*International Relations of the Asia-Pacific* Volume 10 (2010) 441–464
doi:10.1093/irap/lcq013
Advance Access publication on August 17, 2010

# Rethinking alliance and the economy: American hegemony, path dependence, and the South Korean political economy

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## Abstract

The alliance with the United States has not only provided South Korea with a credible military deterrence against North Korea, but also helped normalize its economy through extensive military and economic assistance and assertive policy intervention for macroeconomic stabilization and export drive. South Korea was also one of major beneficiaries of the American-built liberal international economic order. No matter how strong the alliance tie would be, however, major external economic crises or subsequent critical junctures (e.g. the Asian financial crisis of 1997 and the global financial crisis of 2008) tempted South Korea to seek an alternative arrangement by attempting to depart from the US-led economic and financial architecture. Nevertheless, such moves were fundamentally constrained because of the preference of continuing stability in international economic and financial institutions and its renewed emphasis on the alliance in face of North Korea's nuclear


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threats. South Korea is likely to adhere to the American-led currency regime for the time being.

## 1 Introduction

The alliance with the United States has a very special meaning for contemporary South Korea not only because it liberated the Korean peninsula from the Japanese colonial occupation, but also because it saved the Republic of Korea (ROK) from the North Korean invasion. American contribution to the South Korean economy goes much deeper by providing it with a credible military deterrence through the forward deployment of its troops, lessening its macroeconomic burden through extensive military and economic assistance, and transforming its backward, war-stricken economy through aggressive policy intervention. Moreover, it is through the American patronage that South Korea enjoyed free-riding benefits of the GATT and the Bretton Woods monetary system. America was the South Korea's window to the world.

South Korea's loyalty to American leadership cannot be taken for granted, however. Signs of challenge and defiance emerged when costs of loyalty and compliance were perceived to be high. Trade frictions in late 1980s and partner diversification efforts in the wake of the 1997–98 Asian financial crisis exemplify such trend. Major economic crises and the advent of critical juncture have often entailed a rupture in the otherwise congenial bilateral relationship.

A similar situation seems recurring. The 2008 global financial crisis and its aftermath have placed South Korea at cross-road. Although the Lee Myung-bak (MB hereafter) government was able to cope with an acute foreign exchange crisis in 2008 through a currency swap with the United States and still supports the continuation of American-led international monetary regime, public opinion in South Korea is in favor of a more reformed and balanced global financial architecture and Asian financial regionalism that could undercut American leadership and interests. South Korea appears to be facing a major dilemma of whether it should stick to the continuation of status quo (i.e. support of American currency hegemony) or seek alternative currency architecture (i.e. a fundamental alteration of the existing financial order).

The article aims at exploring correlates of alliance and the economy in the South Korean context through the examination of two critical

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cases, the 1997–98 Asian financial crisis and the 2008 global financial crisis. The first section presents brief analytical remarks on the alliance, path dependence, and critical junctures. The second traces impacts of the bilateral alliance on the South Korean economy. Whereas the third section elucidates the case of the 1997–98 Asian financial crisis, the fourth looks into the case of the 2008 global financial crisis under the MB government. Our findings show that although major external economic crises or subsequent critical junctures tempted South Korea to seek alternative economic and financial architecture, such efforts have been structurally constrained by its alliance ties with the United States, delimiting the scope of maneuver.

## 2 Analytical remarks: hegemonic alliance, path dependence, and critical juncture

Alliance is an instrument of national survival or expansion. Great powers seek alliance in order to expand the sphere of influence, whereas smaller countries need alliance ties with the strong to ensure their national survival. Genesis and cohesiveness of alliance depends by and large on the existence of common enemy and common threat (Walt, 1990). Since the end of the Second World War, alliance among equals has been rare. The Cold War bipolarity made hegemonic or bloc alliance universal. Hegemonic rivals, namely the United States and the Soviet Union, weaved relatively weaker countries into an exclusive bloc. The hegemonic alliance, once formed, is not limited solely to the military domain, but extended to economic one. Both the United States and the Soviet Union sought a comprehensive alliance based on tight military and economic linkages. Whereas the Soviet Union combined the Warsaw Pact with COMECON, the United States not only built an arc of military alliance involving NATO, CENTO, SEATO, ANZUS, and bilateral alliance with Japan and South Korea, but also laid the foundation for a liberal international economic order which was manifested in two grand institutions, the General Agreement on Tariffs and Trade (GATT) and the Bretton wood monetary system (Ikenberry, 2001).

American allies were primary beneficiaries of the liberal economic institutions where the GATT fostered economic recovery and common prosperity of American allies in Europe and Asia, while American dollar as top currency, the International Monetary Fund (IMF), and the World

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Bank, all of which were created by the Bretton Woods monetary system offered valuable collective goods for open economies by stabilizing international financial and monetary transactions. The hegemonic alliance was predicated on a rather unique pay-off structure in which most of its allies enjoyed free-riding, while the United States assumed the burden of providing collective goods for these liberal institutions (Olson and Zeckhouser, 1970; Gilphin and Gilphin, 2002). Their loyalty to American leadership was tied to benefits coming from the provision of collective goods. The liberal international institutions of original design did not last long. On 15 August 1971, facing severe domestic economic difficulties, the Nixon administration not only ended the Bretton Woods system by making the dollar inconvertible to gold directly, except on the open market, but also undercut the GATT system by unilaterally imposing a 10% import surcharge, specifically on Japan and West Germany.

Surprising is that the measure by the Nixon administration did not completely end the liberal economic order. Those institutions could sustain even without American hegemonic leadership because of institutional inertia built in them (Keohane, 1984). For allies, exit from the American-led economic institutions was not an easy option because alternative institutional arrangements were not readily available. Path dependence also mattered (North, 1990). Allies are most likely to go along with the existing institutions as long as they do not incur unbearable costs. If costs of complying with American-led institutions are too high, they could either defect by diversifying their cooperative partners or join collective efforts to restructure the American-led economic order. In a world of complex interdependence, exposure to the transmission of severe external turbulence could precipitate such radical adjustment (Keohane and Nye, 2000; Gourevitch, 1986, pp. 235–239).

Thus, need for such drastic adjustment does not usually occur under normal situation. An acute, large scale crisis and major shift in pay-off structure home and abroad, which often take place at a critical juncture in history shaped by the vortex of unforeseen profound contingency or events, drive allies to deliberate on alternative measures such as partner diversification or drastic restructuring of existing institutions (Gourevitch, 1986, p. 235; Keeler, 1993, p. 440; Cortell and Peterson, 2002; Calder and Ye, 2004, p. 197). For existing institutional arrangement cannot handle the crisis and pressures coming from underlying changes in pay-off structure. Ikenberry neatly describes the rise of new

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institutions at the critical juncture of history by stating that 'crisis or war opens up a moment of flux and opportunity, choices get made, and interstate relations get fixed or settled for a while.' (Ikenberry, 2001, pp. 253–254). Likewise, the critical juncture perspective has been employed in accounting for the advent of new institutions. But it can be useful in elucidating intention and behavior of alliance partners. Crisis and critical juncture could drive them to seek alternatives by reordering their preference. Their preference and volition may not be necessarily new institutional outcomes. Strong American opposition and/or perceived high costs resulting from defection or non-compliance could deter them from pursuing alternative actions. With these analytical cues in mind, let us examine the South Korean case.

## 3 Alliance and the South Korean economy: path dependence, free-riding, and economic miracle

The bilateral alliance with the United States has affected the South Korean economy in several significant ways (Haggard and Moon, 1990). The most critical is the American implantation of the capitalist system even before the formation of the bilateral alliance. Upon the victory in the Pacific War, American occupation forces landed in Inchon on 9 September 1945, and governed the southern part of the Korean peninsula for three years. The American military government reshaped the political terrain of South Korea by co-opting local capitalists, landlord class, and pro-American Christian forces, while removing socialist forces, including the Korean Workers' Party and leftist labor movements. By the time the ROK was founded on 15 August 1948, the American military government paved the way to the birth of an anti-communist capitalist state devoid of any formidable opposing social forces in South Korea, making a stark contrast with North Korea which founded the Democratic People's Republic of Korea based on socialism. Paradoxically speaking, were it not for the capitalist path dependence implanted by the United States, today's South Korea could have had quite a different economic outlook (Park, 1990).

The original American intention was to leave South Korea after the founding of the ROK because the USA did not appreciate its strategic value. Most of American occupation forces were withdrawn, and Dean Acheson, then secretary of state, announced that the United States will be lowering its defense perimeter from the 38th parallel of the Korean

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Peninsula to Okinawa in January 1950, precipitating North Korea's invasion of South Korea under Stalin's tacit agreement and encouragement on 25 June 1950. The Korean War lasted three years, ending in July 1953, without any clear winner. Ironically, however, the outbreak of the Korean War fundamentally altered the destiny of US–South Korean military relations. The war offered the two most crucial preconditions for the formation of a military alliance: common enemies and common threat perception. Shared interests between Washington and Seoul in the wake of the Korean War led to a new institutional framework for common defense. On 1 October 1953, the United States and South Korea signed the Mutual Defense Treaty and entered a formal military alliance with the presence of US troops in South Korea.

The alliance entailed sweeping military and economic assistance to South Korea. Between 1950 and 1981, the United States provided a total of $5.34 billion in military aid in the form of Military Assistance Programs (MAP) and Military Assistance Services (MAS). These accounted for the lion's share of defense spending in South Korea. Between 1954 and 1968, the ratio of US military aid to total South Korean defense expenditure was more than 100%. South Korea contributed <20% to overall defense expenditures during this period. US military aid as a percentage of total South Korean defense expenditures was 119.7% in 1966, 103% in 1967, and 128.1% in 1968. Given acute military tension on the Korean peninsula, heavy military spending was unavoidable. Yet, the fiscal capacity of South Korea was very limited in the 1950s and the 1960s. American military aid substantially eased the defense-related fiscal burden and minimized trade-offs between guns and butter. Massive economic aid was also followed, in which a total of $4.5 billion was granted to South Korea between 1945 and 1971. Except food aid through Public Law 480, the majority of the economic aid was used to pay for needed imports to reconstruct the country from the aftermath of the Korean War and to build social and physical infrastructure during the period of import-substituting industrialization. American economic aid proved to be vital to the survival of the national economy during the 1950s and the early 1960s.

American involvement went beyond military and economic assistance. The United States made policy intervention in order to deal with the widespread misuse of aid funds and to fix economic mismanagement (Haggard *et al.*, 1991, pp. 862–868). Using economic aid as a bargaining

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leverage, the United States pressed the South Korean government to adopt an austere macroeconomic stabilization policy in 1963, which was followed by aggressive economic liberalization policies in 1964. A sequence of policy reforms involving macroeconomic stabilization and liberalization paved the way for the transition from import-substituting industrialization to an export-led growth strategy in the mid-1960s (Rhyu, 2003). It was the United States that provided South Korea with detailed technical manual for export promotion. Such policy intervention constituted the critical turning point in South Korea's economic takeoff.

The American government also played an important role in securing foreign capital and much-needed technology for the smooth implementation of the outward-looking strategy. During the first phase of export-promotion strategy (1962–66), over 90% of foreign investment came from the United States under the sponsorship of the US government. The inflow of foreign investment from Japan through diplomatic normalization between South Korea and Japan, despite intense domestic political opposition in South Korea, was also an outcome of American maneuver. During the second phase of the export-promotion strategy (1967–71), Japanese investment accounted for more than 60% of total foreign investment, while the United States investment had declined significantly. Both actions, especially the latter, proved to be critical in expediting export-led economic growth since the mid-1960s. In addition South Korea's involvement in the Vietnam War brought unexpected economic benefits through increase exports via subcontracting and remittance from Korean soldiers and workers.

Equally important was the shaping of international environment favorable to South Korea's export-led growth strategy. It was through the United States that South Korea could enjoy benefits of new liberal international economic institutions, GATT and the Bretton Woods system. Through the Generalized System of Preferences (GSP) of the GATT, itself a creature of American hegemony, South Korea enjoyed preferential access to the markets of the developed world. Since Korea has been a principal beneficiary. In 1976, the number of items eligible for GSP treatment in the US markets was 782. That figure increase to 993 items in 1982 and 1,236 items in 1986. The dollar value of GSP-based exports to the United States also increased by a quantum leap from $327 million in 1976 to $2.2 billion in 1986, accounting for roughly 20% of South Korea's total exports to the United States. Furthermore, for non-GSP

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items, South Korea was not rigorously subjected to the principle of reciprocity. Whereas it was closing domestic markets to the United States, South Korea was granted virtually unlimited access to the US market, the largest in the world. US tolerance of South Korea's free-riding was, in part, the result of geopolitical considerations. In addition to market access, South Korea has been a primary beneficiary of World Bank and IMF lending, both of which are products of a liberal economic regime created and sustained by the United States (Prestowitz, 2007; Ikenberry, 2001).

## 4 The 1997–98 Asian financial crisis, diversification strategy, and its limits

It is not an exaggeration that the South Korean economic miracle was to a large extent a product of the bilateral alliance with the United States. South Korea enjoyed free-riding benefits by showing loyalty to the United States. And despite sporadic frictions in security and trade issues, the ROK and the United States have maintained smooth relations. But the first sign of serious rupture appeared following the Asian financial crisis in 1997–98.

The Kim Young Sam government (1993–98) adopted a *segyehwa* (globalization) strategy as 'the shortcut which will lead us to building a first-class country in the 21st century' (Korea Herald, 7 January 1995). But the strategy proved to be a disaster. The Korean economy collapsed in November 1997 during his tenure, alarming the entire world. During his term in office, South Korea's foreign debts rose from $43.9 billion to $160.7 billion in 1996 and $153 billion in 1997, while foreign reserve assets dwindled from $20.2 billion in 1993 to $12.4 billion in 1997. At the peak of the currency crises, foreign reserves held by the central bank was <$8 billion, spreading the fear of default. With foreign reserves being depleted, the Korean currency rapidly depreciated. In 1993, the won/dollar exchange rate was KW808.1, but the Korean won devalued almost by two times by the end of 1997, posting the exchange rate at 1,415 won/dollar. At one point, the exchange rate reached 2,000 won/dollar. The average annual stock price index, which is generally considered the most reliable barometer of economic vitality, was 808.1 in 1993 and 1,027.4 in 1994, but continued to slide down throughout 1995 and 1996, falling to 375 by the end of 1997, the lowest since the opening

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of the securities market. The Kim Young Sam government filed for national economic bankruptcy by asking the IMF for $57 billion in ball-out funds on 3 December 1997. The myth of the Korean economic miracle was shattered, and national shame prevailed (Moon, 2000, pp.76–79).

The genesis of the Korean economic crisis can be attributed largely to domestic mismanagement. Beneath the 'healthy fundamentals' of its macroeconomy, microeconomic foundations slid into deep trouble. Declining international competitiveness, unruly corporate governance and bankruptcies, mounting non-performing loans and the paralysis of the banking and financial sectors, and extensive government failures all contributed to the downfall of the Korean economy (Moon and Mo, 2000). But equally critical was the backlash of hasty globalization. Unprepared and immature economic globalization has entailed an unbearable transitional trauma. Nevertheless, external factors are to be equally blamed for. Contagion effects originating from foreign exchange crises in Thailand, Indonesia, and the Philippines froze capital markets in Hong Kong and Tokyo, causing a severe liquidity crisis in South Korea.

The Kim Dae-jung government, which was inaugurated in the middle of this financial fiasco, actively sought American and IMF assistance in coping with the crisis. But he realized that dependence on the United States can no longer be solution. He began to deliberate on a new diversification strategy focusing East Asian regionalism, as well summarized in the following statement: 'Northeast Asia has no economic community and is, therefore, vulnerable to financial crises whenever one occurs within the region. Countries in the region need to cooperate in order to survive the global competition.' (Office of the President, 1999). However, there was no institutional mechanism that could bring together heads of Northeast Asian states, China, Japan, and South Korea. He ventured in a sort of detour regionalism through ASEAN by devising the ASEAN plus Three formula. At the first ASEAN Plus Three summit in 1998, president Kim proposed the creation of East Asia Vision Group, which eventually led to the East Asia Forum (2003) and East Asia Summit (2005). Along with then Malaysian Prime Minister Mahathir Mohammed, he was assertive in championing the idea of East Asia community (Kim, 2006, pp.101–102). His commitment notwithstanding, not much concrete progress was made in the ASEAN plus Three framework, however.

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The Kim Dae-jung government also sought cooperation with Japan in currency and trade issues, which was quite unexpected by the bitter history of bilateral relations. At a joint IMF/World Bank meeting held in Hong Kong in September 1997, then Japanese finance minister, Kubo Wataru suggested the idea of forming the Asia Monetary Fund (AMF) in order to assist Southeast Asian countries under financial and foreign exchange crises through the provision of standby loans for current account deficits, extension of trade credits, and the facilitation of foreign exchange defense. The AMF was supposed to pool $100 billion of which $50 billion was to be drawn from Japan, and the remaining $50 billion from China, Hong Kong, South Korea, Taiwan, and Singapore. In parallel with the proposal, Japan was exercising its financial leadership. Since July 1997, Japan disbursed over $44 billion to Asian countries in financial crises through IMF-led bilateral cooperation, assistance for private investment activities, facilitation of trade financing and assistance for structural reforms, social safety nets, and human resources development. As the financial crisis deepened, the Japanese government announced the Miyazawa Initiative in October 1998 through which Japan pledged to provide a package of support measures totaling $30 billion to assist Asian countries under financial crises (Hangyerai, 21, 29 December 1998; Maegyung, 29 October 1998).

South Korea's initial response to the AMF proposal was mixed. The South Korean government was reluctant to endorse it for several reasons. As a recipient of IMF rescue financing, South Korea could not support what the United States and the IMF opposed. And albeit realizing its desirability, it was skeptical of its feasibility because of Japan's lukewarm commitment and leadership as well as its ailing economy. Overall public sentiments in South Korea were not favorable lest such an institutional arrangement could lead to the creation of a yen bloc and Japan's hegemonic ascension in the region's economic sphere (Kim, 1998a).

In the aftermath of the financial crisis in late 1997, however, South Korea gradually changed its attitude. Japan was the largest creditor nation, and it was generous by extending $10 billion through the IMF rescue package and rolling over short-term loans. The Japanese government also turned one-third of the short-term loans (about $7.9 billion) into medium- to long-term loans (Moon and Suh, 2007). Crisis contributed to breeding new trust in Japan. As a result, both the government and the private sector began to make positive assessments of the AMF. The

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first positive signal came from the private sector. Delegates of the Federation of Korean Industries, the top organization representing big business in South Korea, made a quasi-public endorsement of the Miyazawa Initiative and the AMF on 29 October 1998, at its annual meeting with the Keidanren (Japanese Federation of Economic Organizations). They shared with Keidanren a view that there must be greater efforts toward internationalization of Japanese yen and that there is a need for official study of the AMF designed to stabilize the financial system in Asia (*Maegyung*, 29 October 1998). The South Korean government also began to endorse the idea. Then Prime Minister Kim Jong-pil went further by stating that 'The Asian problem should be solved by the hands of Asians and that the Asian Monetary Fund could be a viable vehicle in resolving the Asian financial crisis.' He even argued that the proposed AMF should have a financial pool of $300 billion almost equivalent of the IMF (Kim, 1998b). The harsh IMF conditionalities, an expectation of a reduction of excessive dependence on the American dollar that deepened rigidity in foreign exchange operations, practical gains through reduced interest rate burden, and the increasing feasibility of AMF through an expanded credit pool of East Asian countries all facilitated the shift.

Despite South Korea's endorsement, the Japan-centered AMF proposal never materialized. The United States and IMF were rather critical of the AMF idea for the reasons of duplication, resource waste, and moral hazards associated with the relaxation of conditionalities. And the Japanese Ministry of Finance was rather cautious in steering the proposal primarily because of the enormous financial burden associated with the provision of collective goods. Although the idea of the AMF was aborted, it is quite noteworthy for the Kim Dae-jung government to have actively sought alternative measures to minimize risks of excessive dependence on the US-led IMF.

Another significant development took place in the trade area. The spread of the Asian financial crisis, the consolidation of the European Union and North American Free Trade Agreement (FTA), and the stalemate of APEC forced Japan to venture into new policy alternatives such as a South Korea–Japan free trade area. Japan believes that a Japan–South Korea FTA, along with one for Singapore, would produce positive spillover effects on its FTA efforts toward other ASEAN members. The South Korean government's initial response was rather positive. The first

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Japan–South Korea ministerial meeting under the Kim Dae-jung government, which was held in Kagoshima on 28 November 1998, recommended joint private and public research on the free trade area arrangement. The first official discussions on the Japanese–Korean FTA took place in 1999 within the framework of the Japan–Korea Economic Agenda 21, proposed by Prime Minister Obuchi. The Institute of Developing Economies (IDE) and JETRO of Japan and the Korea Institute for International Economic Policy (KIEP) of South Korea were officially commissioned to conduct research on the feasibility of the FTA. Their research findings were interesting. An analysis by IDE-JETRO shows that trade liberalization through the Japanese–Korean FTA would increase Japan's export to Korea by 16.3%, whereas South Korea's exports to Japan are expected to rise by 8.6%, leading to a 34.5% trade surplus for Japan. KIEP's research findings were very much congruent with those by IDE/JETRO: An FTA between Japan and South Korea would increase Japan's exports to Korea by 16%, resulting in an overall trade surplus of 37.1% for Japan. Along with the short-term anticipated loss in trade, several other factors made South Korea hesitant to pursue an FTA with Japan actively: political opposition from the agricultural sector, fear of Japan's economic domination over South Korea, and the legacy of mutual antagonism rooted in the historical past (Rhyu, 2010).

The domestic opposition notwithstanding, the Roh Moo-hyun government, which succeeded in the DJ government, decided to push for the bilateral FTA by announcing the official deadline of negotiations to conclude by 2005. It was a calculated response to new strategic moves by China and Japan. China has shown a greater interest in establishing an FTA with ASEAN rather than with its Northeast Asian neighbors. In fact, China and ASEAN agreed to establish a bilateral FTA within a decade. In fear of China's initiative, Japan has also been expediting its FTA with ASEAN. Fear of being left out by China and Japan was widespread, propelling South Korea to give more serious attention to its bilateral FTA with Japan. However, it was derailed as both parties failed to reach an agreement over agricultural issues at the sixth round of bilateral talks in November 2004. Worsened bilateral relations followed by disputes over the Tokdo/Takeshima issue, Koizumi's tribute to the Yasukuni Shrine, and amendment of Japanese history textbooks further impeded the bilateral talks.

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Although neither the Japanese-led AMF nor the Japan-ROK FTA were realized, it was the first effort ever undertaken by South Korean political leadership to reduce dependence on the United States through an alternative institutional arrangement. Such move was possible because of the Asian financial crisis and a new critical juncture associated with it, but South Korea could not overcome structural limits posed by American leadership.

## 5 Between reform and status quo: the 2008 global financial crisis and the South Korean dilemma

The second critical juncture emerged during the first year of President Lee Myung-bak who succeeded in Roh Moo-hyun. MB won the president election in December 2008 by chanting the slogan '747' (7% annual growth rate, a per capita income of $40,000, and the 7th largest economy in the world during his term). But the '747' slogan was devastated by an unforeseen chain of external events. The sharp rise in oil and primary commodity prices throughout 2008 dealt an especially harsh blow. Oil prices rose by 84.7% and the price of imported raw materials increased by 79.8% in less than a year, which forced South Korea to pay an additional $60 billion for oil imports in 2008. Worst is yet to come. Deterioration of the global financial situation, which was triggered first by the US sub-prime mortgage crisis and later by the demise of Lehman Brothers, not only precipitated a flight of foreign capital and a severe foreign exchange crunch, but also caused a sharp drop in exports and domestic demand (Moon, 2009). In particular, Korean commercial banks were desperately scrambling for dollars to refinance their foreign currency debt as the global credit market tightened (The Korea Herald, 27 October 2008).

The Korea economy was one of the hardest hit. Its GDP growth rate declined from 6.2% in 2007 to −2.2% in 2008, the first negative growth since the Asian financial crisis. The trade deficit rose to $14.2 billion from a surplus of $11.9 billion a year earlier, while the benchmark KOSPI (Korean Composite Stock Price Index) sunk from 1,895 on 14 December 2007 to 948.01 on 24 October 2008. About KRW 600 trillion worth of wealth has evaporated in less than a year. Furthermore, the Korean currency slid from US$1 to KRW 950 in February to US$1 to KRW 1,450 on 30 October.

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As Ahn (2008, p. 42) diagnosed, 'an excessive opening of the domestic capital market without due monitoring on hedge fund flow and appropriate corrective mechanism have contributed to exacerbating the current crisis.' South Korea's assertive globalization turned into a curse. Almost 75% of its GDP relies on external trade, and until recent capital flight, over 40% of Korean stocks were owned by foreign investors. But adding to the upheaval was the administration's policy mismanagement. Policy inconsistence and confusing signals accelerated public and market loss of confidence in the MB government. Unguarded globalization, the delayed response to the global financial crisis, and lack of policy coordination among government agencies all contributed to worsening economic situation (Moon, 2009).

An acute liquidity crisis amidst the shortage of American dollars in late October placed South Korea on the verge of default, but a currency swap agreement with the United States prevented such a mishap. South Korea was not the only beneficiary of the swap agreement. On 29 October 2008, the Federal Reserve Board (FRB) decided to extend its currency swap agreement to South Korea, Singapore, Mexico, and Brazil. As part of the agreement, South Korea could secure $30 billion from the United States that significantly contributed to stabilizing its foreign exchange and stock markets. IMF's allocation of Special Drawing Rights (SDRs) amounting to US$3.4 billion to South Korea served as an additional stabilizing factor. The FRB's decision was motivated by several factors: preventing financial crisis in newly emerging economies, protecting interests of American financial institutions, maintaining the American dollar's reserve currency status, and co-opting newly emerging economies away from potential rivals (Choi, 2009). This view was shared by Dana Perino, White House Press Secretary, who stated that 'It includes developed and developing nations. And the President thinks it's very important to include developing nations, because they have emerging markets, they're important on a variety of levels to the global economy, and their input is important. (Perino, 2008). But it cannot be denied that beneath this economic rationale lies consideration of alliance and personal ties between President Lee Myung-bak and then President Bush.

The Korean dilemma arises from this context. Alliance, favorable currency swap, political leadership ties compel South Korea to continue to honor and comply with American leadership in the current international monetary regime. But this move could be burdensome from the point of

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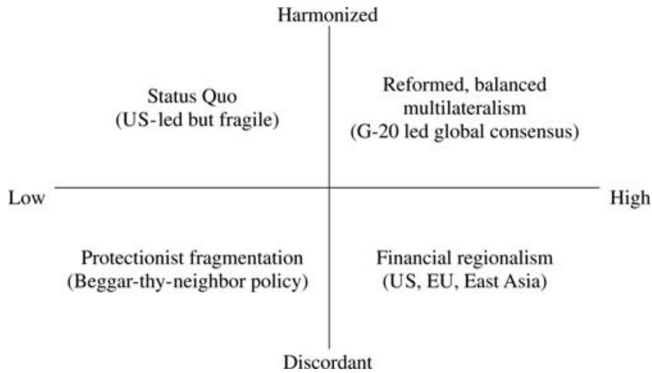


**Figure 1** Future scenarios of global financial architecture. Readapted from the World Economic Forum, 'New Financial Architecture-Briefing Package, Summit on the Global Agenda', Dubai, November 2008.

domestic economic and political calculus. As Figure 1 reveals, South Korea can encounter four possible scenarios for global financial architecture. The first is the status quo scenario (quadrant I), which is predicated on the continuation of the existing international financial architecture, but with a much weakened American leadership. This scenario could emerge under two conditions: limited economic power shift and continuing but rather reluctant compliance with the existing financial architecture. It is plausible if China and other emerging economies, being hostages of the American economy, are reluctant to challenge the dominant American leadership and at the same time, the G-20 fails to produce a new international financial architecture. In fear of an anarchical situation, countries would remain likely to go ahead with the sustaining inertia of the Bretton Woods monetary system where reform of the IMF is limited, and no central supervisory and regulatory authorities are devised. Lack of reform and restructuring would lead to countries' reluctant compliance with and weak commitment to the existing system, heightening the fear of a recurring financial crisis.

The second scenario (quadrant II) is the advent of a new financial architecture that is profoundly reformed and balanced. It becomes plausible when and if G-20 reaches a major global consensus by reflecting a realistic economic power shift and adopting corresponding demands for reform and restructuring into the new financial architecture. Such reform would to a large extent focus on institutional restructuring of the IMF, including its power structure. New reform measures might comprise a

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greater power share for newly emerging economies, while radically reducing American and European shares, which currently account for 49.5% (Europe 32.4%, the United States 16.73%). American veto power could then be rescinded by lowering its share to <15%. The size of its SDRs could also be substantially increased to respond to global liquidity problems with greater speed and flexibility. New institutional design for global financial governance involving the establishment of a world central bank or clearing bank as the last resort lender could also be rendered.

Under this scenario, the G-20 can come up with an institutional design for new norms, principles, rules, and procedures to ensure prudent supervision and regulation of banking and financial institutions on a global scale (Bradford, 2008; Bradford and Linn, 2008). Ideally speaking, the reform and rebalancing of global financial governance should include the establishment of a central bank or clearance bank and the introduction of a super currency or other alternative reserve currency. Although it seems highly unlikely for G-20 to reach a consensus on such revolutionary institutional reforms in the short term, new discourses will follow on how to restructure the existing global financial governance into a fairer and more effective system.

The third scenario (quadrant III) is the emergence and proliferation of financial regionalism that presupposes greater intra-regional financial cooperation and integration. As with the European Union, financial regionalism is characterized by a regional central bank, a common currency unit, and region-wide monetary policy coordination with binding effects. Supervision and regulation of banking and financial institutions can take place on the regional level. Financial regionalism can be complementary to, or in conflict with, multilateral financial governance. When and if the status quo model prevails, financial regionalism can challenge American leadership, leading to greater regional fragmentation. In contrast, it can be complementary when and if the existing financial governance goes through a massive restructuring as in quadrant II. Financial regionalism would emerge under the condition of a higher geo-economic power shift and dissatisfaction with the existing financial governance by new economic powerhouses.

The last possible scenario is mercantile fragmentation (quadrant IV), in which each country seeks its own national economic interests. The pursuit of an arbitrary exchange rate policy, unilateral capital control, trade protectionism, and failure to comply with international

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norms, principles, and rules concerning supervision and regulation of financial institutions characterize the policy orientation under this scenario. Such development could trigger the beggar-thy-neighbor policy reminiscent of the 1930s, making the international monetary and financial system more unstable and unpredictable. This scenario becomes plausible under the continuation of America-led global governance and other countries' non-compliance with such governance.

There could also be other variations outside of this framework. For example, as Fred Bergsten once suggested, the G-2 formula (American–Chinese partnership) could become a possibility. The United States could even accept the proposal by Zhou Xiaochuan, governor of China's central bank, to create a 'super-sovereign reserve currency,' replacing the dollar over the long run through the expansion of SDR in the IMF, while retaining its leadership in the IMF (Bergsten, 2009).[1] Alternatively, Timothy Geithner, US Secretary of Treasury, is known to have been exploring the possibility of a G-4 (US, EU, Japan, and China) that could replace G-20. But as long as the United States takes the initiative, neither the G-2 nor G-4 are likely to produce any major realignments in the existing global financial governance.

Asian countries, including South Korea, are extremely sensitive to changes in the international financial and monetary system, as they predominantly pursue an open economy driven by exports. Such open economies, regardless of size, become vulnerable to global financial and monetary instability, most notably volatile foreign exchange rates as well as rapid increases in short-term, unregulated capital movements. Given that Asian countries are known to hold more than $4 trillion in foreign reserves, mostly in US dollar denominations, sharp depreciation of the American dollar can deal a critical blow to their national wealth.

In view of this, the most desirable scenario for South Korea seems to be a reformed and balanced multilateralism through global consensus at the G-20, whereas the worst one is mercantile fragmentation in which all countries eventually become losers because of built-in financial and foreign exchange instability. The financial regionalism scenario, as long as it complements the new reformed multilateralism, could be beneficial

1 However, Robert Pozen (2009) opposes the idea of using SDRs as a reserve currency not only because it faces constraints in size, but also because it cannot be used as an effective instrument of exchange.

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too since it opens up a new venue for regional cooperation. The status quo scenario would neither ensure sustainable recovery of the global economy nor restore confidence in global financial governance in the long term given the empirical evidence of its shortcomings. What then should be the South Korean choice?

After having succeeded in hosting the next G-20 summit in Seoul November 2010, President Lee Myung-bak made the following statement: 'We will play an active role in setting agenda, selecting participating states, coordinating agreements, and suggesting alternatives for a new world order.... G-20 has now become the governance system to manage global village by transcending G-8 which served as an informal steering committee if international society before the global financial crisis.'(Cheong Wa Dae Homepage at http://www.president.go.kr, last accessed 25 May 2010) This ambitious stance notwithstanding, South Korea has been favoring the status quo scenario, while passively seeking financial regionalism in East Asia. It has been consistently taking side with the United States on an important agenda, while shying away from radically reforming the IMF, expanding SDRs, strengthening the relative position of emerging economies, and setting up new supervisory and regulatory authorities regarding international banking and financial institutions (elements of quadrant II) (*Joongang Ilbo*, 2 April 2009). For example, China and Japan have been calling for a more fair IMF equity share structure because although China, Japan, and South Korea account for 16.7% of world GDP, their share in the IMF voting power is merely 11.15% (Japan 6.1%, China 3.7%, and South Korea 1.35%). China, Japan, and several other Asian countries have been critical of American veto power and have asked either reduction of its share or introduction of a new rule banning the veto. Along with this, there should be greater representation of Asian professional staff in the IMF including the rotation of IMF leadership by region. But South Korea has rather been silent on these issues.

South Korea also did not endorse China's proposal to create a 'super-sovereign reserve currency' through the expansion of SDR in the IMF (Hu, 2009). Overall, South Korea did not join efforts by BRICs and other newly emerging economies in calling for a major restructuring of the global financial architecture. It also did not take explicit position on the creation of new international financial supervisory and regulatory institution proposed by France and Germany, while tacitly taking side

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with the United States who opposed the proposal. Likewise, South Korea's position has been in favor of status quo.

Meanwhile, South Korea has shown some interests in financial regionalism (quadrant III). But as the movement for Asian financial regionalism has been by and large fragmented and underdeveloped (Katada, 2009), its involvement has been passive and limited. The only area in which South Korea has been active is regional currency swap framed around the Chiang Mai Initiative (CMI) that has evolved out of agreements in both the ASEAN plus Three summit and the China–Japan–South Korea summit (see Figure 2). South Korea benefitted from the arrangement immensely during the foreign exchange crisis in 2008. On 12 December 2008, on the occasion of the first China, Japan, and South Korean summit held in Kyushu, South Korea reached a currency swap agreement with Japan (up to $13 billion) and with China (up to $40 billion). South Korea joined China and Japan in mutilateralizing the existing currency swaps under the CMI.

However, South Korea has been rather passive in other elements of the Asian financial architecture. For example, the idea of an Asian common currency or Asian currency unit (Nakasone, 2006; Hatoyama, 2009), which the Hatoyama Cabinet has recently proposed, seems crucial

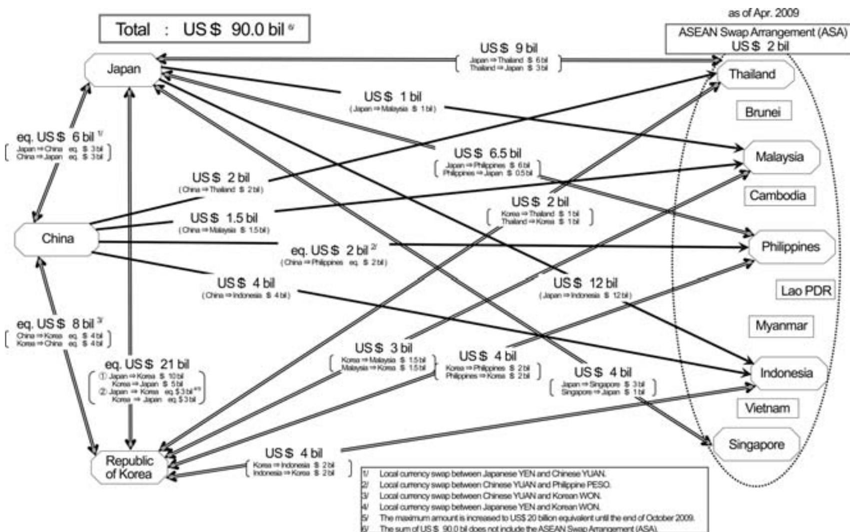


**Figure 2** Network of bilateral swap arrangements (BSAs) under the Chiang Mai Initiative (CMI). *Source*: http://www.mof.go.jp/english/if/cmi.0904.pdf.

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to South Korean interests not only because a stable Asian currency can reduce risks associated with the excessive foreign reserve exposure to the American dollar, but also because it can enhance international standing of the East Asian region commensurate with its economic power. The American dollar is still the dominant foreign reserve currency accounting for 64% of world total in 2008, followed by the Euro (26.5%) (Jang, 2009). Japanese Yen is the only Asian currency which is being used as a reserve currency, but its share constituted only 3.3% in 2008. Thus, a common Asian (or East Asian) currency seems a good idea, but South Korea has been reluctant to endorse the idea partly because of its support of the current American-led financial system and partly because of its unwillingness to relinquish their currency sovereignty.

The Asian Bond Market Initiative (ABMI) constitutes another component of the Asian financial regionalism. Having realized that Asian countries' financial vulnerabilities come from underdeveloped capital markets, the Thai government proposed the idea of the Asia Bond Market in 2002 at the ASEAN plus Three summit, which required each member country to contribute 1% of their respective foreign exchange reserves to launch a regional fund to purchase Asian bonds. The 2005 East Asian summit held in Kuala Lumpur decided to set up the Asian Bond Fund, which began to invest in bonds denominated in Asian currencies with a $2 billion fund. Given the dominance of US dollar and Euro-denominated bond markets and the very weak standing of Japan and China, the promotion of an Asian bond market can be an important step toward Asian financial regionalism. South Korea joined the ABMI, but as a passive follower, not as an agenda-setter.

In view of the above, the critical juncture followed by the 2008 global financial crisis did not bring about any major changes in South Korea's position on global financial architecture. It favors the continuation of status quo under American leadership, with passive involvement in financial regionalism. The attitude can be explained largely by the new Lee Myung-bak government's emphasis on the importance of alliance ties with the United States. On the premise that the previous Roh Moo-hyun government severely undermined the ROK–US alliance, the MB government pledged to restore the alliance by proposing the strategic alliance on common value, mutual trust, and peace-building of global reach (Cheong, 2009). In its new conceptualization, the bilateral alliance was posited as being comprehensive by going beyond the military dimension.

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It is in this context that the MB government has favored the state quo scenario. Support of and compliance with American leadership are considered beneficial not only because it can reduce uncertainty in the international financial system, but also because it can strengthen South Korea's military alliance with the United States in the face of North Korea's nuclear ambition and military provocation. Adherence to American leadership is also bound to delimit South Korea's diversification efforts such as East Asian financial regionalism. This foreign policy orientation has led to the MB government's support of the status quo with a passive financial regionalism. The MB government's policy posture reveals a sharp contrast to that of previous two progressive governments that emphasized regional cooperation and integration as a way of reducing dependence on the United States. Whereas President Kim took leadership in promoting the idea of East Asian community, President Roh initiated the Northeast Asian cooperation project aiming at fostering sub-regional integration in Northeast Asia.

## 6 Concluding remarks

The examination of the South Korean case generates some interesting implications for correlates of alliance and the economy. First, no matter how strong the alliance tie would be, major external economic crises or subsequent critical junctures tempted South Korea to seek alternative arrangements by attempting to depart from the US-led economic and financial architecture. Following the Asian financial crisis in 1997–98, the Kim Dae-jung government attempted to reduce its dependence on the United States by promoting a new Asian regionalism. The MB government has also been under public pressures to seek overall reforms of the existing monetary and financial architecture. In this sense, South Korea's loyalty to American leadership cannot be taken for granted because signs of challenge and defiance could emerge when costs of loyalty and compliance are perceived to be high.

Second, despite such temptation, the scope of South Korea's maneuver was fundamentally limited. The Kim Dae-jung government's diversification efforts were by and large derailed by American opposition and Japanese reluctance. And the MB government has been supporting the continuation of the American-led status quo of the international financial and monetary regime not only because of its emphasis on the

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ROK–US alliance to cope with North Korea's conventional and nuclear threat, but also because of domestic political calculus to differentiate itself from previous progressive governments.

Finally, South Korea is a rapidly globalizing medium-sized country which is extremely vulnerable to the transmission of external turbulences. It prefers stability and certainty in international economic transactions. Any drastic realignments of existing international economic order are perceived of being burdensome and even threatening, which makes South Korea to favor incremental tinkering and changes rather than a radical restructuring of the existing international economic institutions. It is for this reason that South Korea is likely to adhere to the American-led currency regime for the time being.

## Acknowledgement

This research was supported by the BK21 of the Korean Ministry of Education, Science and Technology and the Korea Research Foundation. We would like to thank Takashi Inoguchi and Yoshihide Soeya for comments.

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