The Political Economy of Economic Crisis: The Case of South Korea

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I. Introduction

About four months ago, calling for rich nations' support for an emergency fund to help the hardest-hit countries, President Clinton claimed that the world faced its most serious financial challenge for fifty years.[1)] When the currency crisis started in Thailand in July 1997, nobody seemed to expect that the crisis would spread over most emerging markets and might trigger a global downturn a year later.

South Korea's economy, once admired by a scholar as ‘Asia's Next Giant’[2)], could not avert the contagion and has experienced its most severe depression in recent decades. In the year to the second quarter of 1998, real fixed investment declined thirty percent and consumption thirteen percent.[3)] The unemployment rate reached an unprecedented level of 7.6% as of July 1998, which has been causing numerous social and political problems in a nation without a reliable social safety net. The Kim Dae-jung government is trying to tackle all these difficult problems and achieve the goal of democracy and a market economy simultaneously, 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 the reform efforts of the Kim Dae-jung government. Based on the assumption that politics and economics cannot be separated from each other in the real world, the analysis in this paper will adopt a political-economic approach.

II. Two Explanations of the Economic Crisis

Numerous research papers, statements and speeches on the causes of the Asian economic crisis have appeared since the Thai economic crisis in 1997.[4)] Broadly speaking, we can identify two groups of people who make contrasting arguments. One group emphasizes external factors such as the global financial environment, and the other, internal factors such as domestic economic policies and structures.

For example, Jeffrey Sachs has argued that there was nothing wrong with the fundamentals of the

Korean economy prior to the crisis. The Korean economic crisis was caused not by any weakness of its economic fundamentals but by international investors' panicky behavior in late 1997.[5)] Similarly, Robert Wade, a 'developmental state' theorist, has contended that the Asian economies were relatively healthy and efficient prior to, and probably would remain so even after, the crisis. High savings in East Asian countries naturally led to high debt/equity ratio of industrial firms, which worked as the engine of strong economic growth. According to Wade, it was Western and Japanese banks and investment houses that 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 the exchange rate would remain stable in these countries.[6)]

It is one thing, however, to point to the herd behavior of international investors as the source of the problem, and another to argue that the fundamentals of the Korean economy was strong prior to the crisis. For instance, in a 34 page-long paper on the onset of the crisis, Sachs and Radelet did not devote a single paragraph to the continuous bankruptcies of several chaebols (Korean conglomerates) during the period from early 1997 to the onset of the crisis. They failed to acknowledge the fact that even before the crisis, the Korean banking sector had been saddled with huge amounts of non-performing loans. Instead, Sachs and Radelet emphatically argued that exchange rate depreciation precipitated by sudden withdrawal of capital and the IMF macroeconomic policies were the major cause of the debt problems in Korea.[7)]

It is true that foreign exchange depreciation and high interest rates since December 1997 added to the debt burden of Korean firms. However, we cannot deny the fact that huge amounts of existing debts plus additional debts imposed on the banks by the unprecedented number of bankruptcies of chaebols since the beginning of 1997 was an important cause of the crisis.[8)] For instance, Seoul Bank and First Bank were already close to the point of bankruptcy even before the crisis and this was why negotiators from the IMF and the Korean government decided to liquidate these two banks in negotiations leading to the first IMF bail-out of December 4. In this way, Sachs tries to see only what happened after the crisis and disregards what had happened prior to it.

In one place, Sachs and Radelet argue that "the crisis involved considerable lending to debtors that were not protected by state guarantees."[9)] However, it is common knowledge that all the banks in Korea were guaranteed by the government. This certainly worked as an incentive for foreign banks to make loans excessively to Korean financial institutions. One episode in particular underscored this. When the Hanbo Group collapsed February 1997, the then-secretary of economic affairs to the president announced that the Korean government would not guarantee Korean banks' foreign debts. Of course, this caused enormous consternation among international investors, and the official had to retract the statement in less than a week.

While Sachs sees nothing fundamentally wrong with the Korean economic model, Wade even seems 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.)"[10)]

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 two former presidents and a son of another president being jailed. He might not recognize that this ‘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 and 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. We still remember that Sachs' argument was given wide coverage in the Korean press early 1998 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[11)], has been politically utilized as an ideological tool against economic reform by those who wanted to maintain the status quo and opposed reform of the Korean economy.

A second group of scholars emphasized internal factors as the cause of the East Asian economic crisis. Many in this group focused on the moral hazard problem in the debtor countries' financial and industrial sectors as having the leading role in the crisis. For instance, Paul Krugman says,

"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 excessive risky lending of these institutions created - inflation not of goods but of 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."[12)]

Roubini also argued that the moral hazard problem was the major cause of the crisis. Most banks in 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, pegged mostly to the dollar, also contributed much to the excessive inflow of foreign capital, which, in turn, led to appreciation of the real exchange rate and accumulating current account deficit.[13)]

A balanced explanation of the crisis would be one that considers both the internal and the external factors simultaneously since they are deeply inter-related. The Korean economy did suffer from the problem of moral hazard in the banking sector, which caused over-investment by industrial firms, especially the chaebol groups, and the accumulation of bad loans in the banking sector. This was not regarded as a problem by international investors at the time of the economic boom. However, when the economy slowed down in Korea, they suddenly began to see this as the source of the real problem and withdrew their capital.

It is certainly true that investors' panicky behavior triggered the economic crisis. Nevertheless, without the domestic problem of moral hazard, the crisis could have been avoided, as in Taiwan. When a tree is blown down by a typhoon, there is indeed something wrong with the root of the tree. One may strongly feel like blaming only the typhoon, but it may be much wiser to admit that there was something wrong in the root also, and try to strengthen it first. This is why I am focusing in this paper on the issue of moral hazard instead of that of fixing the international financial system.

III. The Political Economy of Moral Hazard and the Crisis

The origin of the moral hazard problem in the Korean economy dates long back to the 1970s. President Park Chung Hee pursued the heavy and chemical industrial development project (HCIP) in the early 1970s.[14)] Since heavy and chemical industries needed sizable amounts of capital investment and the return on investments was long to be realized, he encouraged big business to invest in these industries by providing various incentives such as tax exemptions, subsidies and bank credits. In particular, President Park directed the banking sector to make huge amounts of low interest policy loans to chaebol groups. Thus, the financial sector was turned into a semi-governmental institution rather than an independent profit-maximizing industry.

From the viewpoint of quantitative development, this strategy was a success, and Korea achieved rapid economic growth until recent years. However, the success came with a serious qualitative distortion of the Korean economy. Accustomed to directions from the government, Korea's banking sector had no chance to strengthen its own competitiveness by accumulating techniques of reviewing loan applications or advanced managerial know-how. Furthermore, chaebols, which could easily borrow from the banking sector with the help of the government, tended to make over- or redundant investments in heavy and chemical industries. Naturally, enormous amounts of bad loans accumulated in the banking sector. Thereafter, the banking sector has long been hostage to the chaebols, while the national economy itself, in turn has become hostage to the unsound banking sector. Moral hazard, in other words, was the price Koreans had to pay in the form of the current economic crisis in return for past economic growth.

Since the inauguration of the massive HCIP by the government, the relative power of chaebols has become too great to be properly handled by the state. The changing balance between the state and the chaebols from dominance to symbiosis has been already analyzed in detail.[15)] Moon also noted that the very success of the developmental state in economic growth resulted in increased social mobilization, which augmented the power base of social forces.[16)] In my view, the story went even further than that in the sense that the Korean state became hostage to the chaebols. State autonomy has been seriously weakened as the result of moral hazard since long before last year's economic crisis.

For instance, heavy government intervention in the private sector for the HCIP in the 1970s helped the chaebols to expand in size rapidly. The bigger the size of the chaebols, the safer their future would be. Owners and managers of chaebols tended to think that the state would not have the luxury of letting them collapse in accordance with market principles during hard times. This was because their collapse would create great difficulties for creditor banks and probably the whole financial system, and affiliated small and medium-sized firms. It would also eventually have a negative political impact due to the resultant massive lay-offs. This mindset in turn made them more irrational investors, almost like gamblers. The state was forced to intervene to regulate their excessive investments and suppress the inflationary impact.[17)] Thus, a vicious circle developed with government intervention leading to further rounds of intervention.[18)]

For example, it is noteworthy that the number of firms belonging to the Hanbo Group increased while an unsound investment in a steel plant went on. This means that bank loans were diverted for the purpose of increasing the number of companies in the group.[19)] Most chaebol-owners in Korea would have thought as the chairman of the Hanbo Group, Chung Tae-soo, did, that the safest way to avoid collapse would be to increase the number and the size of their companies and take the national economy and creditor banks as their own hostages. The president of a commercial bank complained, "The attitude of the chaebol-owners, with the help of politicians and high-ranking bureaucrats in the Ministry of Finance and Economy (MoFE), would suddenly become arrogant when their bank loans exceeded certain levels."[20)]

The chaebol-owners' strategy of taking the national economy hostage usually worked as they expected. Even the former deputy prime minister Kang Kyung-sik, who has been known as a believer of market principles, could not let the chaebols collapse as market mechanisms would dictate. After the collapse of the Hanbo and the Sammi Groups, his ministry (MoFE) directed creditor banks to make an agreement to keep providing additional emergency loans to these chaebols.[21)]

On the other hand, the problem of moral hazard made regulation of the financial system lax, which contributed to excessive inflows of foreign capital and finally, to the occurrence of the currency crisis. International investors believed that the Korean government or the IMF would bail them out if something went wrong. Thus, they did not feel it necessary to examine carefully the soundness of Korean firms and financial institutions to which they made those excessive loans. Similarly, domestic financial institutions tended to think that the government would bail them out if problems arose. Thus, they had no incentive to be prudent when borrowing from international investors and lending to domestic industrial firms.[22)]

The government, to which the final responsibility to monitor international financial transactions fell, did not do its job properly. It had no experience of monitoring international capital transactions and providing the financial system with proper safeguard measures in order to contain risks while letting the market open. For instance, when many Korean firms took on increasing amounts of short-term foreign currency debt without hedging, the government didn't do anything about it at all. For government policy-makers, further liberalization of the financial market, an obligation for new OECD members, and the pursuit of globalization policies meant all or nothing - full opening or no opening at all.

The coexistence of the seemingly sound real goods sector, the weak financial sector and the vacuum in the financial regulatory authority turned out to be the major weakness of the Korean (and probably the Japanese) economic model in the long run.[23)] The strong growth of the real goods sector induced much foreign capital, but the lack of a sophisticated financial regulatory system to contain the risks of international financial markets was, after all, the fundamental cause of the current crisis.

IV. Economic Reform Efforts of the New Government

In my opinion, the current reform efforts in Korea ought to be focused on achieving at least two inter-related goals. One is cleaning up the remnants of the moral hazard of the past, and the government has been mainly involved in this task in recent months. For instance, the Kim Dae-jung government has been trying to restructure the financial, corporate, labor, and government sectors. In particular, resolving the bad loan problem of the banking and the corporate sectors is the most urgent task.

There is another important task for Korea that has not attracted much attention yet. This is reinventing a new institutional framework of inter-relationship among these sectors - especially finance, the industrial firms, and the government - in order to prevent the reoccurrence of moral hazard in the future. Building a constructive check-and-balance relationship among these sectors to facilitate an effective operation of market mechanism is as much as or even more important than other tasks.

With regard to the first task, there has been some progress in the government's efforts but it has not yet proved successful. In the financial sector, a dozen or so merchant banks were closed and five banks were merged with another five better-performing banks. More and more employees in the banking sector seem to be accepting, albeit reluctantly, the reality of lay-offs. This kind of change might have been unthinkable even a year ago.

However, some criticize the bank merger program, since five bad banks may weaken the healthy ones. Seoul Bank and First Bank have survived for about two years since it went almost bankrupt by absorbing vast sums of money from the government. Most of all, considering the size of non-performing loans, 64 trillion won of government funding will not be enough. As of the end of June 1998, total non-performing loans of all financial institutions, broadly defined to include loans classified as ‘precautionary’, were estimated as 136.0 trillion won, or 21.8% of total outstanding loans.[24)] According to one study, the final fiscal costs required to save the financial system could be as much as 125-150 trillion won.[25)]

The task of industrial restructuring is more demanding. Some fifty enterprises were forced to exit the market by the Financial Supervisory Commission. Workers, albeit reluctantly, have tended to accept lay-offs in the process of industrial restructuring except in the strike in the Hyundai Motor Company several months ago. However, the chaebol groups, especially the top five ones, remained very resistant to government efforts to restructure until recently.

Most of all, their continued monopolization of credit even after the crisis hindered the reform process. The debt/equity ratio of the thirty largest chaebols increased from 363 percent in the end of 1996 to 519 percent a year later. The top five chaebols crowded out bank credits for other chaebol groups and small and medium-sized firms. In 1997, they absorbed seventy percent of new bank loans.[26)] In the first seven months of 1998, they accounted for 78 percent of all new corporate bond issues.[27)] Their monopolization of financing had two negative impacts. First, it weakened their own incentive to reform and improve their financial situation. Second, it curtailed credit opportunities for smaller groups and firms which had been actively trying to restructure.[28)]

Similar distortions have occurred since prior to the economic crisis. About a dozen failing chaebols have managed to survive through emergency loans with interest rates lower than the market rate from their creditor banks. The banks might have made loans out of fear that if those indebted chaebols were abandoned to collapse, creditor banks would eventually have to take huge amounts of additional bad loans at a time when they are forced to maintain an eight percent BIS ratio. Or, the government might have worried about the social and political impacts of increasing unemployment resulting from the collapse of the chaebols. Or the debtor chaebols might have lobbied government policy-makers to influence creditor banks to continue financing. Whatever the reason may be, the result is that better-performing companies had to pay twice the rate of interest that failed companies are paying.[29] This kind of distortion will continue to hamper and delay the market-based process of restructuring of the economy and may force Koreans to pay much heavier cost in later years.

V. Conclusion

A more important but probably less noticed task is establishing a new institutional framework of inter-relationship among sectors. Achieving this goal needs a fundamental readjustment of the concept on the role of the state from a ‘developmental state’ to an ‘umpire state’.

The state in most advanced capitalist countries has two kinds of role toward the economic sector. One is the role as an economic actor, like firms and individuals. Here, the state competes like a player in a contest. The other is the role as the manager of the whole economic system. Here the state takes the role of an umpire in a contest. In Korea, too much emphasis has been put on the state's role as a player during the past four decades. The state has intervened in various economic sectors and processes in the name of economic development. In particular, the state allied with the big businesses from the 1970s to utilize the alleged ‘advantages’ of backwardness and economies of scale. One of the results was strong economic growth, but the seeds for moral hazard and the current economic crisis were also sown at the same time.

To avoid becoming hostage to big business again, the Korean state 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 desisting 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 three sectors, the government, the finance, and the industry by installing a new institutional framework. For instance, the autonomy of the Financial Supervisory Commission from the external influence should be guaranteed strictly. Chaebol’s ownership of the banks should not be permitted to prevent financial institutions from becoming hostage to the big business again. The government will also have to revise the laws on national elections and parties to reduce the amount of political fund to be used by politicians.

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2 . Alice H. Amsden, Asia's Next Giant: South Korea and Late Industrialization (New York: Oxford University Press, 1989).
3 . The Financial Times, September 30, 1998.
4 . For example, Professor Roubini's Asian economic crisis homepage shows the depth and width of resources covering the issue. (http://www.stern.nyu.edu/~nroubini/asia/AsiaHomepage.htm).
5 . Jeffrey Sachs, "IMF is a power unto itself," The Financial Times, December 11, 1997; "Korea: riding to the rescue," The Financial Times, December 5, 1997; Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," April 20, 1998.
6 . Wade and Veneroso, p.4.

7 . Steven Radelet and Jeffrey Sachs, "The Onset of the East Asian Financial Crisis," March 30, 1998, p.7.
8 . The bankruptcies of chaebols in 1997 severely weakened the financial system in Korea. For example, by October 1997, over twenty percent of bank loans were impaired in Korea. IMF, World Economic Outlook: Interim Assessment (IMF: Washington, D.C., December 1997), p.13.
9 . Radelet and Sachs, p.5.
10 . Robert Wade and Frank Veneroso, "The Asian Crisis: The High Debt Model vs. The Wall Street-Treasury-IMF Complex," March 2, 1998 (http://epn.org/sage/imf24.htm), p.3.
11 . There are some different versions of the conspiracy theory. However, its key point is that the United States intentionally triggered the crisis to curb rising East Asian economic power.
12 . Paul Krugman, "What Happened to Asia?" January 1998 (http://web.mit. edu/krugman /www /DISINTER.htm), p.3.
13 . Nouriel Roubini, "Asian Crisis: An Interview with Nouriel Roubini," Economics, Jan.27, 1998 (http://economics.tqn.com/library/weekly/aa012 798.htm).
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16 . Chung-in Moon, "Beyond Statism: Rethinking the Political Economy of Growth in South Korea," International Studies Notes, Vol.15, No.1 (Winter 1990), p.26.
17 . As the result of too heavy investments in the late 1970s, the inflation rate rose up to 29 percent in 1980.
18 . For an excellent description of this vicious circle of government intervention, see The Economist, "A Survey of the Korean Economy," June 3, 1995.
19 . The Joongang Ilbo, Feb. 3, 1997.
20 . The Dong-A Ilbo, May 16, 1997.
21 . The Dong-A Ilbo, April 23, 24, May 19, 1997.
22 . For a review of reverse risk-taking behavior of quasi-public financial institutions at the time of the crisis, see Calomiris, pp.6-7.
23 . Even nowadays, there is no central authority in charge of managing foreign exchange transactions. For instance, foreign exchange policy-making is under the control of MoFE, making statistical data and other assigned tasks related to foreign exchange transactions is the responsibility of the Bank of Korea, and supervision over the foreign exchange banks is left to the Financial Supervisory Commission. See Maeil Business Newspaper, Oct. 29, 1998, p.6.
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