above, the *chaebols* could maintain a higher financial leverage of individual firms than independent firms by spreading the loan risk across member firms. A consequence of this money-drawing ability was concentration of domestic financial resources in the hands of the *chaebols*. In 1997, 47.9 per cent of the total debts in the Korean economy were taken by the thirty largest *chaebols*, which employed only 4.15 per cent of total workforce (Table 2.7).

The credit creation system in Korea has been centred at the state–bank–*chaebol* nexus – commonly known as Korea Inc. The government formulated industrial policy and guided the commercial banks to provide loans to strategic industries. And the group structure further expanded credit available to the *chaebols* through interlocked shareholding, loan guarantees, and other mutual assistance among member firms. This state–bank–*chaebol* nexus worked particularly well in the

Table 2.7 The share of the *chaebols* in the Korea economy (% , 1997)

	<i>5 largest chaebols</i>	<i>30 largest chaebols</i>
Value-added	8.48	13.05
Assets	29.22	46.25
Debts	29.79	47.94
Sales	32.29	45.86
Ordinary profit	–2.22 (46.11)	46.73 (46.09)
Employment	2.70	4.15

Source: Adapted from Choi (1999, Table 2.2).

Note: \*Figures in parentheses are for 1995.

HC industries, where economies of scale mattered and large-scale capital mobilisation was necessary. When compared to Taiwan and Singapore, Korea's advancement was therefore pronounced in those items such as cars, steels, shipbuilding, plant engineering, and Dynamic Random Access Memories (the most capital-intensive and standardised segment of the semiconductor industry).<sup>29</sup>

## **2.5 Concluding remarks**

In this chapter, we first defined the traditional Korean economic system, based on the close relationship between the state, the banks, and the *chaebol* – a system that is commonly known as Korea Inc. – from a Gerschenkronian perspective of catching-up. We characterised the Korean system as a late-twentieth-century example of a late-industrialiser following the Gerschenkronian 'substituting' strategy. We first put it in historical perspective by comparing it with the earlier examples of the countries that pursued such strategy, such as Germany, Russia, and Japan. And then we put it in a comparative perspective by contrasting it with those of Taiwan and Singapore, which pursued a 'complementing' strategy during the same period. Following this, we discuss the role of the two most important players in the Korean system, namely the state and the *chaebols*, comparing them with their counterparts in Taiwan and Singapore whenever possible.

The discussion in this chapter shows how the nature and the evolution of the Korean economic system were influenced by the particular development strategy that the country pursued as well as the historical context in which it was pursued. By discussing the Korean system in historical and comparative perspectives, we were able to show how the pursuit of a substituting strategy shaped the evolution of the roles of the Korean state and the business groups, as well as their mutual relationship, in a way that is a lot more complex than the conventional wisdom portrays – a system in which a dictatorial and corrupt, if generally competent, state ran things in league with large and diversified conglomerates that were only sustained through state help, including preferential lending from state-controlled banks. It is on the basis of this understanding that we start our analysis of the 1997 crisis and its aftermaths in the following chapters.

## 3 The 1997 financial crisis and its aftermath

In the previous chapter we defined the key characteristics of the traditional Korean economic system – or ‘Korea Inc.’, based on the nexus between the state, banks, and the *chaebols* – and discussed its strengths and weaknesses as a catching-up system. This was done from a historical-comparative perspective, which allowed us to evaluate the relative merits and demerits of the Korean model in a more balanced way than is possible under the common practice of benchmarking it against some theoretical ideal or an idealised version of the Anglo-American model.

In this chapter, we discuss the 1997 financial crisis and its aftermath, which is essential in understanding the post-1997 corporate sector reform, which is the focus of our book. In the first part of this chapter, we chart the evolution of the 1997 crisis. We then critically discuss the alleged causes of the crisis, which informed – or, rather, misinformed, in our view – the short-term crisis management strategy and the long-term restructuring programmes of the IMF and the Korean government (section 3.2). Then we discuss the unexpected recovery of the Korean economy from the crisis, focusing on whether the IMF programme was the main force behind the recovery, as the IMF and its supporters claim (section 3.3). And we set out our view on the real causes of the Korean crisis, characterising it as a case of ‘transition failure’ (section 3.4), before we provide the concluding remarks (section 3.5).

### 3.1 Evolution of the crisis

The announcement by the Korean government on 3 December 1997 that it was going to call in the IMF shocked the world. To be sure, the international financial market, especially the so-called emerging markets, was looking very unstable following the Thai and the

Indonesian financial crises that broke out in the previous summer. However, for many people it was still difficult to believe that one of the ‘miracle’ economies of the late twentieth century and a newly anointed member of the OECD was going to the IMF with bowl in hand because it did not have enough foreign exchange reserve even to last it for a month (Figure 3.1).

There was an immediate run on the Korean currency. Won, the Korean currency, for a few days fell to one-third of its value before the onset of the crisis. The country suddenly became a subject of harsh criticism by domestic and foreign financial, academic, and journalistic communities. The prevailing view was, and still is to a large extent, that this crisis was an inevitable result of the country’s fundamentally inefficient and corrupt economic system (more on this later). According to this view, this was neither a crisis due to cyclical factors nor even one due to a short-term macroeconomic mismanagement, but one due to long-run structural factors.

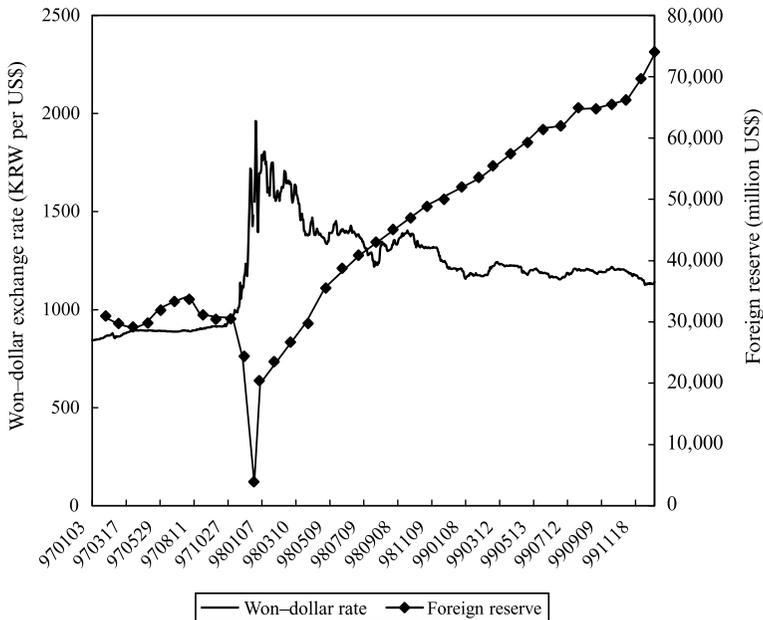


Figure 3.1 The currency crisis in Korea.

Source: BOK website.

As we shall show in the next sections (see sections 3.2 and 3.4), we do not agree with this conventional view. First of all, it over-plays the importance of the 'structural' factors, and, second, as far as the 'structural' factors are important, it identifies the 'wrong' ones. However, before we critically examine the conventional view, we need to take a closer look at the evolution of the crisis to establish certain facts, which will inform our discussions to follow.

The Korean economy started going through what appeared to be a bad patch from 1996. The most visible problem was the mounting trade deficits. The country's current account was more or less in balance in 1993 and 1994 (\$0.4 billion surplus and \$4.6 billion deficit, which is equivalent to about 1 per cent of GDP). Even in 1995, when the country started showing signs of deteriorating trade balance, the deficit was a perfectly manageable at \$8.9 billion (equivalent to 2 per cent of GDP). However, during 1996, it rapidly deteriorated to a more worrying \$23.7 billion (equivalent to over 5 per cent of GDP).

This deterioration in the balance of payment problem was largely due to a fall in export earnings, whose main cause was the cyclical downturn in semiconductor prices. The 64-mega DRAM chip, which made up almost all of the 17.7 per cent share in Korean export that microchips accounted for in 1995, was entering the last phase of its life cycle in 1996 and 1997. The price of the 64-mega DRAM chip collapsed to less than 10 per cent of its height (from over \$40 to \$3–4 per chip) during this period, and largely as a result of this, the unit price of Korean exports fell to 86.6 per cent in 1996 and then to 72.8 per cent in 1997 of its 1995 level. This is a dramatic decline in terms of trade, which is normally reserved for primary commodity exporters (Figure 3.2).

Despite the dramatic deterioration in terms of trade, the current account deficit fell thanks mainly to the slowdown in imports and remained at a more manageable level throughout 1997 (around 3 per cent of GDP).<sup>1</sup> Given that this was a perfectly manageable balance of payments problem by any standard, foreign investors who later exited the country citing 'fundamental' structural problems were certainly exaggerating whatever structural problems the country may have had. Given the cyclical nature of its current account deficit (which was definitely turning around), Korea could have ridden out the problem without going through a crisis, *if it did not have so much short-term debt* – its short-term foreign debt stood at the staggering 58 per cent of total debt throughout 1997.

Moreover, despite the improving balance of payments situation, a series of events happened throughout 1997 that made things very

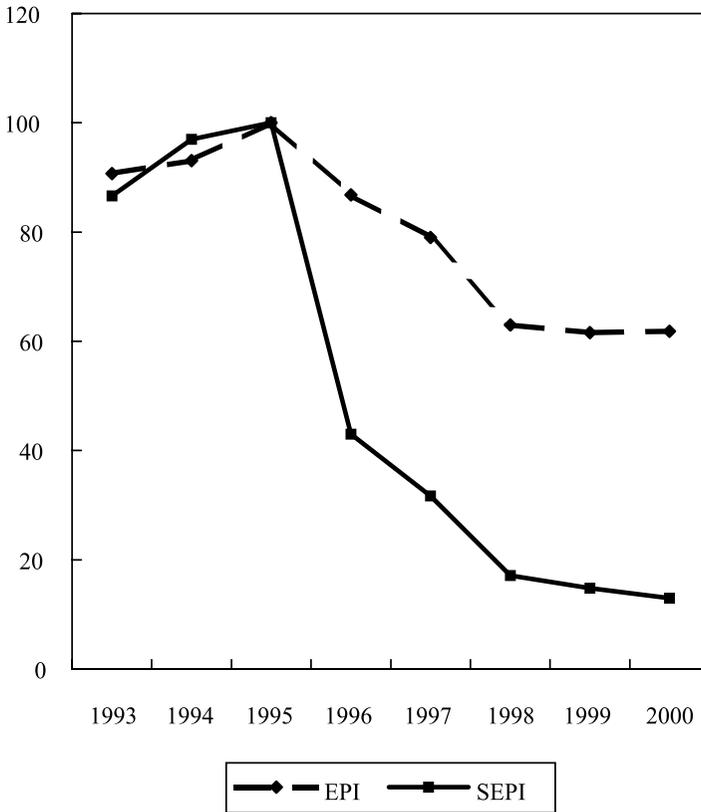


Figure 3.2 The collapse of unit export prices in Korea (1995=100).

Source: BOK website.

Notes: EPI is export price index.

SEPI is semiconductor export price index.

difficult for the Korean economy. The start of this was the bankruptcy of the new major steel company Hanbo in January 1997. In the fall-out following the bankruptcy, it was revealed that there existed a web of high-level corruption, involving some very close associates and the son of the then president Mr Kim Young Sam, around Hanbo's entry into the steel industry and the continued loan extension. Considering the company's dubious record of manufacturing capability and a record of involvement in a former corruption scandal in real estate

development, the granting of the licence and the continued financing of a minor *chaebol* could not be explained otherwise.<sup>2</sup>

The Hanbo case may have revealed certain problems in the Korean corporate sector, but what really battered 'investors' confidence' in the Korean economy – now increasingly that of foreign investors, as the financial market had become increasingly open during the early 1990s – was the saga surrounding the fate of the then third (and once the second) biggest automobile producer, Kia Motors. Kia Motors, the dominant firm in the Kia Group, the eighth biggest *chaebol*, first showed signs of trouble in June 1997. In response, the then finance minister, Mr Kang Kyung Shik, argued that the Korean economy now needed more market discipline and therefore that he did not mind showing that 'even the *chaebols* can fail' by letting Kia go under. The fact that many *chaebols* had been allowed to go under in the past was conveniently forgotten in this new-found faith in market fundamentalism in the Korean economic policy-making establishment (see section 3.2.2 for further details).

Given his well-known connection with Samsung, the second biggest conglomerate, many people interpreted Kang's remark as a coded message that he would let Kia be taken over by Samsung. By this time, Samsung's new automobile venture was looking increasingly doubtful without the acquisition of an existing firm with solid manufacturing capability, as it had already poured in an inordinate amount of money buying and fortifying the expensive but unsuitable reclaimed land in the then president's home town, Pusan.<sup>3</sup> When the Kim government found out that a takeover of Kia by Samsung was not going to go down very well in public opinion, it changed its policies about the fate of Kia many times, undermining international confidence in the economy.<sup>4</sup>

The Kia saga was, of course, unfolding during an especially unfortunate time. In July 1997, the South East Asian financial crisis broke out, starting with the massive devaluation of the Thai baht and the 'contagion' to Malaysia and Indonesia.

The South East Asian crisis contributed to the subsequent Korean crisis in a number of ways. First of all, the 'contagion' effect meant that confidence in all Asian economies, and not just the South East Asian economies first affected by the crisis, was shaken. This is, of course, not to say that the effect was purely psychological. The falling demand in South East Asia meant a fall in export for Korea. Some of the Korean financial institutions that invested in the region were hard hit by the collapsing stock and especially bond markets. It is estimated

that the Korean financial institutions lost at least \$2 billion, and possibly more, in the South East Asian financial markets between July (the beginning of the Thai crisis) and November (beginning of the Korean crisis). Some commentators also argue that the fall in South East Asian asset values prompted some Japanese banks which heavily invested in the region to withdraw loans from Korean debtors in order to improve their balance sheets.<sup>5</sup>

Important though these events of 1996 and 1997 may have been, there was a more fundamental problem that was gripping the country in the shadow of widely publicised current account deficit figures and high-profile corporate bankruptcies (and the corruption scandals surrounding them). The problem was a rapid build-up of short-term foreign debts, which was a direct result of an extensive financial liberalisation implemented from the early 1990s but accelerated with the coming to power of the Kim Young Sam government in 1993 (see section 3.4.2 for further details).

The combination of a liberal licensing policy for entry into financial industries, lax regulation (regarding things like risk exposure and asset-liability match), and, most importantly liberalisation of foreign borrowing, led to a rapid accumulation of foreign debt. Foreign debt nearly trebled from \$44 billion in 1993 to \$120 billion in September 1997 (it fell slightly to \$116 billion by November 1997).<sup>6</sup> This debt build-up was almost twice as fast as that of 1979–85, the period of the country's earlier (near) debt crisis – Korea's foreign debt grew at 17.8 per cent per annum during 1979–85, while it grew at 33.6 per cent per annum during 1994–6 (Table 3.1).<sup>7</sup>

Large and fast-growing Korea's foreign debt may have been, *prima facie* it was *not* at an unsustainable level. The World Bank considers countries with debt/GNP ratios under 48 per cent as low-risk cases, but Korea's debt/GNP ratio was only 22 per cent in 1996, and was still around 25 per cent on the eve of the crisis.<sup>8</sup> The corresponding figures at the end of 1995 were 70 per cent for Mexico, 57 per cent for Indonesia, 35 per cent for Thailand, 33 per cent for Argentina, and 24 per cent for Brazil (World Bank 1997). Also, in terms of another common indicator of debt burden, i.e., debt service ratio (total debt service to exports of goods and services), Korea was well below the World Bank 'warning' threshold (18 per cent) at 5.4 per cent in 1995 and 5.8 per cent in 1996. These compare very favourably with those of countries like Mexico (24.2 per cent), Brazil (37.9 per cent), Indonesia (30.9 per cent), Thailand (10.2 per cent) in 1995 (World Bank 1997).

*Table 3.1* Korea's foreign debt profile, 1960–1997

<i>Year</i>	<i>Total debt (millions of dollars)</i>	<i>Share of short-term debt (%)</i>	<i>Foreign debt to GNP (%)</i>	<i>Debt service ratio (%)</i>
1960	83	1.2	3.9	0.4
1961	83	n.a.	3.9	0.4
1962	89	n.a.	3.8	0.7
1963	157	14.0	5.8	0.9
1964	177	5.6	6.1	2.6
1965	206	1.5	6.9	5.0
1966	392	1.8	10.7	2.9
1967	645	10.2	15.1	5.2
1968	1,199	7.4	22.9	5.2
1969	1,800	10.8	27.2	7.8
1970	2,245	16.6	28.1	18.2
1971	2,922	16.4	31.2	20.4
1972	3,587	17.8	33.9	18.4
1973	4,257	16.5	31.5	14.2
1974	5,933	20.9	32.0	11.2
1975	8,443	28.5	40.5	12.0
1976	10,350	28.9	36.7	10.6
1977	12,649	29.4	33.8	10.2
1978	14,823	21.3	28.5	12.1
1979	20,287	26.9	32.5	13.6
1980	27,170	34.5	44.4	13.3
1981	32,433	31.5	49.0	14.3
1982	37,083	33.5	52.0	16.2
1983	40,378	30.0	50.8	15.7
1984	43,053	26.5	49.5	16.5
1985	46,762	23.0	52.1	18.7
1986	44,510	20.8	42.3	20.8
1987	35,563	26.1	27.6	29.6
1988	31,150	31.4	18.0	13.8
1989	29,368	36.8	13.9	9.7
1990	31,700	45.3	13.3	8.0
1991	39,135	44.0	13.9	4.6
1992	42,819	n.a.	n.a.	n.a.
1993	43,870	43.7	12.7	n.a.
1994	56,850	n.a.	14.2	n.a.
1995	78,439	n.a.	16.1	5.4
1996	104,695	58.3	20.2	5.8
1997	120,800	n.a.	25.5	n.a.

*Sources:* Economic Planning Board and Bank of Korea, various years.

However, the overall debt figures masked one critical problem with Korea's foreign debt, namely, its maturity structure. The share of short-term debt (which is defined as debt with less than a year's maturity) in total debt rose from an already high 43.7 per cent in 1993 to an astonishing 58.3 per cent at the end of 1996 (BAI 1998). The magnitude of these figures can be put into perspective if we recall that, on the eve of the 1980s debt crisis (between 1980 and 1982) in developing countries, the average ratio of short-term over overall debt for the non-OPEC developing countries was only 20 per cent (Koener *et al.* 1986: 8, Table 1.1). This high reliance on short-term foreign debt had made the Korean economy extremely vulnerable when lenders refused to roll over their loans along with the sudden change in their perception of financial risk of the country following the events in 1997, especially the South East Asian financial crisis.

The process of rapid build-up of foreign debt also made it difficult to manage the exchange rate in the face of declining export earnings in the mid-1990s. Traditionally, Korea has been known for its willingness to take quick action against currency over-valuation in order to maintain export competitiveness. As mentioned earlier, the current account surplus of \$0.4 billion in 1993 turned into a deficit of \$4.6 billion in 1994 and \$8.9 billion in 1995. During the period, however, the Korean won appreciated against the US dollar by 2.46 per cent in 1994 and 1.81 per cent in 1995. The Korean won began to depreciate only in 1996 when the country experienced a record \$23.7 billion of current account deficit.

A major reason why the exchange rate moved the 'wrong way' was the rapid inflow of foreign money in the form of loans, direct investment, portfolio investment, and so on. Sterilisation was difficult because it meant reducing supply of money to small and medium-sized companies, which were incapable of raising foreign loans, while leaving big companies with international creditworthiness free to finance their projects from abroad. On the other hand, allowing appreciation of the Korean won was an easier option because it helped in controlling the inflationary pressure stemming from the inflow of foreign money. Moreover, whatever the causes, having already built up a large foreign debt stock, the significant depreciation of the won meant a significant increase in the foreign debt repayment burden. This was one reason why *chaebols*, now with large foreign debts to worry about, did not campaign as vigorously as they used to for currency depreciation in the face of falling export earnings. In this respect, the country was in a vicious circle, as the rapid build-up of foreign debt made currency depreciation difficult, which reduced export earning even further, thus increasing the need for foreign borrowing.

### **3.2 The alleged causes of the financial crisis**

The IMF-sponsored structural reform programme implemented in Korea following the crisis was based on the perception that the crisis was caused by some structural problems in the Korean economy. Often epitomised by terms like ‘crony capitalism’ and ‘moral hazard’, these supposed structural problems were regarded as having obstructed rational functioning of the economic system. Those who held this view, including the IMF, inevitably called for a ‘fundamental’ economic reform of the country.

However, on a closer look, the above diagnosis is theoretically ill-grounded and lacks empirical supports. The resulting ‘reform’ measures, especially the reform of the corporate sector, was consequently highly misguided. Let us examine, in the following, four varieties of this view and expose their limitations.

#### **3.2.1 Industrial policy**

It is well known that the Korean ‘miracle’ was achieved on the basis of extensive industrial policy measures.<sup>9</sup> Starting from this observation, many commentators singled out industrial policy as the major cause of the country’s crisis (e.g., the *Economist*, 15 November, 1997; Brittan 1997). They argue that the Korean government, in its attempts to promote its favoured industries, have explicitly and implicitly under-written the investments in them, which naturally encouraged lax management and excessive risk-taking – or what is known among economists as ‘moral hazard’ on the part of the firms undertaking investments in these industries (for further theoretical considerations, see Chang 2000). This argument is best summed up in the following passage from the *Economist*:

Most of the financial mess is of Asia’s 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 uncreditworthy companies and industries.<sup>10</sup>

(15 November 1997)

Before we discuss the case of Korea, we need to remind the reader that, contrary to the assumption behind this view, state guarantee through industrial policy need not be ‘inefficient’. There are all kinds of ‘market failures’ that justify socialisation of risk through industrial policy as revealed in the recent debates. The examples include: the presence of ‘specific’ assets that make free entry and exit socially

costly; complementarity between investments across industries (the 'Big Push' consideration); externalities present in R&D efforts and other knowledge-generating investments; infant industry considerations arising from the cost of learning; and the capital market failure that makes long-term financing more expensive than is socially desirable (Chang 1994, Ch. 3; Stiglitz 1996; Lall 1998; Chang 2001).<sup>11</sup>

Such policies *do* generate some moral hazard, but the benefits that it brings about (e.g., higher productivity, better-coordinated investments, prevention of the 'wastes' from duplicative investments) can more than offset the costs from the moral hazard that it may generate. The success of industrial policy in Korea and a number of other East Asian countries in the past is a good proof of this.

Of course, as we all know, there are many examples of failed industrial policy attempts all over the world (including in the successful East Asian countries). However, these failures have occurred because of poor policy design and implementation (owing sometimes to political reasons and sometimes to the inevitable imperfection of human foresight), and not because the principle of socialisation of risk itself is inherently wrong. Recent debates have shown that the net benefit from industrial policy critically depends on how exactly it is designed and implemented: how realistically the 'target' industries are selected in light of the country's technological capabilities and world market conditions; how closely the policy is integrated with an export strategy so that there is some 'objective' criterion by which to judge enterprise performance; how much politically willing and able the state is to discipline the recipients of the rents that it creates; how competent and politically insulated the bureaucracy that implements the policy is; how closely the state interacts with the private sector while not becoming its hostage; and so on (Amsden 1989; World Bank 1993; Chang 1994; Evans 1995; Akyuz *et al.* 1998).

Moreover, it is empirically difficult to sustain the argument that industrial policy was responsible for the Korean crisis. Korea certainly had been one of the archetypal 'industrial policy states' and therefore it is natural that many people believe that industrial policy was the main factor behind its crisis, as the above quote from the *Economist* sums it up. Such conjecture sounds even more plausible when we recall that the over-investments that caused the Korean crisis were mostly in industries, rather than in real estate development as in the case of South East Asia (see Henderson 1998, on the role of real estate investments in South East Asia). However, this story does not concur well with the facts.

Contrary to the popular perception, industrial policy was largely absent in Korea in the build-up to the current crisis. It is true that up to the mid-1980s the country practised one of the most comprehensive and systemic industrial policies in the world. However, slowly from the late 1980s, and very rapidly from 1993 with the inauguration of the Kim Young Sam administration, the Korean government had dismantled industrial policy, except for R&D supports in some high-technology industries (see Chang 1998, for further details). If industrial policy was largely absent during the period of debt build-up, it seems rather difficult to blame the Korean crisis on that policy.

Under Korea's traditional industrial policy regime, it was not even the case that moral hazard was widespread. First of all, its government was willing and able to withdraw its support even from firms investing in its favoured sectors, if the performance lagged (Amsden 1989; Chang 1993; Evans 1995). For this purpose, it closely monitored the performance of the enterprises receiving its support, and routinely intervened to encourage (and sometimes force) mergers and take-overs of inefficient enterprises. And even the largest conglomerates were not free from such disciplinary process by the state (see section 3.2.3 for further details). Moreover, given the highly export-oriented nature of the large Korean firms, it was very difficult for an inefficient firm to hide its problems for long. In other words, there was actually little room for moral hazard for the government-supported firms in the traditional Korean industrial policy regime, as continued government supports were *contingent* on their performance and were *not guaranteed* by just being in the 'right' industries.

In fact, we can go even further and argue that it was actually the *demise* of industrial policy, rather than its continuation, which is to blame for the current crisis in Korea. For example, the end to the policy of investment coordination allowed the proliferation of duplicative investments in the key industries that fuelled the massive foreign borrowing between 1993 and 1997 (for more details, see Chang *et al.* 1998). In addition, the demise of industrial policy, as well as the official end in 1993 to the three-decade-old five-year-planning practice, led to the disappearance of the 'rational' criteria according to which government supports had been previously allocated and therefore made it easier to gain access to credits for risky ventures through 'cronyistic' connections or clever political manoeuvring (see section 3.2.2 for further details).

Let us summarise our argument in this section. The state's underwriting of risky investments through industrial policy may create some room for moral hazard and consequently certain social costs, but these

costs have to be set against the gains that it may bring. Moreover, whether and how much moral hazard is created by industrial policy depends on how it is designed and implemented. Empirically, there is little evidence that industrial policy was an important factor behind the Korean crisis. Industrial policy was largely dismantled by 1993 (see section 3.4.1 for further details). It can even be said that the demise of industrial policy critically contributed to the crisis, by removing the restraints on duplicative investments and possibly creating more room for cronyism.

### **3.2.2 *Crony capitalism***

Despite the loose analytical reasoning behind it, ‘crony capitalism’ has been the most popular explanation for the 1997 Asian crises, including the Korean crisis (Krugman (1998) was the most influential piece along this line). The crony capitalism story is often mixed up with the industrial policy story, partly because sometimes cronyistic supports were provided under the guise of industrial policy, especially in some South East Asian countries. However, analytically, government supports based on cronyism and those based on industrial policy concerns need to be clearly distinguished from one another.

In the industrial policy story, the government is seen to have provided guarantees to industrial and financial enterprises in their desire to develop certain industries against the market logic. In contrast, the crony capitalism story sees it as providing such guarantees in order to promote the interests of its political allies. The root of such political alliance, it is argued, can be nepotism (or what Krugman calls ‘minister’s nephew’ syndrome) but it can also be the granting of economic favours in return for political funding. Lenders naturally regarded, the story goes, enterprises with cronyistic connections as having no downside risk (as the government will rescue them if they get into trouble), and were willing to lend them as much as they wanted, thus inflating asset bubbles that led to the crisis (Krugman 1998).

Given the widespread existence of corruption throughout its developmental period and the high-profile Hanbo case in early 1997, it was only natural that many people tried to apply this argument to the Korean case as well.

Upon closer inspection, the crony capitalism story reveals a lot of problems. First of all, cronyism, in various forms and degrees, has been a constant feature in Korea throughout its high-growth period (as in the case of the other Asian-crisis economies). Given this, we may ask: why did it not cause similar crises before?

One possible explanation is that the nature of cronyism prevailing in the country had changed shortly before the recent crisis. For example, the weakening of 'developmentalism' (and the consequent dismantling of industrial policy, financial regulation, and five-year planning) since the late 1980s significantly reduced the scope for state influence in resource allocation, but at the same time it made it easier to abuse whatever residual influence that the state still had through bribery or nepotism (see Chang 1998; also see section 3.4.1). The result was a spilling-over of political corruption from the traditionally corrupt areas (such as urban planning and defence contracts) into the main manufacturing industries, which were previously insulated from corruption to a high degree (for further details, see Chang *et al.* 1998).

However, this is *not necessarily* to say that the changes in the form and the extent of corruption in Korea were so significant as to turn cronyism into the major problem that it was not before. For whatever its worth, the 'corruption perception index' compiled by Transparency International shows that corruption was perceived to be *diminishing* in Korea (and indeed all the other crisis-stricken Asian countries) for a decade before the crisis, *in spite of* the well-established historical fact that during financial euphoria the incidences of corrupt behaviour tend to increase both in the private sector and in the public sector (Kindleberger 1996, Ch. 5).<sup>12</sup>

Anyway, whatever its true extent was, it is not clear whether cronyism can ever be a major explanation of the Korean (and other Asian) crisis, because cronyism by definition has to be selective. It simply does not make sense to argue that all (or even the bulk of) those Korean financial institutions that built up foreign liabilities had such good political connections that they could expect bail-outs in times of trouble. If some foreign creditors thought this was the case, they should have practised themselves those 'advanced' credit risk assessment techniques that they are now so eager to preach to the Korean financial institutions.

To conclude, cronyism did play a role in the generation of the Korean crisis, but it is unlikely to have been more than a minor factor. Cronyism has been a permanent feature in Korean political economy (and indeed the other crisis-stricken East Asian countries) at least in certain sectors during its 'miracle', and there is little evidence that the changes in its form and extent that did occur were so significant as to create a crisis. In fact, as in the other crisis-stricken East Asian countries, corruption in Korea was perceived to have been diminishing in the build-up to the crisis. By definition, cronyism has to be selective,

and therefore it cannot have affected more than a small portion of the borrowings. If some lenders thought otherwise, it can only be as a result of the irrational euphoria that can grip people's minds during a financial mania.

### **3.2.3 *The logic of 'too big to fail'***

Many commentators have argued that the reckless, unfocused investments by the *chaebols* are at the root of the Korean crisis. They say: after all, that is where all the foreign borrowing eventually ended up, isn't it? The *chaebols*, they argue, took excessive risk because they knew that they were 'too big to fail' (henceforth TBTF) in the sense that the government cannot afford to sit and watch them go bankrupt for fear of large-scale 'ripple effects' such as large-scale unemployment and bankruptcy of subcontracting firms (e.g., Yoo 1997; Pyo 1998; Burton 1998). They cite the government rescue of some large firms in the past as the evidence that the logic of TBTF has been in operation in the country – the most frequently cited example being the nationalisation of the bankrupt third-largest car manufacturer Kia in the build-up to the crisis (see section 3.1).

The logic of TBTF seems difficult to dismiss, especially given that it is indeed practised by all governments in all countries, including the ones that claim to be the most market-oriented. The rescue of the US hedge fund, Long Term Capital Management (LTCM) following the Russian financial crises, is one prominent recent example, but the late 1970s rescue of the bankrupt Swedish shipbuilding industry through nationalisation by the country's first right-wing government for over fifty years or the early 1980s rescue of the carmaker Chrysler by the avowedly free-market Reagan administration also seems to demonstrate the power of the logic of TBTF.

The biggest problem with the TBTF story is its conflation of the rescue of a firm and the rescue of its owners or managers who are responsible for making the rescue necessary. To the manager, it is not much of a consolation that his/her firm is saved by the government due to its large size, if the rescue operation involves the termination of his/her contract. So if a manager knows that he/she will lose the job when his/her firm performs badly, there is little incentive for him/her to take excessive risk. The same goes for the owners. If the owners know that the rescue operation requires the ceding of their corporate control (as it has been almost always the case in Korea – see below), they cannot afford to be lax in management (if they are owner-managers) or in supervising the hired managers.

In this sense, the rescue of LTCM, which did *not* involve the removal of the incumbent management (although its control was weakened due to debt–equity swaps), has definitely given a very bad signal to the rest of the financial industry and will probably encourage excessive risk-taking (or ‘moral hazard’) in the future. On the other hand, the rescue of Kia, which involved a change in the top management, could not have sent such a signal to the managers of other large enterprises. In other words, whether government bail-out of some large firms encourages excessive risk-taking by the managers of other large firms depends on whether they are accompanied by punishments for bad management.

The evidence in the case of Korea is simply not on the side of the TBTF story. Especially in the 1960s and the 1970s, when the country was going through rapid structural changes, it was not infrequent to see even some of the largest *chaebols* going bankrupt and their carcasses being divided up through state-mediated take-overs. The second largest *chaebol* during the 1960s, Samho, had all but disappeared by the late 1970s after a series of bankruptcies of its core firms. The Gaepoong *chaebol*, which ranked between the third and the fourth during the 1960s, virtually disappeared by the mid-1970, following a series of business failures. The Donglip *chaebol*, which ranked ninth in the early 1960s, went bankrupt by the end of the decade. The owner of the once-largest car manufacturer in the country, Shinjin, was forced to sell it off to the state-owned Korea Development Bank (which subsequently sold it to Daewoo) in the late 1970s when it got into trouble. Dongmyung, the *chaebol* built around what was the world’s largest producer of plywood around the early 1970s, went bankrupt in 1980.

These are striking statistics. For example, the collapse of three of the top ten *chaebols* of the 1960s (namely, Samho, Gaepoong, and Donglip) is equivalent in American terms to the disappearance by the early 1980s of Standard Oil (New Jersey), Ford Motor, and IBM, which ranked the second, the third, and the ninth respectively in the *Fortune* US enterprise ranking in 1964. As a result, until the mid-1980s, there was a very high turnover even in the ranks of the top ten *chaebols*. Only three of the top ten *chaebols* in 1966 were among the 1974 top ten and only five of the 1974 top ten were in the 1980 top ten (Chang 1994: 123).

After the mid-1980s, and especially in the 1990s, the ranking of the top ten *chaebols* remained highly, if not completely, stable, but among the lesser *chaebols* there was still a high turnover. Between 1986 and 1996, among the twenty *chaebols* that ranked between the eleventh

and the thirtieth, there were on average fourteen changes in the rankings and 2.2 new entries into the group every year (Park 1998, Table 9). Between 1990 and 1996 alone, three of the top thirty *chaebols* (Hanyang, Yoowon, and Woosung) went bankrupt, showing that there is no substance to the claims such as: 'In Korea, none of the *chaebol* had been allowed to fail for a decade before Hanbo steel collapsed in early 1997' (Radelet and Sachs 1998: 42). In 1997, in the build-up to and at the beginning of the crisis, six of the top thirty *chaebols* (Kia, Halla, Jinro, Hanbo, Sammi, and Haitai) went bankrupt, again debunking the TBTF story (Chang *et al.* 1998).

Of course, all this is not to deny that the Korean government not infrequently injected money into ailing large enterprises through the state-owned banks (especially the development bank, Korea Development Bank). However, these financial injections were conditional, with very few exceptions, on the change of ownership and top management, and were always accompanied by tough terms of financial restructuring. In other words, the rescue of large enterprises by the Korean government should be seen as government-mediated take-over or restructuring rather than as bail-out in the strict sense (*à la* LTCM).<sup>13</sup>

Let us summarise the argument in this section. The logic of TBTF seems compelling, given that all governments, and not just that of Korea, have rescued some technically bankrupt large enterprises. However, whether such rescue will lead to 'moral hazard' (in the form of excessive risk-taking) on the part of the managers of other large firms depends on the terms of the rescue, especially whether and how much the existing managers are made to pay for their mistakes (recall our distinction between the Kia and the LTCM types of government rescue). It is only when the managers of the bailed-out enterprises are not properly punished that the logic of TBTF works. There is no evidence that this logic was in operation in Korea in any meaningful degree. Even the largest firms routinely went bankrupt, and state rescue programmes almost invariably involved the ousting of the existing owners and managers, while always imposing tough terms of financial restructuring. What these programmes did was to enable the firm to continue as a going concern, but not to let the incumbent managers get away with their mistakes and thus create 'moral hazard' for the managers of other large firms.

### ***3.2.4 Peculiar nature of the corporate sector***

Related but separate from the TBTF story is the argument that the Korean economy got into the crisis because of the peculiar nature of

its corporate sector. The most important element in this argument is the high leverage combined with low profitability of the Korean firms, especially the *chaebols*, which is shown as a sign that these are inefficient entities which are sustained only through persistent borrowing based on cross-loan guarantees among their affiliates and through continuous (and excessive) diversification into areas where they can drive out the existing firms through their superior financial power. This view is well reflected in the corporate reform agenda pursued by the IMF and the Kim Dae Jung government, which ultimately aims at dismantling the *chaebol* structure.

However, this characterisation of the Korean corporate structure is questionable, and, even if it is correct, it is doubtful whether it can 'explain' the crisis. As the rest of the book will discuss this issue in great depth, we shall not dwell on this point at length here. However, the following key points can be made.

First of all, it is not true that corporate leverage was uniquely high in Korea. The average debt–equity ratio of Korean firms, which historically moved in the range of 300 per cent to 350 per cent, is not exceptionally high by international standards. According to a World Bank study covering the period between 1980 and 1991 (Demigrucc-Kunt and Maksimovic 1996), a key table from which is reproduced below (Table 3.2), the ratios of Japan (369 per cent), France (361 per cent) and Italy (307 per cent) are similar to Korea's. The figures for Sweden (555 per cent), Norway (538 per cent), and Finland (492 per cent) are even higher near or above 500 per cent. The ratio of Japan in the 1970s, which would be fair to compare with Korea's figure in the 1980s given the differences in the stage of development, was around 500 per cent.

Second, it is not clear whether high corporate leverage in itself is a bad thing. There is well-known and still-inconclusive debate in financial economics on the relative merits of equity financing and debt financing, with some people regarding debt financing as having a more 'high-powered' incentive system (Harris and Raviv 1991; Brennan 1995).

Third, the belief that the high leverage of the Korean *chaebols* was the result of the attempts to avoid equity financing for fear of diluting the control by the 'owning' families is also not borne out by facts. The contribution of stocks in investment financing in Korea during the period of 1972–91 was at 13.4 per cent, much higher than that in Germany (2.3 per cent), Japan (3.9 per cent), the UK (7.0 per cent), or the USA (−4.9 per cent) (Table 3.3). Korean corporations had large debts not because they eschewed stock financing, but only

Table 3.2 Capital structure of firms in selected countries, 1980–1991

<i>Countries</i>	<i>Debt-ratio</i>	<i>Long-term debt to total equity</i>	<i>Short-term debt to total equity</i>	<i>Depreciation to total assets</i>	<i>Dividend to total assets</i>	<i>Earnings to total assets</i>
Australia	1.248	0.563	0.653	0.033	0.025	0.064
Austria	2.696	1.121	1.495	0.051	0.017	0.075
Belgium	2.023	0.764	1.259	0.039	0.022	0.092
Brazil	0.560	0.139	0.421	–	0.014	0.057
Canada	1.600	0.990	0.539	0.045	0.007	0.064
Finland	4.920	3.094	1.856	0.042	0.014	0.077
France	3.613	1.417	2.108	0.043	0.013	0.094
Germany	2.732	1.479	1.188	0.070	0.057	0.087
Hong Kong	1.322	0.309	0.967	0.017	0.019	0.121
India	2.700	0.763	1.937	0.038	0.014	0.132
Italy	3.068	1.114	1.954	0.041	0.070	0.080
Japan	3.688	0.938	2.726	0.026	0.007	0.067
Jordan	1.181	0.266	0.915	–	0.033	0.073
Korea	3.662	1.057	2.390	0.053	0.008	0.100
Malaysia	0.935	0.284	0.639	0.021	0.026	0.087
Mexico	0.817	0.375	0.442	–	–	0.076
Netherlands	2.156	0.710	1.297	0.043	0.020	0.094
New Zealand	1.527	0.752	0.776	0.030	0.025	0.106
Norway	5.375	3.495	1.880	0.049	0.009	0.092
Pakistan	2.953	0.595	2.358	0.038	0.028	0.115
Singapore	1.232	0.491	0.718	0.022	0.018	0.077
South Africa	1.115	0.597	0.518	0.013	0.062	0.206
Spain	2.746	1.086	1.649	0.040	0.016	0.095
Sweden	5.552	2.879	2.321	0.036	0.011	0.100
Switzerland	1.750	0.878	0.872	0.043	0.016	0.073
Thailand	2.215	0.518	1.769	0.030	0.029	0.129
Turkey	1.996	1.511	1.511	–	0.068	0.239
UK	1.480	1.065	1.065	0.032	0.025	0.025
USA	1.791	1.054	0.679	0.045	0.016	0.016
Zimbabwe	0.801	0.187	0.615	0.031	0.028	0.028

*Sources:* Chang and Park (1999). Calculated from the International Finance Corporation's Corporate Finance Data by Demigruc-Kunt and Maksimovic (1996: 354).

because they found even these large sums raised in the stock market insufficient for the aggressive investment strategy that they had pursued with impressive results.

Fourth, whether the Korean firms actually suffered from low profitability, which allegedly led to the debt build-up, is also questionable. According to a study by Claessens *et al.* (1998), where they measure

*Table 3.3* Gross sources of finance in selected countries, 1970–1989 (%)

	<i>Germany</i>	<i>Japan</i>	<i>UK</i>	<i>US</i>	<i>Korea*</i>
Internal	62.4	40.0	60.4	62.7	29.0
Bank finance	18.0	34.5	23.3	14.7	18.9
Bonds	0.9	3.9	2.3	12.8	5.7
New equity	2.3	3.9	7.0	−4.9	13.4
Trade credit	1.8	15.6	1.9	8.8	n.a.
Capital transfer	6.6	n.a.	2.3	n.a.	n.a.
Other	8.0	2.1	2.9	5.9	n.a.

*Sources:* Chang and Park (1999). All figures other than those for Korea are from Corbett and Jenkinson (1994: 9).

*Note:* \*1972–91.

corporate profitability in terms of returns on assets, Korea indeed had the forty-fourth lowest returns on assets among a sample of forty-six countries. However, if we use other profitability measures, Korean corporate profitability has not been so exceptionally low. For example, when we use the criterion of ‘operating profit’, that is the profit before paying financial expenses like interest payments, foreign exchange losses (gains) and so on, Korea actually had a higher rate of profit than the US, Japan, or Taiwan during 1988–97 (Table 3.4). Claessens *et al.* (1998: 7, Table 3) also confirm this observation. They show that the ‘operational margin’ (which is similar to the notion of operating profit)<sup>14</sup> among the Korean firms during 1988–96, at 19.6 per cent, was higher than that in the USA (14.4 per cent) and Germany (14.6 per cent), although it was lower than that in five of the eight other East Asian countries for which the figures were available (Japan,

*Table 3.4* Structure of profit in the manufacturing sector in Korea, Japan, the USA and Taiwan (%; average during 1988–97)\*

	<i>Korea**</i>	<i>USA</i>	<i>Japan</i>	<i>Taiwan</i>
Operating income to sales	7.0 (7.1)	6.6	3.3	6.5
Ordinary income to sales	2.1 (2.7)	4.2***	3.3	4.5
Financial expenses to sales	5.6 (5.3)	n.a.	n.a.	2.1

*Sources:* BOK website, BOK (2000), Chang and Park (1999).

*Notes:* \* Taiwan’s figures are for 1986–95.

\*\* Figures in parentheses are for 1986–95.

\*\*\* Net profits.

Indonesia, Taiwan, the Philippines, and Thailand; Hong Kong, Singapore, and Malaysia had lower figures).

Fifth, given the wildly different results that we get from the use of different profitability measures, it is not clear whether low profitability in itself can 'explain' the Korean crisis. For example, as we mentioned earlier, Korea had one of the lowest corporate profitabilities in the world if we use the return on assets criterion, lending support to those who seek the (proximate) cause of the country's financial crisis in low corporate profitability. However, by the very same profitability criterion, the other East Asian crisis economies had very *high* profitability. Thailand and Indonesia ranked the first and the third, and Malaysia ranked eighth (The second was the Philippines, a semi-crisis country). According to this criterion, the other Asian-crisis economies should not have experienced any crisis.

Sixth, the thesis on excessive diversification of Korean *chaebols* also needs to be re-examined. The *chaebols*, especially the large ones, may own fifty to sixty subsidiaries operating in dozens of different industries, but most of their sales revenues are generated by a few core firms. Between 1988 and 1995, the four largest subsidiaries of the top four *chaebols* generated an average of 79.0 per cent of their total sales. Especially in the case of Samsung, the four largest firms, two of which were in the same industry (electronics), alone accounted for about 90 per cent of sales – a striking concentration (rather than diversification) of activities given the number of its subsidiaries (fifty-five as of 1995). The same can be said of the smaller *chaebols*, with the reliance on a small number of subsidiaries tending to increase as their size diminishes. For instance, in 1994, the *chaebols* that ranked between the sixth and the tenth generated 72.6 per cent of their sales from the four largest subsidiaries. In the case of the *chaebols* that ranked between the eleventh and the twentieth, the three largest subsidiaries generated 72.1 per cent of their sales, and in the case of the *chaebols* that ranked between the twenty-first and the thirtieth, as much as 72.3 per cent of the sales were generated by the two largest subsidiaries.

### **3.3 The aftermath of the crisis: the IMF programme and the Keynesian recovery**

In the previous section, we discussed the arguments trying to explain the Korean crisis in terms of the 'structural' flaws of the Korean model – be they industrial policy, cronyism, the large size of its firms, or the peculiar nature of its firms. We have shown how these arguments are based on biased theoretical reasoning and lack empirical evidence. In

this section, we critically assess the impacts of the IMF programme and discuss whether the unexpectedly rapid recovery of the Korean economy since late 1998 proves the validity of the IMF programme, as the IMF and its supporters claim.

### ***3.3.1 The IMF programme***

The IMF programme instituted in Korea after the crisis consisted of three elements: (1) macroeconomic retrenchment, (2) market opening, and (3) structural reform. It is well known that structural reforms are the products of a ‘mission creep’ that the IMF has gone through for the last two decades or so. The IMF’s original charter mandates it to deal only with current account balance of payments problems but it has come to intervene in an increasingly wider range of issues since the 1980s. As we can see from Table 3.5, which details the contents of the IMF programme in Korea, its mission creep reached a new height in Korea, as it now even includes corporate sector reform, something which had never been included in its programmes until then. It was therefore called the ‘IMF plus’ by the local press. With this background, let us examine each component of this programme and its impacts on the Korean economy.

First, macroeconomic retrenchment was enforced by the combination of high interest rate and tight budgetary policy. In its agreement to bail out Korea on 3 December 1997, the IMF demanded that the Korean government reverse the large liquidity injection it had made just before the bailout and to raise the money market rates ‘sufficiently’ (it actually meant over 30 per cent for call market rates, which used to move between 11 and 13 per cent before the crisis). This was ‘[t]o demonstrate to market the government’s resolve to confront the current crisis . . . [and] to restore and sustain calm in the markets and contain the inflationary impact of the recent won depreciation’ (MOFE 1997a). The IMF also requested the Korean government to maintain ‘a small surplus’ in its budget in 1998, although this policy was subsequently reversed (see below).

Second, a fuller liberalisation of product and capital markets was undertaken. All the trade-related subsidies were abolished and the remaining import barriers like the ‘Import Diversification Programme’, which was mainly targeted at Japanese imports, were removed. The upper limit to foreigners’ domestic shareholdings was eliminated, the bond market was fully opened, and commercial lending was further liberalised. As far as market openness is concerned, Korea became a full First World country after the financial crisis.

Table 3.5 Major components of the IMF programme in Korea

<i>Category</i>	<i>Sub-category</i>	<i>Contents</i>
Retrenchment	monetary policy	<ul style="list-style-type: none"> <li>– increase call rates over 30%</li> <li>– reduce the M3 growth rate to 9% in Q1 of 1998</li> <li>– allow ‘cautious’ reduction in call rates (the 4th MOU agreed on 7 Feb. 1998)</li> </ul>
	budgetary policy	<ul style="list-style-type: none"> <li>– maintain a small budget surplus (the 1st MOU)</li> <li>– allow budget deficit up to 0.8% of GDP (the 4th MOU)</li> </ul>
Market opening	product market	<ul style="list-style-type: none"> <li>– remove trade-related subsidies</li> <li>– import liberalisation of remaining items</li> <li>– phase out the Import Diversification Programme</li> </ul>
	capital market	<ul style="list-style-type: none"> <li>– abolish daily exchange rate band and limit intervention in the FX market</li> <li>– remove restrictions on foreign ownership of equities and real estates</li> <li>– full liberalisation of the bond market</li> <li>– remove remaining restrictions on foreign borrowings by corporations and financial institutions</li> </ul>
Four system reforms	financial sector	– refer to Table 4.7
	corporate sector	– refer to Chapter 4
	labour market	<ul style="list-style-type: none"> <li>– introduce a legislation to make redundancy layoff easier</li> <li>– legalise ‘dispatch labour’</li> <li>– introduce social safety net</li> </ul>
	public sector	<ul style="list-style-type: none"> <li>– privatisation of public enterprises</li> <li>– reduce government regulations drastically</li> </ul>

Source: MOFE (1997a, 1997b, 1998a, 1998b, 1998c).

Third, the four major system reforms were carried out to address the alleged ‘structural problems’ in the economy.

In the financial sector, it was thought that the most serious structural problem lay in the supervision and monitoring system. So the Financial Supervisory Commission was launched as the agency for comprehensive supervision of financial institutions. The supervision

standard was tightened by applying the BIS (Bank for International Settlements) capital adequacy ratio, introducing a new standard called forward looking criteria (FLC), and so on. The governance of financial institutions was reformed by introducing the external board system in which a significant number of non-executive directors take part in decision-making. The government also closed many unviable commercial banks and non-bank financial institutions (NBFIs), and forced mergers and acquisitions (M&As) among them (for details, see section 4.1.3).

In the corporate sector, the *chaebol* structure became the major target of reform, because it was accused of being the cause of ‘over-expansion without accountability’ that led to the crisis. The *chaebols* were made to radically reduce their debt–equity ratios, which rose far above 400 per cent at the end of 1997, to 200 per cent in less than two years’ time. Loan guarantees and internal transactions among the *chaebol* affiliate firms were prohibited. The *chaebols* were also requested to concentrate on ‘core’ businesses by selling, closing, and swapping ‘peripheral’ businesses. The reform of corporate governance was particularly predicated on the perception that the ‘dictatorial’ management by the ‘owner’ families was the root cause of their ‘reckless’ expansion and the consequent national financial crisis.

Labour market was also ‘reformed’ in a way intended to increase its ‘flexibility’, despite the fact that Korea already had one of the most flexible labour markets among the OECD countries – even before the crisis, it had the highest ratios of temporary workers in the workforce among the OECD countries (Crotty and Lee 2001). Following the agreement with the IMF, the Korean National Assembly passed a law that made redundancy layoff easier. ‘Dispatch labour’, that is, employing temporary workers recruited through specialised agencies, was also legalised.

As part of the public sector reform, the existing privatisation plan for major public enterprises was strengthened while new plans were added. Civil service recruitment was changed in a way that made mid-career moves in and out of the civil service easier, taking USA bureaucracy as the benchmark. Government regulations over industries were also drastically reduced.

In a nutshell, the structural reforms in the IMF programme were directed at remoulding the Korean economy in the image of the (idealised) Anglo-American system, in the name of keeping up with the ‘global standards’. External liberalisation progressed in full. The financial sector was assigned the role of the nerve centre of economic management. The role of the government was confined to supervising

financial institutions and maintaining competitive market order. Companies were required to compete as independent units, rather than as members of business groups.

The combined effects of macroeconomic retrenchment and structural reform were devastating to the Korean economy particularly in the short term because they blocked the possibility of continued domestic financing during the crucial period of the financial crisis.<sup>15</sup> As domestic firms faced an acute credit crunch as the financial institutions stopped lending and interest rates soared, they simply went bankrupt. The ratio of dishonoured bills, an indicator of corporate failures, suddenly shot up from 0.48 per cent in November 1997 to 2.09 per cent in December 1997 after Korea was placed under IMF stewardship (Figure 3.3). In this situation, foreign money, which became the only remaining source of financing, also did not flow in. With increasing incidence of corporate failures and the possibility of a rapid rise in non-performing loans, private foreign investors actually withheld or even withdrew their money from Korea.

The situation became worse because the crisis was a regional phenomenon. Other East Asian countries were also hit by financial crises

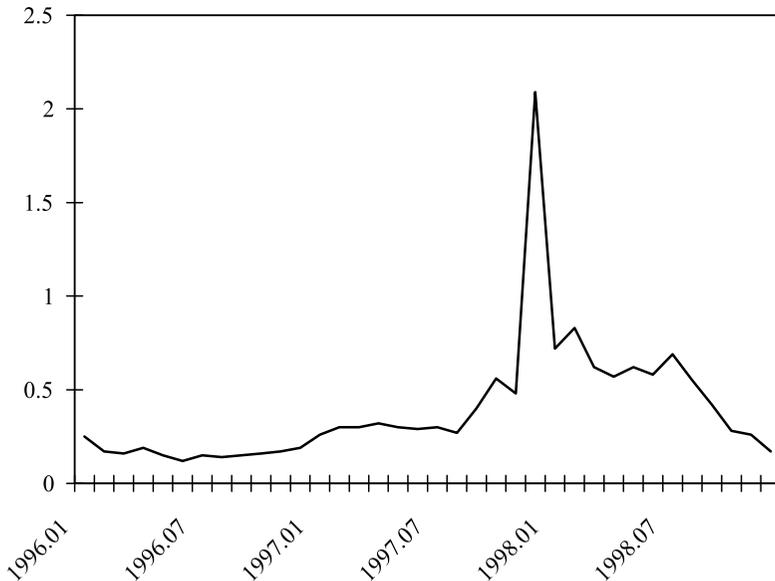


Figure 3.3 Changes in the ratio of dishonoured bills.

Sources: BOK website.

and they were also retrenching, thereby reducing imports from neighbouring countries. Korea's trade balance dramatically turned around to a surplus of nearly \$20 billion during the first half of 1998 from a deficit of \$9.1 billion during the first half of 1997. But this was not because Korea increased its exports by exploiting the depreciation of its currency, but because it had to radically reduce imports due to the macroeconomic retrenchment imposed by the IMF. If the export earnings from the \$1.8 billion of nationwide gold collection campaign to 'save the country' were excluded, Korea's exports were stagnant while its imports fell by 36.6 per cent in the first half of 1998. The economy contracted by 4.7 per cent in the first quarter and further by 8.0 per cent in the second quarter of 1998. As Table 3.6 shows, this kind of 'beggar-thy-neighbour' phenomenon spread all over East Asia and the region fell into a vicious circle of economic contraction.

*Table 3.6* Trade contraction in East Asia during the first half of 1998  
(US\$ million, % year-on-year)

	<i>1997 (full year)</i>			<i>1998 (first half)</i>			
	<i>Export</i>	<i>Import</i>	<i>BOT</i>	<i>Export</i>	<i>Import</i>	<i>BOT</i>	
Korea	136.2 (5.0)	144.6 (-3.8)	-8.5	67.1 (2.8)	47.1 (-36.6)	19.9	Jan.-Jun.
Japan	421.2 (2.5)	388.2 (-3.1)	83.0	191.7 (-17.7)	141.8 (-17.7)	49.9	Jan.-Jun.
HK	188.0 (3.8)	208.6 (5.1)	-20.6	69.2 (-5.0)	77.0 (-5.0)	-7.7	Jan.-May
China	182.8 (21.0)	142.1 (2.4)	40.7	71.1 (8.5)	51.5 (-11.6)	19.5	Jan.-May
Singapore	124.8 (-0.2)	132.2 (0.7)	-7.4	45.6 (-10.7)	43.3 (-19.8)	2.2	Jan.-May
Taiwan	122.2 (5.1)	114.5 (10.6)	7.7	54.4 (-7.1)	53.2 (-3.5)	1.2	Jan.-Jun.
Malaysia	79.3 (1.3)	79.4 (1.3)	-2	23.6 (-8.8)	20.7 (-20.4)	2.9	Jan.-Apr.
Thailand	52.4 (2.6)	58.7 (-12.3)	-63	17.4 (-5.7)	13.6 (-41.3)	3.7	Jan.-Apr.
Indonesia	53.5 (7.4)	41.6 (-3.0)	11.8	12.2 (-0.9)	7.2 (-32.4)	50	Jan.-Mar.

*Source:* MOCIE (1998).

*Notes:* Korea's export in the first half of 1998 is \$65.3 million (0%) when that of gold collection (\$1.8 billion) is excluded.

BOT is balance of trade.

### 3.3.2 The recovery – an unacknowledged Keynesian path

The Korean economy made a dramatic turnaround from late 1998. Contrary to initial predictions that growth would be stagnant for at least three or four years after the crisis (the so-called L-shaped recovery), the economy actually experienced a sharp recovery (the so-called V-shaped recovery).<sup>16</sup> After a 6.7 per cent contraction in 1998, the GDP started growing at 5.8 per cent during the first quarter in 1999. GDP growth then rapidly increased to 11.2 per cent in the second quarter, 13.0 per cent in the third quarter, and 13.0 per cent in the fourth quarter, resulting in a 10.9 per cent annual growth rate. The Korean economy posted another high growth of 9.3 per cent in 2000 before it slowed sharply to an estimated 3 per cent of growth in 2001 (BOK website).

The IMF and its supporters claim that this quick recovery happened mainly because the Korean government faithfully followed the IMF programme. This cannot be further from the truth. The IMF programme was originally geared to, first, stabilising the value of the currency at any cost, through severe macroeconomic retrenchment in the short run, and, second, to preventing future currency crises through various reform measures in the longer run. Thus it was natural that the programme militated against economic growth in the short run. Indeed, as we shall show in detail below, it actually deepened the crisis, rather than alleviating it. Therefore, it is closer to the truth to say that the Korean economy recovered *despite* the IMF programme, not because of it.

In terms of short-term macroeconomic policy, the IMF's high interest rate policy in particular undermined the confidence in, rather than stabilising, the Korean currency, because Korean firms had a high level of debts and were highly dependent on external financing for their daily businesses. A sharp increase in interest rates and the subsequent liquidity crunch drove many companies to bankruptcies and increased non-performing loans (NPLs) in the already shattered financial system. So even Lee Hun Jay, then the Chairman of the Financial Supervisory Commission, who was so committed to the reform as to earn the nickname of 'Mr Restructuring' by the foreign press, reflected that 'components of the IMF program, such as tight monetary policy, complicated our recovery efforts by deepening the recession' (Lee Hun Jay 1999). The economic recovery in Korea started only after the IMF changed its stance on macroeconomic policy.

Moreover, the reform measures had the effect of adding further uncertainties during the period of the crisis. As Radelet and Sachs

(1998: 61) point out, they ‘greatly amplified the jitters . . . by declaring . . . that [the crisis] was mainly the result of deep fundamental weaknesses’. Like ‘crying “fire!” in a crowded theatre’, the IMF rubbished the Korean economy as a shambolic one in need of a fundamental institutional overhaul, thus magnifying foreign investors’ panic and ultimately undermining the very purpose of its bail-out operation. From the viewpoint of foreign investors, it is more in their interests to pull out their money as soon as possible rather than putting their money into a crisis-hit country and waiting for the uncertain results of an institutional overhaul to materialise, especially when they are told by the IMF that the scale of the overhaul required is absolutely gigantic.

Of course, it may be possible to argue – and certainly it has been argued in certain quarters – that the IMF programme helped the recovery by forcing the Korean government to commit itself strongly to various structural reform measures which were absolutely necessary if the Korean economy was to remain competitive in the long run but which it could not implement for various reasons. As a result, it is argued, many foreign investors who had left the country came back despite the severe short-term macroeconomic contraction engineered by the IMF programme, because they were now more confident about the future of the economy. This renewed – or even increased – inflow of foreign capital, according to this story, was critical in putting the Korean economy on the path to a rapid recovery.

In assessing the validity of this claim, it is important to distinguish the effects of the emergency foreign exchange injection and debt rescheduling that comes with any IMF programme from those of the ‘reform’ measures that come as conditionalities that are attached to it. We believe that the restocking of the nearly depleted foreign reserves with \$35 billion from international agencies and the rescheduling of Korea’s short-term foreign debts worth \$23 billion (at the end of January 1998) were critically important in stopping the run on the currency. But this does not mean that other measures that came as the conditions for the rescue operation also benefited the Korean economy. For example, the emergency foreign exchange injection and the debt rescheduling may have stopped the currency bout, but the high interest rate policy increased corporate failures, increasing the uncertainties surrounding the economy.

In this regard, it is useful to look at the changes in FDI inflow into the Korean economy. The Korean government and the IMF often have advertised the increase of the FDI after the crisis as a major achievement of the IMF programme, especially of the institutional reforms

that it instituted. They point out that, even in 1998, the year of sharp contraction of the economy, inward FDI increased by 26.9 per cent to \$8.8 billion from \$6.9 billion in 1997. It rose further by 75.5 per cent to \$15.5 billion in 1999. However, if we slightly extend our horizon, it turns out that the increase of FDI in 1998 was in fact a ‘dip’, rather than a ‘leap’, in the existing trend – FDI into Korea had been already on a path of rapid increase before the financial crisis. It jumped from \$1.9 billion in 1995 to \$3.2 billion in 1996 (an increase of 68.4 per cent), and again to \$6.9 billion in 1997 (an increase of 115.6 per cent), thanks to the relaxation of regulations on FDI and market opening in the middle of the 1990s. There is no indication that the reforms after the crisis changed the trend of the FDI inflow (Figure 3.4, more on this in section 4.2).

Moreover, after the crisis, it seems that foreign money returned to Korea because the economy began picking up, not the other way around. Monthly figures of FDI show that it began its return to Korea seriously from November of 1998, only after the uncertainties surrounding the Korean economy were substantially reduced with the recapitalisation of commercial banks by public funds. Monthly FDI inflows remained at US\$545 million on average until October 1998. It was only from November 1998 that it significantly increased – it

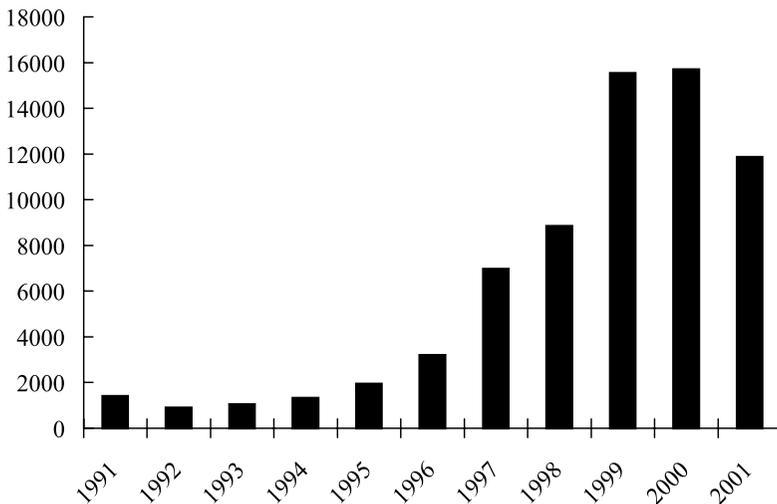


Figure 3.4 Trend of FDI inflow in Korea (US\$ million).

Source: MOCIE website.

increased to \$1,370 million in November and further to \$1,943 million in December 1998 (MOCIE website). Thus seen, it is more plausible to interpret the increase in FDI as a consequence, rather than a cause of the recovery.

If the IMF programme on the whole made things worse for the Korean economy, what was the cause of the quick recovery? We will show that it was neither the contractionary macroeconomic programme of the IMF nor the structural 'reforms' that the programme imposed, but the often-vilified Keynesian macroeconomic policy package that enabled the quick recovery.

As detailed above, the IMF initially adopted its customary contractionary macroeconomic stance in relation to Korea. However, as the economy went into a free fall largely as a result of its stringent macroeconomic policy, it allowed the Korean government to make a U-turn on macroeconomic policy in mid-1998 and to adopt an expansionary Keynesian policy package. This package had two key components – monetary policy and budgetary policy.

First, in relation to monetary policy, unprecedented reductions in interest rates were made. For instance, the inter-bank call market rate, on which the Bank of Korea had a decisive influence with its dominant position in supplying call money, steadily returned to the pre-crisis level by July 1998 and was radically lowered to 8.1 per cent in September and 6.6 per cent in December 1998. Consequently in September 1998 the three-year corporate bond rate, a representative market interest rate in Korea, dropped to 12.5 per cent, a level close to where it was just before the crisis, and plunged further to 8.3 per cent in December 1998. Both the call rate and the three-year bond rate had never recorded one-digit figure in the history of Korea's industrialisation. Therefore, from the second half of 1998, the Korean economy was supported by low interest rates it had never experienced before (Figure 3.5).

The drastic reduction in interest rates boosted the economy by improving the profit prospect of the firms, thereby enabling the financial institutions to extend their loans to the corporate sector. For instance, the total liability of the manufacturing sector was 390 trillion won (US\$ 355 billion) in 1998 and a 4 percentage points reduction in interest rate amounted to 15.6 trillion won of cost saving, which was about 60 per cent of the operating profit of the whole sector in 1998. Given that the high interest rate policy was so fatal to the Korean firms, this reversal to a low interest policy was a life-saver to them.

Second, the budgetary policy also underwent a great reversal. The IMF began allowing budget deficits from its second MOU with the

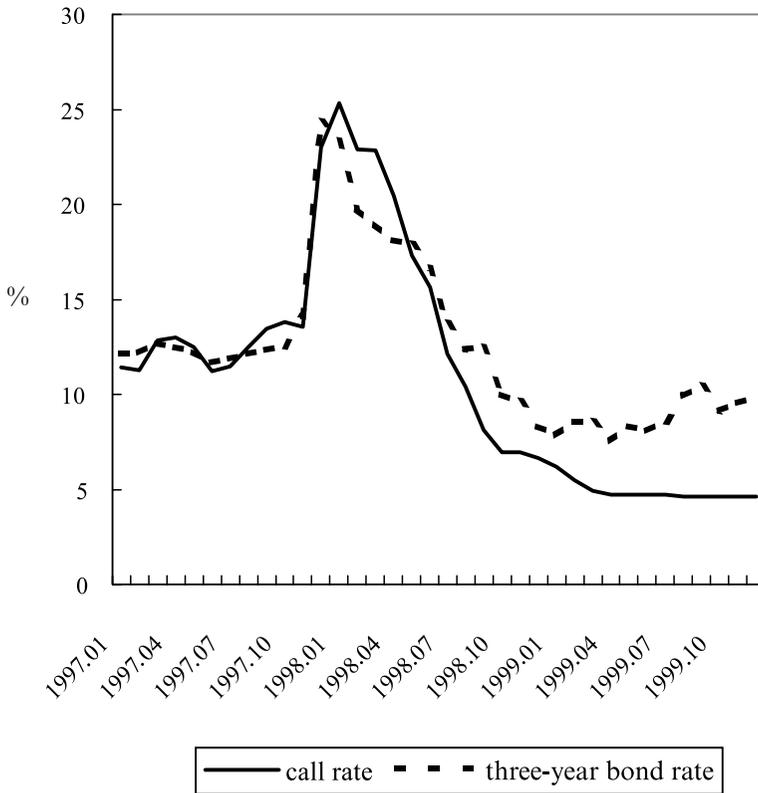


Figure 3.5 Changes in call rate and three-year bond rate in Korea.  
 Source: BOK website.

Korean government in January 1998, mainly in order to provide the ‘safety net’ for the rapidly swelling group of unemployed workers. However, what really increased the budget deficit substantially was the recapitalisation of financial institutions through the injection of 64 trillion won (about US\$50 billion) of public funds in September 1998. As a result, the slight surpluses that have characterised the Korean budget throughout the 1990s up to the crisis rapidly changed into sizeable (although not large) deficits – equivalent to  $-3.2$  per cent of GDP in 1998 and  $-3.0$  per cent of GDP in 1999. The importance of this U-turn in budgetary policy cannot be underestimated because, without the recapitalisation of financial institutions with public money, the recovery of the Korean economy would have been very slow.<sup>17</sup>

The Korean government likes to present the recapitalisation as a part of its financial sector reform programme (for instance, see MOFE 1999), but this is misleading. Injection of public money in the financial sector was necessary, whether or not the Korean government was committed to some institutional reform in the sector, if it was serious about reviving the financial sector swamped with NPLs.

What really mattered in reversing the 'market sentiment' was the size of the public fund that beat the market expectation. The Korean government provided the commercial banks with much more public funds than was regarded as necessary by foreign investors (e.g., following their recapitalisation, these banks could maintain BIS ratios of over 10 per cent, higher than the minimum requirement of 8 per cent). This restored (though temporarily) the health of the country's banks and, in turn, allowed them to begin extending loans to the corporate sector without the fear of a run or a bankruptcy. And in all these, presenting this recapitalisation as an exercise in institutional reform served a useful function, given the obsession of the foreign investors with the progress of 'reform' in the country.<sup>18</sup>

Thus seen, the IMF's U-turn on its macroeconomic policy in mid-1998 was critical in allowing the Korean economy to recover, as without it the severe credit crunch would have continued, resulting in continued corporate bankruptcy and thus the accumulation of NPLs in the financial sector, which in turn would have further exacerbated the credit crunch. In other words, contrary to the conventional wisdom, the Korean economy recovered thanks to the adoption of the often-vilified Keynesian macroeconomic policy package since mid-1998, rather than thanks to the confidence-restoring ability of the contractionary macroeconomic policy that the IMF implemented before that – as even the IMF (2000b: 19) later reluctantly acknowledged: 'The recovery has been helped by the supportive macroeconomic policy stance since mid 1998, the temporary measures implemented to alleviate the credit crunch, and progress made in implementing structural reforms.'<sup>19</sup>

It should be noted that the adoption of the aggressive Keynesian policy in Korea, especially the interest rate cut to historically unprecedented levels since the latter half of 1998, was mainly due to a sudden change in the global economic environment. The world economy, which was slowly recovering from the shock of the Asian financial crisis during the first half of 1998, was gripped by a financial panic after the crises in Russia and Brazil in August, and the near-bankruptcy of Long Term Capital Management (LTCM), a hedge fund based in New York, in September. According to Sakakibara (1999), the then vice minister of finance in Japan, who earned the

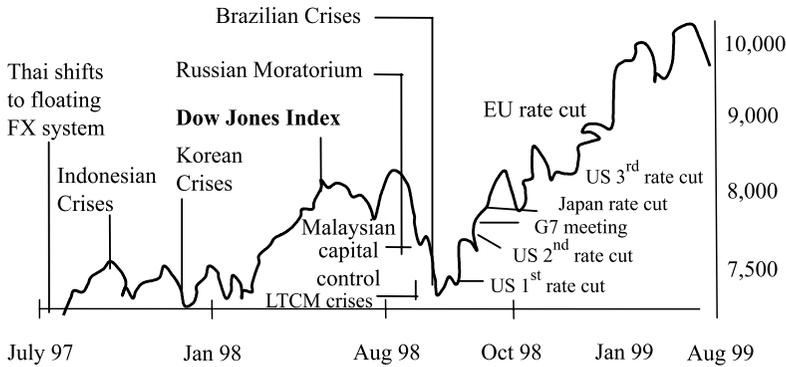


Figure 3.6 The crisis and the path of the global Keynesian solution.

nickname of ‘Mr Yen’ due to his influence on the yen–dollar exchange rate, after the LTCM crisis, the high-ranking officials of the USA and Japan agreed that the world economy was heading towards a ‘serious crisis’ and began working on counter-measures to combat it. G7 countries thereafter took concerted actions of lowering interest rates and expanding monetary supply. For instance, the Federal Reserve Board (FRB) of the US, in its unprecedented move, reduced its key interest rates three times for less than two months from September to October 1998. Japan and European countries also followed suit and implemented a global Keynesian policy (Figure 3.6).

Given this, the boldness of Korea’s Keynesian policy can be understood only in relation to the aggressiveness of the global Keynesian policy that was pursued by the G7 countries in order to prevent the imminent global financial crash during the second half of 1998. The Bank of Korea radically lowered the call market rate from 13 per cent in July, to 8 per cent in September, and further to 6 per cent in December 1998. The rate further dropped to 4.7 per cent in April 1999 and the level was maintained during the rest of the year. It would have been counterproductive to lower interest rates that radically if Korea were to do it by itself because this would have been likely to attract currency attack, as its financial market was nearly completely open following the IMF-sponsored reform after the crisis.

### 3.4 Explaining the Korean crisis: a ‘transition failure’

In the above, we have shown that the diagnosis underlying the IMF programme – namely, the diagnosis that the 1997 Korean financial

crisis was caused by fundamental institutional defects of the traditional Korean model – is incorrect. We have also shown that Korea's unexpectedly quick recovery from the crisis was not the result of the 'reforms' instituted under IMF tutelage but the result of a Keynesian reflationary policy that enabled a quick recapitalisation of the financial sector with public money and lowered interest rates substantially.

If this is the case, how do we explain the crisis? Was Korea simply unlucky? Was there any serious policy mistake? Or was the crisis caused by some structural factors that are not mentioned in the conventional literature? In order to answer these questions, in this section we characterise the Korean crisis as a 'transition failure', where its plan to move away from the old model was neither well conceived nor was it well implemented, and discuss how the conflation of internal changes (economic, political, and ideological) and external developments led to this failure.

For this, we first discuss the most important structural factor that was behind the (failed) transition in Korea – namely, the demise of the developmental state (section 3.4.1). And then we look at the most critical policy failure that followed from this, namely, the failure of financial liberalisation process (section 3.4.2). We also show how the transition failure was not simply a matter of failure of the state, but also of the private sector, by discussing how the *chaebols* failed to adequately respond to the challenges of globalisation (section 3.4.3). Finally, we conclude this section by summarising the arguments and drawing implications (section 3.4.4).

### ***3.4.1 The decline of the developmental state***

Given the prominent role that it played in the development of the country, it seemed natural to many people that the developmental state was the cause of the 1997 crisis. However, as we have suggested above, it was the demise, rather than its persistence, of the developmental state that was behind the Korean crisis. The most important consequence of this decline in the capability of the state as the system manager was, as we shall see below (section 3.4.2), the mismanagement of financial liberalisation during the 1990s, which was the key cause of the financial crisis. But before we analyse the failure of financial liberalisation, let us discuss why and how the decline in state capacity occurred.

Despite its dominance in 'Korea Inc.', the challenge to the Korean developmental state had been present even throughout its 'miracle' period. In the very early days (1960s), it came in the form of the

challenge from the conservative, pro-democratic alliance led by Yoon Bo Sun. Since the 1970s, it took the form of the challenge by the pro-democracy, centre-left opposition forces led by Kim Dae Jung (president since 1998), and to a lesser extent by Kim Young Sam (president, 1993–8). However, the biggest and the ultimate challenge came from the Neo-Liberal forces that began to crystallize from the late 1970s in an alliance between the ‘liberal’ faction in the bureaucracy, the majority of the intellectual community, and the increasingly powerful *chaebols*.

The Neo-Liberal forces made a critical breakthrough after the assassination of President Park in 1979 by his intelligence service chief. Initially, the political vacuum left by the death of Park seemed to open a space for the pro-democracy forces led by the two Kims. However, they were soon crushed by the two-stage military coup (1979–80), which culminated in the Kwangju massacre (May 1980), by the ‘new military’ under the leadership of General Chun Doo Hwan.

General Chun was by no means a Neo-Liberal himself, but he allied himself with Neo-Liberal bureaucrats and implemented a series of institutional changes that signalled the start of a Neo-Liberal offensive against the developmental state. He adopted the anti-inflationary rhetoric of Neo-Liberalism in a bid to deal with the inflationary pressures created by the Second Oil Shock and the subsequent recession. He also privatised a number of banks while partially liberalising the financial market in 1983. Also introduced was the Industrial Development Law (henceforth IDL) in 1986, which, while clearly accepting the need for an activist industrial policy, shifted the country’s industrial policy towards a more ‘functional’ (as opposed to ‘selective’) direction (see Chang 1993, for further details).

However, it would be a gross exaggeration to say that the changes under Chun’s rule made the subsequent demise of the developmental state inevitable. While its force was somewhat diminished, developmentalism still remained the overarching ideology of the regime, and proved formidably effective in the development of certain industries, especially information technology industries (see Evans 1995, for details). Many of the formal institutional changes in Neo-Liberal direction made under Chun, such as financial liberalisation and the introduction of IDL, were limited in scope and had their effectiveness curtailed by the inertia stemming from the more slowly changing informal institutions such as bureaucratic convention and business practices (see Amsden and Euh 1990 on financial liberalisation and Chang 1993 on the introduction of the IDL).

A more fundamental shift was set in motion, however, with the success of the mass pro-democracy protest in the summer of 1987 against Chun's attempt to hand the presidency over to his chosen successor and erstwhile collaborator, General Roh Tae Woo, through the rigged electoral college system (by which he himself was formally elected the president). The success of the protest led the military to capitulate to the public demand for a truly democratic presidential electoral system, although Roh managed to win the subsequent election held in late 1987.

The consequent political discrediting of the military rule led to a rapid weakening of the legitimacy of developmentalism, because it was seen, in our view mistakenly, as the former's Siamese twin. What was decisive in this process was the increasing conversion of the intellectual elite, especially the bureaucratic elite, to Neo-Liberalism. The increasing number of elite bureaucrats and academics who got advanced degrees from the US at the height of its Neo-Liberal revolution meant that there were more and more people inside and outside the government who were convinced of the virtues of the free market and saw developmentalism as a 'backward' and 'mistaken' ideology.<sup>20</sup> It needs to be added that in this ideological battle, the Neo-Liberals were critically helped by the ideological dominance of Anglo-American academia and media at the world level. In this way, Neo-Liberalism established itself as the dominant ideology among Korean elite circles, including the elite bureaucracy, somewhere between the late 1980s and the early 1990s.

Many of the bureaucrats, however, still had an instinctive attachment to developmentalism, as can be seen in the intellectual confusion found in policy documents of the time, where Neo-Liberal pronouncements on overall policy direction uneasily sat together with developmentalist policies in particular areas. However, there were many other bureaucrats whose conversion to Neo-Liberalism was wholehearted and sometimes even dogmatic. For example, by the early 1990s, one frequently encountered bureaucrats from the Economic Planning Board (EPB), which somewhat paradoxically had become the home of Neo-Liberalism in the Korean state at the time, calling for a radical retreat of the state and especially for the abolishment of their own ministry on the ground that planning is not feasible anymore due to the increasing complexity of the economy, if it ever was desirable.<sup>21</sup>

Moreover, since the late 1980s, the *chaebols* increasingly came to the view that the Korean state had become more of a liability than an asset in their competitive struggle in the world market. A series of spectacular successes that they had in those export markets which

were previously thought to be the exclusive domains of the most advanced economies, such as memory chips and automobiles, convinced them that they could now stand on their own. Their confidence was corroborated by the approval that they started gaining in the international capital market. By the mid-1990s, the leading *chaebols* were considered creditworthy enough to float bonds in advanced country capital markets. Their rapidly growing foreign ventures, although still not on a scale that could lead to a significant change in their relationship with the state, also started to weaken their identification with the nationalistic outlook of developmentalism (more on this in section 3.4.3).

By the mid-1990s, the *chaebols* had become staggeringly aggressive in calling for the withdrawal of the state from economic management. Many of the 'owners' and the top managers of the leading *chaebols* made public pronouncements against state intervention at every conceivable opportunity. The *chaebols* also set up a small but extremely well-funded research institute called Korea Centre for Free Enterprise, which churned out numerous documents with a strong Neo-Liberal flavour, while translating a whole array of classical works in Neo-Liberal tradition (e.g., Hayek, Buchanan, etc.) and inviting well-known American Neo-Liberal thinkers to give high-profile talks in Korea.

The height of this offensive was the ultra-Neo-Liberal policy report prepared by the Federation of Korean Industries (FKI), the club of the *chaebols*, in the spring of 1997. This report called for a radical retrenchment of the state and, among other things, called for the abolition of all government ministries except Defense and Foreign Affairs and the consequent reduction of government bureaucracy by 90 per cent. Although the official withdrawal of this document at the public uproar following a pre-publication leak showed that the Korean public was not yet ready for this kind of ultra-Neo-Liberalism (but then no people ever are), the mere fact that such a report could be prepared as a public document by the FKI shows how aggressive the *chaebols* had become in their offensive against the developmental state.

It was not simply the *haute bourgeoisie* who wanted to dismantle the developmental state. The professional classes also started to revolt against the nationalistic and anti-consumer biases of developmentalism. These people had been previously happy to comply with the 'buy Korean' policy and the consequent restriction on luxury consumption, but they now wanted to exercise their newly acquired purchasing power in buying domestic and foreign luxury consumption goods

without having to feel guilty about being ‘unpatriotic’ and ‘anti-social’. As a result, they now wanted further trade liberalisation and the lifting of restrictions on luxury consumption goods and luxury housing. They were also beginning to feel frustrated by the ‘protective’ regulations concerning agriculture, urban planning, and small-scale retailing, which put restraints on their ability to engage in consumerism – a feeling that usually found its most vivid expression in their fascination with the ‘quality of life’ in the US such as cheap food, spacious housing, large cars, and huge shopping malls.

Further push towards Neo-Liberalism was provided by the US and other advanced countries. From the late 1980s, they started stepping up their demands on what they saw as a now-developed country to become more ‘responsible’ by abandoning all those ‘unfair’ protections of their industrial, and especially financial, enterprises and thus giving them better access to what was an increasingly attractive market. The decision made in 1993 by the Kim Young Sam government to join the OECD (which Korea joined in 1996) made it even more necessary to open up various markets as a condition for the membership.

The results of these changes were far-reaching. Industrial policy, the hallmark of the developmental state, started to be dismantled, initially tentatively, from the late 1980s, and was basically gone from the scene by the mid-1990, creating excess capacity in a number of key industries.<sup>22</sup> Financial liberalisation, including capital account liberalisation, gained momentum since 1991, but accelerated since 1993, when Korea signed a bilateral agreement with the US for financial market liberalization and opening. Most symbolically, the five-year plan was terminated in 1993 while the Economic Planning Board was abolished (as some of its own members had wished for some time) and merged with the Ministry of Finance to form the Ministry of Finance and Economy (MOFE) in 1994. Although certain residues of developmentalism could still be found in places (e.g., supports for R&D in certain high-technology industries), the dismantling of the developmental state was effectively finished by the middle of Kim Young Sam’s presidency (say, 1995).

### ***3.4.2 Mismanagement of financial liberalisation***

The most important consequence of the demise of the developmental state, and the institutional vacuum left behind by it, at the level of policy is in the mismanagement of financial liberalisation.

An inevitable feature in Korea’s catching-up system was the relative underdevelopment of the financial sector. The lending decisions were

ultimately made by the government, and not by the financial institutions, especially when it came to large projects with government priority. As a result, the incentive to improve risk management capacity on the part of the financial institutions was generally weak. Moreover, unlike the industrial sector that was exposed to international competition from the beginning (albeit in a controlled way), the financial sector had remained cosily under government protection and regulations.

This, of course, was not a fatal problem *when seen from the systemic point of view*. In the traditional Korean system, the state ultimately bore the risks that accompany all lending decisions and therefore the financial institutions were largely conduits for state industrial policy. In this context, the efficiency of the financial institutions was not really a key problem. However, many people did not see the weaknesses of the financial sector from such a systemic point of view, and were naturally concerned with it.

The efficiency of the Korean financial sector was perceived as a problem from at least the early 1980s, and many saw financial liberalisation as an obvious solution. Nevertheless, until the early 1990s the financial liberalisation measures during the 1980s, were 'cautious and slow in terms of . . . order and speed' (Park 1996: 252), and the financial sector remained under tight control by the state (Amsden and Euh 1990). However, from the early 1990s, the Korean government started relaxing its control over the financial sector significantly and, under the Kim Young Sam government, which came to power in 1993, the liberalisation process was greatly accelerated. Table 3.7 charts the evolution of this process in detail.

The five-year financial liberalisation plan announced by the Kim government in 1993 was regarded as the first such plan announced by a Korean government to have a relatively well-defined (although not precise) timetable and unambiguous policy contents. It aimed at, among other things, interest rate deregulation, abolition of 'policy loans' (or 'directed credit programmes'), granting of more managerial autonomy to the banks (which were under state ownership and/or strict control), and reduction of entry barriers to financial activities. Most importantly, it included capital account liberalisation, something that Korea's previous plans of financial liberalisation had characteristically failed to include (Choi 1993). Unfortunately for the country, this financial liberalisation programme was ill thought out and badly managed.

The first obvious flaw in the programme was the belief that licensing more financial firms would increase competition and thus efficiency in the financial sector. As a result, between 1985 and the outbreak of

Table 3.7 Major financial liberalisation measures in Korea during the 1990s

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1 *Interest rates deregulation (in four stages: 1991 to July 1997)*

By 1997, all lending and borrowing rates, except demand deposit rates, were liberalised

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):

expansion of the securities business of deposit money banks (1990, 1993, 1994, 1995)

freedom for banks and life insurance companies to sell public bonds over the counter (1995)

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 liberalisation*

Adoption of the Market-Average Foreign Exchange Rate System (1990)

Easing of the requirement for documentation proving 'real' (i.e., non-financial) demand in foreign exchange transactions (1991)

Setting up of foreign currency call markets

Revision of the Foreign Exchange Management Act (1991):

changing the basis for regulation from a positive system to a negative system

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):

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 (Jan. 1997), and non-guaranteed convertible bonds issued by large companies (Jan. 1997)

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Table 3.7 (Continued)

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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 in so far 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 (Jan. 1997)

Liberalisation of borrowings related to foreign direct investments related (Jan. 1997)

5 *Policy loans and credit control*

A planned termination of all policy loans by 1997 is announced (1993):  
a step-wise reduction in policy loans to specific sectors (e.g., export industries and small and medium-sized firms)

Simplifying and slimming down the controls on the share of bank's loans to major conglomerates in its total loans

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Source: Chang *et al.* (1998).

the financial crisis in 1997, ten new commercial banks were chartered, the number of merchant banks (short-term finance companies officially called 'merchant banking corporations') was increased from six to thirty, and twenty-nine new life insurance companies came to existence.

The result was a proliferation of weak financial institutions of 'sub-optimal' sizes that would not survive the full-scale opening-up of the financial market that was planned, especially at a time when the world's leading financial institutions that were getting ready to enter Korea were becoming bigger and unified across market segments through M&As and alliances. Indeed, a significant part of the non-performing loans accumulated in the financial sector during the 1990s can be attributed to the excessively high risk that these immature financial institutions took for survival.

Leading this excessive risk-taking were the inexperienced merchant banks, whose number increased from six to thirty during the three years from 1994 to 1996 as part of the 1993 financial liberalisation programme. In their rush to branch into international financial activities, they increased their total foreign debt stock by around 60.1 per cent per annum during 1994–6, from \$7.27 billion to \$18.62 billion (BAI 1998), vastly outpacing the growth of total foreign debt at 33.6 per cent per annum that we have already referred to as unprecedented.

After the crisis, the number of merchant banks was reduced to nine in 2000, nearly to the level in 1985. Similarly, the number of commercial banks was again reduced to twenty-two, slightly below the level in 1985 (Table 3.8). The overall number of financial institutions also returned to the level in the pre-liberalisation period. Considering the fact that further consolidation of financial institutions is still under way, financial liberalisation since the late 1980s is an excellent proof showing how an ill-conceived liberal licensing policy could create an ‘over-capacity’ problem and a consequent ‘crisis’ in the financial sector.

The second flaw in the financial liberalisation programme was that it did not include any action to strengthen government supervision of the financial institutions. Given that many financial firms were allowed to enter the industry, there was a high likelihood that many of them would take excessive risks, partly out of inexperience (including the shortage of skilled manpower) and partly under competitive pressure – which is exactly what happened, as we discussed above. Given this, strengthening the supervision system was vital but it was simply not done. For instance, the huge mismatch in the maturity structures between merchant banks’ borrowings (64 per cent of their \$20 billion total foreign borrowings were short-term) and lendings (85 per cent were long-term) was unnoticed and/or ignored by the government before the crisis.

This was partly an oversight but was more fundamentally because the Kim Young Sam government erroneously equated financial liberalisation with near-total withdrawal of the state from the financial sector. To make things worse, the supervision authority was divided between the Ministry of Finance and Economy (MOFE), which was responsible for state-owned banks and non-bank financial institutions and the Bank of Korea (BOK), which was also put in charge of areas

*Table 3.8* Changes in number of financial institutions in Korea

<i>Financial sector</i>	<i>1985</i>	<i>1997</i>	<i>2000</i>
Banks	23	33	22
Merchant banks	6	30	9
Securities firms	25	36	43
Insurance cos	21	50	40
Investment Trust cos	3	31	27
Leasing cos	8	25	18
Mutual Savings & Finance cos	239	231	164
Total	325	436	323

*Sources:* BOK (1999b) and SERI (2001a).

of commercial banks. There was no love lost between the two organisations. Under the traditional system, the MOFE had the BOK under strict control. However, under the Kim Young Sam government, the BOK gained more autonomy and challenged the authority of the MOFE. As a result, the rivalry between the two organisations intensified, to the extent that the information on the states of financial institutions did not flow well between the two agencies. This provided companies with loopholes to exploit by under-reporting their total liabilities, thus making it difficult to monitor changes in financial risk at the systemic level.

The most fatal of the flaws in Korea's financial liberalisation programme of the 1990s, however, was the decision to open the capital account, which made it possible to turn a 'domestic' financial crisis into a currency crisis. But why was this decision taken?

Until 1986, Korea had suffered from chronic current account deficits, which motivated and enabled its government to have strict foreign exchange controls, the two pillars of which were the so-called Foreign Exchange Concentration System, under which all foreign exchange had to be surrendered to the central bank, and the Foreign Exchange Management Act, which put severe restrictions on the use of foreign exchange (e.g., limits on overseas remittances, on overseas real estate acquisition, or even on expenditure on foreign tourism, which was severely restricted until the late 1980s).

Given the Foreign Exchange Concentration System, the large trade surpluses between 1986 and 1989 generated excess liquidity in the system, prompting the government to scale it down. Although the trade surpluses disappeared subsequently, the surge of capital inflow in the 1990s that made up for it provided the justification for the continued raising of the ceiling on foreign exchange holdings until the system was finally reduced to near insignificance in 1995. At the same time, the improving credit ratings of Korean corporations and banks in the international financial markets meant that the private sector started regarding government involvement in their foreign exchange transactions as a burden rather than a necessity (see sections 3.4.1 and 3.4.3). Adding to these 'structural' pressures was the continued pressure from the US government to open up the financial market. The March 1992 bilateral talks were its culmination, and it was the agreement arising from these talks that formed the basis for the 1993 financial liberalisation programme.

Given these factors, it may have been difficult for the Kim Young Sam government to maintain the traditional system of capital account control. However, the capital account liberalisation programme under

Kim went well beyond the minimum that had to be done. For example, upon taking power in 1993, it decided to apply for membership of the OECD, which subjected the country to further external demands for financial market liberalisation.

Moreover, even within the given parameters, the detailed design and execution of the capital account liberalisation programme was poorly managed. For example, liberalisation was much more extensive in relation to short-term foreign borrowing than to long-term foreign borrowing, when caution would have demanded the reverse. So, while those who were contracting long-term loans were required to provide detailed information and obtain permission from the MOFE, short-term borrowers were not required to do so. Combined with the stricter information requirements for long-term loan applications that foreign lenders typically require, this gave the borrowers the incentive to go for short-term loans in order to cut the 'overhead' costs of borrowing. The result was the well-known accumulation of short-term debts.

To summarise, the post-1993 financial liberalisation in Korea was critical in generating the current crisis as, for the first time in the country's history, it instituted a very substantial, if not a complete, capital account liberalisation. It was not simply the extent of the liberalisation but also its detailed design that contributed to the crisis. For example, it gave the incentive to the borrowers to contract short-term, rather than long-term, loans from abroad. For another example, it failed to strengthen the supervision system, despite the greater possibility of excessive risk-taking following the sudden entry of a host of inexperienced financial firms, allowing the huge asset-liability mismatch to go unchecked.

### ***3.4.3 Challenges to the chaebols from globalisation***

As we discussed above, the demise of the developmental state and the consequent breakdown in industrial policy and mismanagement of financial liberalisation in Korea led to an uncoordinated investment boom in manufacturing industries by the *chaebols*. This is an important contrast with other countries where mismanaged financial liberalisation usually led to a consumption boom and/or real estate boom, rather than to a manufacturing investment boom in industry. For this reason, it is important to understand how the *chaebols* acted in this particular way in the build-up to the crisis, if we are to understand the Korean crisis correctly.

After the 1997 financial crisis, many, including the IMF, have argued that the crisis was the proof that the *chaebols* are not viable in an

increasingly globalising world any more. The argument is that the *chaebols* appeared internationally competitive only because they could indirectly subsidise their exports through the excess profit they were making in the domestic market thanks to import protection. According to this view, however, increasing globalisation put pressure on Korea to open its markets, which deprived the *chaebols* of the excess profits that they could use to subsidise their exports.<sup>23</sup>

The problem with this view is that no one, including those who espouse this view, has shown any evidence that *chaebol* exports remained viable only because they were subsidised by the excess profits made in the protected domestic market. This, of course, is not to deny the importance of the challenges that the *chaebols* faced in an increasingly globalised world. Globalisation did pose great challenges to them, and the mis-handling of some of these was indeed a cause of the crisis. What we are trying to argue is that the challenges that globalisation posed to the *chaebols* were much more complex than the conventional wisdom suggests – that it simply deprived them of the excess profits that they were enjoying thanks to import protection. Moreover, globalisation not only put extra constraints on the *chaebols* but it also gave them new opportunities, which could have been (and to a limited degree were) used to their benefits.

In the following, therefore, we propose to analyse ‘challenges of globalisation’ to the *chaebols* in more detail, in order to show its complex nature. We will do this in relation to two different but interconnected layers of globalisation: globalisation of the product market and that of the financial market, both of which provided the *chaebols* with their own opportunities and constraints.

With globalisation in the product market, the *chaebols* came to have new market opportunities in other countries, especially in the emerging economies, although they had to face stiffer competition in the domestic market. Their responses can be epitomised by their espousal of ‘global management’, made popular by the now-defunct Daewoo Group. This meant, in a nutshell, the *chaebols* attempting to emerge as full fledged MNCs by investing overseas to capture new market opportunities while investing locally to keep their domestic markets. This attempt naturally stretched the managerial resources of the *chaebols* and increased their financial risks. Therefore, after the financial crisis, this attempt came to be criticised as a natural result of their ‘peculiar’ structure allowing ‘irrational’ behaviour (for a criticism of this, see section 3.2 above).

However, the aggressive investment strategy that most *chaebols* deployed in the 1990s should be understood as an inevitable response

to the challenges of globalisation, rather than as a product of their peculiar corporate governance structure. In an environment of increasing globalisation, the *chaebols*, pursuing a Gerschenkronian ‘substituting strategy’ (see sections 2.2 and 2.4) had to take part in global competition whether or not it exposed to them to greater financial risk, if they were to succeed in their strategy. The post-crisis corporate reform programme has assumed, implicitly or explicitly, that the *chaebols* should not have so aggressively invested during the 1990s, but it was not an option, given their overall strategy, which has some enormous strengths (see section 2.4).

Globalisation, however, did not simply come to the *chaebols* as a constraint. At the same time, it gave them an important additional advantage by opening up new, ‘emerging’, markets, entry into which carried high risk and therefore was suited more to the *chaebols* with greater risk-bearing capability than to single-product firms.

For single-product firms, it is difficult to invest in emerging markets because backward and forward linkage industries are not developed. In contrast, with their diverse resources and centralised decision-making, the *chaebols* could make ‘package deals’ with the governments or companies in emerging markets. For instance, when they build automobile factories, they can also bring along their own mechanical engineering and steel businesses. Their construction units can oversee and execute the overall process of building the factories. They can even set up commercial banks to provide consumer financing for their products. In this respect, the *chaebol* structure was better than that of single-product firms at ‘market creation’ in developing countries.

Reflecting this strength, Korea became, by the mid-1990s, one of the largest foreign investors in a number of developing and transition economies, not just in Asia but also in Europe (e.g., Indonesia, Vietnam, Poland, Uzbekistan). Korean companies’ investments in emerging markets also resulted in a fast growth in sales with reasonable profit rates, though their investments in developed countries did show low or even negative profits even with rapidly increasing sales (Table 3.9). Given the increasing importance of emerging markets, especially those in South East Asia, in the operation of many Korean *chaebols*, it is not surprising that many of them got into trouble following the South East Asian financial crisis, which damaged their ventures in the region and also made ventures in other emerging markets more precarious.

Globalisation of finance also provided the *chaebols* with both opportunities and constraints. On the one hand, it allowed them better

Table 3.9 Business indicators of foreign direct investment by Korean companies (% , 1995)

	South East		North	Latin	America
	Asia	China	Europe	America	
Growth rate of sales	62.77	105.94	111.14	48.62	33.11
Growth rate of assets	18.80	33.06	75.41	30.98	14.57
Operating income to sales	6.78	-3.92	-0.14	2.85	4.16
Net income to sales	3.95	-4.86	-2.44	-0.1	2.18
Debt-equity ratio	324.86	270.04	682.62	318.25	609.8

Source: Wang (1997).

access to financial resources, but it also increased their financial risks by increasing their exposure to the fickle sentiments of the international financial markets. Since the cost arising from financial expenses was so decisive in their profitability and there was a big gap in interest rates between domestic and international markets, the *chaebols* clamoured for liberalisation of the financial market. An easier access to cheaper (but ultimately riskier) foreign money was what they needed, especially when they were investing heavily in order to cope with the increased global competition in product markets. This domestic pressure matched perfectly well with external pressure from developed countries, especially from the US, to open Korea's financial market (see sections 3.4.1 and 3.4.2).

However, in all this, the *chaebols* were ignoring the 'dark side' of financial globalisation at their own peril. A greater exposure to the international financial market meant that they had to deal with more fastidious bankers and investors, who were willing to withdraw their money any time, unlike their domestic counterparts, who behaved in a more 'patient' way partly due to the local business norms but also due to government regulation. Exchange rate risk was also hardly taken into account in the *chaebols'* lending decisions, given that the main concern of the Korean economy in the middle of the 1990s was actually to slow down the pace of appreciation of the Korean won in the face of the rapid inflow of foreign capital.

For the *chaebols*, the mid-1990s was the period of 'mixed blessings', both of expanding opportunities and increasing financial risks. However, they, as well as the Korean government, failed to guard against the growing financial risks in their over-zealous drive to seize the new opportunities. The financial crisis was a consequence of this negligence on the part of the *chaebols*, as much as it was that of the decline of the state capacity and failure in government supervision of the financial sector.

### 3.4.4 *Summary and conclusion*

In this section we have discussed the ‘real’ causes of the Korean crisis – the decline of the developmental state, the consequent mismanagement of financial liberalisation, and the failure of the *chaebols* to fully meet the challenges of globalisation (magnified by the decline in the supervisory and coordinating capabilities of the state).

The point that we are trying to make is *not* that the traditional Korean system was some perfect model that did not have any problem. The model had certain weaknesses. For example, features like relatively high dependence on foreign borrowing (sections 2.2 and 3.1), low ordinary – or post-interest-payments – profit in the corporate sector (sections 2.2.2 and 3.2.4) were certainly factors that increased the Korean economy’s vulnerability to external shocks.

However, these ‘weaknesses’ were the flip side of the coin to its strengths, such as its ability to take high risk, which more than offset the weaknesses on the whole. For example, the ‘low ordinary profit with high debt’ financial structure was basically a consequence of Korea’s catching-up strategy in the heavy and chemical industries in the face of capital shortage. In a way, the persistence of relatively high levels of debts without a major debt crisis before 1997 was an indirect proof that the country was able to sustain its foray into these difficult industries.<sup>24</sup> It is no coincidence that the Korean success was more pronounced in items like automobiles, steels, and shipbuilding that required a large-scale investment and a long gestation period. Exposure to higher financial risks was an unavoidable consequence of taking part in those high-risk projects.

Needless to say, we are not suggesting that since it had succeeded in the past, the Korean system will have worked well forever. A catching-up system, which we characterised the Korean system as, is by definition transitory and never stationary. It should undergo continual adjustments as the gap with the forerunner is narrowed. In the Korean case, as the capital shortage that shaped the traditional Korean system was relieved thanks to the very success of the system since the late 1980s, the *chaebols* began seeking greater freedom from the government’s tight grip, unleashing the forces that pushed for system transition. Moreover, this was happening at a time when globalisation accelerated and threw up new constraints and opportunities, some of which the traditional Korean system was not well designed to cope with.

All these meant that the traditional Korean economic system did need some adjustments during the 1990s, although, we repeat, it is not

correct to see it as having been in need of ‘fundamental’ restructuring. What happened, unfortunately, was that successive Korean governments since the late 1980s, but especially the Kim Young Sam government that presided over the most decisive move away from the traditional system, wanted to remedy these weaknesses by demolishing the existing system altogether. In the process, the very strengths of the system were also destroyed. Moreover, this was done too rapidly, which gave the country little time to build a new system that is appropriate for the higher stage of developmental stage that was had entered by then – it was a ‘transition without system building’ (Lee Jay-Min 1999).

### **3.5 Concluding remarks**

This chapter started by charting the evolution of the Korean financial crisis of 1997. Then we discussed the alleged ‘structural’ causes of the crisis, which have informed the IMF programme and the dominant thinking on post-crisis economic reform in the country. Industrial policy, crony capitalism, the so-called logic of ‘too big to fail’, and the peculiar nature of Korean corporations were discussed. We argued that all of them are based on faulty reasoning and lack empirical evidence. If its diagnosis of the causes of the crisis was flawed, it was only natural that the IMF programme that was supposed to deal with it did not work, as we subsequently analysed. We showed that it was only after the IMF made a U-turn in its macroeconomic policy that Korea was able to engineer a recovery by reflation of its economy and, more crucially, by recapitalising its banking sector with public money and thus allowing them to resume their industrial financing. It is in this sense that we call the Korean recovery a ‘Keynesian’ one. Finally, we provided an alternative explanation of the crisis, which characterises it as a result of ‘transition failure’.

Our discussion in this chapter shows how the conventional view on the Korean crisis is based on very partial and misleading analyses. Most of the features it identifies as structural weaknesses of the traditional Korean system do exist, but many of them cannot be held responsible for the crisis, except in very marginal ways – cronyism being the best example. Moreover, even when they have some apparent relationships with the crisis – such as the high-debt corporate finance system – they have to be understood as parts of a bigger system, rather than in isolation and with reference to some ideal standards. In our view, many of the alleged structural weaknesses of the Korean system were inevitable by-products of the country’s catch-up system, which on the whole was highly successful.

Of course, as we said earlier, this is not to say that there was no problem with the traditional Korean system. There were certain features in it which were in need of change and upgrading in line with the country's success in catching up. However, the Korean governments since the late 1980s, especially the Kim Young Sam government (1993–8), implemented a series of policy changes in the mistaken belief that changing these features meant making a transition to a whole new system. And this was done without careful planning and, more importantly, without the efforts to put alternative mechanisms in place before the old ones were dismantled. It is in this context of 'transition failure' that we need to understand the post-1997 corporate reform programme, which we will analyse in detail in the next chapter.

## 4 Assessing the post-1997 corporate reform

As we mentioned in the previous chapter, the Korean corporate reform after the financial crisis was predicated on the premise that the *chaebol*-dominated corporate structure brought about over-investment and excessive diversification because it lacked adequate institutional mechanisms to restrain ‘despotic’ management decisions by the ‘owners’.

Based on this premise, the corporate reform programme contained the following elements. At the more symptomatic level, a radical reduction of corporate debt was thought necessary in order to reduce financial vulnerability of the *chaebols*. The ‘Big Deal’ programme (the business swaps among the *chaebols* operating in overlapping industries), and the ‘Workout’ programme (the bank-sponsored rehabilitation programme for ailing firms) were also implemented in order to reduce over-capacity and the degree of business diversification. At the more fundamental level, radical changes in external and internal governance mechanisms were made. Fair trading regulations were stringently applied to check ‘unfair’ expansion of the *chaebols*. Financial supervision was strengthened in order to control *chaebols*’ investment through lending institutions (rather than through state intervention, as before). Changes in internal corporate governance were introduced in order to reflect more closely the shareholders’ point of view in the running of the companies. This new system of ‘check and balance’ among companies, financial institutions, and shareholders is based on the ideal of the Anglo-American economic system.

Although several years have passed since this programme was introduced, it may still be too early to draw up its full balance sheet. New costs are still being added to the system and the anticipated benefits that may materialise, if ever, may materialise only in the long run. Despite this qualification, we argue that, at least up to now, the

reform has failed to achieve even its stated aim of reducing financial risks in the corporate sector, while running up a huge ‘bill’ by attempting a radical systemic transition in a short period of time. The attempt to seek new ‘engines of growth’ in increased foreign direct investment (FDI) and small and medium-sized venture business was also far from successful.

We argue that this disappointing performance of corporate reform was not simply because the reform was implemented too rapidly or there were technical failures in carrying out the reform, although these were indeed important factors. It was mainly because the reform was misdirected, in the sense that it has been trying to introduce a system of corporate governance and financing that was not appropriate for the Korean economy.

To show this, we will discuss benefits and costs involved in the corporate reform under the following headings: restructuring the *chaebols* (section 4.1), attracting foreign investment (section 4.2), and nurturing venture businesses (section 4.3). We will then deal with costs involved in the system transition more comprehensively by analysing public funds spent in the process of the reform (section 4.4).

#### **4.1 Restructuring the *chaebols***

The reform of the *chaebols* was the main thrust of the post-1997 corporate reform programme. The major benefit anticipated from the *chaebol* reform was the lowering of financial risks in the corporate sector, which in turn would lower the financial risks for the overall economy. In the longer run, it was also expected that the reform would help improve the competitiveness of Korean firms by improving their governance. However, these benefits, as far as they materialise (which they may never do), should be set against the costs involved in systemic transition, which in our view have been substantial.

With this cost-benefit analysis framework in mind, we will below evaluate the three major measures of *chaebol* reform: (1) the radical reduction in corporate debt–equity ratios, (2) the big deals and the workout programme, and (3) changes in the governance structure of the *chaebols*.

##### **4.1.1 Reduction in the debt–equity ratio**

The drastic reduction in corporate debt–equity ratio is claimed by the current Korean government to be one of the most successful achievements in the post-crisis corporate reform. Following the crisis, the five

largest chaebols were mandated to lower their debt ratios, which stood at 473 per cent on average at the end of 1997, to below 200 per cent by the end of 1999. They 'over-achieved' the target by reducing it to 235 per cent in 1998 and to 148.9 per cent in 1999. The ratio for the thirty largest chaebols also went below 200 per cent in 2000 (Table 4.1). The debt–equity ratio of the manufacturing sector as a whole consequently fell from 396 per cent in 1997 to 214 per cent in 1999 and to 210.5 per cent in 2000, the lowest since 1968 (also see Figure 2.3).

But this drastic fall in debt–equity ratios has not really been translated into a lowering of financial risks in the corporate sector.

To begin with, the reduction in debt–equity ratio did not lead to a corresponding reduction in interest payments. In 1999, financial expenses to sales in the manufacturing sector fell from 9 per cent in 1998 to 6.9 per cent – an apparently significant reduction. However, the 1999 figure was still higher than the figure in 1997 (6.4 per cent), the year when the financial crisis broke out, as well as the average figure during 1990–7 (5.8 per cent). This was because Korean companies reduced their debt–equity ratios mainly through new stock issue, asset sales, and asset revaluation, rather than through repayment of their debts. The amount of total debt in the manufacturing sector in fact slightly increased from 389.6 trillion won (\$324 billion) in 1998 to 391.2 trillion won in 1999 (BOK 1999a; 2000). The financial expenses to sales did show a significant fall only in 2000, reaching 4.7 per cent, but once again this was, according to the Bank of Korea, mainly due to 'debt–equity swap or debt write-off of companies under the workout programme' rather than to 'efforts at improving capital structure by the corporate sector' (BOK 2001: 23).<sup>1</sup>

The 'financial engineering' that was involved in this process has brought, on the whole, few benefits. Of the three key measures that the Korean companies used in order to reduce their debt–equity ratios, asset sales contributed to improving profitability of the manufacturing sector by around 1 per cent point in 1999 (BOK 2000: 16).<sup>2</sup> However, this was nearly cancelled out by the costs incurred in asset revaluation,

Table 4.1 Trend of debt–equity ratios of the 30 largest *chaebols* (%)

	1995	1996	1997	1998	1999	2000
5 largest	297.6	344.2	472.9	235.1	148.7	162.0
6–30 largest	435.1	460.8	616.8	497.1	498.5	186.0
total	347.5	386.5	512.8	379.8	218.7	171.2

Source: FTC website.

Note: Figures at the end of the year. Financial affiliates are excluded.

which was another major method taken by the *chaebols* to reduce their debt–equity ratios.<sup>3</sup> The thirty largest *chaebols* reduced their debt ratios by 56 per cent points on average in 1999 simply by revaluing their assets. However, in revaluing their assets, they had to incur substantial transaction costs (e.g., valuation fees and transaction taxes), while accepting a substantial increase in depreciation costs in their balance sheets.<sup>4</sup> Depreciation cost to sales in the Korean manufacturing sector increased from 4.7 per cent in 1997 to 5.4 per cent in 1998 and 5.5 per cent in 1999, and most of the increase was due to asset revaluation (BOK 2000).<sup>5</sup> The end result was that Korea’s manufacturing sector improved its profitability by 1 per cent point through asset sales but made it worse as much through revaluation of their assets, both of which might have not been that necessary, if the debt–equity ratio itself had not been targeted as a major objective of the corporate reform.

Exactly because it was achieved in these ‘wrong’ ways, the reduction in debt–equity ratios did not raise the traditionally low profitability of Korean corporations, which was ultimately why the reform measures were being implemented. The ratio of ordinary income to sales (ordinary profit rate) for the manufacturing sector recovered to 1.68 per cent in 1999, from negative figures in 1997 and 1998, but it slipped again to 1.29 per cent in 2000 and further to 0.4 per cent in 2001. The average ordinary profit rate for the two years of vigorous economic recovery in 1999 and 2000 was only around half of the historical average before the financial crisis (2.8 per cent during 1973–96). If we include the figure for 2001, the year of sharp economic slowdown, the average is even worse at 1.12 per cent. The corporate sector with ‘high debt plus thin profit margin’ has been transformed into something possibly even worse – namely, one with ‘*lower debt plus even thinner profit margin*’ (Figure 4.1).

Moreover, there was no improvement in operating profit or sales, which in our view are better measures of corporate competitiveness than ordinary profit. In fact, their post-crisis figures show deterioration. The ratio of operating income to sales (operating profit rate) for the three years of recovery was 6.5 per cent on average – lower than the 7.2 per cent average for 1990–7. It is noticeable that operating profit rate showed a marked decline to 5.5 per cent in 2001, the year of economic slowdown, which is a sharp contrast with what happened in 1997, the year of financial crisis, when the Korean corporate sector actually raised its operating profit rate to 8.2 per cent, from 6.5 per cent in 1996, to survive economic slowdown. This implies that the corporate sector has somehow lost its capacity to combat recession

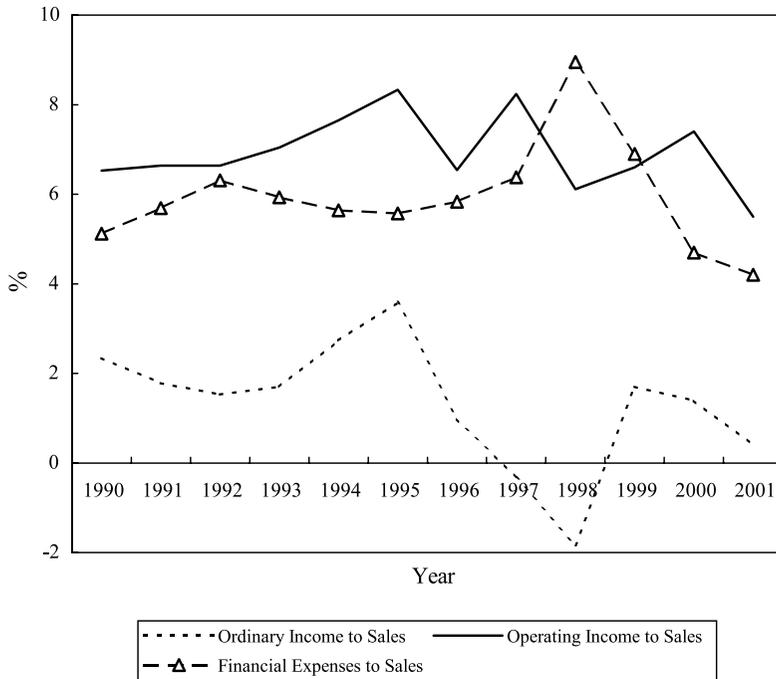


Figure 4.1 Trend of profitability in the manufacturing sector in Korea.

Source: BOK website.

after the crisis and the subsequent reform, which in our view has to do with the institutional straitjacket that the reform process has enforced upon it (more on this in section 4.5).

These profit rate figures are even worse than they may appear at first sight, when we consider that the denominator (sales) was not growing during this period as fast as it used to. Sales growth rate in the manufacturing sector in 1999 and 2000, the years of sharp macroeconomic turnaround, was 11.6 per cent on average, much lower than the average during 1990–7, which was 14.5 per cent. Similarly with the case of operating profit rate, sales growth rate also dropped significantly to 1.7 per cent in 2001 following the economic slowdown, recording the lowest figure since 1961 except 1998 (0.7 per cent), the year of severe economic contraction after the crisis. The average sales growth rate during the three post-crisis years (1999–2001) was therefore only 8.3 per cent.

If the benefits of the radical, policy-driven reduction in debt–equity ratio are difficult to find, if not non-existent, its costs were significant. Above all, companies with high debts were categorically regarded as non-viable ones regardless of their short-term efficiency or long-term prospects. Financial institutions, facing stiffer supervision standards and preoccupied with their own survival, called in or stopped rolling over their loans to those companies with high debt–equity ratios, driving them to bankruptcy or near-bankruptcy. This was a major reason why credit crunch in the Korean financial market persisted well into 2000, even though the BOK reduced its call rates to a historically low level since the middle of 1998.

Thus seen, a large part of the build-up of non-performing loans (NPLs) after the crisis was due less to the inherent inefficiencies of the Korean corporate sector than to an abrupt change in financial environment in a way that excessively punished high debt (see section 4.5). The debt–equity ratio reduction policy also drove the Korean firms to sell their assets at bargain prices. Although what exactly constitutes a bargain price can be debated, considering the asymmetry of negotiating power between sellers and buyers in times of financial crisis, it seems reasonable to suppose that those assets they sold were mostly sold at heavily discounted prices (see sections 4.2 and 4.5).

#### ***4.1.2 The ‘big deals’ and the ‘workout programme’***

In dealing with *ex post* adjustments of industrial capacity and financial problems, the Korean government adopted different approaches between the five largest *chaebols* and the smaller ones. For the five largest *chaebols*, which were regarded as having sufficient financial and managerial resources for restructuring by themselves, the government ‘encouraged’ the ‘big deals’, that is, business swaps among the *chaebols* in industries with over-capacity. For the sixth to the thirtieth largest *chaebols*, who were considered too weak to restructure by themselves, the government devised the ‘workout programme’, a banks-sponsored restructuring process. In July 1998, it was announced that eight major business sectors that include seventeen companies of the five *chaebols* were going to be subject to the big deals. One hundred companies were also put under the workout programme.<sup>6</sup>

Unfortunately, there is no noticeable achievement from the big deals and the workout programme as we write this chapter in early 2002. Among the eight big deals proposed, none proceeded in the form of business swaps. Most of them ended up as one-sided take-overs or as simple mergers. Even worse, some proposed ‘deals’ were

simply not made (Table 4.2). Also, among those deals concluded, many projects do not show signs of turnaround. In semiconductors, Hyundai Electronics, after its acquisition of LG Semiconductors, faced serious liquidity problems with accumulating losses and withdrawal of loans from financial institutions, and was put on sale to Micron Technology, a rival US semiconductor firm.<sup>7</sup> In other areas like power generation facilities, railway vehicles, and aerospace, the newly set-up companies are still losing money (as of the end of 2001).

Likewise, despite a substantial debt restructuring, a large portion of the 'workout' companies have not been turned around yet. Creditor banks rescheduled 86 trillion won of debts and newly provided 4.5 trillion won in fresh money to these companies by May 2000. Of the

Table 4.2 The state of the 'big deals'

<i>Type of industry</i>	<i>Contents of the agreement in December 1998</i>	<i>The state as of the end of 2001</i>
Automobiles/ electronics	Business swap between Samsung Motors and Daewoo Electronics	Samsung Motors was sold to Renault Sale of Daewoo Electronics to foreign investors or manufacturers is in progress Daewoo Motors to be sold to General Motors*
Semiconductors	Hyundai Electronics' acquisition of LG Semiconductors	Hyundai Electronics took over LG Semiconductors in June 1999 Hynix (a new name of the combined company) put on sale to Micron Technology
Oil refining	Hyundai Oilbank's acquisition of Hanwha Energy's oil-refining business	Hyundai Oilbank agrees to take over Hanwha Energy's oil-refining business in April 1999 Due diligence was completed in June 1999
Petrochemicals	Establishment of a company through the merger between Hyundai Petrochemical and Samsung General Chemicals	Due to the delay of the merger caused by the hesitation of Japanese consortium, the deal is as good as given up

Table 4.2 (Continued)

<i>Type of industry</i>	<i>Contents of the agreement in December 1998</i>	<i>The state as of the end of 2001</i>
Power generation facilities	Sale of assets of Hyundai Heavy Industries and Samsung Heavy Industries to Korea Heavy Industries, a state-owned company	Assets of Hyundai Heavy Industries and Samsung Heavy Industries were sold to Korea Heavy Industries in November 1999
Marine engines	Sale of Samsung Industries' engine division to Korea Heavy Industries	The two companies agreed to a merger on a 6:4 investment basis in November 1999
Railway vehicles	Hyundai, Daewoo, and Hanjin jointly established a company	The three companies invested on a 4:4:2 basis, establishing the Korea Railway Vehicle Co. in July 1997
Aerospace	Establishment of Korea Aerospace Industries through the merger of the aerospace division of Samsung Aerospace, Daewoo Heavy Industries and Hyundai space & Aerospace	The aerospace divisions of the three companies were merged in Korea Aerospace Industries in October 1999

*Sources:* MOCIE website, SERI (2001a).

*Note:* \*The deal was finalised in April 2002.

100 companies selected for the workout programme, however, twenty-nine companies went bankrupt and thirty-five companies were still under the programme as of June 2001. Some thirty-six companies that 'graduated' from the programme were mostly small and medium-sized enterprises (MOFE 2001; SERI 2001a).

In assessing the performance of the big deal and workout programmes, it should be noted that they were not really 'reform' measures, as the Korean government likes to argue, although they were important 'restructuring' measures. If a large number of companies face insolvency problems, the government and/or creditor banks are inevitably drawn into the restructuring process, regardless of their commitment to systemic reform.

The only sense in which these two programmes can be seen as 'reforms' is that they were seen as ways of reducing the 'excessive'

diversification of the *chaebols*. One key objective of the big deal was to make the *chaebols* concentrate their resources in the areas of their ‘core competence’. Therefore, when arranging the big deals, the government put pressure on the *chaebols* to reduce the number of their businesses. Consequently, the average number of businesses run by the five largest *chaebols* was reduced from 30.0 in 1997 to 23.2 in April 2001. The total number of affiliates of the thirty largest *chaebols* also fell by 22.3 per cent, from 804 in April 1998 to 624 in April 2001 (MOFE 2001).

Was this a good thing? Unfortunately, there is no empirical evidence that diversification of the *chaebols* was a negative thing. Lee and Eo (2000), on the contrary, find that the degree of *chaebol* diversification was negatively correlated with bankruptcy during and after the financial crisis (Table 4.3). To be sure, there have been some corporate failures due to ill-managed diversifications such as the cases of the Kia Group or the Hanbo Group. However, the diversified business structure provided the *chaebols* with a better ability to survive economic downturn by spreading risk, on the one hand, and by performing the role of ‘lender of last resort’ to weaker business units in difficult times, on the other hand.

As we emphasised above (section 2.1), one of the strengths of the *chaebol* structure lies in its capability for diversification. There are both pros and cons for business diversification, and there is no such thing as an ‘optimal’ degree of diversification that fits all business groups. It varies greatly according to the technological trend of the day, technological and managerial capacity of individual groups and so on. Moreover, if there had been any ‘excessive’ diversification, the *chaebols* would have reduced it for their own survival. With the increased pace of globalisation, the increased competition both in the

Table 4.3 Factors affecting bankruptcy of the *chaebols*

	<i>Before crisis</i>	<i>After crisis</i>
Debt ratio	+	+
Total asset	–	–
Rate of fixed asset increase	+	+
Diversification	–	–
Transfer of management to the second generation	n.s.	n.s.

Source: Lee and Eo (2000).

Note: n.s. is not significant.

domestic market and in the international market should make it more difficult for them to subsidise non-viable affiliates.

One salient feature of the Korean government's post-crisis adjustment programme was its resort to the rhetoric of 'free market' economy. Having declared its abandonment of previous industrial policy practices, the Korean government emphasised that it was only a 'facilitator' of the big deals and the workouts that were voluntarily undertaken by creditor banks' initiatives.<sup>8</sup> However, this rhetoric did not fit the reality. The government in fact put enormous political and economic pressures on the *chaebols* for big deals as a part of its corporate reform programme.<sup>9</sup> The commercial banks were also not able to independently manage the workout programme because most of them were already nationalised in the process of recapitalisation by public money, and therefore all of their important decisions had to be made 'in consultation with' the all-powerful Financial Supervisory Commission (FSC).

It seems to us that this discrepancy between the rhetoric and the reality had several adverse effects in facilitating corporate restructuring in Korea.

First, there was no coherent long-term strategy that guided the corporate restructuring process. Amid the combination of the zeal for reforming the *chaebols*, the necessity to 'clean up' the financial institutions, and the pronounced abandonment of industrial policy practices, no one asked what kind of organisational forms and industrial mix were desirable for the 'new' Korean economy. And the 'reform directives' like reducing corporate debt-equity ratio and dismantling the group structure were simply not designed to give answers to such questions. However, the fact is that there still existed a *de facto* industrial policy like the big deals and the workout programmes, and consequently the end result was incoherence and confusion in the restructuring process.

Second, and related to the above, there was no one that assumed the risks involved in this adjustment exercise. Especially when one attempts to rehabilitate ailing companies, someone should not only provide those selected for revival with financial resources but also take managerial responsibility by reorganising them and motivating their employees and so on. This role requires not only determination and long-term vision but also support from financial institutions and also from the public. But, hiding behind the rhetoric of the free market economy, the government officials did not come forward as the principal risk bearers, as they used to in the old days. Financial institutions, preoccupied with their own survival, were only interested in improving their short-term balance sheets. The owners of the com-

panies concerned were mostly excluded from this process, because they were categorically branded as incompetent managers.<sup>10</sup> Thus a vacuum in the risk-taking function was created. This was especially evident in companies under the workout programme. Although their debts were written off and/or rescheduled and sometimes even new money was provided, adequate managerial efforts at turnaround did not follow. In this respect, SERI (2001a: 109) attributes the underachievement of the workout programme to “the lack of a responsible body to promote it and the severe conflict between parties concerned”.

Third, unnecessary costs were incurred when ill-thought-through deals were pushed by the government and eventually fell through. A case in point is the deal between the Samsung Group and the Daewoo Group over Samsung Motors and Daewoo Electronics. From the beginning, the Samsung Group was not interested in acquiring Daewoo Electronics because it did not have any need to expand its consumer electronics operation. Its major interest was the disposal of the ailing Samsung Motors, but it was reluctantly drawn to the business swap discussion due to mounting pressure from the government. On the other hand, the Daewoo Group saw the deal as an opportunity to save Daewoo Motors, which was the main source of its liquidity problem, created by the car division's overly rapid expansion in Korea and abroad, especially in emerging markets like Poland, Uzbekistan, Vietnam, and India. Thus with its only hope pinned on the conclusion of this deal with Samsung, Daewoo survived the seven months between the announcement of the big deal with Samsung Group and its eventual break-off in June 1999, by borrowing more and more on higher and higher interest rates. Consequently, its debt increased by 52.9 per cent from 28.7 trillion won in 1997 to 43.9 trillion won in 1998, and its financial expenses nearly doubled from 2.99 trillion won in 1997 to 5.92 trillion won in 1998 (Table 4.4), eventually leading to its bankruptcy, the biggest corporate failure in Korean history. Even after the group was placed under a workout programme in August 1999, creditor banks had to pour in additional 10 trillion won, without any impact on its revival.<sup>11</sup>

#### ***4.1.3 Reforming the governance of the chaebols***

If the radical reduction of debt–equity ratios, the big deals, and the workout programme were intended to deal with the symptoms of the *chaebol* structure, there were also attempts to change the very structure that was supposed to have caused these symptoms. Therefore, regulations on fair trading, accounting, financial institutions, mergers and acquisitions, and internal corporate governance underwent far-

Table 4.4 Financial flows of the Daewoo group (trillion won)

	1997	1998
Total loans	28.7	43.9
Bank loans	8.6	8.2
Loans from NBFIs	8.1	8.2
Corporate bonds	8.4	19.7
Commercial papers	3.6	12.0
Operating income	3.0	3.1
Financial expenses	2.9	5.9
Net profit	0.1	-0.5

Source: FSC (1999).

reaching changes (Table 4.5). And as a result, previous mechanisms that made the *chaebol* structure viable were nearly dismantled. Below we shall explain those changes in detail and discuss their implications for the Korean economy.

#### A. Fair trading regulation

A major strength of business groups like the *chaebols* lies in their ability to make internal resource transfers *at prices designated by the centralised decision-making authority within the group*. Indeed, if affiliated firms transacted with each other only in market prices, the business group would lose its *raison d'être* (see section 2.4). Accepting this logic, before the financial crisis, the Fair Trading Commission (FTC) in Korea focused on restraining the concentration of economic power by the *chaebols* without denying the desirability of business grouping. As a result, it was lenient in regulating internal transactions among affiliates of the *chaebols*, although its attitude slowly but continuously hardened from the early 1980s.

However, the corporate reform after the financial crisis was carried out on the assumption that the *chaebol* structure has no benefit. And from this point of view, transactions among *chaebol* affiliates that do not use market prices were seen as 'unfair' trading. Consequently, in the three years during 1998–2000, the FTC embarked on unprecedented investigations of 'unfair internal transactions' by the *chaebols*, and levied 234.3 billion won (US\$ 195.2 million) of fines on the thirty largest *chaebols*, most of which was on the five largest *chaebols*.<sup>12</sup> These fines were calculated according to the gap between market prices and the internal prices used among the *chaebol* affiliates in their 'unfair' transactions.

Table 4.5 System changes in governance of the chaebols

<i>Classification</i>	<i>Main contents</i>
Fair trade regulation	<ol style="list-style-type: none"> <li>1 Strengthening punishment on 'unfair' internal transactions</li> <li>2 Revival of regulation on the amount of investing in related firms to 25% of net assets of a business group</li> <li>3 Abolition of debt guarantee</li> </ol>
Accounting standard	<ol style="list-style-type: none"> <li>1 Introduction of consolidated financial statements</li> <li>2 Obligation of establishing election committee for the assignment of outsider auditors for listed companies and affiliates of the chaebols</li> </ol>
Financial market discipline	<ol style="list-style-type: none"> <li>1 Regulations in banks loans:                     <ul style="list-style-type: none"> <li>Debt–equity ratio 200% became a de facto limit in provision of loans</li> <li>Prohibition of new loans with guarantee by affiliated firms</li> <li>Establishing a system for constant assessment of corporate credit risk, including introduction of forward looking criteria (FLC)</li> </ul> </li> <li>2 Liberalisation of M&amp;A market:                     <ul style="list-style-type: none"> <li>Permitting hostile takeovers</li> <li>Abolition of regulations on foreigners' shareholding</li> </ul> </li> </ol>
Internal governance	<ol style="list-style-type: none"> <li>1 Outsider director system:                     <ul style="list-style-type: none"> <li>One quarter of the board of directors should be outside directors</li> </ul> </li> <li>2 Responsibility of major shareholders:                     <ul style="list-style-type: none"> <li>Registration of the controlling shareholder as the representative director of leading affiliates</li> <li>The removal of the 'Chairman's Office'</li> </ul> </li> <li>3 Right of minority shareholders:                     <ul style="list-style-type: none"> <li>Loosening conditions for derivative suits, inspecting accounting books, and request for the dismissal of directors and auditors by shareholders</li> <li>Introduction of a cumulative voting system when appointing directors</li> </ul> </li> <li>4 Right of institutional investors:                     <ul style="list-style-type: none"> <li>Allowing voting rights for shares in funds managed by investment trust companies and bank trust accounts</li> </ul> </li> </ol>

Sources: MOFE website, SERI (2001a).

*Table 4.6* Removal of debt guarantee in the 30 largest *chaebols* (trillion won)

	<i>Apr. 1998</i>	<i>Apr. 1999</i>	<i>Dec. 1999</i>	<i>Mar. 2000</i>
Loans with guarantee	26.9 (39.5%)	9.8 (9.7%)	4.3 (4.3%)	0 (0%)
Number of firms with debt guarantee	216	127	68	0

*Source:* FTC website.

Another pillar of intra-*chaebol* transaction, i.e., debt guarantee among affiliates, was also completely abolished. Debt guarantee was singled out as an important factor that allowed ‘unfair’ expansion of the *chaebols*. It was also seen as increasing financial vulnerability at the group level, as it can lead to ‘chain bankruptcy’. Thus, the abolition of debt guarantee was undertaken not only as a fair trading regulation but also as a measure to strengthen financial market discipline over the *chaebols*. The size of debt guarantee of the thirty largest *chaebols* stood at 26.9 trillion won as of April 1998, an amount equivalent to 39.5 per cent of their total loans at the time. Under the joint pressure from the FTC and FSC, this was reduced to 9.8 trillion won by April 1999 and became nil at the end of March 2000 (Table 4.6).

### *B. Accounting standards*

As a measure to increase transparency and thereby accountability of the *chaebols*, the Korean government revised the external audit law and made it compulsory for the thirty largest *chaebols* to produce ‘consolidated financial statements’, that is, accounts for the business group as a whole, and not just for the individual affiliates. Previously, *chaebol* affiliates reported their financial status as separate legal entities, and as a result the size of internal transactions and interlocked shareholding were not very visible in their financial statements. The consolidated financial statement, in contrast, shows financial situation of a business group as a single entity by eliminating overlapping transactions among affiliates.

With the introduction of the consolidated financial statement, it has become possible for outsiders to see the ‘true’ financial situation of a business group, which used to be internal knowledge confined to insiders. On the other hand, it became impossible for the *chaebols* to inflate the value of their sales and assets through internal transactions and ‘circular’ or ‘roundabout’ holding of shares, which was a typical way of overcoming lack of financial resources (see section 2.4).

Apart from the introduction of the consolidated financial statement, the Korean government has also made it obligatory for the *chaebol* affiliates and all listed companies to establish an election committee for the assignment of outside auditors in order to ensure their objectivity.

*C. Regulation of the chaebols through financial regulation*

Since the accumulation of non-performing loans (NPLs) in the financial sector was an immediate cause of the financial crisis, the restructuring of the financial sector itself was a major item on the reform agenda. The financial sector therefore underwent the biggest reorganisation in its history. The details of the financial sector restructuring programme are set out in Table 4.7.

Table 4.7 Major measures taken for restructuring the financial sector

<i>Classification</i>	<i>Main contents</i>
Strengthening financial supervision	1 Established Financial Supervisory Commission in April 1998
	2 BIS ratio strictly applied as a deciding indicator of soundness of financial institutions (8% for commercial banks and 4% for small financial institutions) along with introduction of prompt corrective action measures
	3 Introducing forward looking criteria (FLC), conforming to 'global standards', in December 1999
Disposal of insolvent financial institutions and consolidation	1 Disposal of 572 ailing financial institutions by end-April, 2001 (27.2 % of total financial institutions in existence at end of 1997)
	2 Injecting 137 trillion won of public funds into the sector
	3 Consolidated four commercial banks and one merchant bank into the Woori Financial Holding Company
Partial deposit guarantee system	1 Changed the previous Full Deposit Guarantee System into a Partial Deposit Guarantee System (When a financial institution enters bankruptcy, only up to 50 million won of deposits is guaranteed)
Governance	1 Introduction of outsider director system
	2 Introduction of a committee for recommending appointment of bank presidents
	3 Credit is assessed by an independent credit assessment committee

Source: MOFE website.

As a result of this programme, 572 ailing financial institutions (27.2 per cent of total financial institutions in existence at the end of 1997) were closed down and several major commercial banks were nationalised as they were recapitalised with public money (see Table 3.8). Other financial institutions that survived the financial crisis have undergone or are undergoing voluntary or government-induced merger and acquisitions (M&As). In addition, the Financial Supervisory Commission (FSC) was established as a comprehensive financial 'watch-dog', functions of which had been previously divided between the Bank of Korea and the Ministry of Finance and Economy. Financial supervision standards were also significantly strengthened.

What is notable is that many financial reform measures were designed in close coordination with the corporate reform programme, because the problem of NPLs was closely associated with performance of the corporate sector. For instance, the prohibition of loan guarantee among *chaebol* affiliates was not simply a change in financial supervision criteria but also a change in fair trading regulations over the *chaebols* (see above). New financial supervision criteria, such as the forward-looking criteria (FLC), were introduced at the end of 1999 as a way of restraining possible over-investment by the corporate sector. Under the previous standard, financial institutions were required to set aside provisions only against those loans on which interests are not actually paid.<sup>13</sup> But the FLC require that financial institutions set aside provisions against the loans even though interests on which are regularly paid, if borrowers' management conditions, financial status, future cash flow, and so on are regarded inadequate. In judging a borrower's future business prospect, corporate debt-equity ratio is again seen as one of the key considerations (FSC 2000).

Other financial reform measures like strict application of the BIS minimum capital adequacy standard (the so-called BIS ratio) are mainly geared to maintaining the soundness of the financial institutions. Unfortunately, this also had a crippling effect on corporate financing. For instance, the Korean government instituted a system to automatically force liquidation or merger of financial institutions when they do not maintain the BIS ratio. This means that financial institutions can no longer remain flexible when their corporate customers are in need of cash due to short-term liquidity constraints or due to a deterioration of the overall business environment. As the maintenance of the BIS ratio became the top priority for their own survival, financial institutions came to reduce, or even altogether stop, corporate lending, even when they were sure that a further provision

of loans to the corporate sector at the expense of lowering BIS ratio in the short run would increase their profits and soundness in the long run. Similar to the introduction of debt–equity ratio as a *de facto* maximum limit to provision of loans to the corporate sector (see section 4.2), the BIS ratio regulation has substantially increased the need for corporations to maintain a higher level of liquidity, reducing the volume of financial resources available for long-term investment.

It seems to us that one of the most serious problems arising from applying rigid criteria of financial regulation like the BIS ratio or the corporate debt–equity ratio lies in their pro-cyclical nature. In a recession, an increase in bankruptcy and fall in asset prices shrink the asset base of the financial institutions, which induces them to withdraw their loans from the corporate sector, if they are to meet the BIS standard, which makes the recession even worse. Also, in a recession, firms need to increase their borrowing in order to maintain their cash flows, as their sales decrease and raising money through stock issuance becomes difficult. However, the debt–equity ratio regulation precludes the possibility of riding out a short-term liquidity problem by increasing debts, which used to be a characteristic way of dealing with business cycles by Korean firms. This pro-cyclical nature of the new financial regulations is behind the prolonged credit crunch during the period of crisis, as we shall elaborate later (section 4.5).

#### *D. Liberalisation of the mergers and acquisitions (M&A)*

Another element in the corporate reform programme was to institute a fuller liberalisation of the M&A market, which was supposed to introduce harsher discipline into the corporate sector. The Korean government removed the acquirer's obligatory tender offer of shares up to 51 per cent of total shares outstanding and abolished restrictions on the total amount of shareholdings a company can have in other companies, which used to be powerful obstacles to hostile takeovers. M&A market was also opened to foreigners. Previous regulations on foreigners' shareholding of domestic companies were mostly abolished.

Although the M&A market was liberalised, hostile M&As are scant as yet. This is partly because hostile M&As are still frowned upon by the majority of the population, but also because domestic institutional investors, who would be the main players in the M&A market, are still cautious about initiating hostile M&As due to previous cultural restraints as well as lack of funds. Legally, however, there are no obstacles to hostile M&As, and it may only be a matter of time before

the M&A market becomes active (although this is not a foregone conclusion). And knowing this, the thirty largest *chaebols* increased their internal shareholding from 43.2 per cent in 1997 to 50.5 per cent in 1999 (FTC website) in order to safeguard themselves against hostile M&As, despite the fact that this was a period of severe liquidity constraint and therefore such a move must have cost them dearly.

#### *E. Internal governance reforms*

Internal governance reforms were directed at improving the managerial transparency and accountability of the *chaebol* owners.

First, the 'Chairman's Office', which had been the nerve centre of co-ordination within the *chaebols*, was abolished. At the same time, legal responsibility of the *chaebol* owners was strengthened, as they were forced to register themselves as representative directors of their leading affiliate firms, which makes them liable for public prosecution and civil lawsuit for managerial misconduct. Officially, the Korean government only 'recommended' these changes. However, right after the crisis the political unpopularity of the *chaebols* was such that all of them felt compelled to abolish the office or change its name into the 'office of restructuring', while all of their owners registered themselves as representative directors of their major affiliates.

Second, the government revised the commercial law to make it obligatory for listed companies to appoint at least one-quarter of directors from outside the firm. People who share interests with major shareholders were also banned from being elected as outside directors.

Third, the rights of institutional investors were significantly enhanced. Investment trust companies and bank trust accounts were given voting rights. Although institutional investors are required to get approval from the Fair Trade Commission when they are involved in take-over activities, they have come to acquire almost all the rights of other shareholders.

Fourth, the rights of minority shareholders were strengthened. The minimum proportion of shares that are required in bringing a lawsuit against misconduct of managers was relaxed from 1 per cent to 0.01 per cent. The minimum requirements for inspecting the accounting books were also weakened from 3 per cent to 1 per cent of shareholdings (0.5 per cent in case of listed companies with more than 100 billion won worth of equity capital). A cumulative voting system was also introduced in order to make it easier for the minority shareholders to appoint board members representing their collective interest.<sup>14</sup>

*F. Assessing the governance reform measures*

There are certainly some positive aspects in the governance reform programme implemented since 1998. For instance, the strengthening of regulations on auditing and accounting is important in providing concerned parties with objective and reliable performance indicators of companies, especially when the number of concerned parties becomes large as companies diversify and broaden their sources of finance. In the same vein, it is desirable to strengthen the rights of minority shareholders to defend their interests from possible neglect by the managers, who tend to cater for the interests of major shareholders.

However, the system changes discussed above have had several negative effects for the national economy both in the short run and in the long term. In the short run, as explained above, many reform measures created, or at least intensified, the credit crunch because they made it necessary for the corporate sector to maintain a higher level of liquidity whilst putting pressure on the financial sector to withdraw liquidity from the corporate sector. This, in turn, increased non-performing loans in the economy and consequently the public burden for adjustment after the crisis (more on this in section 4.5).

In the long run, the governance reforms put the *chaebols* under serious constraints in operating as business groups. The most important of them is the rigid government regulation on internal transactions. To be sure, there can be negative effects of internal transactions, such as drainage of financial resources from healthy affiliates to unhealthy ones. However, internal transactions have positive effects, which have more than offset the negative ones in the case of Korea, such as economising on managerial resources, overcoming market uncertainties, allowing a longer-term perspective in investment and so on, as we emphasised above (section 2.4). By altogether banning internal transactions and other features of the *chaebol* structure, the reform programme may have destroyed the positive aspects of the group structure as well – a classic case of ‘throwing the baby away with the bath water’.

Previously, internal transaction was a major source of the *chaebol's* strength in supporting new large-scale ventures, as evidenced by Samsung's entry into the semiconductor industry or Hyundai's entry into the shipbuilding industry (section 2.4). Owing to the ban on loan guarantee and other internal transactions, it is now almost impossible to set up such ventures by relying on support from profitable affiliates. Coupled with the stringent regulation on corporate debt–equity ratio, the restriction on internal transaction has substantially reduced

financing options for the *chaebols*. And it is not likely that the growth in equity financing, the only remaining option for large-scale financing, will be sufficient to compensate for this constraint, at least in the near future.<sup>15</sup>

As we emphasised earlier (section 2.4), the internal transfer of resources constitutes basic strengths of the *chaebol* structure and should be understood as an institutional mechanism for latecomer firms to compete with their forerunners in the international market. A critical question here is whether the Korean companies have now grown strong enough to compete with the forerunners on the basis of individual firms without utilising the group structure – the answer to which is, in our view, a clear ‘no’.<sup>16</sup>

More fundamentally, it is questionable whether it is desirable for the government and international organisations to specify an ideal type of business structure and enforce companies to conform to it. Especially if we follow the Neo-Liberal logic that underlies the post-crisis corporate reform programme, it should ultimately be the shareholders who decide what kind of business organisation is desirable for their own interests. Some shareholders may prefer business grouping, expecting a faster growth of their share prices even though they may be fully aware of the possible risks from interlocking among affiliates. Others may not. The risks involved in forming a business group are also different according to the extent of financial market development, degree of competitive pressure in the product market, regulatory framework, and so on. Business structure evolves out of the interaction between the owners’ collective preference and the environment they face. There is no guarantee that operation by individual firms, rather than by a business group, is the most efficient nor is it clear that this is necessarily going to be the preference of the majority of the shareholders.

With the increased pace of globalisation, the *chaebols* were already facing pressure for change even before the crisis, because the increased competition both home and abroad was making it more difficult to subsidise non-viable affiliates. Facing ‘tougher’ attitudes from financial institutions following the pre-crisis domestic deregulation and opening-up, they also had to improve the transparency of internal transactions anyway. The extent of ‘ideal’ internal transaction could only be determined when the newly emerging structure fully evolved. The post-crisis governance reform has gone too far in neglecting this evolutionary process and imposing an idealised form of business structure while destroying the old system without salvaging its positive features.

## 4.2 Attracting foreign investment

While reining in the *chaebols*, the Korean government attempted to find alternative engines of growth in FDI and in small and medium-sized venture businesses. It is surely desirable for the Korean economy, which has been dominated by the state-bank-*chaebol* nexus, to have the roles of foreign companies and SMEs enhanced. This is also what was likely to happen anyway as the Korean economy becomes mature and globalised. However, as we shall see in this section and the next, the results of these attempts have been rather disappointing.

In assessing the benefits of the increase in FDI after the financial crisis, it is important to clarify the causality. A popular view, which also formed the basis of the IMF programme in Korea and elsewhere, is that the economic recovery in 1999 and 2000 was mainly due to the restoration of 'investors' confidence' and consequent inflow of foreign money into Korea, which was driven by Korea's commitment to, and progress in, structural reforms. According to this reasoning, the remarkably quick macroeconomic recovery Korea staged in 1999 and 2000 was thanks to an increased inflow of foreign money, which in turn was prompted by the progress in structural reform.

However, as we emphasised above (section 3.3.2), it is closer to the truth to say that the Korean economy recovered in spite of the IMF programme and the short-term recovery can be better understood as a Keynesian recovery based on low interest rates, currency depreciation, and a large-scale injection of public money into the economy (especially the financial sector). Foreign money, in particular private funds, flowed into Korea again only after the economy began showing signs of recovery, and not before. And it is this point that we have to bear in mind when we interpret the rise in inward FDI after the crisis, which is often cited by the Korean government as a major achievement of its reform programme.

First, as we pointed out before (section 3.3.2 and Figure 3.4), the rapid increase in FDI did not begin with post-crisis reforms. FDI was already on a rapidly increasing trend before the crisis, jumping by 68.4 per cent in 1996 and by 115.6 per cent in 1997. This implies that, even without corporate reforms and the government's efforts at attracting FDI after the crisis, overall market opening and relaxation of regulations on FDI, combined with the strong growth of the domestic economy, were enough to bring about a strong trend increase in FDI. There is no clear evidence that Korea needed those fundamental corporate reforms to increase the volume of FDI.

Second, most of the increase in FDI was related to asset sales by Korean companies and financial institutions, and was not the result of 'green field' investments. Therefore, inward FDI increased sharply in 1998 (26.9 per cent) and 1999 (75.5 per cent), when the government pressure on domestic institutions to sell their assets was strong, and subsequently became stable in 2000 (1.0 per cent) and fell sharply in 2001 (-24.4 per cent) (Figure 3.4). Asset sale in itself can hardly be regarded as a benefit to the economy. It can be beneficial to the economy only if those changes in ownership of the assets are translated into a better performance of the economy as a result of infusion of advanced technologies and management practices. But this positive effect of FDI on the economy is not in sight as yet, as the languishing sales and profitability figures of the corporate sector indicate (see section 4.2). Moreover, if those assets were sold at heavily discounted prices as a result of 'distress sales' in a crisis situation, the difference between their 'real' value and their sale prices should be counted as costs to the economy, no matter how big the size of FDI was. In this regard, the Korean experience is very negative.

Domestic companies and financial institutions in crisis-hit countries usually have to engage in 'distress sales' to avoid liquidity constraints, while foreign investors are in no hurry to buy those assets and can take their time to choose. Considering this asymmetry of negotiation power between domestic institutions and foreign investors, it is more natural to suppose that the assets that the domestic institutions can sell in a crisis situation will be mostly those with exceptionally bright prospects and/or at bargain prices.

In the Korean case, the asymmetry was exacerbated by the government policy. The Korean government portrayed FDI as the 'saviour' for the crisis-hit economy and applied tremendous pressure on domestic institutions to sell their assets to foreigners quickly, while providing the latter with various financial incentives. For instance, in carrying out corporate reform, the government specifically requested the *chaebols* to detail the amount of *foreign money* that they were planning to bring in through asset sales by the end of 1999. So when the top four *chaebols* reported their 'successful' restructuring at the end of 1999, \$10.82 billion of their assets were transferred to foreigners (SERI 2001a).

Some assets over which the government had direct control were earmarked for foreign sale to show the country's determination to attract foreign capital. The most important example of this was the sale of the Korea First Bank. The bank, a representative 'bad bank' thanks to its heavy exposure to the bankrupt Hanbo Group and Kia

Group, was placed for foreign sale under the agreement with the IMF. Its controlling shares (50.99 per cent of the total share) were sold to the sole bidder, Newbridge Capital, a US investment bank, at 500 billion won at the end of 1999. Under the deal, the Korean government agreed to purchase all NPLs arising over the next two to three years. This meant the US investment bank could hardly lose from the deal – given that all NPLs would be cleaned up by public money, it would make profit as far as the share price of the Korea First Bank rise above its face value (5,000 won per share).<sup>17</sup> The Korea First Bank is already earning handsome profits. It recorded a 306.4 billion-won net profit in 2000 and a 200.2 billion-won net profit for the first half of 2001 alone (FSC website). The net profit made by Newbridge Capital for the one and half years is already more than its original investment.

A similar deal was struck in the sale of the Daewoo Motors to General Motors (GM). The creditor banks of Daewoo Motors, led by the state-owned Korea Development Bank (KDB), agreed to sell it under the following conditions in September 2001: (1) GM will set up a new company to acquire Daewoo Motors and put \$400 million for 67 per cent of the total share of the company; (2) this company will selectively acquire \$1.2 billion of assets and \$834 million of debts of Daewoo Motors, but not the whole company; (3) the company will pay \$1.2 billion to the creditor banks by preferred stocks, not by cash, for the assets acquired; (4) the creditor banks will provide the new company with long-term loans up to \$2 billion (KDB 2001).

For GM, this is a deal out of a dream. In this deal, it is to pay only \$400 million to acquire the controlling share of Daewoo Motors, *which was estimated to have 12.9 trillion won (\$10.7 billion) of assets even according to a very conservative estimate.*<sup>18</sup> It also avoided acquiring large part of bad assets of Daewoo Motors and the burden of them still remains on the shoulders of the creditor banks, and ultimately on the taxpayers, as the creditor banks are being injected with public funds. Moreover, as it is promised a large-scale injection of long-term capital by the creditor banks, which it is not obliged to repay if the new company goes bankrupt, GM will lose only the paid-in capital of \$400 million even in the worst case scenario.

In contrast, the only way that the creditor banks can get their money back is by selling preferred stocks of the new company after the compulsory *ten-year* holding period. They are also to put \$197 million of their own money to the new company as shareholders, owning the remaining 33 per cent of the shares, and also have promised to provide long-term loans up to \$2 billion.<sup>19</sup> The asymmetry in this deal can be put into perspective if we compare this deal with the one when

Hyundai Motors acquired Kia Motors in November 1998. Hyundai Motors paid 1.2 trillion won (\$10 billion) of cash and took over 6 trillion won (\$50 billion) of Kia's debt with no promise of long-term capital provision from creditor banks (*Maeil Business News*, 19 October 1998).

These highly asymmetric deals were made only because the Korean government had excluded the possibility of reviving those ailing banks and companies by mobilising domestic resources and capabilities. The sale of the Korea First Bank was stipulated in the agreement with the IMF and the Korean government felt obliged to keep the promise and regarded this as an important step to regain 'investor's confidence'. In the case of Daewoo Motors, it excluded the options of nationalising the company for fear of damaging its new-found image as a market-oriented government, while refusing to allow a take-over by other *chaebols* lest it would bring allegations of favouritism or of the failure in its 'will' to reform the *chaebols*.

Thus seen, the Korean government ended up pushing for a number of deals that could be almost described as give-aways to foreign investors, which were based on, even in the most charitable interpretation, totally unrealistic expectations about the benefits that FDI can bring. If it did not take a dogmatic position on the benefits of FDI and went for 'sales to foreigners at any cost' and weighed its costs and benefits more carefully, it is unlikely to have endorsed, even less pushed for, the kind of deals that we just described.

Whilst the policy of desperately attracting foreign money has probably cost more to the national economy than it benefited it, there is no doubt that major beneficiaries of the policy were foreign investors and related service providers.

First, foreign investment banks, consulting firms, law firms, and accounting firms dominated the businesses related to restructuring such as advisory services, M&A deals, underwriting of new security issues and so on. The fees of these service-providers are a business secret and therefore there is no reliable data in this regard, but anecdotal evidence indicates that the size of the 'industry' and its profitability have increased tremendously. For instance, the FSC made a contract with foreign investment bankers for advisory service in corporate restructuring in October 1998 and it allocated \$3.3 million for this. The creditor banks paid to Morgan Stanley and Lazard about 14 billion won (\$11.6 million) for the *failed* deal to sell Daewoo Motors to Ford Motors. Commercial banks have reportedly paid 2–3 billion won each to foreign investment banks as advisory fees when they proceeded with M&As. One investment banker told one of the

authors in an interview in October 1998 that he estimated extra revenue for foreign service providers at least at 500 billion won (\$416.6 million) in 1998 (Shin 1999: 145–7; *Hankyoreh Shinmoon*, 8 June 2001).

Second, foreign investors have also dominated the secondary market in NPLs. It was reported that, as of May 2001, foreign investor had purchased over 20 trillion won (\$16.6 billion) of NPLs either from the Korea Deposit Insurance Corporation (KDIC) and the Korea Asset Management Corporation (KAMCO) – the two government agencies that purchased NPLs from financial institutions with public funds – or directly from domestic financial institutions (*Hankyoreh Shinmoon*, 8 June 2001; Table 4.8). The five largest foreign investors (e.g., Lone Star Fund, Morgan Stanley) alone bought 7.5 trillion won (\$6.3 billion) of NPLs from the KDIC and KAMCO. Eight commercial banks also sold 4.8 trillion won (\$4.0 billion) of NPLs to foreign investors (Table 4.9).

There is nothing wrong with the domination of the NPL market by foreign investors *in itself*. It may be argued that these foreign investors are simply taking the risk that the domestic institutions are not willing to, and therefore any profit that they make out of this should be regarded as rewards for their more aggressive risk-taking than that by Korean investors. However, the fact is that the KDIC, the KAMCO, and domestic financial institutions were under great pressure from the government to dispose of their NPLs quickly, and under situations of extreme liquidity constraint. Under such circumstances, it is likely that much of the sales of NPLs by them would have been ‘fire sales’, which in turn means that the profits made by their buyers would have been greatly inflated over and above the ‘just’ return for their risk-taking.

Table 4.8 Disposal of NPLs by government agencies to foreign investors (as of May 2001, billion won)

<i>Government agencies</i>	<i>NPLs sold to foreign investors</i>	<i>Foreign buyers</i>
Korea Deposit Insurance Corporation (KDIC),	2,349	Lone Star
Korea Asset Management Corporation (KAMCO)	2,143	Morgan Stanley
	1,658	Goldman Sachs
	791	Sonnenbrit Gold
	610	Lehman Brothers
Total	7,551	

Source: *Hankyoreh Shinmoon*, 8 June 2001.

*Table 4.9* Disposal of NPLs by commercial banks to foreign investors (as of May 2001, billion won)

<i>Commercial banks</i>	<i>NPLs sold to foreign investors</i>	<i>Foreign buyers</i>
Seoul Bank	420	Lone Star, Merrill Lynch, GE Capital
Korea Exchange Bank	450	Land Lease, SalomanSmithBarney
Chohung Bank	1,762	Lone Star, SalomanSmithBarney, Lehman Brothers
Hana	487	SalomanSmithBarney, Lehman Brothers
Korea Export-Import Bank	180	SalomanSmithBarney
Hanvit Bank	210	Lone Star
Korea Development Bank	900	Lone Star
Pyongwha Bank	444	Lone Star
Total	4,853	

*Source: Hankyoreh Shinmoon, 8 June 2001.*

Third, foreign capital has made a significant inroad into the stock market. As a part of the reform programme, the stock market was completely opened to foreigners from May 1998. As a result, the weight of foreign-owned shares in market capitalisation of the Korea Stock Exchange (KSE) rose from 14.6 per cent at the end of 1997 to 21.9 per cent in 1999, to 30.1 per cent in 2000, and further to 36.8 per cent in 2001 (Table 4.10). Foreigners' investment is mostly concentrated in the 'blue chip' companies – foreigners invested 86.9 per cent of their money in the thirty largest companies listed in the KSE at the end of 2001 (KSE website). Now, foreign-owned shares account for more than 50 per cent in many major Korean companies, including Samsung Electronics, POSCO, Hyundai Motors, and Kookmin Bank (Table 4.11). If one looks at the ownership structure of major Korean

*Table 4.10* Foreign advancement in the Korean stock market

	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
Value of foreign-owned stocks (trillion won)	10.4	25.6	76.6	56.6	88.2
Weight in the KSE (%)	14.6	18.6	21.9	30.1	36.8

*Sources:* SERI (2001a) and KSE website.

*Note:* The weight is against total market capitalisation of the KSE.

Table 4.11 The weight of foreign-owned shares in major blue chip companies (%), at the end of 2001)

<i>Kookmin Bank</i>	<i>Samsung Electronics</i>	<i>POSCO</i>	<i>Hyundai Motors</i>	<i>SK Telecom</i>	<i>Samsung Insurance</i>
71.1	59.7	61.9	52.6	32.4	51.6

Source: KSE website.

companies and commercial banks, Korea is now dominated by foreign capital, a 180-degree reversal from its 'nationalistic' model of economic management of the past.

### 4.3 Nurturing venture businesses

There had been several initiatives by previous Korean governments to promote small and medium-sized enterprises (SMEs). However, the support for SMEs through the subsidisation of 'venture business' and of venture capital by the Kim Dae-Jung government after the financial crisis is unprecedented in several respects.

First, the government promoted the Small and Medium Business Administration (SMBA) to a separate vice-ministerial-level organisation and put it in charge of the new, comprehensive scheme to promote SMEs. The SMBA used to be under the direct control of the Ministry of Industry, Commerce and Energy (MOCIE), in which the view of large businesses used to be more dominant. However, by making the SMBA directly accountable to the president, the Kim government gave it considerable power. The Kim government made the MOCIE itself take the promotion of SMEs (in collaboration with the SMBA) as one of its key tasks.

Second, an unprecedented amount of public money was poured into supporting venture business. The government launched the 100-billion-won Korea Venture Investment Fund with co-investment by foreign investors in 1999. Public funds spent in supporting the establishment of new SMEs, mainly in the form of investing in or lending to venture capital and venture companies, increased by 36 times from 34.4 billion won (\$28.7 million) in 1997 to 1,237 billion won (\$1,030.8 million) in 1999 (SMBA website).

Third, the government also enacted several laws specifically designed to support venture businesses and provided them with an array of taxation and financial benefits. For instance, those certified as venture companies or 'venture capitalists' by the government were exempt from or got reduction in income and sales taxes. Incomes from

stock swaps among venture companies were also exempt from capital gains tax. Various incentives for encouraging spin-offs from universities and research institutes were also introduced. Existing regulations on KOSDAQ, the Korean version of NASDAQ, were substantially eased so that start-ups could be more easily listed in KOSDAQ. Even de-listing from the Korea Stock Exchange and re-listing at KOSDAQ was encouraged (Yoo 2000; Sung 2001).

This active promotion of venture business by the government coincided with the domestic restructuring of large firms and the worldwide Internet business boom. After the financial crisis, job mobility was substantially increased due to large-scale layoffs in large firms, both in *chaebol* firms and in public enterprises. The explosive growth of NASDAQ in the US led by Internet-related stocks also fuelled the Internet boom in Korea as in a number of other countries.

The combined result was an exponential growth of KOSDAQ. The market capitalisation of KOSDAQ, which stood at only 7 trillion won (\$5.8 billion, \$1=1,200 won) in 1997 jumped over 15 times to 106.2 trillion won (\$88.5 billion) at the end of 1999. KOSDAQ composite index also rose to 256.1 at the end of 1999, a 263.4 per cent increase from 1997 (Figure 4.2). At the height of the venture business boom in 1999, the Korean government estimated that the number of venture companies would increase to 40,000 in 2005 from 5,000 in 1999, and that the share of venture companies' value added in GDP would

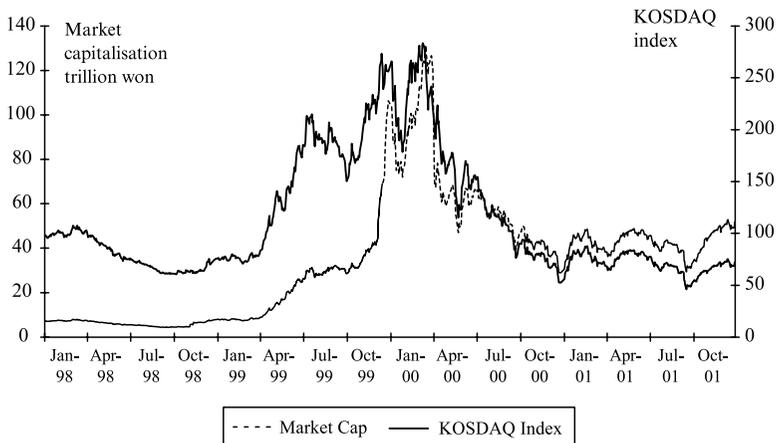


Figure 4.2 The rise and fall of KOSDAQ.

Source: KOSDAQ website.

increase to 15–20 per cent in 2005 from 2 per cent in 1999 (MOCIE website).

The establishment of a vibrant SME sector is desirable for any economy, but it was all the more so for the Korean economy, one of whose weak spots lies in the relative underdevelopment of SMEs. However, the attempt to achieve this overnight led to a huge bubble in the KOSDAQ market, which crashed in the latter half of 2000 as spectacularly as it boomed. Its market capitalisation shrank to 29 trillion won (\$24.1 billion) at the end of 2000, barely above one-fourth of the figure at the end of 1999. The KOSDAQ composite index also dropped to 52.5 at the end of 2000, one-fifth of the figure at the end of 1999. It would have been a great improvement in the Korean economy if the investment funds for SMEs increased linearly from 7.9 trillion won in 1998 to 29 trillion won in 2000. However, this was unfortunately accompanied by the bursting of the huge speculative bubble in the KOSDAQ market, which naturally had downside effects.

First, when the KOSDAQ was under the spell of an ‘irrational exuberance’, financial resources flowed into the Internet-related firms regardless of their future profitability, depleting the funds for existing SMEs engaged in traditional businesses. So during the period of unprecedented stock market boom in 2000, many traditional SMEs faced credit crunch and lost their ground. Second, the market crash not only wiped out a large amount of paper wealth but also has created new NPLs in the financial sector, which is still struggling to clear the existing NPLs.

To sum up, the government’s effort at creating a new engine of growth in the form of venture businesses has succeeded in enlarging the financial resources available for the SME sector, as we mentioned above. However, it is still far from certain whether the Korean government has succeeded in turning the SME sector into an alternative engine of growth. The share of SMEs’ contribution to manufacturing production increased only by 1 per cent point from 46.3 per cent in 1997 to 47.3 per cent in 2000 (SMBA website). The Korean economy is still dominated by large companies, as it has always been for the last few decades.

It is also yet to be seen how many of the SMEs established during the early post-crisis period will emerge as sustainable businesses. In addition, the costs from the crash of KOSDAQ to the national economy are, while only beginning to emerge, likely to be substantial. All in all, therefore, it is difficult to maintain that the promotion of venture business has brought major positive net benefit to the Korean economy.

#### 4.4 Transition costs in ‘restructuring Korea Inc.’

In the first three sections of this chapter, we discussed the three main elements of Korea’s post-1997 corporate and financial restructuring programme – or what we call ‘restructuring Korea Inc.’ They were the *chaebol* reform, attraction of FDI, and development of the SME sector. The interim balance sheet for the programme is as follows.

The financial system has been cleaned up by the government-administered disposal of bad assets and bad institutions, but is still undergoing a process of reorganisation. The *chaebols* have reduced their debt–equity ratios and the number of their operations, whilst their internal and external governance systems have been reformed. New engines of growth were also sought in FDI and venture businesses, but with disappointing results.

In this process, however, public debt has increased dramatically, as NPLs in the financial sector were offset by public funds. Moreover, many assets previously held by Korean companies and financial institutions were sold to the foreigners at greatly discounted value. The additional burden on public finance and the loss from the ‘fire sales’ of domestic assets by the private sector and by the government constitute the major components of ‘transition cost’ in Korea.<sup>20</sup>

After a financial crisis, it is inevitable for any government, regardless of its ideological inclination, to raise public funds to clear NPLs and reorganise financial institutions in order to make the financial system function. To take an extreme example, the Chilean government under General Augusto Pinochet, which did not hesitate to use violence to quell the opposition its Neo-Liberal policy, nationalised the entire banking sector in 1982, when the country experienced a severe financial crisis. In the Korean case, the timely and large-scale injection of public money in 1998 was indeed crucial in earlier-than-expected recovery of the Korean economy, as we discussed before (section 3.3).

However, a noticeable trend so far is that, despite the fact that NPLs *within the financial sector* have fallen drastically, the total NPLs *in the national economy* have been increasing. Thanks to unprecedented injection of public funds and pressure from the government over financial institutions to improve their balance sheets, the amount of NPLs within the financial sector, which shot up to 136.3 trillion won, or 21.8 per cent of total loans, in June 1998, was reduced to 66.7 trillion won (11.3 per cent) at the end of 1999, and 59.5 trillion won (9.6 per cent) in March 2001.<sup>21</sup> However, the economy-wide total of NPLs, which include those ‘driven out of the financial system’ through purchase by public funds, sales to the private sector, and liquidation

increased from 97.4 trillion won at the end of 1997 to 232.8 trillion won at the end 2000. In other words, during the first three years after the financial crisis (December 1997–December 2000), 135.4 trillion won of *new NPLs* was created in the economy, although that held by the financial institutions fell by more than half, with the trend continuing throughout 2001 (Table 4.12).<sup>22</sup>

It is impossible to objectively determine how much of this increase in NPLs in the economy was due to *ex post* realisation of the latent troubles within the corporate sector accumulated before the crisis or due to the difficulties created by the new economic system. However, if

Table 4.12 Changes in non-performing loans after the financial crisis (trillion won, %)

	Dec. 1997	June 1998	Dec. 1998	June 1999	Dec. 1999	June 2000	Dec. 2000	March 2001
Banks	31.6	40.0	33.7	37.1	39.7	56.5	42.1	38.1
Non-banks	12.0	23.6	26.5	26.3	27.0	26.0	22.5	21.4
Total (A)	43.6 (86.4)	63.6 (136.3)	60.2 (102.7)	63.4 (84.4)	66.7	82.5	64.6	59.5
Ratio of NPLs (%)	6.7 (13.2)	10.2 (21.8)	10.4 (17.7)	11.3 (15.0)	11.3	13.6	10.4	9.6
Accumulate purchase of NPLs by public funds (B)	11.0	13.8	44.0	46.1	56.0	81.5	95.2	90.6
Accumulate disposal of NPLs by financial institutions (C)	0	0	6.0	–	52.0	–	73.0	
Accumulate NPLs when purchase or disposition were not made (A+B+C)	97.4	150.1	152.7	–	174.7	–	232.8	–

Sources: Adapted and calculated from PFOC (2000, 2001) and FSC website.

Note: Figures in parentheses represent amount of NPLs or ratios of NPLs to total loans when forward looking criteria (FLC) are applied. The FTC began using FLC from the end of 1999 in reporting NPLs.

we look at the financial flows from the financial sector to the corporate sector, the importance of the latter becomes clear.

As Table 4.13 shows, a remarkable trend in corporate financing after the crisis was an abrupt depletion of external funds available for the corporate sector. The total amount of external financing of the corporate sector dropped from 117 trillion won in 1997 to less than a quarter, i.e., 27.6 trillion won in 1998. Even during the period of vigorous economic recovery in 1999 and 2000, the external funds available for the corporate sector were only around half of those available in 1997 and the situation became worse in 2001.

The major culprit here was the fall in the borrowing from financial institutions, i.e., indirect financing. In 1998 when the country was in the depth of the crisis, financial institutions *withdrew* 15.8 trillion won of loans from the corporate sector in their attempts to raise their BIS ratios and to reduce their risk exposure – in other words, it was actually siphoning money out of the corporate sector! Although indirect financing slowly began to recover from 1999, its level fell far short of the pre-crisis level, even if we accept that there may have been a certain amount of ‘excessive’ lending before the crisis. The amount of external financing available in 1999, at 2.2 trillion won, was only about 5 per cent of the 1997 level (43.4 trillion won). In 2000, it was, at 11.4 trillion won, still only 26 per cent of the 1997 level.

As the economy began to slow down sharply along with the recession in the world economy, indirect financing shrank dramatically again in 2001. In 2001, indirect financing shrank back to just under

*Table 4.13* External financing of the corporate sector (billion won)

	1996	1997	1998	1999	2000	2001
Total	118,769	118,022	27,664	51,755	66,531	51,939
Indirect financing	33,231	43,375	-15,862	2,198	11,391	1,185
From banks	16,676	15,184	259	15,525	23,348	3,381
From NBFIs	16,555	28,191	-16,550	-13,267	-11,997	-2,377
Direct financing	56,097	44,087	49,496	24,792	18,996	36,838
CPs	20,737	4,421	-11,678	-16,116	-1,133	4,210
Stocks	12,981	8,974	13,515	41,137	20,806	16,504
CBs	21,213	27,460	45,907	-2,827	-2,108	11,761
Foreign borrowing	12,383	6,563	-9,809	11,537	15,765	2,283
Others	17,059	23,997	3,839	13,228	20,380	11,633

Sources: Flow of Funds, BOK website.

Note: CP is corporate paper. CB is corporate bond. Others include corporate loans, government loans and so on.

1.2 trillion won, or down to 2.5 per cent of the 1997 level. The corporate sector has tried to survive this severe credit crunch by increasing issuance of stocks and corporate bonds. However, as the shrinkage in total external financing throughout the post-crisis period shows, they were far from sufficient to compensate for the reduction in indirect financing. The amount of external financing available for the Korean corporate sector during the post-crisis period (1998–2001) was on average 49,472 trillion won, or only 31 per cent of the pre-crisis level (118,409 trillion won on average for 1996–7). Moreover, these options to issue corporate bonds or new stocks were available only to the largest companies who had established their credibility in the securities market. For example, when excluding asset-backed securities, the share of big firms in the corporate bond market reached 99 per cent in 1998 and 95 per cent in 1999 – the corresponding figure was 72 per cent in 1991 and 87 per cent in 1994 (Crotty and Lee 2001). All this means that the smaller firms had virtually no access to external financing.

It seems to us that the credit crunch resulting from the sudden decrease in flow of funds from the financial sector to the corporate sector was an important factor in explaining the continuous increase in NPLs within the economy. Considering Korean companies' thin profit margin and heavy reliance on external debts, few companies were able to survive this new financial system with extreme contractionary bias. The Korean government continually introduced policy measures to ease this credit crunch, but they were far from effective in normalising the financial flow because the fundamental logic of the new system dictated extremely risk-averse behaviour from financial institutions.<sup>23</sup>

On top of the NPLs that have been newly created during the period of restructuring, the loss from 'distress sales' of assets should be considered as transition costs incurred in Korea's transition to its new economic model. Even if the inflow of FDI may be beneficial under certain circumstances, trying to increase it radically in the middle of a major financial crisis can only lead to distress sales of domestic assets. As we mentioned above, there is no objective way to measure the extent of discount in the sales value of assets that was the result of government pressure. However, we have earlier provided some anecdotal evidence to support the theory that the discounts are likely to have been substantial (section 4.2), and it is not impossible to come up with some rough estimate of these costs.

There were two types of costs from distress sales. The first was the difference between the actual sales prices, on the one hand, and the

prices they would have got from selling the same assets under normal circumstances or the future income streams from those assets that they would not have sold if not for government pressure, on the other hand. The second type of cost was the extra burden on public finance from selling assets under government control – such as assets of bankrupt companies or financial institutions that were under the control of government-owned banks or the government – at discounted prices and/or providing foreign buyers with unnecessary incentives.

There is no easy way to calculate the first type of cost mentioned above because it appears only in the accounts of individual companies. Unless we gather all data on asset sales by private companies and future movement of their valuation, we are not able to estimate this type of cost. However, the second type of cost appears in government accounts. It is of course not easy to distinguish between the costs from distress sale of government-controlled assets and those from usual creation of NPLs. But the size of public funds spent in the process of the reform can be understood as a rough indicator of the size of the total transition cost. How much was it?

The Korean government has raised total 158.9 trillion won of public funds for restructuring, nearly all of which (156.2 trillion won) were injected into the financial system by March 2002. The funds were used for: (1) equity participation in troubled financial institutions through recapitalisation (60.2 trillion won); (2) purchase of NPLs and other assets (53.6 trillion won); (3) capital contribution to financial institutions who acquired other ailing financial institutions (16.4 trillion won); and (4) deposit insurance payments to depositors of liquidated financial institutions (26.0 trillion won) (Table 4.14).

*Table 4.14* Breakdown of public funds used (Nov. 1997–Mar. 2002, trillion won)

	<i>Equity Participa- tion</i>	<i>NPL Purchase</i>	<i>Assets Purchase</i>	<i>Capital Contribu- tion</i>	<i>Deposit Payoffs</i>	<i>Total</i>
Bond issuance	42.2	20.5	4.2	15.2	20.0	102.1
Recovered fund	3.9	16.7	4.35	1.2	5.95	32.1
Public money	14.1	1.5	6.3	–	0.05	22.0
Total	60.2	38.7	14.9	16.4	26.0	156.2

*Source:* PFOC (2001, 2002).

Some of the above, like deposit insurance payments, are not directly related to corporate restructuring. However, given that the overall performance of the financial sector is closely related to that of the corporate sector, the size of unrecoverable public funds can be used as a rough measure to assess the result of the corporate restructuring programme. According to an estimate by Park (2001), only 25.2 per cent of the total fund injected is likely to be recovered, even under the most optimistic scenario. If the lost interest earnings to public funds and other opportunity costs are included on top of the loss in public money injected, the total loss to public finance is calculated to be 139.3 trillion won, or equivalent to 26.9 per cent of GDP in 2000. And it will put a great pressure on public finance, requiring the government to pay back 22–30 trillion won annually from 2002 for four years, which amounts to 16–22 per cent of total budget of the central government.<sup>24</sup> These are just rough estimates, but give us some idea as to the magnitude of costs that the post-crisis restructuring process has imposed on Korea.

#### 4.5 Concluding remarks

As we have argued in previous sections, the anticipated benefits of Korea's system transition to an Anglo-American economic system were not realised. Major corporate performance figures, like ordinary profit rate, operating profit rate, and sales growth rate, have not only failed to improve but in fact deteriorated. There is also no ground to say that financial risks in the corporate sector have been reduced thanks to the corporate reform programme.

The only positive result of the reform is the establishment of a strong 'check and balance' system between financial institutions, companies, and shareholders, which may help reduce some of the worst abuses by the dominant shareholders (or the 'owners') of the *chaebols*.

However, in return for this small benefit, a very high price has been paid, and will be paid. Excessively contractionary macroeconomic policy in the earlier phase of the crisis, the establishment of new conservative financial and corporate governance systems (especially when they were installed very quickly), and the government pressure to drastically increase FDI all conspired to create a huge credit crunch, led to unnecessary bankruptcy, and to the sales of domestic assets at unacceptably low prices. A massive amount of public funds were injected in order to prop up the financial system. In the long run, the ability of the corporations to mobilise investment financing has been vastly reduced, as they have been forced to reduce their debt–equity

ratios dramatically and as the financial institutions have been forced to become extremely conservative in their lending decisions. Without access to large investment funds, the ability of the Korean companies to catch up with the forerunners will be severely restricted.

The reformers argued that Korea will benefit enormously from the transition to an Anglo-American system of corporate governance and finance. When the expected benefits did not materialise, they have attributed it to a 'slow progress in the reform'. In their view, if Korea sticks to the current reform programme, the benefits will eventually materialise, in the end outweighing the costs of the restructuring process (which they tend to vastly underestimate). For them, a possible dilution in the 'will to reform' or a change in the direction of the reform is a prime danger to guard against.

In our view, however, the costs incurred in the economy so far are already too large to justify the meagre achievement of the corporate reform, as we discussed above. It is also unlikely that the alleged benefits, even if they are realised, will be so large as the reformers claim. This is primarily because the reform was misdirected from the beginning – a transition to the Anglo-American system was not desirable for the Korean economy to begin with. It is true that the previous corporate system had the weakness of 'thin profit margin with high debt' which made it vulnerable to external shocks, but this was the flip side of the strength of the system, including a high risk-taking capability and its capacity for market-share expansion. The post-crisis reform programme simply got rid of its strengths without fundamentally correcting the perceived 'structural' weakness.

Thus seen, what is required for Korea is a fundamental change of the direction of the current reform programme, not its speedier and fuller implementation, as its supporters argue. This change in direction may not be easy, partly for political reasons but also for the reason that once made, institutional changes are difficult to reverse, but without such change the long-term viability of the economy will be seriously compromised.

## 5 Conclusion

### What future for Korea?

In the preceding chapters, we discussed Korea's catching-up model in historical and comparative perspectives, charted its journey to the financial crisis, analysed the causes of the crisis, and on these bases critically assessed the subsequent institutional reforms implemented by the IMF and the Kim Dae Jung government.

The backbone of the traditional Korean system – sometimes known as Korea Inc. – was 'the state-banks-*chaebols* nexus' that operated on a close cooperation and consultation among the government, commercial banks, and big businesses. The strength of this system lay primarily in its ability to mobilise large amount of financial and other resources and thereby engage in investment competition in large-scale projects by utilising economies of scale and scope.

As we have shown, the 1997 financial crisis was *not* a direct consequence of this catching-up system but that of the failure to adjust the system to the new challenges thrown up by the country's economic maturity and by globalisation. However, the IMF-sponsored institutional reforms have destroyed the traditional Korean system altogether with a view to shifting it to an Anglo-American one in the belief that the traditional economic system itself was the main cause of the crisis. This is unfortunate, because the Anglo-American system is not necessarily the best economic system, and in particular not very suited to a country at Korea's level of development. Moreover, the attempt to make this systemic transition imposed unduly high costs on the national economy.

What then is the future for the Korean economy? Already substantial 'transition costs' have been incurred, but, even worse, if the newly introduced institutional changes are ill suited to the country's needs, the future can be worrying. Is there anything that should be, and can be, done to improve the future prospects of the economy? These are the questions we discuss below.

## 5.1 Future implications of the post-1997 reform

In discussing the big deals and the workout programme (section 4.1.2), we pointed out the discrepancy between the ‘free market’ rhetoric used in policy discourse and the policies actually implemented. The reformers, who believe in the inherent efficiency of the free market, regard the government’s active involvement in the economy during the post-crisis period as ‘temporary’, one that will end when the market recovers its ‘normal’ functioning. Similarly, they will regard the disappointing corporate performance so far, especially in terms of profitability and sales growth (section 4.1.1), as a ‘transitory’ one until Korean companies adjust themselves to the new institutional environment. In this view, the free market dynamics will prevail in the end, no matter how long it will take, if the market-oriented reform is faithfully pursued.<sup>1</sup>

However, we do not agree with this naive view of the working of the Korean economy. In our view, the discrepancy between the free market rhetoric and the reality is a key symptom of the incoherence that lies at the root of the post-1997 reform exercise and at the same time a cause of such incoherence. And we believe that the discrepancy will persist rather than disappear.

One principal area of the discrepancy lies in the practice of industrial policy. The Korean government officially denounced the country’s traditional industrial policy practices as going against free market principles and abolished most of the industrial policy tools that remained after the liberalisation exercise in the 1990s. However, it was also very determined to rein in the *chaebols*, which meant that it actively used its strengthened financial supervisory power for this purpose, as we saw in the forced reduction of corporate debt–equity ratios or in the big deals.

In particular, the government introduced financial supervision measures that enabled it directly and intrusively to control private sector investments. The ‘forward-looking criteria (FLC)’ are the most conspicuous example. The FLC require financial institutions to classify the soundness of their corporate lending according to their assessment of the borrowing companies’ management capabilities, as well as their future cash flows and other financial conditions (section 4.1.3). Naturally, these criteria are inherently subjective and often arbitrary. This, in turn, means that the financial supervisory authority can overturn any loan agreement that it does not like, thereby deeply affecting the borrowing companies’ ability to invest.

Therefore, while it may be done all in the name of the health of the financial sector, there is much room for industrial policy intervention.

Of course, at the moment, there is no great willingness on the part of the government to conduct an active industrial policy and there is little need for it because there are few major corporate investments going on. However, if and when Korean companies once again start to compete in large-scale industries, the financial supervisory measures can be easily used as a means to conduct covert industrial policy, should the government wish.

The most important consequence of this discrepancy between the policy rhetoric and reality is the weakening of the economy's risk-taking capability. In Korea's traditional catching-up system, the financial risks involved in new large-scale investment projects were shared between the state, banks, and the *chaebols*. The *chaebol* structure, through internal transaction of resources, further strengthened the economy's risk-taking capability. The state's control of cross-border financial flows also reduced financial risks and thereby allowed the economy to take higher risks while borrowing from abroad. However, the institutional reforms after the crisis substantially weakened the economy's risk-taking function, which had been already malfunctioning following the badly designed liberalisation exercises in the mid-1990s.

Following the 1997 crisis, although it can, and still does, intervene indirectly, the Korean government's official commitment to non-interventionism has made it difficult to assume the same strong risk-taking role as before. The risk-taking ability of the *chaebols* has also been severely reduced, as their affiliates are forced to operate as individual companies, rather than as members of a business group, and as a strict limit has been set on their level of debts. Therefore, in the new institutional framework, the financial sector has become the only agent that can take significant risk. The unfortunate thing is that its capability to do so is also severely constrained.

First, since commercial banks are in the process of ongoing re-organisation and many of them are placed under the ownership of the government, their primary concern is to meet the newly introduced supervision standards like the BIS ratios and FLC, which in general penalise corporate lending. They have little incentive to take high risks in corporate lending.

Second, the managers in the financial sector have strong incentives to underestimate the viability and the value of the firms that are currently in trouble. If they let those firms fail now, the failure will be considered as a result of poor lending decisions by their predecessors, whereas they will be held responsible if the firms to which they extend further loans fail. They therefore tend to sell those firms, often at a highly discounted price, or liquidate them, rather than to put in efforts

to turn them around. And this incentive becomes even stronger if the assets related to the ailing firms are already classified as NPLs and therefore provisions against them have already been made.<sup>2</sup>

This weakness of risk-taking function in the financial sector has been translated into a substantial reduction in corporate lending and the continued credit crunch in the corporate sector despite the economic recovery (section 4.4). Even if commercial banks are privatised, which is in our view unlikely to happen in the short run, it is difficult to expect that the financial sector's risk-taking capability will soon be enhanced sufficiently to provide the corporate sector with necessary funds, because of the extremely conservative financial supervision standards that have been introduced following the crisis.

A notable feature of the Korean economy after the reform is the non-existence of major risk-taking agents. None of the major agents in the system, the state, banks, or the big companies, has the willingness and/or the capability to take the risks involved in new investment projects or in reviving ailing firms. Foreign investment and venture business were regarded by the reformers as alternative risk-taking agents. However, they have been far from satisfactory in fulfilling this expectation and failed to emerge as new engines of growth for the Korean economy (sections 4.2 and 4.3).

## **5.2 The need for a 'second-stage catching-up system' for the Korean economy**

In our view, what was needed for Korea after the crisis was not to try a transition to an idealised Anglo-American system but to build what we call a 'second-stage catching-up system', which the country had failed to do before the crisis.

Our position starts from the recognition that Korea's catching-up still has a long way to go. The country may have succeeded in the first stage of catching-up but still is only a middle-income country with per capita income of \$9,628 in 2000, around one-fourth that of the US. According to Lee Jay-Min's (1999) estimate of 'relative backwardness', Korea in 1995, when the country's per capita income reached \$10,000, was approximately where Japan was in the middle of the 1960s, when the Japanese catching-up system was most spectacular in its success.

The reformers believe, at least implicitly, that Korea's transformation from a middle-income country to a high-income one would be automatically achieved only if the 'global standards' in finance and corporate governance they have introduced can be made to stick.

However, as we pointed out above (sections 3.3 ad 4.1), the reform measures were principally geared to reducing financial risk of the system, even to the extent of over-killing the economy in the short run. Nowhere in the reform programme was the question of long-term growth and catching up considered. Indeed, we would argue that the 'global standard' financial and corporate institutions that the reform programme has introduced are likely to damage the growth prospect for the Korean economy.

A case in point is the BIS capital adequacy ratio. A main rationale behind this is that financial institutions should maintain a minimum level of capital base to cope with possible financial risks in an increasingly interconnected international financial market. So the BIS rule requires that the capital base of financial institutions should correspond to the weighted risk of their assets. The problem is that this is an 'unfair' rule from the developing country point of view, as they have relatively scarce financial resources but are required to maintain the same capital base per lending. Moreover, the pressure on developing country financial institutions to adopt the BIS standard more or less overnight forced them to expand their capital base very rapidly, thus creating a severe credit crunch, as seen in the case of Korea (section 4.4).<sup>3</sup>

This is not all. If the logic behind the BIS ratio is fully applied, the latecomers are put in an even more disadvantageous position. Financial risk for assets in developing countries is normally higher than that for assets in developed countries, and this means that financial institutions in developing countries should maintain a larger capital base for the same amount of loan exposure, compared to their counterparts in developed countries. In fact, the 'New Basel Accord' announced by the Basel Committee in January 2001 requests that financial institutions should apply different weights to corporate lending according to the ratings given to the borrowing company by international credit rating agencies. So, for instance, if a company has a credit rating between AAA and AA<sup>-</sup>, 20 per cent of risk weight is applied, whereas 150 per cent of risk weight is applied to a company with a credit rating of BB<sup>-</sup> and below, into which category most Korean companies were classified in 2001 (BIS 2001; SERI 2001b).<sup>4</sup> This new, stricter version of the BIS rule may be perfectly all right from the viewpoint of financial institutions in advanced countries with global financial portfolio. However, from the viewpoint of the companies or financial institutions in developing countries, this is a major blow to their ability to attract or provide investment financing.

The same argument applies to other components of the ‘global standard’ institutions. For instance, if equity-financing is considered as a global standard for corporate financing, this will have particularly adverse effects on countries that have been heavily relying on debt-financing. In the Korean case, this idealised preference for equity-financing created a far too negative perception about its relatively high corporate debt–equity ratio and brought about the policy aimed at its radical reduction, which resulted in a severe credit crunch and ‘fire-sales’ of corporate assets. For another example, if a condition for ‘fair’ competition is that each company operates as a stand-alone unit, those companies which have been growing through business grouping are suddenly put into a disadvantageous position.

It was Gerschenkron’s fundamental insight that the latecomers have little hope of catching up with the forerunners if they simply follow in the latter’s footsteps. They lack the so-called ‘prerequisites’ for development like capital, technologies, and so on, which puts them at a disadvantage in their competition with the forerunners. They therefore need to devise different strategies and institutions as ‘substitutes’ for their relative lack of those prerequisites. In Gerschenkron’s vision, catching up takes place in the process of creating those substitutes and thereby overcoming the disadvantages of late development.<sup>5</sup>

As an economy that is still catching up, Korea needed, and still needs, to devise a new economic system that is more suited to the higher, or second, stage of its catching-up. In our view, this new system should be built on the strengths of the traditional system, and not based on a complete abandonment of it. We sketch below the two key features of this system, namely the role of the state and the role of the *chaebols*.

### **5.2.1 Revitalisation of the state**

For the last decade or so, the dominant view in Korea has been that the role of the state, even if it was useful in the past, should be reduced as an economy matures and becomes globalised. The liberalisation of the Korean economy before the crisis and the further liberalisation after the crisis have all been based on this perception, implicitly or explicitly. However, in our view, the role of the state in Korea requires a revitalisation, rather than diminution.

One reason for this is, somewhat counter-intuitively, globalisation. Many people believe that globalisation makes state intervention at best ineffective and at worst counter-productive – a view that has also been very popular in Korea. However, one ironical thing about global-

isation is that, as more and more factors become mobile, national competitiveness becomes more and more dependent on the more immobile assets, such as the labour force and the state. This is because in a highly globalised world, mobile assets can easily leave, if a country's immobile assets are not attractive enough. Arguably, the national government is the most immobile of all the assets, and therefore its quality is going to become increasingly more critical in determining national competitiveness with further progress in globalisation.

Underlying this observation is the fact that the government is *the ultimate system manager of the national economy* and therefore cannot be substituted for by the market. The Korean experience is a real world example in this regard. After the crisis, the degree of state intervention actually increased, contrary to the IMF prescription and the Korean government's rhetoric, because the state was the only agent that could get the economy going again when the market stopped functioning. We agree that globalisation may constrain the state's power and the way the state can intervene in the economy, but its role as the ultimate system manager is likely to become even more important with globalisation.<sup>6</sup>

The most important lesson we can draw from the experience of the post-crisis reform in redefining the role of the Korean state, in our view, is that the state should act as the 'mediator' between the homogenising forces of globalisation and the unique characteristics of the local economy. The economic reforms in Korea were designed and implemented in the belief that the country should adopt 'global standard' institutions. The unique characteristics of the local economy were regarded as outdated, or even pathological, and thus were destroyed or allowed to languish. As we have repeatedly pointed out, however, the 'global standard' institutions have not only imposed unnecessary costs but many of them are currently functioning more as obstacles to, rather than spurs for, further development of the economy.

Of course, in the present international environment, it will be difficult for Korea to completely resist the introduction of certain 'global standards'. However, it does not mean that it has to follow these standards blindly, regardless of their consequences for the national economy.

A case in point is, once again, the adoption of the BIS capital adequacy ratio. Given that the BIS rule is an international norm, there was little that the Korean government could do in changing the rule itself. However, it could still have applied it more flexibly, in a way that promotes national interest. For instance, rather than applying the rule to all the domestic commercial banks, it could have made it obligatory

only for those that have high international exposure, whilst applying less stringent standards to those that have limited exposure to international financial markets. In this way, it could have softened the massive credit crunch that followed the introduction of the BIS rule in the middle of a recession.

A similar kind of creative response is required in relation to industrial policy. Outwardly, the Korean government has almost totally given up on industrial policy. However, there still exist important *de facto* industrial policy measures, especially the regulations on corporate lending, which were implemented on the recognition that the country can easily fall into a financial crisis if the investment competition in large-scale projects is not properly managed. The problem with this approach is that if industrial policy is implicitly conducted through the financial supervision system, it is likely that it will inevitably be geared towards the needs of the financial sector, rather than those of the whole economy. Therefore, if it is felt necessary to control the financial risks from investment competition by major firms, it should be dealt with by explicit industrial policy measures tied to a long-term development strategy, rather than through indirect intervention through financial regulation, which is too blunt an instrument for the job.

In a similar vein, the state should regain its control over cross-border capital flows. Of course, the degree of external financial liberalisation is basically a result of international negotiation, and therefore there is certainly a limit in deciding on the degree of financial openness purely on the basis of domestic considerations. However, the state should at least maintain some policy tools to guard the economy against the disruptive forces of capital flows. For instance, the IMF has to impose a high interest rate policy on crisis-hit countries, only because it rules out the introduction of capital control as a policy option. With capital control, the currency crisis can be resolved with much less disruption in the real economy because interest rates do not need to be pitched at such a high level for the sole purpose of countering possible speculative attacks on the local currency.

### ***5.2.2 Utilising the strengths of business grouping***

The *chaebols'* aggressive participation in global investment competition and the consequent rapid increase in their reliance on short-term foreign debts were certainly a contributing factor to the outbreak of the financial crisis in 1997. However, we would argue that the *chaebols*

were essentially 'supporting actors' rather than the 'leading actor' in the drama surrounding the crisis.

In a capitalist economy, the corporate sector is the principal risk-taking agent. Firms grow in the process of taking risks in innovation in their quest for realising 'super-normal profits'. In contrast, conservatism is the principal characteristic of the financial sector. It is basically the role of financial institutions to check firms from taking 'excessive' risks. The state is, as the ultimate system manager, responsible for balancing the risk-taking tendency of the corporate sector and the conservative tendency of the financial sector. Therefore, if there is too much risk in the economic system, we should first blame the financial sector, whose major role is risk management, and the state, which is the system risk manager, rather than the corporate sector, whose main role is risk-taking.

In the first-stage catching-up system of Korea, the state pushed the financial sector to help the corporate sector take risk in large-scale projects. The corporate sector, especially the *chaebols*, took further risks through utilising their group structure. This can be understood as an institutional response by a latecomer to the challenges posed by the relative lack of financial, technological, and managerial resources in its competition with the forerunners (sections 2.3 and 2.4). In contrast, the IMF-sponsored economic reform after the financial crisis was directed at radically strengthening conservatism in the financial sector, especially in commercial banks, by defining the main role of the state as maintaining the stability of the financial sector and discrediting its role in encouraging risk-taking by the corporate sector. At the same time, the reform substantially weakened the *chaebols'* internal transaction mechanisms.

In the previous section, we emphasised the importance of the 'mediating role' for the state in middle-income countries like Korea for their second-stage catching-up in the era of globalisation. If the state performs this role properly and the balance between risk-taking and risk management is maintained in the economy, we see no reason why Korea should attempt to reduce financial risk further by dismantling the *chaebol* structure. As we have pointed out before (section 4.1.2), there is no evidence that diversification had increased the financial risk of the *chaebols*. On the contrary, their diversified structure is an effective weapon for the *chaebols* in international competition. Mutual subsidies and other intra-group resource mobilisation, which make it possible for several affiliated companies to work as a team when they embark on strategic projects, constitute major sources of strength for

the *chaebols*. As a middle-income country, Korea still needs to utilise this positive aspect of business grouping.

The possible abuse of internal transactions can be checked by increasing transparency of corporate management and strengthening the right of minority shareholders, rather than by an outright ban on internal transactions. Also, as we mentioned before (section 4.1.3), even without such policy change, in the years preceding the crisis, the *chaebols* were to reduce the scale of internal transactions and increase their transparency anyway, as they were facing more hard-nosed financial institutions and tougher competition in both domestic and international markets.

One important reason that internal transactions among related companies – rather than collusion among independent firms as in the Anglo-American countries – became the targets of fair trading regulations in post-1997 Korea was because they were regarded as the main reason behind the weakness of the SME sector in the country. According to this view, the country's SMEs have failed to develop because the *chaebols* have 'encroached' into their business areas and 'stunted' their developments. And in this view, the *chaebols'* ability to engage in internal transactions is seen as having been most critical, as this allowed them to expand rapidly into new business areas. Therefore, it is believed by the supporters of this view, SMEs in Korea will never develop unless the expansionary tendency of the *chaebols* based on internal transactions is structurally suppressed.

The biggest problem with this view is that it sees the *chaebol*–SME relationship purely in competitive terms. However, there is a strong cooperative element in this relationship. Businesses of most SMEs mainly consist of subcontracting to big companies, most of which are *chaebol* affiliates in Korea. Given this, it is not clear whether the weakening of the *chaebols* by restricting their internal transactions will necessarily help the SMEs.

Indeed, the relative underdevelopment of the SME sector was the price that Korea had to pay in order to remain competitive in its key export industries. Given the country's export promotion strategy based on assembly-type industries (e.g., automobile, electronics, shipbuilding), the country had to rely heavily on imported inputs, because the domestic SMEs did not have the technological capabilities to supply equipment, components, and intermediate goods of sufficient quality. This led to the relative underdevelopment of the SME sector, but it was the flip side of Korea's strength in assembly businesses.<sup>7</sup>

We believe that nurturing SMEs need not mean destroying the *chaebols* – after all, Japan developed a strong SME sector during the

period when the *keiretsu* system was at its height. And conversely, developing SMEs is not against the interests of the *chaebol* companies either. As global competition intensifies and as the Korean manufacturers have to upgrade their products, a broad base of high-calibre SMEs supplying parts and components will become more important for the very survival of the *chaebols*. Government policy should strengthen the linkages between the *chaebol* companies and the SMEs, rather than restrain the *chaebols'* capacity for expansion, which will hurt the entire economy.

### 5.3 Some final thoughts

The corporate reform programme implemented by the IMF and the Korean government following the 1997 financial crisis set out to destroy what remained of the traditional economic system of the country after the liberalisation exercise in the 1990s and replace it with an Anglo-American-style system, despite the fact that what the country needed was a reinvention of the traditional model.

The new system is mainly geared towards ensuring the stability and the profitability of the financial sector. It is, therefore, not a big surprise that corporate financing has dried up, significantly reducing the investment capability of the corporate sector. However, the new system has even failed to reduce financial risk of the corporate sector while imposing significant transition costs on the economy.

Can Korea get out of this hole which it has dug itself into? The answer critically depends on the future shape of the country's political economy: what kind of political regime will emerge in the next successions of election, what forces both in domestic and international arena will influence the economic policy platforms of the future governments, and so on. The country's political current is too wild for us to predict its future. However, given the problems of the post-crisis institutional reforms, the country will have to figure out a way to forge a second-stage catching-up system, which revitalises investment dynamism while managing financial risk properly in the economy. The biggest challenge for the country will be whether it can come up with a political coalition that can carry this project through.

# Notes

## **1 Restructuring Korea Inc.: the 1997 financial crisis and structural reform**

- 1 For a comparison of these three crises, see Chang and Yoo (2002).

## **2 The Korean model in historical perspective**

- 1 For a fuller discussion and extension of Gerschenkron's theory, see Shin (1996; 2002).
- 2 For instance, refer to Hirschman (1958; 1968), Rosovsky (1961; 1972), Amsden (1989), and so on.
- 3 It cannot be denied that the British government practised mercantile policies of protecting and supporting its local industries like other European countries in the eighteenth century and the early nineteenth century (refer to Kemp 1993; Deane 1979; Chang 2002). As Kemp (1993: 92) points out, the British Industrial Revolution progressed hand in hand with nation-building, and 'a more complex state apparatus' and 'a hierarchy of officials' were established. However, on the whole, in comparison with those of the follower countries in the nineteenth century like Germany and Russia, private-sector initiatives played a more important role in British industrialisation.
- 4 Gerschenkron (1970: 130) himself emphasises this aspect as follows: 'We deal in particular or existential propositions. It is the very nature of an historical hypothesis to constitute a set of expectations which yields enlightenment and increases the stock of our empirical knowledge within a spatially and temporally limited zone.'
- 5 He argues that, in Denmark, 'no comparable sudden spurts of industrialisation and no peculiar emphasis on heavy industries could be observed' and instead the country gradually developed by utilising a complementary relationship coming from 'the great opportunities for agricultural improvement that were inherent in the proximity of the English market' (1962: 16).

- 6 For a fuller discussion and extension of Gerschenkron's schema to these countries, see Shin (1996).
- 7 For the case of the steel industry, see Yonekura (1991). For the case of the automobile industry, see Kawahara (1997: 64–5); Morikawa (1997); Sato (1980); Komiya (1990); Hirono (2000).
- 8 Similarly, Patrick and Rosovsky (1976: 47) argue that 'the main impetus to growth has been private . . . Government intervention generally has tended (and intended) to accelerate trends already put in motion by private market forces'.
- 9 For studies on the role of the state in the Korean industrialisation, refer to Jones and Sakong (1980), Amsden (1989), Chang (1994), among others.
- 10 For the Russian case, refer to Gerschenkron (1962: Chs 1 and 6).
- 11 In fact, Singapore did not have a close forerunner, like Japan for Korea or Germany for Russia, to compete and emulate. Located in Southeast Asia, it was surrounded by equally, and often more, underdeveloped neighbours.
- 12 For instance, TSMC, currently the largest semiconductor foundry in the world with \$5.3 billion of sales in 2000, was set up in 1987 as a joint venture between the Taiwanese government (48 per cent), Phillips (27 per cent), local private investors (25 per cent) (Hou and Gee (1993); Chen *et al.* (2000); Lim and Pan (1991)).
- 13 According to an estimate, 'the stock of FDI reached over 9 per cent of world output in 1913, a figure which had not been surpassed in the early 1990s' (Bairoch and Kozul-Wright (1996: 10)), implying that the globalisation of production is not a new phenomenon in the latter half of the twentieth century. This is certainly true at the aggregate level, but a little over half of FDI went directly to the primary sector during this period, and the MNCs were not a major driving force in the world economy then. Moreover, during the earlier period, the growing role of FDI in the manufacturing sector was as a substitute for trade in response to rising tariff barrier (Kenwood and Lougheed 1994, quoted in Bairoch and Kozul-Wright (1996: 11)). This was quite different from the trend in the latter half of the twentieth century, when trade liberalisation progressed hand in hand with the increasing role of MNCs in the world economy.
- 14 The beginning of the electronics industry was similar in Korea. The Korean electronics industry in the 1960s was characterised by a 'dual structure'. The consumer electronics sectors like radios and TV sets, which had domestic demand, was under strict import-substituting policy, while it was simultaneously promoted as export items. But other segments, like semi-conductors, electronic calculators, tape recorders and electronic digital watches, were initially developed solely for exports without significant linkages with domestic demand (Kim 1980; Suh 1975; Shin 1996). The difference in the Korean case is that the country later pursued vigorous integration of those enclave developments into the national economy, thereby displacing MNCs with local enterprises, rather than trying to upgrade MNCs investment by upgrading the complementary assets.

- 15 In an attempt to increase exports and reduce its reliance on foreign companies, the Korean government introduced various taxation and financial incentives to promote GTCs in 1975. Leveraging also on the *chaebols'* expansion, the Korean GTCs increased its share of country's exports from 14.0 per cent in 1975 to 47.9 per cent in 1982 while the share of the *sogo shosha*, Japanese GTCs, decreased from 15.6 per cent in 1976 to 7.9 per cent in 1982 (Cho 1986; Fields 1995).
- 16 The share of local traders, in which not only GTCs but also the local SMEs, state enterprises, and trading agencies are included, was 82.1 per cent in 1982 in Korean export, whereas the corresponding figure was around 40 per cent in the 1980s in Taiwan (Fields 1995; 204, 225).
- 17 For instance, the Taiwanese government was slow in commissioning development banks for industrial promotion and began to authorise strategic industry loans managed by the development banks only in 1982. But this sector-specific credit facility accounted for only 4.3 per cent of total loan dispensed by state-owned banks in 1988 (Cheng 1993: 56–7).
- 18 Despite the name, the 'Taiwanese' are not indigenous people of the island. They are the descendants of the immigrants from the Fujian province of China over the last few centuries. The indigenous people of Taiwan are not ethnic Chinese and are called the 'Kaoshan' (meaning 'high-mountain dwellers'). There are very few of them left and they are socially excluded.
- 19 Therefore, the state sector was much bigger in Taiwan than in Korea. In 1976, public enterprises accounted for 22 per cent of Taiwan's gross domestic product but the share was only 9 per cent in Korea (Johnson 1987: 149).
- 20 Policy loan in Korea therefore constituted more than 40 per cent of total domestic loan even in 1993 when the country already began opening its financial markets (World Bank 1993: 309). According to one estimate, it reached 74.1 per cent in 1985 (Kim 1986).
- 21 Leff (1978: 664–5) argues that business groups in developing countries did not draw much attention until the late 1970s because of the dominance of MNCs in terms of firm size in many developing countries. He finds widespread existence of business groups among local firms in countries commonly regarded as dominated by MNCs.
- 22 Of course, it must be added that even in today's developed countries, business groups played an important role in their high growth periods in the nineteenth century or in the early twentieth century. During the period, (quasi)-business groupings through cartels and trusts were very important in these countries (Trebilcock 1981; Chandler 1990; Pohl 1982).
- 23 He defines the 'economic group' as 'a multicompany firm which transacts in different markets but which does so under common entrepreneurial and financial control'.
- 24 Refer to Sato (ed.) (1980); Aoki (ed.) (1984); Imai and Komiyama (ed.) (1994); Odagiri (1992); Miyashita and Russell (1994); Morikawa (1997).
- 25 For the case of the general machinery, see Amsden and Kim (1986). For the computer industry, see Kim and Lee (1987).

- 26 For instance, the total sales of Samsung group were \$21.1 billion in 1987 (Mody 1990: 295, Table 3), and those of Hitachi and Toshiba were \$23.6 billion and \$20.2 billion, respectively (KEIPA 1988: 173–5, US\$=123.5 yen at the end of 1987).
- 27 The inter-subsidiary shareholding in Korea was in the form of ‘circular shareholding’, in which member firm A owns member firm B’s stocks, B owns C’s stocks, and C in turn owns A’s stocks, because, unlike in Japan, ‘mutual shareholding’ or ‘cross shareholding’ has been forbidden by law. In the two countries, holding companies were forbidden until recently during the postwar period.
- 28 For a more elaboration of this, see Chang and Park (1999). In Japan, mutual shareholding rapidly increased during the heavy industrialisation of the 1960s and the early 1970s, reaching to nearly 30 per cent in 1973 for the five largest horizontal *keiretsu* (Hashimoto and Taketa 1992: 346–7, table 7.6). It seems to us that this trend implies that mutual shareholding was also employed in Japan to increase investment funds during its high-growth period.
- 29 In contrast, the Taiwanese or Singaporean catching-up in the semi-conductor industry was marked in ASICs, half-customised chips, which require much less capital outlays but more responsiveness to varying customers’ needs than DRAMs (Shin 1996; Mathews and Cho 2000).

### 3 The 1997 financial crisis and its aftermath

- 1 Contrast this with the situations in the Southeast Asian countries, which had current account deficits of 7–10 per cent of GDP for a few years in the run up to their crises. Their current account situation was already so vulnerable in 1995 that the Thai and the Malaysian currencies became targets of currency speculation in the aftermath of the Mexican financial crisis.
- 2 The corruption surrounding the Hanbo case was, despite the currently popular perception, *not* typical of what was going on in the country under its ‘traditional’ state-led model of development. Needless to say, in the traditional model, a large sum of money flowed from big business to the politicians and top bureaucrats. These flows were often tied to particular projects in areas like urban planning and government procurements, but they were rarely directly related to particular *projects in the main manufacturing sectors*. Moreover, under the Kim Young Sam government, for the first time in the post-1960s Korean history, we heard the names of some particular *chaebols*, such as Samsung, talked about as being ‘close to the regime’. In the old days, the *chaebols* as a group were preferentially treated, but rarely was any one or few of them regarded as being closer to the government than others. The Hanbo scandal was the first revelation that there had been a fundamental transformation in the state–business relationship in Korea, which meant that the major manufacturing sectors were now not as insulated from corrupt political exchanges as before. For further details, see Chang *et al.* (1998).

- 3 It is widely believed that the Kim government gave a go-ahead to Samsung's proposed automobile venture only when it decided to build the factory in the then president's home town, Pusan, instead of its initial choice of Taegu, the group's home base. In the build-up to this decision, Mr Kang Kyung Shik, a native son of Pusan, then a local MP with ministerial experience, was leading the local campaign for Samsung's automobile factory to be located in his home town.
- 4 Subsequently, Kia was nationalised and then sold to Hyundai in an international open bidding process. The firm is now revived, recording ordinary profit of 2,279 million won (\$1.8 million) in 1999 and 3,687 million won in 2000 (Kia Motors website).
- 5 According to an internal report by the Ministry of Finance and Economy (1998d), the Japanese banks called in \$13 billion among \$22 billion of their outstanding short-term loans to Korea in 1997.
- 6 The definition of foreign debt here follows the World Bank definition, and therefore is different from the concept of 'external liabilities', which include the offshore borrowings of Korean banks and overseas borrowings of the overseas branches and subsidiaries of Korean banks. The IMF and the Korean government started using this definition following their accord on 28 December 1997. At the end of November 1997, Korea's external liabilities amounted to \$157 billion, of which \$92 billion was of less than a year's maturity.
- 7 The Bank of International Settlement (BIS) data, which is also frequently used, shows that by 1997 Korea's foreign debt was already slowing down. Its foreign debt increased from \$105 billion at the end of 1996 to \$120 billion in September 1997 – an annualised growth rate of 19 per cent – and, as we have already seen, actually decreased to \$116 billion by the end of November 1997.
- 8 In the World Bank classification, a country is 'less indebted' when the debt/GNP ratio is less than 48 per cent, 'moderately indebted' when this ratio is between 48 per cent and 80 per cent, and 'severely indebted' when it is over 80 per cent. For the exact definitions, see World Bank (1997: 49–50).
- 9 However, it is interesting to note that right up until the crisis some pro-market economists stuck to the view that Korea succeeded *in spite of* industrial policy, although this view increasingly going out of fashion. See Chang (1993) for a review of the early pro-market literature.
- 10 Although it is often mixed up with the 'crony capitalism' argument that we discuss in section 3.2.2, the industrial policy argument can be, and should be, analytically separated from the latter, as it does not necessarily assume nepotism or corruption in the choice of favoured industries and companies.
- 11 It was not just in Korea and other East Asian countries but also in a number of European countries (e.g., France, Austria, Finland, and Norway), where industrial policy played an important role, at least until

- the 1970s. However, the industrial policy debate since the 1980s concentrated on the East Asian experience. Reviews of the earlier phase of this debate, which focused on Japan, can be found in Johnson (ed.) (1984, introduction)
- 12 On a scale of 0 (very corrupt) to 10 (very clean), Korea's score went down from 3.93 during 1980–5 to 3.50 during 1988–92, but significantly went up to 5.32 in 1996. Thailand showed the same pattern – that is, corruption problem was perceived as having become worse in the late 1980s and the early 1990s but as much improved on the eve of the crisis compared to the early 1980s. The figures were 2.42 (1980–5), 1.85 (1988–92), and 3.33 (1996). In the Malaysian case, corruption was also perceived to have become worse and then better, although the perception of corruption in 1996 was *worse* than that of the early 1980s – its figures were 6.29 (1980–5), 5.10 (1988–92), and 5.32 (1996). Indonesia, starting from a very low base, has shown a continuous and marked improvement right up to the crisis – its figures were 0.20 (1980–5), 0.57 (1988–92), and 2.65 (1996).
  - 13 When the money involved in the rescue operation (e.g., debt write-offs, tax exemption, and other direct and indirect subsidies) was considered too large, the government went for direct nationalisation. The merger and subsequent nationalisation of the four companies in the power-generating equipment industry in the early 1980s is the best example (for further details, see Chang 1993: 148–9).
  - 14 The notion of 'operational margin' used by Claessens *et al.* (1998) is defined as the difference between sales and the costs of goods sold as a share of sales. This is slightly different from the notion of 'operating profit' that we use, as it does not subtract selling and administrative expenses from the numerator. We think our measure is somewhat superior because the measure used by Claessens *et al.*, by not subtracting the selling and administrative expenses, does not fully reflect the managerial efficiency of the firm.
  - 15 Just after the Korean government officially announced its application for the IMF rescue on 21 November 1997, it was said that corporate finance managers in Korea were operating on the principle of so-called 'three no questions' – they asked no question about the interest rate, the source, or the borrowing period of the fund. In view of the previous experience of the IMF-sponsored rescue packages in other countries, they were rightly convinced that there would soon be a hike in interest rates, which meant that companies had to increase liquidity at any cost if they were to survive.
  - 16 The growth forecasts by the IMF were notoriously wide of the mark. Even in its fourth MOU with the Korean government made in February 1998, it projected a 1–2 per cent growth for the year, although it did not exclude the possibility of a negative growth. In its fifth MOU made in May 1998, it revised its projection down to a 1–2 per cent contraction. As the economy went from bad to worse and posted a 6.7 per cent contraction in GDP in 1998, the IMF forecast in January 1999 that the

economy would again contract by 1–2 per cent and post a positive growth of 2–3 per cent only in 2000 (Lane *et al.* 1999).

- 17 Of course, the large-scale injection of public money into the financial system would not have been possible without the room for manoeuvre that was made available by the sound budget that the Korean government had maintained before the crisis – despite this substantial increase of budget deficits, Korea's ratio of public debt to GDP was only 23.4 per cent at the end of 1999, still one of the lowest among the OECD countries (MPB website).
- 18 We may contrast this with the continuing decay in the Japanese financial system that is due at least partly to the slowness and the small scale of recapitalisation that the Japanese government have managed to organise for its banks.
- 19 In addition to the Keynesian policies above, the currency crisis itself that resulted in a sharp depreciation of Korean currency was another macro-economic factor that affected the recovery. Korea improved its balance of payments substantially mainly due to a drastic fall in its imports – the value of imports was reduced by \$51.3 billion in 1998 from the 1997 figure and the balance of payment turned around from \$8.1 billion of deficit in 1997 to \$40.3 billion of surplus in 1998, the largest current account surplus in Korea's history. Thanks to this import reduction and the injection of foreign funds through the IMF programme, the foreign reserve increased to \$48.5 billion at the end of 1998, the highest level until then, from \$8.8 billion at the end of 1997.
- 20 Alice Amsden (1991) was the first one who highlighted the potential danger to the Korean economic model posed by the rapid increase in and the intellectual ascendancy of what she calls the ATKEs (American-trained Korean economists). Going through the lists of Ph.D's from economics departments in the USA published every year since 1987 in the *Journal of Economic Literature* (these lists are unfortunately not comprehensive), we were able to identify no less than 9.7 per cent of the names in the lists between 1987 and 1995 as Korean (776 out of 8,040). In no less than three out of the nine years (1991, 1992, and 1994), over 10 per cent of the names were identified as Korean, with the Korean names accounting for 12.1 per cent of the list in 1991 (114 out of 946). This is an astonishing statistic, given that Korea accounts for about 0.75 per cent of world's population (45 million out of 6 billion) but account for nearly 10 per cent of US economics Ph.D output over the last decade (some of the names may have been Korean-Americans, but these are very few). An overwhelming proportion of these economists subsequently returned to Korea, thus steering university economics education increasingly in a Neo-Liberal direction. In addition, many elite bureaucrats, who were increasingly being educated along Neo-Liberal line in Korean universities to begin with, were sent to the US for two-year advanced studies. Some of them even stayed longer to get a Ph.D. Most, although not all, of them eventually returned to their old jobs in the Korean government.

- 21 It is interesting, although difficult, to contemplate why the ‘planning’ ministry became the home of pro-market Neo-Liberal thinking in the Korean bureaucracy. One possible reason is that, not being tied to particular ‘clients’ as in the case of other economic ministries, the EPB had traditionally behaved more ‘ideologically’, whatever the exact ideology may be. It is also possible to argue that the EPB, being the top economic ministry, had always recruited people with top scores in the economics section of the High Civil Service Examination, which meant that its bureaucrats were likely to do better in graduate studies in the US and came up with higher and more prestigious degrees. However, we are not able to provide any systematic evidence for this conjecture.
- 22 Unrestrained investment competition in major industries in the 1990s such as in the steel industry, the motor vehicle industry, the semiconductor industry, the chemical industry and so on, the consequent excess capacity in these industries, and their becoming the targets of the ‘big deals’ after the crisis (refer to section 4.1.2), had to do with the dismantling of the developmental state. If the Korean government had retained its will and tools for industrial policy, the Hanbo’s entry into the steel industry and the continued loan extension would have been deterred. The allowance of Samsung’s entry into the already crowded passenger car market, which triggered massive ‘pre-emptive’ investments by existing car manufactures and brought about the eventual downfall of the Kia, would not have happened under the old industrial policy regime. In the case of the semiconductor industry, there could have been some policy measures to mitigate adverse impacts from cyclical fluctuation in DRAM prices by facilitating diversification of semiconductor production out of DRAMs. Indeed, this kind of diversification was carried out only after the Korean economy had paid huge costs from the crisis. After acquiring LG Semiconductors, Hyundai Electronics (later Hynix) changed to former LG’s DRAM factories into ASICs production lines while concentrating DRAM production in existing Hyundai factories.
- 23 The following passage from Keun Lee (1999: 4) best sums up this view: ‘Undeniably, it [the aggressive expansion of the *chaebols*] also laid the basis for a sudden break-down sometime in the future when careless pursuit of growth was no longer profitable. . . . One of the important implications from such a story of rapid growth with diversification is that with imports restricted and demand guaranteed, the only constraint for *chaebols*’ growth was finding financial resources to invest into production facilities.’
- 24 One might argue that it was a structural failure of Korea having not been able to reduce its debt–equity ratio in the 1990s, say, to the 200 per cent level, after its success in heavy and chemical industrialisation. But it took nearly three decades for Japan, whose pattern of economic development Korea followed most closely, to reduce its debt–equity ratio to the 200 per cent level. Korea’s pace of reducing the debt–equity ratio until the early 1990s was actually faster than that of Japan (Figure 2.3). Moreover,

Korea's level of debt–equity ratio in the 1990s, which ranged between 300 per cent and 350 per cent, was not exceptionally high by international standards as we pointed out above (section 3.2.4).

#### 4 Assessing the post-1997 corporate reform

- 1 As Table 4.1 shows, it was only because of large-scale debt–equity swap and debt write-offs between 1999 and 2000 that the debt–equity ratio of the sixth to the thirtieth largest *chaebols*, who were the main target of the workout programme, fell from 498.6 per cent in 1999 to 186.0 per cent in 2000.
- 2 The BOK estimated that the extraordinary income in the manufacturing sector, which it said came mainly from asset sales, amounted to 1.0 per cent of total sales, i.e., 4.6 trillion won (US\$ 4 billion) in 1999.
- 3 The Korean government did not allow revaluation of corporate assets from 1981 for fear that the *chaebols* might leverage on it for speculation of real estates. Once the debt level became a critical issue, the *chaebols* persuaded the government to allow revaluation of their assets to get a fair valuation of their financial status since the denominator, the value of their debt, was varying with price movements while the numerator, the value of their equity was fixed in accounting.
- 4 *Maeil Business News* 13 November 1999. For instance, the Hyundai Group reduced its debt–equity ratio by 120 per cent points by revaluation alone. Business groups with sound financial balance did not rely as heavily on revaluation in reducing their debt–equity ratios because they naturally wanted to avoid the huge taxes and other transaction costs involved in revaluing their assets.
- 5 Valuation fees and transaction taxes, exact figures of which are not available, should be added to this depreciation cost in calculating costs involved in asset revaluation.
- 6 The programme soon expanded to smaller conglomerates and medium-sized companies, and later included the twelve Daewoo affiliates after the group became technically bankrupt in August 1999 (MOFE 2001; SERI 2001a).
- 7 It was renamed Hynix Semiconductors after it was separated from the Hyundai Group.
- 8 Refer to Chang (1994) and Chang and You (2002) for earlier episodes of industrial adjustments in Korea.
- 9 The major agreement on the big deal programme was made at a meeting between the government and business leaders, and announced jointly in July 1998. As the programme did not progress, the government again pressed the top five *chaebols* to facilitate the process and to announce an agreement for a speedier implementation of planned deals in December 1998 (*Maeil Business News*, various issues).
- 10 In this context, it is interesting to note that Mr Choi Won-Sok, the disgraced former chairman of the Dong-A group was returned to his old

- position in the spring of 2002 by a group of minority shareholders, despite opposition from the creditor banks.
- 11 According to a testimony by Mr Kim Woo-II, former financial chief of the Daewoo Group, the group sometimes had to pay back 3 trillion won of principals and interests a day from February 1999. But the commercial banks, under pressure from the government to support the deal, kept receiving commercial bills issued by the Daewoo Group from other financial institutions and other companies without defaulting them, although the group was in a state of technical default from March 1999 (*Monthly Chosun*, November 2001).
  - 12 During this period, the FTC conducted four investigations on the largest five *chaebols* and one investigation on the other 6–30 largest *chaebols*, and imposed 216.2 billion won of fines on the former and 18.1 billion won on the latter (FTC website).
  - 13 With the introduction of FLC, the very definition of NPLs itself became more stringent. Now loans are to be automatically classified as NPLs if borrowers do not pay full interests for three months. The period was six months under the previous regulation standard.
  - 14 This system lets shareholders vote on *all of the directorships*, not on individual directorship separately. In a system where shareholders vote on individual directorship, minority shareholders cannot win any single directorship against majority shareholders. However, in the cumulative system, they can concentrate their votes on one or a few directors and elect their own candidates.
  - 15 Regarding this, a leading businessman in Korea, in an interview with one of the authors in August 2000, said the following: ‘It has been possible for major *chaebols* to mobilise a large amount of investment funds through internal mechanism without letting foreign competitors or foreign financial institutions know about their plans. The size and the speed of mobilisation of those resources were what foreign competitors feared most. But now, even the major *chaebols* (the five largest ones) have to go to the international financial market if they need an investment over 1 trillion won (US\$ 870 million).’
  - 16 In this regard, one corporate executive in Korea cynically told one of the authors in an interview in July 2000 that ‘[i]f the “global standard” is strictly applied, Samsung Electronics will be the only company to survive in Korea’.
  - 17 The Korean government purchased 12.46 trillion won (\$10.3 billion) of NPLs and other assets from the Korea First Bank from the end 1999 to May 2001 (*Chosun Ilbo*, 20 June 2001).
  - 18 This figure is from a valuation by auditors in August 1999 after the Daewoo Group was placed under the workout programme. The book value of the assets was 20.6 trillion won (\$17.1 billion) in June 1999 (FSC 1999).
  - 19 This deal was finalised in April 2002 basically on similar terms, but with some changes that further favoured the GM (*Maeil Business News*, 30 April 2002).

- 20 The concept of 'transition cost' was first proposed by Khan (1995). He uses it mainly in relation to political costs involved in institutional change. It seems to us the concept can be also applied to understanding economic costs incurred in the process of radical institutional transition as in the case of Korea as shall be discussed below.
- 21 The official amount of NPLs at this time was 63.6 trillion won, 10.2 per cent of the total loans, which was reported under previous standard of classifying NPLs. The Korean government began applying the FLC from the end of 1999, which has broader definition of NPLs (see section 4.1.3.c). The figures quoted here are estimates by the Korean government calculated by applying the new standard to loans made before the FLC were introduced, in an attempt to maintain inter-temporal consistency in statistics (PFOC 2000: 282).
- 22 For instance, according to BOK (2002), companies with lower than 100 per cent of interest coverage ratio, that is, whose operating profit falls short of their interest payments obligations, have increased to 28.6 per cent of listed manufacturing companies in 2001 from 26.3 per cent in 2000.
- 23 For instance, the government continuously expanded loan guarantee schemes for the SMEs by the government-owned credit guarantee agencies like Korea Credit Guarantee Fund. When the bond market was crippled after the collapse of the Daewoo Group in latter half of 1999, the government increased the ownership limit of corporate bonds that they put on the commercial banks. In December 2000, it authorised the state-owned Korea Development Bank to use 20 trillion won of public money to facilitate the rollover of corporate bonds (MOFE website).
- 24 The percentages here are calculated against the budget in the year of 2000, 134.7 trillion won (MPB website).

## **5 Conclusion: what future for Korea?**

- 1 In this context, refer to the following statement by the chief of the IMF Seoul office when Korea finished repaying the IMF loans on 23 August 2001, three years earlier than the original schedule: '[S]tructural reforms have reoriented Korea's economy. The financial system has been stabilized; corporate leverage has been reduced; financial supervision and the framework for corporate governance have been strengthened; transparency has been enhanced; and capital markets have been liberalized. These reforms should help put the Korean economy on a growth path driven by market discipline, competition, and productivity. . . It is particularly encouraging that they [Korean authorities] remain convinced that reforms must be continued even though the IMF-sponsored program has ended and loans have been repaid' (Chopra 2001).
- 2 This was well reflected in creditor banks' preference for selling Daewoo Motors and Hynix to foreign buyers rather than attempting to turn around them with their own initiatives.

- 3 This kind of credit crunch happened even in Japan in 1997 and 1998. One reason why the Asian financial crisis was exacerbated was that, according to the Basel Accord, Japanese commercial banks had to meet the 8 per cent of BIS ratio by March 1998 when the quality of their assets substantially deteriorated due to the spread of the South East Asian financial crisis and the prolonged recession in the local economy. As a consequence, they had to withdraw existing loans to raise their BIS ratios (MOFE 1998d).
- 4 Even in the old BIS rule, there are some differences between the OECD member countries and the non-member countries in the application of the BIS rule. For instance, loans to commercial banks receive the risk weight of 20 per cent (compared to 100 per cent risk weight that corporate lending has) in the OECD member countries, while they receive a higher weight in non-member countries. But the risk weight was same within OECD countries, or within non-OECD countries, in the old rule.
- 5 For a detailed discussion about different views on catching-up, refer to Shin (1996, Ch. 1).
- 6 In this regard, it would be worthwhile to return to Gerschenkron's original idea on the role of the state. He distinguishes what he calls the 'negative' role of the state which is 'in the nature of creating a suitable framework for industrial development', from 'promoting it directly' that might be called the 'positive' role of the state (1962: 19). And he incorporates only the latter in his schema. By so doing, different institutions, i.e., the British (unorganised) market, the German universal banks, and the interventionist Russian state, are compared as *functional substitutes*, the common function of which is to 'increase supply of capital' and to concentrate it on growth sectors. This dichotomy between the negative and positive role of the state is mainly for the purpose of comparison across countries. But he never belittles the importance of the negative role of the state, which is akin to the role as the system manager. For instance, Gerschenkron notes the importance of institutional building in the Russian take-off like the emancipation of the peasants and 'the great judicial and administrative reforms of the sixties [1860s]' (1962: 12), and in France like Napoleon III's 'determined effort to untie the strait jacket in which weak government and strong vested interests had inclosed the French economy' (1962: 19). These roles were separated from the positive role because they can be carried out only by the state. They are related to the measures 'to remove obstacles that had been earlier created by the state itself' (1962: 19), and there is *no functional substitute* for the negative role of the state. In this respect, the negative role of the state is important in any country regardless of the degree of backwardness in Gerschenkron's schema.
- 7 The situation was quite different in the case of Japan where, as a relatively more developed country, SMEs were capable of supporting the export competitiveness of Japanese assemblers. In Taiwan, the SME sector developed better than in Korea because of the country's decision to give up assembly-type industries and focus on international subcontracting.

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