

The Economic Crisis of South Korea and Its Political Impact

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The spectacular performance, until recently, of East Asia's emerging economies, popularly known as the Asian tigers,¹ has fueled wild speculation in the West about the so-called "Asian Century." "Never before in world history," noted the *Economist* in March 1997, "has any region sustained such rapid growth for so long." The GDP per capita of Taiwan (\$13,200) and South Korea (\$11,900) were already impressive enough in 1997 to place them at the gate of the advanced industrialized nations of the world. Japan, of course, has long been an acknowledged super-economy, often said to have led the flock of economic "flying geese" before they turned into what Chung-In Moon ten years ago called the "swarming sparrows" in Asia.² Then suddenly last summer, seemingly as if from the blue, came the financial crisis in Pacific Asia. In reality, however, it followed what had been a decade-long period of sclerosis in the Japanese economy.

The awe inspired by the image of the Asian "miracle" has been quickly replaced by derisive commentaries in the Western media about "crony capitalism" and its "bubble economy." The close government-banking-business connections which once inspired admiration in the West as a driving force behind the alleged miracle are now said to have been its nemesis. The current popular image of Asian countries is that they have bubble economies characterized by reckless overinvestment, carried out by favored Asian business groups who have received corrupt government protection against the competitive discipline of the free, open, and fair markets of the world. To many observers, the bottom has dropped out of debt-financed Asian economic growth as the capital flow into the region has abruptly reversed its course. A dark cloud now hangs over much of East Asia, with structural adjustment programs demanded as the condition for IMF loans. With rising unemployment in Asia, with daily reports of business and bank failures, and with both blue- and white-collar layoffs, the world wonders if the Asian miracle indeed is over, or if it ever existed.

Among East Asian countries, South Korea, which is my main

focus, is experiencing its gravest economic crisis in decades. Almost all output figures are being revised downward. At the time of this writing, it appears that the economy is swinging from growth of more than 5 percent in 1997 to contraction on the same order of magnitude in 1998. Industrial production is down 12 percent from a year earlier. Capacity utilization is less than 70 percent — the lowest on record. Unemployment is more than 8.4 percent and rising (*Business Week*, November 16, 1998). The trade surplus is increasing, but this is mainly due to import compression. Exports are growing strongly in real (volume) terms, but in dollar (value) terms are more or less flat, due to falling dollar export prices. The Bank of Korea (BOK) sees no positive signs for the second half of 1998. Private growth forecasts are on the order of -1 to -7, with the consensus around -4 to -5, as reported in Table 1.

Table 1: GROWTH FORECASTS

	1997 (Actual)	1998 (Actual)	1999 (Forecast)
United States	3.8		
Blue chip consensus		3.4	2.2
<i>Financial Times</i> consensus		3.2	2.4
Japan	0.8		
Blue Chip consensus		-1.6	0.4
<i>Financial Times</i> consensus		-1.6	0.4
South Korea	5.5		
Blue Chip consensus		-4.4	0.7
<i>Financial Times</i> consensus		-5.1	1.4
China	8.8		
Blue Chip consensus		6.0	6.3
<i>Financial Times</i> consensus		7.0	7.2

Sources: Blue Chip Economic Indicators, 10 September 1998, and *Financial Times* Currency Forecaster, September 1998.

South Korea is afflicted with dual crises, in currency and banking. With the caveat mentioned below, the currency crisis is not

biting; South Korea is running a large trade surplus and the exchange rate has stabilized. However, the domestic financial crisis significantly clouds the horizon. Bad loans are officially put at more than 30 percent of GDP, though Deutsche Bank estimates that the actual figure is more than 40 percent.³ Moreover, Korea has a bank-centered financial system. Korean firms are highly leveraged. This means that even "good" firms may have trouble raising capital if bank lending is impaired, and it could take a long time to unwind this situation.

The South Korean government has developed a plan which envisions the issuance of 50 trillion *won* worth of government bonds to recapitalize the banking system (equivalent to about 12 percent of GDP). But the plan may be overly optimistic; actual outlays could prove to be much higher. One reason is that the estimates of bad loans may be understated, thereby minimizing the problem. Another is that the country may not be able to attract foreign investment on the scale envisioned in the government plan. The non-transparent accounting and "business as usual" attitudes and practices that occur in both corporate and government bureaucracies are deterring foreign investment. Non-transparent accounting means that foreign investors are afraid of buying failed businesses; they fear they will find out too late that what they thought were viable enterprises are in fact saddled with large contingent liabilities in the form of cross-enterprise loan guarantees. The recently botched auction of the failed automaker Kia, in which Ford (its shareholder through investment in Mazda) was essentially forced out of the bidding, is an example of hostility to foreign investment.

South Korea's difficulties are compounded by relatively tough external conditions. An obvious comparison is the situation that Mexico confronted in 1994. Unlike Mexico, Korea faces a regional crisis. When the Mexican *peso* collapsed in 1994, the nominal depreciation was translated into real depreciation and enhanced competitiveness in the traded-goods sector. By contrast, if the *won* depreciates, the currencies of its neighbors may also depreciate, diluting any real depreciation that could boost competitiveness. Moreover, unlike Mexico, South Korea is relatively "big" in some product markets, most obviously DRAMS (dynamic random access memories), steel, autos, and ships. As Korean exports increase, downward pressure is generated on world prices in value terms, offsetting the increase in export volume. Finally, in 1994 Mexico had access to the booming United States market, while South Korea must contend with Japan. One consequence of the weakness of Japan and the

likely Japanese reliance on a cheap currency policy (to export their way out of their own crisis), is that South Korea will be forced to rely even more heavily on the United States market. The emergence of large bilateral surpluses with the United States could well lead to trade tensions and even retaliatory action.⁴

South Korea's economy, once admired by a scholar as "Asia's next giant,"⁵ has not held real investment, which has declined 30 percent, and consumption, which has declined 13 percent.⁶ The unemployment rate will go up and cause numerous social and economic problems. These problems are particularly troublesome since there is no reliable social safety net in Korea. There will be more protest demonstrations similar to those which took place on November 9, 1998, in Seoul — when about 30,000 workers, farmers, and students marched demanding speedy reforms to overcome South Korea's economic crisis. More than 10,000 riot police were deployed for possible violence, but there were no reports of arrest or serious clashes. Organizers, representing sixty labor and civic groups, demanded that the government disband the nation's bloated, debt-ridden conglomerates and increase financial assistance to the unemployed.⁷ The Kim Dae Jung government is trying to tackle all these difficult problems and achieve the goal of democracy and a market economy simultaneously. It must do so, moreover, while facing resistance from various social sectors.

The purpose of this paper is to review the causes of the economic crisis in Korea and evaluate their impact on Korean politics. The discussion will focus on the political-economic complex which has produced corruption and cronyism in the economy. I will discuss some reform measures which are necessary to alleviate the political and economic crisis.

Explanation of the Economic Crisis

The main story of the East Asian crisis began with persistent, large current account deficits and what Martin Feldstein calls the "misguided attempt of Thailand, Indonesia, Malaysia, and the Philippines to maintain fixed exchange rates relative to the dollar."⁸ The heroic attempt by the Thai government to support a dollar-pegged *baht* failed.⁹ The collapse of the *baht* was inevitable, as the speculative attack on it from various sources began in earnest in May 1997. The currency crisis soon spread to Indonesia, Malaysia, and the Philippines, and Feldstein observes that "financial investors became worried about their large account deficits, high ratios of foreign debt to local GDP,

and deteriorating trade competitiveness."¹⁰ The contagious effect of the Southeast Asian financial crisis soon reached the northern Pacific shore, notably Korea, which represented a "phase transition" in the speculative process.

To be sure, there were signs of trouble in Korea even before the *baht* crisis erupted in Thailand. In January 1997, the news of Hanbo Steel Group's default on its loans shook the nation. Scandal soon broke: it was discovered that the Hanbo Group, the country's fourteenth-largest *chaebol* (conglomerate), had bribed the banks and government officials to obtain huge loans to build the world's fifth-largest steel-mill complex, in Tangjin, Korea. The Hanbo scandal exemplified a reckless business adventure in the extreme—corrupting government officials to obtain an extraordinary loan to build a mammoth venture—one which, furthermore, totally disregarded the overcapacity problem (Korea already had the huge Pohang steel mill), while accumulating some \$6 billion in debt, sixteen times as much as Hanbo's entire equity. If the Hanbo default was an extreme case, it nevertheless brought into the open more general problems of debt-financed industrial growth centered around *chaebols*. One financial journalist summed up the problems in the following words:

Korean banks had traditionally been easily influenced by the government. They lent money according to the government's wishes, without regard for the soundness of the borrower. Bank directors' elections are influenced by the government, making them vulnerable to corrupt government officials.

Double-digit growth in Korea's plant capacity since 1995 had flooded markets with too many products, creating a growth in stock inventories, followed by price cuts. This in turn caused a drop in profits for Korean companies that left them helpless in the face of their crushing debts, commonly several times their equity.

The Chaebols were having trouble paying the interest on their loans. Even in the tax year 1996, when the economy grew at 7%, more than a third of the top 30 Chaebols were losing money.¹¹

The Hanbo bankruptcy was a sobering experience for the Korean banks. They began reexamining their banking practices and started calling in short-term loans, thereby "creating a vicious circle of liquidity."¹² This, in turn created a "domino effect" as more companies failed. The biggest blow came to Kia Motors, Korea's eighth-largest *chaebol*. Its debt was greater than Hanbo's. Kia was, however, different from Hanbo. Hanbo could be accused of blatant corruption and total recklessness in a business venture, whereas Kia was a respectable

chaebol. Efforts by creditor banks to save Kia from bankruptcy nonetheless failed. Ten days later, because of "the bank sector's exposure to Kia and other debt-ridden conglomerates," several Korean banks were placed on "negative outlook" by Standard & Poor's and Moody's. The result, says Callum Henderson, who played a key role as Standard & Poor's Money Market Managing Currency Analyst (Asia), was an "increased credit risk within the Korean financial system as a whole and thus rising market rates and bond yields to compensate."¹³ The rush was on. In September, Jinro, Korea's nineteenth-largest *chaebol* — and the largest liquor group — failed.¹⁴ The bankruptcy of the Korean First Bank, which soon followed, was particularly ominous because it was generally considered one of the premier banks in Korea. By the end of the year, over 15,000 companies, large and small, went bankrupt; and one million people lost their jobs.¹⁵ The total flight from Korea of the famous (or infamous) Soros Management Fund symbolized an age of instant and unfettered capital flow which moved in and out of countries in search of international profit-making. Indeed, Korea exhibited many common weaknesses that have come to light in the Southeast Asian crisis. This is particularly true with respect to "immature" banking institutions and corporate governance.

Yet, despite all these internal problems arising from corruption, scholars like Jeffrey Sachs, Robert Wade, and Martin Feldstein blame external factors such as the global financial environment. They are particularly critical of IMF recommendations for solving the financial crisis in Asia. Politically and philosophically, they are opposed to the IMF as the appropriate institution for solving international financial

Criticizing the IMF, Feldstein contends that Korea needed only "coordinated action by credit banks to restructure its short-term debts, lengthening their maturity and providing additional temporary credits to help meet the interest obligations," which was the approach taken fifteen years earlier with the Latin American debtors.¹⁶

The rate of interest required to attract such long-term foreign lending on a voluntary basis — and thereby avoids withdrawal of private lending to other emerging-market countries — was about four percentage points above the interest rate on U.S. Treasury bonds and therefore well within what Korea could finance by its exports.... The I.M.F. could have helped by providing a temporary bridge loan and then organizing the banks into a negotiating group [which the I.M.F. did in late December].¹⁷

"Instead," notes Feldstein, "the I.M.F. organized a pool of \$57 billion from official sources — the I.M.F., the World Bank, the U.S.

and Japanese governments, and others — to lend to Korea so that its private corporate borrowers could meet their foreign currency obligations to U.S., Japanese, and European Banks."¹⁸ It was as much a rescue operation for creditor banks in the advanced economies as for private corporate borrowers in Korea. In exchange for these public loans, the IMF required Korea to undergo the fundamental structural changes alongside such contractional macroeconomic policies as higher taxes, reduced spending, and high interest rates. Regarding IMF policies, the following list of eight structural changes required of Korea is very revealing:

1. Foreign investors should be able to own majority stakes in Korean business.
2. The Korean domestic financial markets must be fully open to foreign banks and insurance companies.
3. There should be no restriction on industrial products, especially Japanese cars.
4. Korean banks must adopt a system of good credit evaluation in making loans (thus abandoning the Japanese style and adopting the Western banking method).
5. The Bank of Korea must be independent and adopt price stability as its goal.
6. The corporate structure and activities must be more open and transparent.
7. Korean corporations must lower high debt-to-capital ratios.
8. Korean labor laws must be liberalized to allow easier layoffs as well as the flow of workers between companies.¹⁹

It is interesting to note that Feldstein objects to the IMF's "conditionality" requirement for Korea on the ground that an international agency and its technical staff ought not to usurp the sovereign right of the state "to determine the nation's economic structure of its institutions." He argues, a "nation's desperate need for short-term financial help does not give the IMF the moral right to substitute its technical judgments for the outcomes of the nation's political process." This would be so even if there were unanimity of agreement on the appropriate policies for Korea. There was no such unanimity. Many of the structural reforms included in the IMF's early December package, Feldstein observes, were "not needed for Korea to gain access to capital markets." In fact, according to Feldstein, Korea's outstanding economic performance — persistent high growth rate, combined with low inflation and low unemployment—"suggests that

the current structure of the Korean economy may now be well suited to Korea's stage of economic and political development and to Korean cultural values stressing thrift, self-sacrifice, patriotism, and worker solidarity." Korea, he says, is now unfairly "forced to cause widespread bankruptcies, by tightening credit when inflation is very low, when the rollover of bank loans and the demand for the won depended more on confidence than on Korean won interest rates."²⁰

Feldstein is particularly critical of the way in which the IMF came to the Korean rescue. By rushing in too quickly with the promise of public loans, the IMF probably has made the "moral hazard" problem worse since lenders could see IMF action as a promise of future bailouts. Meanwhile, the toughness of the reform programs imposed on Korea would discourage the emerging markets from asking for the IMF's help "until it is absolutely necessary." In order to avoid painful medicine from the IMF, the emerging market economies would be inclined to accumulate large foreign currency reserves by running trade surpluses and savings, while they could instead better use the money to import productive capital goods for their further growth. These were the lessons for Hong Kong, Singapore, Taiwan, and China, which with large foreign exchange reserves could remain relatively safe from international speculative attacks.²¹

Another prominent critic of the IMF, Jeffrey Sachs, has also argued that there was nothing wrong with the fundamentals of the Korean economy before the crisis. The economic crisis was not caused by any weakness in Korea's economic fundamentals but by international investors' panicky behavior in late 1997.²² Similarly, Robert Wade, a "developmental state" theorist, has contended that the Asian economies were relatively healthy and efficient prior to the crisis, and probably could have remained so even after it. High levels of savings in East Asian countries naturally led to a high debt/equity ratio in industrial firms, which worked as the engine of strong economic growth. Wade, like Feldstein, believes that Western and Japanese banks and investment houses were responsible for the crisis. These international bankers, who usually had a powerful incentive to follow the herd, ignored their own prudential limits and lent heavily to Asian companies over the 1990s. They just assumed that high growth would continue and that the exchange rate would remain stable in these countries.²³

The problem with critics who pinpoint the IMF as a major culprit in the Korean crisis is that they concentrate on only external factors in explaining the crisis. They totally fail to acknowledge that

from early 1997 (thus even before the crisis), the Korean banking sector had been saddled with huge amounts in non-performing loans and several *chaebols* had experienced bankruptcies. Instead, Sachs and Radelet emphatically argue, exchange rate depreciation was precipitated by sudden withdrawal of capital and that the IMF macroeconomic policies were the major cause of the debt problems of Korea.²⁴

If Sachs sees nothing fundamentally wrong with the Korean economic model, Wade seems even to admire it. For instance, according to Wade, those Western commentators who dismiss the system as "crony capitalism," missed

the financial rationale for cooperative, long-term, reciprocal relations between firms, banks and government in a system which intermediates high savings into high corporate debt/equity ratios. (They also miss the crony capitalism US-style, generated by the regime of electoral campaign finance.)²⁵

As a distant observer of the Korean economy, Wade might not have been able to understand the agony of most Koreans when they had to witness the jailing of two former presidents and another president's son. He might not recognize that these "cooperative, long-term, and reciprocal relations between firms, banks, and government" also provided politicians and *chaebol* owners with the opportunity to seriously distort Korea's political and economic structure. The slush fund scandals of former presidents Chun and Roh, as well as the Hanbo collapse, have vividly shown how seemingly benign trilateral relations could be turned into ugly ones. The "moral hazard" phenomenon, rampant in the Korean banking and industrial sectors, was nothing but the mirror image of these "cooperative, long-term, and reciprocal relations."

Some Koreans might have felt comforted by the arguments made by Sachs and Wade. Sachs's point of view was given wide coverage in the Korean press early this year, when most Koreans were angry about the IMF bailout and the reform measures adopted by the government. In other words, this argument, as well as the "conspiracy theory" on the East Asian crisis,²⁶ has been politically utilized as an ideological tool against economic reform by those who opposed reform of the Korean economy and wanted to maintain the status quo.

A balanced explanation of the crisis would be one that considers both the internal and the external factors simultaneously,

since they are deeply interlaced.²⁷ Externally, Korea suffered from the contagious effects of the Asian financial crisis and earlier from a global recession in its key export industries, such as semiconductors. The magnitude of the latter shock was so severe that Korea's terms of trade reached the lowest point since the early 1980s.

Although the external shocks were significant, we cannot deny that the Korean economy might have survived them had its fundamentals been sound. But external factors alone cannot explain why Korea fell in 1997. Other countries in East Asia, especially Taiwan, have been able to escape the financial crisis so far. So we must look for internal factors. Regarding economic factors, it took a congruence of three forces (bankers, bureaucrats, and *chaebols*) to create a banking and currency crisis in Korea: deterioration of bank balance sheets, mounting foreign debts, and declining corporate profits. Korea could have survived the adverse international conditions if any one of these three factors had been absent. For example, a banking crisis could have been prevented from spilling over to the currency market if it had not had such high exposure to international debts.²⁸

In contrast to Sachs, Feldstein, and Wade (who tried to view the Korean economic crisis as a liquidity and currency crisis), Paul Krugman and Nouriel Roubini focus on the moral hazard problem in the debtor countries' financial and industrial sectors. For instance, Paul Krugman states,

The problem began with financial intermediaries -institutions whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems. The excessively risky lending of these institutions created inflation of not goods but asset prices. The overpricing of assets was sustained in part by a sort of circular process, in which the proliferation of risky lending drove up the prices of risky assets, making the financial condition of the intermediaries seem sounder than it was.²⁹

Roubini also argued that the moral hazard problem was the major cause of the crisis. Most banks in the East Asian economies have been implicitly and explicitly guaranteed by governments. Thus, international investors made excessive loans to the banks in East Asian countries, which in turn transferred capital to firms involved in risky projects. This caused the asset bubble. The fixed exchange rate of Southeast Asian nations, mostly pegged to the dollar, also contributed much to the excessive inflow of foreign capital. This in turn led to

appreciation of the real exchange rate and accumulating current account deficits.³⁰

Political Analysis of the Korean Economic Crisis

The major causes of the financial crisis in Korea can be investigated by examining the long history of the political-economic complex. The merger of politics and economy in South Korea started when President Park Chung Hee launched the First Economic Development Plan in 1962. In the early stages of the economic takeoff, it was necessary for the Korean government to allocate limited resources to specific industries. This determination was based on the unbalanced growth strategy.³¹ President Park provided various subsidies for import substitution and export promotion. He suppressed labor movements like those in other developing countries. Moreover, special favors went to selected business owners in his home province, creating a fortified political base which allowed him to defend the weakness of the regime's legitimacy and to supply easy funds for political operations. This in turn helped him maintain his dictatorial rule against anti-government movements until he was assassinated in December 1979.³²

During his tenure, President Park achieved rapid economic growth for the nation, but his economic success came only with a serious distortion of the Korean economy. For example, Park initiated the *chaebol* as an offspring of his state-led development strategy. As the years passed, the *chaebols* came to monopolize the market and play the leading role in the economy. Thus the *chaebols* have been the natural target of political criticism involving the Korean economic crisis. As one Korean analyst puts it, the *chaebols* "have become symbols of corruption and failure."³³ *Chaebols* have faced a host of accusations: they have dominated the economy to the exclusion of small and medium-sized enterprises, they have pursued market shares rather than profits, and they have become over-leveraged and overextended. Family control of *chaebols* has been blamed for their failure to respond appropriately to changes in the global market and for poor business decisions, such as investment in native industries facing overcapacity. A special economic adviser to the president, You Jong Keun, has gone so far as to say, "The families that control the *chaebol* are the same ones responsible for bringing the country to such a mess."³⁴ These claims have led many inside and outside of government to call for sweeping changes. *Chaebol* reform has been attempted by successive governments since 1980, but in each case the effort

ultimately failed because there were both lack of consensus within the economic bureaucracy and strong vested interests in the private sector. Some believe the *chaebols* have become too powerful to be handled by the state. The changing balance between the state and the *chaebol*, from dominance to symbiosis, has already been analyzed in detail.³⁵ Chung-In Moon also notes that the very success of the developmental state in economic growth resulted in increased social mobilization, which augmented the power base of social forces.³⁶

As Lord Acton pointed out, absolute power brings absolute corruption. The *chaebol* became too powerful and degenerated into a corrupt enterprise without much efficiency. Under Park, Chun, and Roh, the Korean government became too powerful to be responsive to the people's desires. Even the civilian president Kim Young Sam was authoritarian in style. Furthermore, his lack of knowledge and the corruption displayed by his son begot economic troubles that occurred later in his term. To avoid just such abuses, political philosophers such as Locke and Montesquieu advocated separation-of-powers and checks-and-balances principles in government.

In South Korea, instead of separation of powers, however, a political monopoly has been established by the professional, power-seeking politicians and bureaucrats. A business monopoly has been dominated by top *chaebols*. The *chaebol* has become powerful under government protection. This interrupts resource allocation in the economy. Monopoly in both politics and economics reduces competitiveness and encourages more corruption.

Unfortunately, corruption is deeply rooted in Korean society. As pointed out, this corruption is a product of the combination of political dictatorship and economic monopoly. The system of anti-democracy and anti-market economy provides fertile ground for corruption. There are very few grossly corrupted nation states among the economically and politically developed countries, but there are many among less-developed countries. Democracy and a free market economy should be further implemented in Korea; this is the best medicine for the eliminating of corruption.

Among forty nations listed by Transparency International in its corruption index, Korea is ranked twenty-seventh. The least corrupt is Denmark, and the United States is eleventh, and Japan seventeenth.³⁷ The practice of corruption worldwide has become so alarming that the OECD and five other countries signed the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The signatory countries are expected to implement their

obligations arising from the convention into their respective domestic laws by the end of 1998.³⁸ This pact penalizes businessmen who offer bribes to foreign government officials to win contracts. It was endorsed in a cabinet meeting in Korea chaired by President Kim Dae Jung on October 19, 1998.³⁹

The government of Kim Dae Jung is serious about political and economic reform, and the president has repeatedly declared the Anti-Corruption Campaign. However, as long as the domination of government by the presidency and executive branch continues, corruption cannot be easily eliminated. It should be pointed out again that the main source of corruption in South Korea is due to the lack of check-and-balance system among the three branches of government. The Ministry of Finance and Economy is a good case in point. It demonstrates how the lack of separation of powers is detrimental to effective functioning. The Ministry of Finance and Economy has monopolized fiscal and planning function by controlling central banking, financial supervision, and budget allocation. This ministry has been unsuccessful in supervising banks, *chaebols*, and the foreign currency reserves. Instead of supervising, the government has been allied with big business since the 1970s, utilizing the alleged "advantages" of backwardness and economies of scale. One of the results was strong economic growth, but the seeds of corruption, the "moral hazard,"⁴⁰ and the current economic crisis were also sown at the same time.

To avoid becoming hostage to big business again, the Korean government should begin to focus more on taking up the role of the manager of the whole economic system. The state will have to reduce its role as an economic player by, for example, privatizing state-owned companies and resisting from its past habit of intervening in the financial sector. On the other hand, it will have to increase its role as a neutral umpire who executes fair rules of the game, protects property rights, and provides legal as well as physical infrastructure for economic players. It will also have to remove the possibility of collusion among the financial, industrial, and governmental sectors, by installing a new institutional framework. For instance, the autonomy of the Financial Supervisory Commission should be strictly guaranteed. Financial institutions must not again become captives of big business via the chaebols' ownership of the banks. *The government will also have to revise the laws on national elections and political parties to reduce the amount of political funding that can be used by politicians.*

Conclusion

The financial crisis in South Korea was caused by more or less corrupt politics, overexpanded business, and uncompromising labor. Corrupt politics forced financial institutions to give loans to business groups without proper examination of credit qualifications, so businesses had easy access to the financial market. This caused business overexpansion through debt-financing, raising the capital costs in production. Meanwhile, the Parliament passed labor laws prohibiting layoff, and the workers could then force employers to comply with their continuous demands for wage increases. The high labor costs made Korean businesses prefer investment in foreign countries, where they could pay lower wages. This expedited capital outflow and shortage of foreign exchange reserves. In short, the politicians sold their generosity to both business and labor in order to achieve easy compromise. This practice cannot survive forever in any economy. In Korea high costs of capital and labor reduced the country's economic efficiency and competitiveness and invited economic decline.

In addition to the issue of corruption, some other immediate causes of the Korean financial crisis which afflicted the Korean economy must not be ignored. Broadly, they can be grouped into three areas: labor, finance, and *chaebol* problems (each area having multiple sub-issues).⁴¹ Since these problems were so closely related to the immediate causes of the crisis, we can argue that if the government had taken corrective measures early on, it may have been able to prevent the crisis or at least weaken its severity.

At least two conditions make this line of reasoning valid. First, the government was aware of the problems long enough to tackle them. Second, there is little disagreement that a policy of institutional reform measures in those three areas would have made a difference. Most of the issues have been publicly debated, and the government has taken some actions to address most of them, though without much success.

How important was the success of the economic reforms to the Korean economy? One indicator is that a package of structural reforms that the Korean government promised to the IMF (as bailout conditions) covered all three areas of reform and explicitly addressed most of the sub-issues. The issues that the IMF left out—such as corruption and industrial relations—were outside the traditional boundaries of structural reform programs. Thus, it is fair to say that successful early reforms would have spared Korea a painful economic adjustment under the IMF.

Unfortunately, few reforms were carried out before 1997. Areas in which some progress had been made before the crisis include the labor reform of 1997 and the financial liberalization plans in 1993-94. However, even those successful reforms came too late, and there have been some doubts about their effectiveness. For example, more than a year after the new layoff clauses became law, unions and management are still disputing their interpretation. As the IMF bailout conditions showed, the level of financial liberalization was far short of international standards.

Currently, Korean political, business, and labor leaders are choosing to steer clear of painful choices. Many are simply too weak or too closely linked to vested interests to undertake sweeping reforms. Structural bottlenecks, bureaucratic resistance, and labor issues slow or even thwart reform. It is hard to see how these leaders, who were so deeply involved in creating the problems, can turn around and now create their solutions.

Now there are fears that South Korea will remain so mired in the old ways of doing business that reform will founder. Then the chronic problems — cronyism, opaque banking practice, immature political systems — will continue to fester, weakening foundation for recovery and setting the stage for future crisis.

In South Korea, president Kim Dae Jung runs a weak coalition government. Prime Minister Kim Jong Pil, a partner in the coalition, advocates the constitutional amendment even before settling the economic crisis. The government of reform-minded Kim Dae Jung, in the eyes of many Koreans, seems to have opted to play politics the old-fashioned way, by hitting its opposition with corruption probes rather than setting up strong institutions that can truly combat cronyism. The *chaebols*, the target of President Kim's reform, still have not moved to overhaul themselves. There is also little sign of change in a banking culture that has produced staggering loan losses. Essentially, the banks cannot afford to allow the *chaebols* to fail, because the banks themselves would incur staggering loan losses. Most analysts estimate that it will cost at least \$70 billion to cover bad loans and recapitalize banks, far more than the \$37 billion pledged by the government.⁴² Newspapers in Korea report many company bankruptcies and rising numbers of unemployed.

The Korean economic crisis cannot be turned around unless there is a strong political will on the part of political leaders, and a strong general will (as in Rousseau's *Social Contract*) on the part of Korean citizens.

Notes

1. Beginning with the original four "tigers" — Hong Kong, Singapore, Taiwan, and South Korea — the East Asian NICs now include Malaysia, Thailand, Indonesia, and China.
2. For an insightful view, that the "flying geese" image, suggesting a hierarchical industrial order based on the level of technology and division of labor, has been replaced by a horizontal "swarming sparrow" pattern of development in East Asia, see Chung-in Moon, "Conclusion: A Dissenting View on the Pacific Future," chapter 13 in Stephan Haggard and Chung-in Moon, eds., *Pacific Dynamics: the International Politics of Industrial Change* (Boulder, CO: Westview Press, 1989), pp. 359-74.
3. It is worth mentioning two things in regard to the banking crisis in South Korea. First, at the time the crisis broke, private analysts were estimating that the ratio of non-performing loans to GDP was as high as 30 percent, but the South Korean government maintained that the true figure was less than one percent. Subsequent revelations proved the private analysis right, weakening the government's credibility on this issue. Second, whether loans are good or bad is based on macroeconomic conditions. A loan that is good when the economy is growing at a rate of 5 percent a year may turn bad when the economy is shrinking by a similar amount. Some of the bad-loan problem could be solved by increasing growth.
4. Marcus Noland, Sherman Robinson, and Zhi Wang, "The Global Economic Effects of the Crisis in Japan," Working Paper Series 98-6 (Washington: Institute for International Economics, 1998).
5. Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989).
6. *Financial Times*, September 30, 1998.
7. *Washington Post*, November 11, 1998, p. A17.
8. Martin Feldstein, "Reforming the I.M.F.," *Foreign Affairs* 77, 2 (March/April 1998), p. 22.
9. Leo Gough, *Asian Meltdown: The End of the Miracle* (Oxford, U.K.: Capstone, 1998), p. 93.
10. Feldstein, "Reforming the I.M.F.," p. 23.
11. Gough, *Asian Meltdown*, p. 113.
12. Callum Henderson, *Asia Falling: Making Sense of the Asian Crisis and Its Aftermath* (New York: McGraw-Hill, 1998), p. 141.
13. *Ibid.*, pp. 140-41.
14. *Ibid.*, pp. 141-42.
15. Gough, *Asian Meltdown*, p. 114.
16. Feldstein, "Reforming the I.M.F.," pp. 20-33. Feldstein blames IMF policy for worsening the Korean economic crisis.
17. *Ibid.*, pp. 25-26.

18. Ibid., p. 26.
19. Ibid.
20. Ibid., pp. 27-29.
21. Ibid., pp. 30-31
22. Jeffrey Sachs, "I.M.F. Is a Power unto Itself," *Financial Times*, December 11, 1997; "Korea: Riding to Rescue," *Financial Times*, December 5, 1997; Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," *Financial Times*, April 20, 1998.
23. Robert Wade and Frank Veneroso, "The Asian Crisis: The High Debt Model vs the Wall Street-Treasury-I.M.F. Complex," March 2, 1998, <http://epn.org/sage/IMF.24.htm>, p. 3.
24. Steven Radelet and Jeffrey Sachs, "The Onset of the East Asian Financial Crisis," *Financial Times*, March 30, 1998, p. 7.
25. Wade and Veneroso, "Asian Crisis," p. 3.
26. The key point of the conspiracy theory is that the United States intentionally rigged the crisis to curb rising East Asian economic progress.
27. Jongryn Mo and Chung-in Moon, eds., "Democracy and the Origin of the Korean Economic Crisis," in *Democracy and the Korean Economy* (Stanford: Hoover Institution Press, 1998). Mo and Moon used internal and external factors in explaining the Korean financial crisis.
28. Jongryn Mo, "The Political Origins of the Asian Economic Crisis: Democracy, Gridlock, and Failed Economic Reforms in South Korea," paper presented to the American Political Science Association, Boston, 1997, p. 9.
29. Paul Krugman, "What Happened to Asia?," January 1998, <http://economics.tqn.com/library/weekly/aa012798.htm>
30. Nouriel Roubini, "Asian Crisis: An Interview with Nouriel Roubini," *Economics*, January 27, 1998, <http://economics.tqn.com/library/weekly/aa012798.htm>
31. WheeGook Kim, "Alternative Growth Strategies of North Korea: Lessons from Experiences of South Korea and Taiwan," paper presented at the 1996 annual convention of Allied Social Science Associations, San Francisco, January 5- 7, 1996, East-West Research Institute monograph, pp. 3-6.
32. WheeGook Kim, "Evolution of Democracy and Economic Development: A Case for South Korea," paper presented at the Philadelphia symposium on "Korea's Challenge Ahead: Economic Security and International Relations," 1998, p. 4.
33. Chung Soo Kim, "How the Chaebol Can Survive," *Win*, September 1997, p. 50.
34. *Washington Post*, December 22, 1997. However, the government is not free of culpability. For example, the government had no small role in the Hanbo implosion. Hanbo was able to receive billions of dollars in loans for its white-elephant steel-mill venture as a result of government pressure on banks.
35. Eun Mee Kim, "From Dominance to Symbiosis: State and Chaebol in Korea," *Pacific Focus* 3 (Fall 1997). pp. 105-32.

36. Chung-in Moon, "Beyond Statism: Rethinking the Political Economy of Growth in South Korea," *International Studies Notes* 15, 1 (Winter 1990), p. 26.
37. *Han Kook Ilbo*, October 24, 1998.
38. Rivaz Pattin and John Boscariol, McCarty Tetrault, January 1998, Toronto, [http://www. McCartly. Caloeed. html](http://www.McCartly.Caloeed.html)
39. *Han Kook Ilbo*, October 20, 1998.
40. Calomiris offers a good definition of the moral hazard problem for banks. "If the risk-taking bankers know that future gains from taking on risks will be private, but losses will be borne by taxpayers (again), that amounts to a government subsidy for risk, which thereby encourages excessive risk taking." Charles W. Calomiris, "The I.M.F.'s Imprudent Role as Lender of Last Resort," *Cato Journal* 17, 3, p. 5, [http://www.cato.org/pubs/journal/cj17n3-1 I.htm](http://www.cato.org/pubs/journal/cj17n3-1.htm)
41. Jongryn Mo classifies all of these sub-issues into three tables for clarification. See Mo, "Political Origins of the Asian Economic Crisis."
42. *Business Week*, October 5, 1998, p. 62.