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Economic Performance in Post-Crisis Korea:
A Critical Perspective on Neoliberal Restructuring

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Abstract

This paper evaluates the neoliberal economic restructuring process implemented in Korea following the 1997 Asian financial crisis. We first argue that the austerity macroeconomic policy of late 1997 and early 1998 was the main cause of the economic collapse in 1998, and that the decision of the IMF and President Kim Dae Jung to impose a radical neoliberal transformation of financial markets and large industrial firms in the depressed conditions of 1998, though defensible on political grounds, made the failure of these reforms virtually inevitable. A detailed analysis of the macro economy, labor markets, financial markets, and nonfinancial firms in Korea in the past three and one-half years shows that neoliberal restructuring has created a vicious cycle in which a perpetually weak financial sector fails to provide the capital needed for real sector growth, investment and financial robustness, while real sector financial fragility continuously weakens financial firms. Neoliberal policies may have pushed Korea onto a low-investment, low-growth, development path, one with rising insecurity and inequality. Meanwhile, the removal of virtually all restrictions on cross-border capital flows has led to a dramatic increase in the influence of foreign capital in Korea's economy. The paper concludes by arguing that Korea should reject radical neoliberal restructuring and instead adopt reforms designed to democratize and modernize its traditional state-guided growth model.

Key Words: Globalization, Korean crisis, neoliberalism, economic restructuring, Korean economic model.

Introduction:

In the mid 1990s, a vast inflow of short-term foreign loans fueled an investment-led boom in Korea.1 The boom created excesses of various kinds, which, exacerbated by the financial crisis that broke out in Southeast Asia in July of 1997, became apparent to foreign banks toward the end of 1997. They demanded immediate repayment of their loans, which had been used primarily to finance long-term investment projects. Already suffering the ill effects of the crisis, Korean firms were unable to repay their local banks on demand; domestic banks were thus in no position to repay foreign banks. Pushed to the verge of default, Korea accepted an International Monetary Fund (IMF) loan to repay foreign debt in return for effective IMF control of Korean economic policy. In December 1997, the IMF ordered the Korean government to impose austerity macro policy on the country in what was later explained to have been a failed attempt to restore foreign investor confidence.2 Interest rates were boosted to 30% and fiscal policy was tightened in the first half of 1998. These policy shifts were followed by a precipitous economic decline and a financial collapse. Simultaneously, the IMF ordered President-elect Kim Dae Jung to drastically accelerate the transition of the Korean economy from its traditional East Asian, state-guided development model to a neoliberal model -- like the US and UK. Under neoliberal restructuring, the Korean economy rebounded from its 1998 collapse faster than expected. After falling near 7% in 1998, real GDP growth was almost 11% in 1999 and near 9% in 2000. The Asian Development Bank described Korea's "economic recovery and financial stabilization" following the crash of 1998 as "remarkable" (Asian Development Bank 2000). Korea's Ministry of Finance and Economics early in 2001 proclaimed: "The result of the reform process has been a resurgent economy, stable inflation, and low unemployment" (Korea Economic Update, January 19, 2001, p. 1).

These facts are not in dispute, but there is an ongoing debate concerning the lessons they teach us about the kinds of government economic institutions and policies that are appropriate for Korea, as well as other countries at an intermediate stage of economic development. Everyone agrees that by the mid-1990s serious flaws had evolved in Korea's economic system, and that these flaws caused or at least permitted the imbalances that led to the 1997 crisis. Supporters of neoliberalism argue that these flaws were built into, or *inherent* in, the deep structures of Korea's traditional state-led growth model. They consider the East Asian model an anachronism; only a lightly regulated, globally integrated economy can function efficiently in today's world. This belief is often summarized by the acronym TINA – there is no alternative (to neoliberalism) (Korea Development Institute (KDI) 1999, Greenspan 1999, Brittain 1997, Hahm and Mishkin 2000, Borenstztein and Lee 1999).

In this view, the 1997 crisis was a blessing. It created a political environment in which radical neoliberal restructuring could be forced on a Korean population who would never have accepted it in the absence of the economic and political chaos created by the crisis. After what might be a painful transition period, it is argued, neoliberalism will restore prosperity to the country. The unexpected vigor of the rebound in 1999 and 2000 is seen as proof that neoliberal restructuring was the right path for

1 Foreign short-term credit, which stood at $12 billion in 1993, rose to $32 billion in 1994, $47 billion in 1995, and $67 billion in 1996.

2 As Stanley Fischer, Managing Director of the IMF, put it in his farewell speech upon leaving his position: "our initial judgment on fiscal policy was faulty" (2001, p. 6).

Korea.

There is an alternative position, to which we subscribe (Crotty and Dymski 1998a, Chang, 1998, Chang et al., 1998, Stiglitz 1998, Radelet and Sachs 1998, Furman and Stiglitz, 1998, UNCTAD 1998). By the late 1980s, a powerful coalition of interests inside and outside Korea had come to support the radical liberalization of Korea's economy. In the decade preceding the crisis, this coalition affected substantial changes in Korea's version of the East Asian development model, greatly weakening state control over crucial dimensions of domestic and cross-border economic activity. By the mid-1990s, the Korean economic system had lost its coherence. Government no longer had the tools or the political mandate to monitor and control the broad contours of economic life. Yet Korea's market system remained 'immature' or under-developed. It is easy to explain how this incoherent system staggered into the 1997 crisis. The key difference from the neoliberal perspective is that the mid-1990s flaws in Korea's economic model are here seen as *contingent*. In the absence of the ill-conceived process of excessive liberalization in the 1990s, it is argued, no system-shaking crisis and collapse would have taken place.

In the alternative view, TINA is understood to be an ideological slogan, not a scientifically demonstrated fact. Abstracting from political power considerations, there is always more than one viable economic development path. We believe that in late 1997 and early 1998 the Korean people could have chosen to modernize and democratize their traditional state-guided model, repairing the most serious of the contingent flaws created in the economy in the mid-1990s through inappropriate acts of liberalization – and that the majority of Koreans would have been better off in both the short and long run if they had done so. As we demonstrate below, the neoliberal restructuring of the past three and one-half years has badly damaged Korea's economy, not restored it to health. A reformed Korean 'East Asian' model could hardly have performed more poorly. Neoliberalism conquered in 1997-98 not because there were no alternatives, and not because it was demonstrably more likely than alternative paths to deliver prosperity to the majority of Koreans, but because its supporters were able to grab the reigns of political power. Korean and Western media and free-market oriented economic and financial 'experts' claimed that the crisis proved that the traditional model was inherently inefficient. The crisis itself created mass confusion in Korea, and put the neoliberal IMF in charge of economic policy. The sharp rise in unemployment in 1998-99, which was *deliberately* created by austerity macroeconomic policies in late 1997 and early 1998, then swept away the remaining barriers to the radical restructuring efforts of the IMF and President Kim Dae Jung. The crisis and subsequent economic collapse created an economic environment in which the labor movement and the public were too weak and too frightened to offer effective resistance to the powerful array of forces pushing big-bang liberalization.

This paper offers a defense of the alternative view. We reject TINA and argue in the last section of the paper that the reform of the traditional model was possible in 1997 and is still possible today. We ask whether the policy of neoliberal restructuring has been a success or even a 'miracle' as many of its supporters claim. A careful examination of relevant data leads to the conclusion that, to date at least, it is a double failure. First, it has failed on its own terms. Three plus years of restructuring have created neither a healthy financial sector nor a profitable industrial sector. Instead, it triggered a *vicious circle* in which ongoing problems in real-sector firms keep financial institutions perpetually weak, and weak financial institutions are never able to provide industrial firms with the capital they desperately

need to invest and grow. Moreover, rather than 'wither away,' the Korean state has exercised a higher degree of direct administrative control over the private economy since 1997 than at any time in the past two decades. Second, neoliberal restructuring has failed to restore Korea to a sustainable high-growth path. Assertions to the contrary notwithstanding, the economic recovery of 1999 and 2000 was imbalanced and unsustainable; it appears to have petered out in late 2000. The economic condition of the majority of the population has deteriorated, as has the position of organized labor. Inequality has risen significantly, as it does in every country that falls under IMF control. Ominously, the rate of capital accumulation in Korea may well be experiencing a pronounced secular decline. If this turns out to be the case, the Korean 'miracle' will certainly have ended in 1997

The rest of the paper is organized as follows. Section I provides background information about the crisis and the subsequent decision to embark on big-bang neoliberal restructuring. Section II provides a broad overview of general economic performance since the crisis. The next three sections discuss the impact of restructuring efforts on labor, industrial corporations, and financial institutions. Section VI looks at the rising influence of foreign capital on the Korean economy. The last section offers guidelines for thinking about alternative development paths for Korea.

I The Emergence of the Neoliberal Revolution in Korea

Prior to the crisis, Korea's version of the state-guided East Asian economic model was universally admired for its exceptional long-term development record. In the traditional Korean economic model, state industrial policy guided the development process (Amsden 1989, Chang 1994, Wade 1990)**.** Korean governments, in consultation with business leaders, identified the next rung in the technology ladder the country had to climb to develop successfully, and helped selected firms enter and prosper in targeted industries through credit allocation at below market interest rates, research and development assistance, and temporary protection from domestic and foreign competition. To assure that investment was of the right magnitude as well as allocated efficiently, the government tightly regulated and coordinated the investment plans of the highly diversified, family-controlled conglomerates called "chaebol" that dominated Korea's economy. The government had to control both the domestic banking system and cross border capital flows in order to regulate chaebol investment spending (Cho and Kim 1994). Cross border capital controls were also needed in the early decades so that the state could allocate the foreign loans required to finance investment in excess of domestic saving. In later years, they were required to prevent capital flight and, in so doing, keep the rising volume of national saving within the domestic financial system, and make sure the chaebol could not escape state investment control by using foreign funds.

The prolonged rapid rate of capital accumulation that was the cornerstone of Korea's industrialization success required state-controlled banks to provide liberal credit to selected chaebol firms so that they could invest more than their retained earnings. This led to debt/equity ratios that would be considered unsafe in many liberalized, Anglo-American style economies, but were not inconsistent with leverage ratios in other bank-based systems such as France, Italy and the Scandinavian countries**.** Until the outbreak of the Asian crisis, the government was able to insulate the highly levered real sector of the economy from severe financial distress through its control over capital flows, even in the face of

several large external shocks.

Guided by its traditional model, Korea built an economic record that remains the envy of the less developed world. Over the 35 years ending in 1996, Korea had an annual average annual real GDP growth rate of about 8%, while real wages grew by more than 7% a year. Under their unique version of the East Asian economic model, Koreans experienced perhaps the most successful three-decade economic development success in world history.

The 1997 crisis caused a sea change in way that most economists, businessmen and political leaders in the West viewed Korea's East Asian model. The main thesis of this new view is that the structure of Korea's political economy prior to the crisis was fatally flawed, a now incontrovertible 'fact' that somehow escaped the attention of Western analysts before 1997. The government credit allocation process was now seen as corrupt, a problem captured by the phrase "crony capitalism." The chaebol were excessively diversified, over-indebted, and run by inept sons of the original founders. Empire building through over-investment was common, causing profit rates to fall and marginal capital-output ratios to rise. Profit rates could not be restored through downsizing, wage cutting, and mass firings as required in neoliberal theory because Korea's labor laws were too inflexible and its unions too militant and powerful. Nor could chaebol firms be forced to raise their efficiency through vigorous competition from imports and foreign direct investment, since both were restricted by the state. Having merely implemented decisions made by government officials for decades, banks were hopelessly inept at evaluating loan applications and monitoring corporate performance as required by sensible moves to liberalize the Korean financial system taken in the 1990s.

From this perspective, the fast paced liberalization of the Korean economy and its rising integration with global markets in the early to mid 1990s was the *trigger* but not the *cause* of the crisis. Liberalization merely exposed the underlying rot within. Thus, the draconian agreement imposed on Korea by the IMF in December 1997 merely accelerated a transition that was in any case inevitable. Neoliberal restructuring is also believed by its supporters to be responsible for what is seen as a near miraculous recovery after 1998.

Though these criticisms have been grossly exaggerated for political effect, they contain important elements of truth. The central debate generated by the crisis is not over the existence of serious problems in Korea's economy in the 1990s, *but over their cause*. We believe that the crisis was caused primarily by inappropriate acts of liberalization from the late 1980s through the mid-1990s.3 In this period, the state ended its control of chaebol investment decisions, substantially reduced regulation of domestic financial markets, and liberalized short-term capital flows -- moves that eventually led to the 1997 crisis.4 Ill-advised liberalization was a precondition for the rapid inflow of short-term foreign loans from 1994-97 that financed excessive investment, and for the mass capital flight of late 1997 and 1998 that brought Korea to its knees (Chang et al. 1998, Cho 2000, Lee et al. 2002). As Stiglitz put it: "Many of the problems these countries face today arise not because governments did too much, but because they did too little – and because they themselves had deviated from the policies that had proved so successful over preceding decades" (Wall Street Journal, February 4, 1998). *In the absence of such destructive liberalization, Korea would not have experienced a severe external crisis in*

3 Section VII discusses inefficiencies in the Korean model in the 1990s not associated with excessive liberalization.
4 The elimination of controls on short-term foreign bank loans was the proximate cause of the Korean crisis.

1997 followed by a virtual foreign takeover in 1998.

Those who believe that the deconstruction of the traditional Korean model rather than its innate inefficiency was the primary cause of the crisis of 1997 point to major political developments that significantly reduced the efficiency of state economic guidance in the years prior to 1997. "The problems of the [Korean] development state lie first of all in domestic politics and derive in part from the domestic political consequences of economic success" (Chang and Evans 1999, p. 20). In the late 1980s and, especially, the 1990s, the chaebol grew increasingly powerful politically, in particular based on financial dependence from the government (Lee, 1998); it was becoming unclear as to whether the state controlled the large chaebol or vice-versa. This was extremely destructive because effective state-led growth requires that key government bureaucracies retain their power to impose decisions on private sector agents even when such agents oppose them. The 1990s saw rising external pressure in support of liberalization from the IMF, G7 governments, and multinational firms and banks, who wanted their piece of the Korean 'miracle,' and rising internal pressure from the powerful chaebol and wealthy Korean families, who wanted to pursue their self-interest free of government restraint. There was also a gradual ideological shift towards liberalism among key government bureaucrats. As a result, the government abandoned or weakened economic control mechanisms that were central to the efficiency of the traditional model.5 Chang and Evans argue that "the dismantling of the development state was effectively finished by … 1995" (1999, p. 29).

After the outbreak of crisis, internal and external supporters of neoliberalism used an extreme version of the "inevitable breakdown" thesis to argue that a radical free-market restructuring of Korea was the only rational response.6 Whatever the merits of their position, the outbreak of crisis gave this formidable array of forces the political power to get what they wanted. Elaborately detailed restructuring plans were laid out in a series of IMF agreements with the Korean government (IMF 1997)**.** The ultimate goal was to create a system based on minimal government interference with market incentives and maximum integration with global markets. The fact that no country had ever successfully developed using such a model failed to attract much attention. Freedom of trade and capital flows was a crucial aspect of the project. Portfolio investors around the world would guide the investment decisions and overall strategies of Korean firms and banks through the purchase and sale of stocks and bonds, multinational banks would provide loans only to those firms and households that offered them high profit at low risk, and foreign trade and investment would force domestic enterprise to the frontier of technology and managerial competence.

The core of the IMF program for Korea was the immediate implementation of severely restrictive macro policy, followed quickly by the radical transformation of Korea's traditional industrial, labor-relations, and financial structures into a neoliberal mode, a process intended to take but a few years time. We believe that this 'big-bang' transformation program was not designed to meet the

5 Chang and Evans 1999 stress the fact that an extraordinary large proportion of Korean economists and bureaucrats were trained in conservative, free-market US economic programs. "Neoliberalism established itself as the dominant ideology among Korean elite circles, including the elite bureaucracy, somewhere between the late 1980s and the early 1990s" (p. 26).

6 The standard defense of this position was that the actually existing Korean economy had developed serious problems in the mid-1990s, whereas in pure neoliberal theory, free-market economies are immune from serious economic failures.

economic needs of the majority of the Korean people and could not possibly have done so.

Following on the heels of the crisis of 1997, the imposition of austerity macro policy was certain to trigger an economic collapse. Austerity was justified by the need to restore foreign investor confidence, and thereby limit the extent of capital flight, but this clearly was a smoke screen. The collapse of the won accelerated as soon as these policies were announced.7 When the crisis broke out in late 1997, the appropriate macro policy response would have been expansionary budgets, low interest rates, and the maintenance of a supply of credit adequate to maintain moderate growth in demand. Such a policy would have avoided an economic and financial collapse and, in so doing, reduced investor pressure to flee Korea (Radelet and Sachs 1998, Sachs 1997). This is the typical policy response of developed country governments in such situations, as well as the approach taken by Korean governments in all previous crises.8

Those who imposed austerity macro policy knew at the time of its imposition that it would have disastrous consequences; *they had to know because everyone else did*. Severe criticism of this policy was widespread. A *Business Week* editorial in December 1997 argued that "the medicine Asia is being told to swallow may make it sicker. The IMF demands that Asia cut growth and consumption. But this will hurt consumers, make for lower wages, and penalize the poor rather than the rich" (Dec. 12, 1997). The *Wall Street Journal* reported that Joseph Stiglitz and other "prominent Wall Street economists," were "wondering aloud whether the IMF is prescribing too much austerity" (January 8, 1998). Stiglitz cautioned that "you don't want to push these countries into severe recessions," which was exactly what the IMF programs were designed to do. Jeffrey Sachs attacked the IMF program, calling it "folly" and an "indiscriminate punishment" of Korea. He argued that "the IMF's seal of approval is a seal of doom" (*New York Times*, Dec. 12, 1997). In his view, "the region does not need wanton budget cutting, credit tightening, and emergency bank closures. It needs stable or even slightly expansionary monetary and fiscal policy to counterbalance the decline in foreign loans" (*New York Times*, Nov. 11, 1997). Sachs believed that the IMF was squeezing Korea so that foreign lenders could "leave the field of battle unscathed". "Looking back," he said, "it's hard to imagine that the Korean won could have fallen any further if the IMF had punished the lenders rather than the borrowers" (*New York Times*, January 8, 1998). Paul Krugman suggested that default would have been better than the IMF program: it might "have been better to let South Korea declare a moratorium on foreign debt problems" (*New York Times*, Dec. 18, 1997)

The decision to implement the radical restructuring of Korea's industrial corporations and financial institutions *in the midst of an economic and financial collapse* cannot be justified on economic efficiency grounds. It is impossible to identify and eliminate weak and inefficient firms and banks when almost every firm and bank faces insolvency and the entire price-profit system is in chaos.9

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7 "The IMF programs, rather than inspiring confidence, seem to have accelerated the flight of currency from the region" (Radelet and Sachs 1998, p. 29).

8 Consider, for example, that US Fed Chairman Alan Greenspan slashed interest rates in reaction to the US recession and bank credit crunch of the early 1990s. Paul Krugman observed that "policy makers in Washington and bankers in New York often seem to prescribe for other countries the kind of root-canal economics that we would never tolerate here in the U.S.A." (*New York Times*, July 18, 2001).

9 Worse, dynamic, innovative firms who invest aggressively to take advantage of the latest technologies and new products will be the most vulnerable, since they are most likely to be highly indebted. Keynes made a similar point in

The Samsung Research Institute (SERI) made this point as follows: "In the beginning of 1998, particularly, not only non-viable but also healthy companies went bankrupt due to the excessively high interest rates and banks' efforts to observe the BIS capital adequacy ratio within a short time period, both required by the IMF. This worsened the bad debt problems of banks, and, therefore, increased the cost of handling them" (Two Years after the IMF Bailout, March 2000, p.111).

Without doubt, excessive liberalization and its after effects in the 1990s made the onset of a difficult economic period inevitable. They also created the necessity for a major reform of state-economy relations. Critics of neoliberalism agreed with its supporters that fundamental changes in key institutions and policies were needed. It was the nature of these changes, their form and their timing, that was in dispute. Sensible macro policy could have prevented the financial and economic collapse of 1998, and in so doing, created an environment in which necessary alterations in Korea's economic institutions and practices could have been implemented over an extended period of time without unnecessary transition costs. Prior to the crisis, there was substantial agreement among Koreans that the traditional model needed to be thoroughly democratized, and most Koreans understood that the state-economy nexus needed to be modernized in response to changes brought on by its previous successes -- though there no consensus about the precise form such change should take.10

However, if the neoliberal powers had tried to impose their free-market revolution in more normal times, when it would be much easier to distinguish between well run and poorly run firms and banks, they would have met fierce political resistance from labor, large segments of the Korean people, and even some sectors of the business community. This is *the paradox of neoliberal revolution*: efficient restructuring, whether defined within or outside the neoliberal paradigm, requires a semblance of economic normalcy. But neoliberal policies are so contrary to the perceived interests of the majority of the population, particularly in the years immediately following their implementation, that they are extremely politically unpopular.11 Thus, *neoliberalism cannot be achieved through normal democratic processes in normal economic times*. Only times of crisis and chaos, when a panicked public can be led to believe that failure to accept IMF dictates would be even more disastrous than their implementation, is it possible for neoliberalism to be victorious. Larry Summers, former Secretary of the Treasury, phrased this point in the following way: "Times of financial emergency are time when [outside political] leverage is greatest. Times of financial emergency are often moments when there is the greatest malleability with respect to structural change" (2001). Barry Bosworth agrees: The IMF "used the [Asian] crisis to force these countries to adopt its own agenda" (1998, p. 83). *We argue that the collapse of 1998 brought on by IMF policies was a political precondition for the immediate, radical liberalization of the Korean economy.*

Most Koreans who cast their vote for Kim Dae Jung in the December 1997 presidential

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1928 is a discussion of the restructuring of the struggling Lancashire cotton industry. If the depression in the industry continues for long, he said, "the mills which are financially weaker, though not perhaps technically inefficient, will become bankrupt" (1981, p. 590).

10 . We know of no evidence that the extreme form of neoliberalism backed by the IMF and Kim Dae Jung had significant popular support. Prior to the crisis, most Koreans favored reform, not revolution.

11 The strength of the potential political backlash to the proposal of neoliberal restructuring in "normal" times will depend in part on the performance of the economy in the period leading up to the proposal. It will be weakest where economic performance was abysmal prior to the IMF takeover.

election did so in the hope that he would utilize the opportunity presented by the crisis to reduce the excessive political and economic power of the chaebol and deepen democratic rights. Some were sympathetic to the idea that some increase in liberalization might reduce the economic power of the chaebol. They were later shocked to discover that Kim was an enthusiastic supporter of the whole neoliberal project, including austerity macro policy. However, the public should not have been so easily mislead. Strongly influenced by his American protectors and mentors, Kim had been a fervent neoliberal for at least two decades.12 In a 1985 book titled *Mass-Participatory Economy: a Democratic Alternative for Korea***,** written while in residence in the US, he stated that "maximum reliance on the market is the operating principle of my program" (p. 78) and that "world integration is our historic mission" (p. 34). Kim believed that allowing firms and banks from the most developed nations to enter the country would modernize the Korean economy and destroy the ability of the large chaebol to block necessary economic reforms. Foreign investment, he said in 1999, was essential to the successful restructuring of Korean industry and finance, and would be maximized by the "liberalization of the foreign exchange and capital markets" (KDI 1999, p. 138). "I believe that the crisis will be remembered as a blessing," Kim announced that year, "because it is forcing essential economic changes" (New York Times, Feb. 18, 1999).

Given the great pride Koreans have shown throughout history in their determination to remain independent of outside powers, the absence of significant popular resistance to the IMF takeover of their country and the subsequent rising influence of foreign capital appears to be a puzzle. Its solution is grounded in the knowledge that the outstanding economic development record that constitutes Korea's 'miracle' was achieved at great human cost. First, prior to 1987, the government was both authoritarian and severely repressive; it ruled with an iron fist. Even after that, democratic rights remained quite limited. Second, Korean workers had virtually no standing prior to 1987 and little power thereafter, and their work year was among the longest in the world. The Korean government helped create a dramatic rise in worker incomes after 1961, but severely repressed all attempts by labor to gain significant influence in politics or on the shop floor. Third, female workers were especially over-worked and under-paid. Fourth, the powerful families that controlled the chaebol were, if anything, more fiercely anti-labor and anti-democratic than the government, and their political power was growing.

To explain the passivity of the Korean people in the face of the disastrous series of economic events and political decisions that have taken place since 1997, this ugly underside of the Korean economic 'miracle' must be taken into account. The majority of Koreans hate the insiders who control the great chaebol and consider the excessive economic power of the conglomerates to be the cause of many of Korea's economic ills. They also despise the traditional government power structure, including both economic bureaucrats and political party operatives. This shared set of feelings and beliefs helps explain why no important segment of Korean society, with the important exception of the militant wing of the trade union movement represented by the Korean Confederation of Trade Unions (KCTU), vigorously opposed the disastrous neoliberal economic policies imposed on Korea by the IMF, the US, and other powerful external forces.13 However destructive the effect of these policies, they were

12 Kim's whole-hearted adoption of neoliberalism may be explained by his desire to punish the chaebol and, perhaps, to erase his earlier 'radical' image in the minds of middle-class voters.

13 In private correspondence, Ha-Joon Chang suggests an additional reason why there was little middle-class

politically seductive initially because their stated intent was to break up the chaebol conglomerates, invite giant multinational banks and firms to Korea to destroy chaebol monopoly power, and dramatically reduce the role of government in the economy. Initial popular response to the IMF takeover was conditioned by the ancient but often misleading aphorism that "the enemy of my enemy is my friend."

II. An Overview of the Korean Economy Since the Crisis

Table 1. Major Macroeconomic Indices (%, $ billion)

	93-95	1996	1997	1998	1999	2000
Real GDP growth rate	7.6	6.8	5.0	-6.7	10.7	8.8
Unemployment rate	2.4	2.0	2.6	6.8	6.3	4.1
CPI growth rate	5.4	4.9	4.5	7.5	0.8	2.3
Trade balance	-1.7	-15.0	-3.2	41.6	28.3	16.6
Equipment investment growth rate	14.1	7.3	-8.7	-38.8	36.3	34.3*
Exchange rate (won/$) (end of the year)	790	844	1,415	1,207	1,145	1,259
Government balance / GDP	0.35	0.26	-1.5	-4.2	-2.7	1.05*
Foreign Reserves	23.4	29.4	8.9	48.5	74.1	96.2
Total foreign debts	89.6	163.5	159.2	148.7	137.1	136.6

Source : Bank of Korea, National Accounts, Ministry of Planning and Budget
$ billion for current balance, foreign reserves and total foreign debts
* : expected value

Though Korea had low inflation and its budget was in surplus in the mid-1990s, the IMF demanded that the government immediately implement severely restrictive macro policy, including cutbacks in government spending, an increase in taxes, and a substantial rise in interest rates. The interest rate on three-month corporate bonds, which was 12% in November 1997, rose to 30% in early January in the wake of the IMF agreement.14 The combined effects of the crisis itself, IMF-mandated

resistance to radical restructuring. Large segments of the professional class – for example, lawyers, accountants, managements consultants, financial market analysts, and neoliberal economists – profited handsomely from the new regime.

14 The Organization for Economic Cooperation and Development (OECD) described the IMF macro policy in these terms. "On the monetary policy side, the key objective was to stabilize the exchange rate at a more normal level. This required very high money market rates, which jumped from 12 percent prior to the crisis to 27 percent at the end of 1997," after the IMF agreement. "A more restrictive monetary policy was accompanied by fiscal restraint... The balanced budget objective was maintained even though the growth rate projected under the initial IMF programme was more than halved" -- a projection which turned out to be extraordinarily over-optimistic. "The initial stance of fiscal policy in 1998 was decidedly contractionary," according to the OECD, "thus compounding the effect on

austerity macro policy, and the corporate and financial sector reforms described in sections IV and V depressed domestic demand. These initial problems triggered a Keynesian "multiplier" process that led to further decline. Initial reductions of investment and government spending, along with rising bankruptcies, created increased unemployment and fear of job loss. These developments induced falling real wages and a collapse of consumer confidence that caused a rapid decline in consumption demand. These effects were built into the IMF's policy.

The drop in the pace of economic activity in early 1998 was precipitous. In the first quarter of 1998, gross fixed capital formation and household consumption spending dropped 33% and 12% below their fourth quarter 1997 levels. For the year, fixed investment fell by 22% and consumption by 12%. The official unemployment rate, which had been 2.0% in 1995 and 1996, was still only 2.1% in October 1997. It rose to 3.1% in December, then leapt to 6.5% by March 1998 on its way to over 8% by year's end as the chaebol took advantage of the IMF-imposed labor law revisions to engage in mass firings (Bank of Korea (BOK), Monetary Statistical Bulletin, Sept. 1998, p. 133).

Of course, with domestic demand in free fall, the balance of trade improved dramatically, generating the foreign exchange thought by the IMF to be needed to pay off foreign bank loans and raise investor confidence. Trade in goods was in approximate balance in July through October 1997, then moved into moderate surplus in the last two months of the year as the economy slowed. In the first half of 1998, a $19 billion surplus was created by a collapse of imports. The dollar value of imported goods fell by 36%, or more than $50 billion, in 1998, creating a trade balance of $41.6 billion for the year -- a record 13 percent of GDP. This enormous improvement in the trade balance was the only thing that kept Korean aggregate demand and employment from a total collapse. Real GDP fell only 6.7% for the year, but real final domestic demand fell by 13.8% -- or by 19.6% if we include the decline in inventories (OECD 2000a, p.124).

In 1999 and 2000, South Korea's economy recovered faster than anyone expected. Indeed, Korea became the new poster child for the free-market or neoliberal economic restructuring the IMF is peddling to a suspicious public in the developing world. In early 2000 the IMF touted Korea's "dramatic turnaround" after the crisis. Not only had Korea's output surpassed it pre-crisis value, but, the IMF gleefully proclaimed, but "over the past two years bold policies and a commitment to reform have made Korea a more open, competitive, and market driven economy." (IMF Survey, March 6, 2001, pp. 78 and 80)

It is not hard to assemble evidence in support of the IMF's triumphalist view. Korea's real GDP grew by almost 11% in 1999, and near 9% in 2000. The unemployment rate, which peaked at over 8% in early 1999, temporarily dipped below 4% in 2000. Continued trade surpluses ($28 billion in 1999 and $17 billion in 2000) helped restore the country's production and employment levels.

A closer look at the data, however, suggests that the recent Korean recovery was not as impressive as neoliberals claim. In 2000, three years after the crisis hit, consumption was only 5% above its pre-crisis level. The Korean 'miracle' from 1961-96 was built on high investment, yet real fixed capital investment in 2000 was still 9% lower than in 1997 largely due to the prolonged collapse of the construction industry. Real machinery and equipment spending for the economy as a whole was

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demand of high interest rates" (OECD 1998, pp. 6-7).

41% and 19% below its 1995-97 average in 1998 and 1999, but in 2000 it rose to 8% above the pre-crisis average. However, in 2000 *real equipment investment by large manufacturing firms – the core of Korea's export-led economy – was still 38% below its 1995-97 level* (Korea Development Bank (KDB), 2000). Forecasts call for a sharp drop in all investment categories in 2001. This data raises the serious questions of *whether neoliberalism has permanently shifted the Korean economy from a high to a low investment regime.*

High growth in 1999 and 2000 is attributable to large trade surpluses, the rebound of investment from its collapse in 1998, and a dramatic shift from contractionary to expansionary macro policy after mid-1998. The government ran a budget surplus from 1993 through 1996, but deficits in 1998 and 1999 of 4.2% and 2.7% of GDP. The huge trade surplus was central to the recovery. GDP minus net exports of goods and services in 2000 was still 4% below its 1997 level, and gross national income, which adjusts GDP for losses due to terms of trade and cross-border factor payments, was less than 2% higher. But the trade surplus is shrinking as global growth slows. Exports for July and August 2001 were 20% below the previous year's level (*Chosunilbo*, August 1, 2001), and in August the current account balance turned negative. Moreover, the terms of trade (which depend on export and import prices and the exchange rate) have moved dramatically against Korea; by the fourth quarter of 2000, they had fallen 32% below 1995. This is forcing the country to export ever-larger quantities of goods to pay for any given quantity of imports. The dollar value of exports rose by 41% from 1995 to 2000, but only because the quantity of exported goods rose by 117%. Even if Korea could continue to export its way to acceptable growth rates, which it cannot do, it would make no economic sense to rely on export-led growth in an environment of collapsing terms of trade.15

Significant fiscal stimulus is also not likely to continue. External agencies such as the IMF and the OECD are demanding a return to fiscal and monetary conservatism. In 2000, the Korean government actually ran a budget surplus in excess of one percent of the country's GDP (International Institute of Finance, April 30, 2001), though it shifted into deficit once again in response to the slowdown in early 2001. Since Korea's broadly defined public debt rose from 17% to 39% of GDP in the three years following the crisis, the government may not in position to provide adequate fiscal stimulus program in the coming years.

The recovery appears to have ended in late 2000. GDP growth slowed dramatically in the year's fourth quarter, and was only 3.7% in the first quarter of 2001 and 2.7% in the second quarter. Total fixed investment fell by 3.7% in the opening quarter of 2001 and 7.6% in the second quarter from year-ago levels. Investment in machinery and other equipment, which had been growing rapidly, slowed in the late 2000, then fell at an 8% annual rate in the first quarter of 2001 and at an 11% rate in the second quarter (BOK, National Accounts, BOK website). A survey of the top 400 firms taken in July forecast a decline in investment spending of 9.3% for 2001 (*Chosunilbo*, July 18, 2001), reinforcing concerns about a possible permanent decline in the rate of capital accumulation. Consumption grew at an annual rate of just 0.4% in the first quarter of 2001. The terms of trade continue to deteriorate. Hit hard by the global slowdown and especially by the collapse in US investment in information and communication equipment, Korean exports are expected to fall dramatically in 2001. The

15 . We return to the issue of excessive dependence on exports in section VII.

unemployment rate rose well above 4% in early 2001 before declining in the summer in response to emergency fiscal stimulus. The consensus forecast for real GDP growth in 2001 is between 1.7% and 2.5%, which would be the lowest growth rate in near two decades, 1998 excepted. An editorial in the *Chosunilbo* of June 13 summed up Korean economic prospects as of mid 2001 quite nicely: "our economy is unstable, uncertain, and more than a little off track."

Meanwhile, Korea, a country fiercely proud of its tradition of social solidarity, is discovering that there are no exceptions to the iron rule that neoliberalism generates rising inequality everywhere. Not only was real household income in mid-2000 still below its 1997 value, but the Gini coefficient, which equaled .28 in 1997, reached .32 three years later, and the ratio of the income of the highest quintile of households to that of the lowest quintile rose by 16 percent from 1997 to 2000. Table 2 shows that real labor income for the top 20 percent of urban households, after standing still in 1998, increased substantially in 1999 and 2000, ending up 12.5% above its pre-crisis level. The majority of households fared worse, with the incomes of the bottom 40% declining significantly. The poorest fifth suffered income losses relative to 1997 of 17%, 13%, and 5% in 1998,1999 and 2000. Not surprisingly, poverty has also worsened since the crisis. The household poverty rate, which stood at 5% in 1996, more than tripled by 1999 (Park, 1999).

Table 2. Trends in Income for Different Income Groups (Won, %)

	1997	1998	1999	2000	Rate of Change (1997-2000)
Top 20%	4,254,829	4,243,950	4,475,049	4,786,279	12.5%
60-80%	2,653,761	2,440,219	2,541,984	2,704,911	1.9 %
40-60%	2,028,062	1,827,226	1,885,134	2,029,242	0 %
20-40%	1,551,587	1,368,326	1,404,109	1,512,804	-2.6 %
Bottom 20%	947,097	784,086	815,551	899,183	-5.1 %

Source: National Statistical Office (NSO) web page, recalculated on the basis of KOSIS data.

III. Restructuring Labor

Policy

In January 1998, the main obstacle to the IMF-Kim plan to create a neoliberal capitalism in Korea was a militant labor movement whose power was sustained in part by 'rigid' labor laws and the permanent full employment achieved under the traditional model. Breaking the labor movement thus became a central IMF-Kim policy goal.

With the election of President Kim and the IMF take-over of the economy in December 1997, the labor movement found itself under fierce attack on several flanks. The large chaebol believed that the biggest obstacle to their development as world-class multinationals was not intense foreign competition or weak global markets or crushing debt burdens, but the excessive power of Korean unions and their inability to fire workers as they pleased. An important leader of the main chaebol trade organization told one of the authors in March 1998 that Korean big business actually supported the

draconian IMF agreement (though there were some provisions they disliked) because, while chaebol efforts to weaken the labor movement in the last decade had been unsuccessful, the IMF agreement would finally bring the union movement to heel. (See Crotty and Dymski 1998b).16 Chaebol firms wanted to layoff large numbers of workers to avoid bankruptcy and gain complete control on the shop floor.

President-elect Kim was determined to raise competitive pressure on chaebol firms through massive foreign investment. Foreign firms were certainly willing to cooperate, but they were hesitant to take control of Korean businesses as long as workers remained committed to militant unionism and opposed to labor flexibility. The defeat of labor was understood to be a precondition for large-scale FDI.

In 1996, in an illegal meeting held without the knowledge of opposition parties, the legislature dramatically changed Korea's traditional labor laws, creating greater 'flexibility' with respect to layoffs. Workers responded with a general strike in January 1997, which forced the government to modify these laws and postpone their implementation for several years. Capital-labor conflict over the flexibility issue was thus at a temporary standoff in 1997. This changed dramatically in early 1998 as labor received two severe blows.

First, the IMF austerity policy sent an already weak economy into free-fall. The number of unemployed tripled from 1997 to mid 1998 in an economy in which permanent full employment had been taken for granted.17 The sudden, unexpected creation of a "reserve army" of unemployed terrified most workers and disoriented union leaders.

In the election campaign, Kim Dae-Jung strongly opposed mass layoffs in response to the crisis. He argued that layoffs should be minimized in favor of reduced hours and lower wages – the union position. He promised that, if elected, he would renegotiate a better deal with the IMF. However, upon becoming president he immediately accepted the existing IMF deal. "During the campaign, Mr. Kim attacked the I.M.F. agreement, in part because it would lead to takeovers of Korean firms… But on Dec.19, the day after he was elected, Mr. Kim embraced the IMF plan: 'I will boldly open the market. I will make it so that foreign investors can invest with confidence'" (*New York Times*, Dec. 27, 1997, 1). In late December, 10,000 KCTU members attended a meeting in Seoul to protest President-elect Kim's rejection of his campaign pledge to ban mass layoffs: "We workers are deeply disappointed and feel betrayed by President-elect Kim" a KCTU leader told the crowd" (*Korea Herald*, Dec. 27, 1997).

The December 17, 1997 issue of the *Korea Herald* reports that the Minister of Labor predicted a doubling of unemployment from its already high level, and quotes a consensus forecast by private-sector economists that unemployment would triple to over two million. The January 17, 1998 edition of the *New York Times* predicted that Korean unemployment would reach 10%. The January 18 edition of the *New York* Times reported that President Kim acknowledged the "feared mass layoffs included in the harsh IMF conditions," but argued that they "must come as soon as possible," because "without layoffs, foreign investors would not come into the country." Kim "had no word of comfort" for

16 The *Korea Herald* of December 19, 1997 reported that the Federation of Korean Industries, the major chaebol trade association, "stressed the need for the new President's faithful implementation of the IMF terms…."
17 The rate of unemployment was 2.1% in October 1997, but rose to 8.6% by February 1999.

Korean workers who feared the employment disaster. In the first week in January, the *Korea Herald* quoted Kim as saying that "mass redundancies should go ahead because without them, foreign investors will not come to Korea" (Jan. 7, 1998). A headline in the *Korea Herald* of January 9, 1998 reflected the position of the chaebol: "Employers Call for Expansion of Massive Layoff Plan." In February, *Business* Week ran a story on Korea titled "Sky-high interest rates could crush the whole economy" (Feb. 16, 1998, 54). *We stress the fact that everyone knew in advance that the IMF's austerity macro policy would cause a dramatic rise in unemployment because it supports our thesis that mass unemployment was an essential part of the restructuring plan.* Without it, union power could not be broken, the chaebol could not be forced to restructure, and there would be no boom in foreign investment.

Second, with labor reeling from the explosion of job insecurity, the IMF, with the enthusiastic support of Korea's most powerful business leaders, demanded that the government immediately repeal the traditional labor laws, as its agreement specified.18 Labor flexibility would allow the chaebol to slash costs through mass layoffs and would weaken their unions. Downsizing plus weak unions would then establish conditions necessary for a substantial rise in inward FDI. According to the KCTU:

> "Labour market flexibility" has been the central agenda of the Korean government and business since the early 1990s. The economic crisis of 1997-98 provided the environment for the state and capital to pursue the neoliberal agenda without hindrance. (KCTU 2001, p. 34)

The government's official explanation of its restructuring policies stressed the need for greater labor flexibility.

> Increasing flexibility in the labor market is necessary to solve Korea's current unemployment problem and revitalize its economy. Once greater flexibility is attained, companies will regain competitiveness and foreign investment will increase, invigorating the Korean economy and creating jobs. (KDI 1999, p. 115)

The Kim government took the public position that, since great sacrifice would be required by all Koreans in this time of national crisis, tough decisions should be arrived at by consensus. Toward this end, it created a "tripartite committee" in January 1998, consisting of representatives of labor, management, and government. Some labor leaders, especially those from the conservative, government-allied Federation of Korean Trade Unions (FKTU), were flattered just to be allowed for the first time to be present as representatives of the state and capital made economic policy. Representatives of capital, the state, and the FKTU pressured delegates from the more militant and independent Korean Confederation of Trade Unions to agree to the labor law changes, arguing that the crisis made their passage inevitable, and that concessions (such as granting permission for union officials to run for public office, and giving teachers and government workers the right to unionize), could be extracted in the

18 The initial agreement was kept secret; a domestic newspaper, the Chosunilbo, reported its contents on December 8, 1997.

context of the tripartite committee.19 KCTU representatives eventually conceded, giving President Kim a huge domestic and international public relations victory. Rank and file KCTU members were furious with what they saw as a sellout of their interests. The KCTU immediately "reneged on its leaders initial approval of the pact, after a majority of member unions rejected it" (*Wall Street Journal*, Feb. 11, 1998). They insisted that all aspects of restructuring, including those affecting the financial and public sectors, be included in tripartite decisions, and that labor representatives be given real, not just symbolic, influence. When the government refused their demands, the KCTU withdrew from the committee and tried to organize general strikes in the May-June period.20

The new capital-friendly labor laws were enacted in February 1998. For the first time in modern Korean history, firms were allowed to fire as many workers as they pleased in cases declared to be of "urgent managerial need" – which included all mergers and acquisitions. The layoff system adopted in 1998 was even more generous to management than the one outlined in the illegal 1996 revisions. Moreover, temporary help agencies became legal after July 1998. By the end of the year, 789 such agencies had been established, employing a total of 42,000 temporary workers, who were allowed to join firms for up to 2 years and could be used in all occupations. (KDI, 1999).

The government acknowledged that restructuring would significantly raise unemployment and the incidence of poverty over the next few years, and indeed that workers' economic insecurity would remain high even after the new economic model was fully in place. The tradition whereby large firms offered lifetime employment to their key employees was out; from now on all workers could expect to hold a series of different jobs, with bouts of unemployment in between. In January 1998, President-elect Kim argued that, given the mass unemployment that would inevitably follow austerity macro policy, "we have no option but [to pledge] to install a US-style safety net in the form of unemployment insurance and retraining programs" (*New York Times*, Jan. 18, 98).21 Social spending did increase substantially after the crisis. Firms that retained redundant workers were given modest subsidies in 1998 and 1999. Vocational training was expanded: in 1998 some 340,000 unemployed received help. Measures to strengthen job placement were improved. The existing Employment Insurance System was extended to cover small firms. Temporary and part-time workers received some benefits starting in October 1998. The minimum contribution period to qualify for benefits was shortened to 5 months from 1 year. By 1999, 70% of all employees were included in the employment insurance scheme. The government also substantially increased public works spending.

Unfortunately, the level of income protection for most workers is still woefully inadequate. An 2000 OECD report on Korean labor and welfare policies reported that only one in nine unemployed workers receive unemployment benefits, such benefits amount to but 50% of the previous wage, and the maximum duration of benefits is three to eight months. Moreover, only a quarter of those of retirement age receive a pension of any kind, while the average pension is about two to three US dollars per day

19 Though President Kim got the agreement he wanted, the government never fulfilled its commitments to labor.
20 The KCTU charged that the Tripartite Commission was "never contemplated by the government as a forum empowered to set the basic framework for restructuring… [but rather] as a convenient excuse for the government to avoid and deny direct negotiation and consultation between the government and trade unions" (KCTU, Report to ILO, p. 33).
21 See the Comprehensive Employment Policy announced by the government, on March 26, 1998. For greater detail, see KDI 1999, pp. 120-128.

(Adema, Tergeist and Torres, 2000).

Total public spending on all such programs including unemployment insurance was 3.7 trillion won in 1996 and 4.2 trillion in 1997, but rose to 5.6 trillion in 2000 (KDI 1999, OECD 1999). However, the government will never be able to create a welfare system generous enough to assure economic security to all Koreans in the wake of neoliberal restructuring, even if that really is President Kim's intention. Given the enormous cost of such a system and the ever-tighter constraint on government budgets, this promise cannot be kept. Total social welfare spending as a percent of GDP did rise after the crisis – from 5.5% of GDP in 1995 and 6.8% in 1997 to over 7.5% in 1999 – as unemployment, poverty, and homelessness increased (Koh, 1999; NSO website) Even under these dire circumstances, however, Korea's welfare spending came nowhere near the US level of 15% of GDP, never mind Western European levels well in excess of 20% of GDP (Martin and Torres, 2000).

Results

Table 3 presents a number of important indices of labor market performance in the period following the crisis. Unemployment soared in 1998, peaked in early 1999 at 8.6% of the workforce, then fell to under 4% in 2000, before rising above 4% again late in the year. If the increase in those unemployed is added to the number of workers who dropped out of the workforce between 1997 and 1999, we get a total more than six times the number unemployed in 1997 (KCTU 2001, p.34). In the face of rapidly rising unemployment, real wages fell by 10% in 1998, and though they increased significantly in 1999 and modestly (by Korean standards) in 2000, their growth rate in these years was well below the rate of growth of productivity -- which was spectacular in 1999. With real wages rising more slowly than productivity, labor's share of national income fell from 62.8% in 1997 to 61.3% in 1998 and 59.8% in 1999 (BOK, National Accounts). Since the wage data in Table 3 cover only permanent workers employed in workplaces with more than 10 workers, and do not include the large bonuses traditionally paid to permanent employees, it is probably biased upward.

Table 3. Major labor markets indices (all sectors) (%)

	91	92	93	94	95	96	97	98	99	00
Labor force participation rate	60.6	60.9	61.1	61.7	61.9	62.0	62.2	60.7	60.5	60.7
Unemployment Rate	2.3	2.4	2.8	2.4	2.0	2.0	2.6	6.8	6.3	4.1
Productivity growth	13.8	11.1	8.8	9.4	10.3	12.5	14.9	11.8	15.9	10.7
Real Wage growth	8.2	9.0	7.4	6.4	6.7	7.0	2.5	-10.0	11.2	5.7

Source: Ministry of Finance and Economy, National Statistical Office.

In Korea, "permanent" workers have employment contracts for more than one 1 year; "temporary" workers have contracts between one month and one year, and "daily" workers have contracts for less than one month. Non-permanent workers receive on average about 60% of the wages and few of the benefits associated with regular employment. Even prior to the crisis, Korea was the only OECD country with near half (46%) of those who worked for a non-family member in the insecure and poorly treated status called non-regular or non-permanent. (OECD 2000a, p. 174, Martin and Torres 2000). No other country had anywhere near Korea's proportion of irregular workers. Thus, there was significant 'flexibility' in Korea's total workforce before the crisis, if not in the union strongholds in many large-chaebol firms. Indeed, until the early 1990s, many economists considered the substantial degree of labor flexibility in Korea and other East Asian countries to be one reason for their 'miracle' performance.

Table 4 shows the impact of the IMF-Kim policies on work status. From 1992 to 1996, between 57% and 59% of Korean workers had permanent status. But in the context of collapsing sales in 1998, the chaebol were able to take immediate advantage of the new laws by firing large numbers of permanent workers in 1998 and early 1999, then hiring mostly cheaper, non-union, temporary workers when demand improved in 1999 and 2000. Their actions pushed the percent of permanent workers down to just above 48% in 1999 and just below 48% in 2000.22 70% of female employees had irregular status in 2000, compared to 57% in 1995.23 Crisis and restructuring cut about nine percentage points from the permanent worker category – already the lowest in the OECD, spreading job insecurity ever more widely. The combination of high unemployment, the shift toward non-permanent work, and wage cuts in 1998 badly mauled family incomes, as we saw in Table 2.

Table 4. Labor market structure (%)

	91	92	93	94	95	96	97	98	99	00
Permanent workers	55.2	57.0	58.8	57.9	58.1	56.7	54.1	53.0	48.4	47.6
Temporary workers	28.7	27.7	26.6	27.8	27.7	29.5	31.6	32.8	33.4	34.3
Daily	16.1	15.3	14.6	14.4	14.2	13.8	14.3	14.2	18.3	18.1

Source: National Statistical Office, Survey on employment trend, Monthly report on economically active population survey.

Moreover, Koreans have traditionally worked very long hours. In 1999, the Korean manufacturing work year totaled 2760 hours, second in the OECD only to Turkey. The manufacturing workweek, at 50 hours in 1999, was seventh longest among the 75 countries covered by International

22 The OECD reports that in 1999 "less than 30% of workers had a permanent (i.e., open-ended) contract … the lowest number [sic] of workers holding a permanent job in the OECD" (Adema, Tergeist and Torres 2000).
23 Women suffer multiple forms of employment discrimination. About 70% of working women are employed at establishments with 5 or fewer workers; they receive on average about 63% of male wages. (KCTU 2001, p. 38)

Labor Organization data (ILO 1999).24 It is quite surprising that the collapse in 1998 brought almost no reduction in hours (see Table 5) even though the labor movement demanded that workers be allowed to share the pain of the crisis through reduced hours rather than high unemployment. The economic rebound in 1999 obviously brought no relief, as hours worked met or exceeded their decade highs.

Table 5. Work week in Korea (hours)

Year	91	92	93	94	95	96	97	98	99	00
All	47.9	47.5	47.5	47.4	47.7	47.3	46.7	45.9	47.9	47.5
Manufacturing	49.3	48.7	48.9	48.7	49.2	48.4	47.8	46.1	50.0	49.3

Source: Ministry of Labor of Korea, Report on monthly statistics of labor

The KCTU tried again and again to organize resistance to anti-labor restructuring policies. Table 6 shows that after 1997, several indices of strike activity rose significantly above their levels in the mid 1990s. But it faced several strong roadblocks. The country was in near depression conditions in 1998 and the labor movement was split – between the militant KCTU and the conservative FKTU, and between the highly unionized permanent workforce and the ever-increasing numbers of hard-to-organize non-permanent workers. The media was solidly against them, the middle class feared that labor struggles would worsen the crisis, and the student movement was all but dead. In addition, Korea's harsh labor laws, which prohibit industrial unions, made it very difficult to organize coordinated strikes. For these reasons, the KCTU's heroic efforts to organize effective mass resistance to neoliberal restructuring since 1998 have, to this point, been a failure.

To make matters worse, President Kim responded to serious labor activism in the same general fashion as his military predecessors, though with less physical brutality. The KCTU made it clear that their main post-crisis goal was to "end neoliberal structural adjustment," and President Kim made it clear that no social force will be allowed to stand in the way of the restructuring agreement he made with the IMF (KCTU web site, July 1, 2001). Strikes against mass layoffs or restructuring are always declared to be illegal, immediately trigger arrest warrants for key union leaders, and often unleash brutal police repression against strikers. For example, over 60 leaders of the Seoul Subway Union were arrested in their strike in April 1999. In April 2001, police attacked union members demanding access to their office at a Daewoo Motor factory. Even the conservative *Korea Times* deplored the scenes of "bloodied unionists being viciously attacked by riot police," and the conservative opposition political party called for the resignation of the government's Prime Minister (April 17, 2001). When the KCTU organized a coordinated series of strikes in June 2001 that affected 50,000 workers, the government ordered the arrest of most KCTU leaders, including Chairman Dan Byong-Ho, and riot police assaulted strikers, often viciously. The *Korea Herald* lectured President Kim: "The government should stop

24 The countries with greater work hours per week than Korea were all relatively poor: Jordan (58.3 in 1995), Egypt (57 in 1996), Sudan (56.1 in 1992), Srilanka (54.7 in 1998), Makau (51.8 in 1998), and Turkey (51.2 in 1998) (ILO, 1999). The *New York Times* of June 10, 2001 reported that the Korean workweek, at 55.1 hours, was the longest of 31 countries surveyed. For comparison, both China and the US have workweeks of 42.4 hours.

regarding striking workers as targets of suppression…; it was not pleasing to see the government mobilize the police as soon as requested by businesses to do so" (June 11, 2001). President Kim attacked the KCTU, arguing that "illegal and violent strikes would certainly scare away foreign investors": "foreign confidence in the country will rise [only] if more flexibility is guaranteed in the labor market" (*Korea Herald*, June 12, 2001). Addressing a mass rally, KCTU Chairman Dan declared that "the Kim Dae-Jung administration is bent on the unprecedented oppression of labor" (*Korea Times*, June 17, 2001). As of July 12, 168 workers had been arrested in 2001, almost 50% more than in all of 2000 (KCTU web site).

Table 6. Indices of industrial relations

	91	92	93	94	95	96	97	98	99	00
Unionists	1803	1735	1667	1659	1615	1599	1484	1402	1480	--
Org. rate	15.8	14.9	14.1	13.5	12.6	12.2	11.2	11.5	11.8	--
Strikes	234	235	144	121	88	85	78	129	198	238
Participants	175	105	109	104	50	79	44	146	92	162
Days lost	3271	1528	1308	1484	393	893	445	1452	1366	--
Arrested	515	275	46	161	170	95	35	217	116	106

(Unionists, participants : 1000 people, lost days: 1000 days)
Source: Ministry of Labor, KCTU

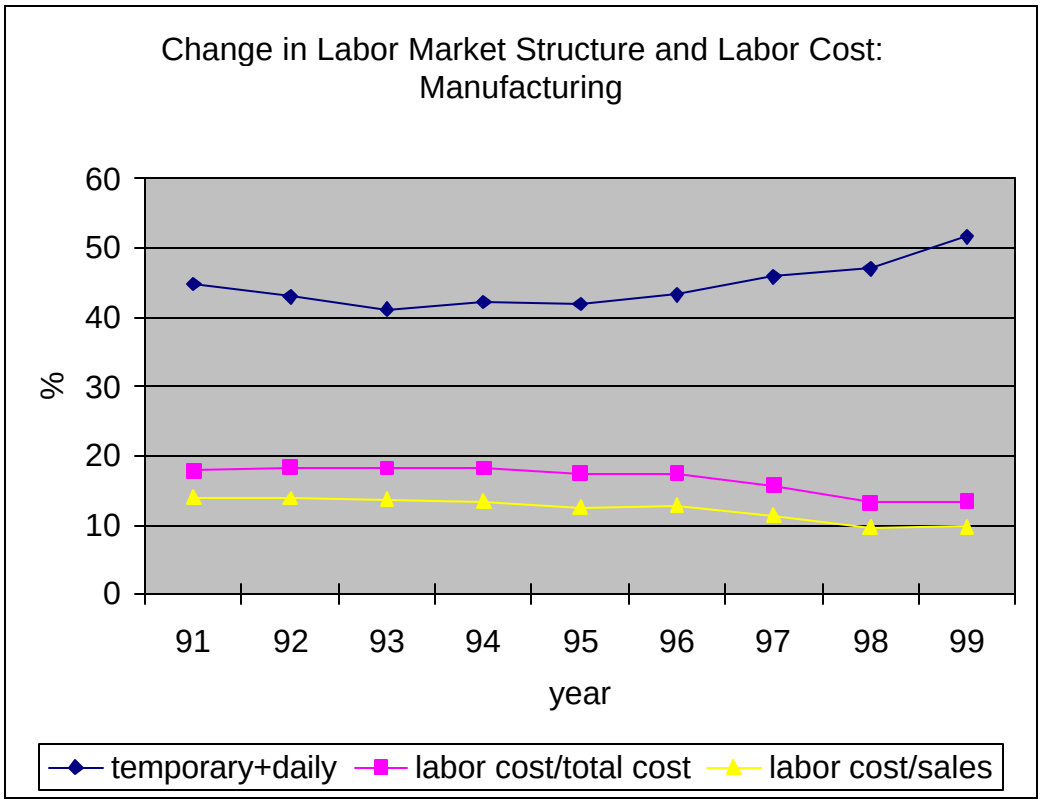
On June 5, 2001, the KCTU submitted a formal complaint to the International Labor Organization charging the Kim government with serious violations of the fundamental rights of Korea's workers. "The Kim Dae Jung regime has created an ideological climate in which 'restructuring' is accepted as an "absolute good," it argues; "the struggles and efforts of workers in response to issues of restructuring are branded as sabotage of the 'national effort to overcome economic crisis'" (KCTU web site). The indictment continues: "The natural extension of 'labour exclusion' inherent in the neoliberal regime is repression. The Nobel Peace Award Laureate President Kim Dae Jung is thus blemished by the fact that a greater number of trade unionists are imprisoned under his regime in three and a half years in office than during the five years of the previous government". In July the KCTU called for "the resignation of the Kim Dae Jung regime responsible for the destruction of people's lives, misdirected reform, and environmental degradation" (KCTU website, July 1, 2001). In response to constant government harassment of unionists, Amnesty International urged "the government of President Kim Dae-Jung not to arrest trade unionists for legitimate trade union activities" (April 22, 1999 statement; KCTU website). The OECD seems in general agreement with the KCTU's assessment of government-labor relations. "Arresting and imprisoning workers for what might be considered legitimate trade union practices is back in vogue, a matter of considerable concern both at the OECD and the International Labor Organization. The arrests are …a threat to the exercise of fundamental workers' rights" (Adema, Tergeist and Torres, 2000).

From the perspective of capital and the state, labor market restructuring has been quite

successful, though they will not be fully satisfied until there is unlimited labor flexibility. Large chaebol firms have cut employment, substituted non-regular, non-union workers for permanent workers, and raised productivity significantly. As Chart 1 shows, after1996 labor cost as a percent of total cost and of sales revenue in the manufacturing sector declined significantly. The union movement has been badly weakened, though it is not yet broken – strike and protest activity increased in the spring and summer of 2001. After hesitating in 1998 to see whether the Kim government and the chaebol would make good on their promise to tame Korea's unions, foreign capital poured into Korea in 1999 and 2000. Korea is now seen as a country where capital has the upper hand, not only in politics, as is traditional, but in the work place as well. None of these results would have been possible in the absence of both the crisis of 1997 and the mass unemployment of 1998-99.

Conversely, labor restructuring has taken a terrible toll on Korean workers. Unions represent fewer workers (see Table 6) and are unable to adequately protect their members' economic interests. Labor today, even more than in 1997, is an object to be manipulated and bullied by capital and the state rather than an active stakeholder in Korea's economic and political system. The permanent full employment achieved by the traditional Korean model has been replaced by a regime of higher average unemployment with pronounced instability. Job insecurity has increased qualitatively because of higher joblessness and the ongoing shift from permanent to irregular status.

Chart 1



Source: Bank of Korea, National Statistical Office

IV. Restructuring Nonfinancial Corporations

Policy

In January 1998 the incoming Kim government announced five principles of corporate restructuring whose stated purpose was to break the traditional dominance of the large chaebol conglomerates, introduce greater competitive pressure on chaebol firms, and raise productive efficiency. They were: improved transparency; the end of cross-debt guarantees by conglomerate firms; a drastic and immediate reduction of corporate leverage; chaebol concentration on core businesses; and, in an attempt to weaken founding family control and move toward global shareholder capitalism, greater managerial accountability to minority shareholders. Other objectives added in 1999 included reduced chaebol influence on financial markets and lower cross-shareholding among chaebol firms. Chaebol were to be transformed into more specialized businesses, with efficient corporate governance, and much lower leverage, ultimately monitored and controlled by capital markets.25

The top chaebol had long dominated Korea's economy. The value added by the largest 30 chaebol was 16.2% of Korean GDP and they accounted for 41% of manufacturing value added in 1995. They also had gained immense political power, especially in the Kim Young Sam administration that governed from 1992 to 1997. President Kim Dae Jung's attack on the hated chaebol through restructuring was extremely popular with the Korean people, earning him approval ratings of 80% in 1998 even in the face of an economic disaster.

By virtue of the public monies it injected into the financial system after 1997 to prevent its collapse, the government soon controlled most large banks. It designated one or two banks as lead or main creditor banks for each large chaebol. Lead banks were to monitor chaebol activity, control their access to credit, and regulate the use to which credit was put. The government was thus in position to attempt to force structural change on the chaebol. From February to April 1998, 57 heavily indebted chaebol affiliates signed agreements with creditor banks in which they pledged to cut their debt-equity ratios to 200% by the end of 1999, restructure their businesses, and cede veto power over investment spending to the banks (SERI 2000, p. 58). The government pressured the top 5 chaebol to drastically reduce their degree of diversification by swapping lines of business across groups through a policy know as "big deals" or "big swaps." It even selected the firms that were to be exchanged among them. Electronics, auto, railway vehicle manufacture, electricity generation equipment, airplane parts and components, semiconductor and petrochemicals firms were involved.26 These swaps, announced in July 1998, were to be enforced by lead banks, which threatened to cut off credit to groups that would

25 Korea has many large publicly owned firms, some of which are of world-class caliber. In mid 1998, reflecting its belief that only markets can induce efficiency, the government announced plans to privatize 72 out of 108 such firms, inviting foreign firms to play a leading role in this process.

26 The "big swaps" policy was not a success. Deals in electronics, autos and petrochemicals collapsed, and companies in industries where they were carried out are currently in trouble.

not cooperate. In the end, restructuring via mergers and takeovers were completed in semiconductors, oil refining, aerospace and railway vehicles.

The government ordered chaebol-wide financial statements to increase transparency, and required firms to give as many as half of all seats on the Board of Directors to outsiders to reduce insider control over chaebol decisions. Measures to increase the power of capital markets to control chaebol decision-making were introduced. For example, tight restrictions against M&As were scrapped, hostile takeovers by foreign firms was permitted for the first time, and bank and investment trust companies (except those owned by large chaebol) were permitted to vote the shares they held. Minority shareholders' rights were strengthened. Companies were also pressured to make high stock prices, not fast growth or rising market share, their main management objective.

Creditor banks maintained tight control over many of Korea's largest firms throughout the restructuring process, and the government kept tight control over the main banks; in each case, the mechanism of control was the threat of bankruptcy. Threats of credit cutoffs were not idle. In June 1998, creditor banks pulled the plug on 55 firms, including 20 firms in the top five 5 chaebol, and 23 companies in the top 6-30 chaebol. After July 1998, twenty smaller chaebol went bankrupt. In mid-1999, in a move designed to show that no chaebol was "too big to fail," Daewoo, the third largest chaebol, was forced into bankruptcy, an event that crippled the bond market. In November 2000, the government ordered the banks to close down 52 more companies.

The restructuring process thus reflects the following paradox. In order to achieve its goal of transforming Korea into a free-market economy, the government took direct control of the financial system and used the power this gave it to dictate restructuring policy to the largest nonfinancial corporations. Though President Kim and the IMF espoused the general position that the state was inherently incapable of efficient economic intervention in the current era, *their actions reflect the counter thesis that restructuring is too complex and too important to be left to market forces.* Both the IMF and President Kim called upon the state to accomplish this extraordinarily difficult task.

Results

The government's restructuring policy has had some success. The top 30 chaebol reduced their average debt-equity ratio. It was 3.9 in 1996; leapt to 5.2 in 1997 as the crisis began, then fell back to 3.8 in 1998. President Kim's policy hit hard in 1999 as the leverage ratio dropped to 2.2. But 7 of the 30 either went bankrupt or dropped from top 30 ranking that year; debt-equity for the remaining 23 was only 1.6, rising to 1.7 in 2000. Using a moving sample containing whichever firms were in the top 30 chaebol in each year yields the same degree of leverage decline. This appears to be a great triumph for the government.

Though debt levels did fall after 1997, most of the decline in chaebol debt-equity ratios came about because the denominator rose, through new stock issues, asset sales, and asset revaluations.27 New issues on the Korean Stock Exchange in 1997 were only 3 trillion won, but this rose to 13.5 trillion in 1998 and 33.5 trillion in 1999. (SERI 2000, p. 66, Jang 1999). Whereas the debt of the top 30 chaebol fell by 26% in the two years following the onset of crisis in December 1997, the value of

27 Korean law allows firms to revalue assets such as real estate to reflect current market price.

equity rose by 125%. Top-30 chaebol debt stood at 219 trillion won in 1995 and 276 trillion won in 1996. In 2000, the top 30 chaebol had debts of 265 trillion won, significantly more in nominal terms than in 1995 and slightly less than in 1996. Combined financial statements for the top chaebol constructed in mid 2001 using the more rigorous accounting standards required by the Financial Supervisory Commission showed that "almost all the top chaebol with the exception of the Samsung and Lotte groups show their respective debt-to-equity ratios rising sharply" in the fiscal year ending on March 31, 2001.28 For example, Hyundai's debt-equity ratio jumped from 230% in 1999 to 478% in 2000, while LG rose from 273% to 309% (*Korea Herald*, July 2, 2001*).* An examination of the broad nonfinancial corporate sector shows that total debt in 2000 was 23% higher than in 1996, and less than 4% lower than in 1997, its peak year.

Since, on average, corporate debt levels have not experienced a major decline, interest burdens remain high even as interest rates have fallen**.** For all manufacturing firms, net financial costs as a percent of sales, which averaged 4.2% from 1993-96, rose to 4.9%in 1997, before hitting 6.7% in 1998. The debt burden remained high at 5.4% in 1999, before dropping back to 3.8% in 2000. But all this does is restore the pre-crisis average – no long-term improvement has taken place. In 2000, 29% of manufacturing firms had interest coverage ratios less than one, an 8.1 percentage point rise from a year earlier, an indication that all was not well (*Korea Herald*, July 21, 2001*)*. Deteriorating economic conditions in 2001 have likely pushed this ratio much higher. Many firms may have trouble this year rolling over the large volume of three-year bonds they floated in 1998. For example, in May 2001 the government pressured the main creditor banks of Hynix Semiconductor (formerly Hyundai Electronics), the world's second largest producer of semiconductor chips, to provide the firm with trillions of won in new financing to prevent its collapse. A key element of the rescue operation was pressure on Korea investment firms to "extend the payments for 680 billion won worth of Hynix bonds that mature next year" (*New York Times*, May 9, 2001, A23).29

Profit data paint a similarly disappointing picture. Contrary to conventional wisdom, which asserts that Korean firms sacrifice growth for profits, they have always had gross profit rates as high as firms in other countries. For example, from 1990 through 1995, Korean manufacturing firms' operating profit as a percent of sales averaged 7.1%. By this measure, Korean firms' profit share was higher than US firms' share in every one of these years, and higher than Taiwan's in five of the six years (BOK, Financial Statement Analysis, 1997, Chang and Park 1999). But high leverage, though essential for Korea's fast-paced investment and rapid productivity growth, kept ordinary profitability low. Ordinary profit as a percent of sales for the top 30 chaebol traditionally measured two to four percent. The collapse in key export markets in 1996 drove this ratio to 0.2%, and the onset of crisis in 1997 dropped it to minus 0.8%. In the collapse and high interest rates of 1998, net profits were minus 4.5% of sales, but in 1999 the figure rose to 2.5% if we count only the 23 conglomerates that remained in the top 30 from the previous year. If we include the seven new firms added to fill out the top 30 in 1999,

28 The sharp rise in debt brought out by the combined financial statement, which covers all affiliated firms, suggests that pre-crisis leverage may have been higher than previously thought.

29 The US government strongly protested the government's rescue operation. "U.S. lawmakers have already pressured the U.S. Trade Representative to bring a case against South Korea in relation to Hynix, arguing that its financial support violates World Trade Organization rules" (NY Times, 5\9\01).

the net profit figure was a negative 3.4%. In 2000 top 30 chaebol ordinary profits fell to 0.5% of sales as the economy soured late in the year (Fair Trade Commission 2001).30

As Table 7 indicates, ordinary profit as a percent of sales in manufacturing was satisfactory by Korean standards in 1994 and 1995, fell to 1.0% in the global export slowdown of 1996, then fell again to minus 0.3% and minus 1.8% in 1997 and 1998. 1999 saw a slight rebound to 1.7%, and profitability rose substantially in the first half of 2000. But firms ran up against the sharp drop in the growth rate later in the year, which lowered the annual rate to 1.3%. However, if we exclude Samsung Electronics, whose profits soared with the semiconductor boom of 2000, *the rest of manufacturing posted only a 0.8% ordinary profit share of sales in 1999 and suffered a negative 0.2% share in 2000* (BOK, Financial Statement Analysis, 2001). The recent global downturn in ITC investment has now battered Samsung Electronics; it is expected to have operating losses in the third quarter of 2001 – a development that is "unprecedented for the firm" (*Chosun Ilbo*, Sept. 26, 2001).

Clearly, restructuring has yet to restore even normal profit levels in Korean industry, never mind create a new high-profit regime.

Table 7. Profitability and debt of manufacturing sector (%)

	94	95	96	97	98	99	00
Operating profit/sales	7.65	8.33	6.54	8.24	6.11	6.62	7.4
Ordinary profit/sales	2.74	3.59	0.98	-0.33	-1.84	1.68	1.3
Net financial costs/sales	--	--	4.3	4.9	6.7	5.4	3.8
Debt ratio	302.5	286.7	317.1	396.3	303.0	214.7	210.6

Source: Bank of Korea, Financial Statement Analysis

Substantial progress appears to have been made in the attempt to shift Korea's corporate capital structure away from its traditional reliance on debt. Whereas firms used to rely heavily on external funds to finance their ambitious investment programs, this practice seemed to change dramatically in 1999.31 Table 8 presents data on the sources of finance for manufacturing equipment investment. They show that in 1999 and 2000 about two thirds of equipment finance was supplied by internal funds. If this change reflected a permanent new pattern of investment finance, the implications for restructuring would be far reaching. One of the most profound weaknesses in the neoliberal plan to convert Korea from a state-guided, bank-based model to a

30 Ordinary profit is defined as operating profit plus the non-operating balance. Financial costs such as interest payments are the most important component of the non-operating balance; when leverage rates and/or interest rates are high, ordinary profit will be much lower than operating profit.

31 Net saving as a percent of internal funds fell dramatically in the crisis and the restructuring period. In 1995 depreciation expense was 71% of net saving; it rose to 83% in 1997, 140% in 1998 and 106% in 1999. Firms are living off their fat, relying on tax savings from depreciation provided by high investment rates in the mid 1990s (BOK 2000).

Table 8. Financing of equipment investment in manufacturing (%)

	81-85	86-90	91-95	96	97	98	99	00
External financing	62.8	66.5	70.4	75.6	76.0	66.4	37.3	30.3
Direct	11.3	18.3	21.5	26.5	23.5	36.0	20.9	9.0
Stock	5.0	6.7	4.8	2.8	3.4	8.7	12.1	2.1
Bond	6.3	11.6	16.7	23.7	20.1	27.3	8.8	6.9
Indirect*	51.5	48.2	48.9	49.1	52.5	30.4	16.4	21.3
Financial institutions	27.7	33.3	29.2	33.2	34.7	20.4	11.7	18.1
Internal financing	37.2	33.5	29.6	24.4	24.0	33.6	62.7	69.7

* includes all other financing

Source: Bank of Korea, Analysis on Recent Equipment Investment Behavior, 2000.

capital-market based model, as in the US, was the dramatic difference between the proportion of internal funding available to finance investment in the two countries. Internal funds are large enough to finance the lion's share of US investment, and often exceed investment spending. Indeed, in the last two decades nonfinancial corporations in the US were large net *buyers* of stock, putting enormous quantities of their own funds *into* the market to finance mergers and acquisitions and support their stock price in the face of large sales by stock option holders. But in Korea, internal funds normally covered only between a third and a quarter of enterprise investment expenditures. For this reason, the proposed rapid, forced conversion of Korea to a capital-market based system of finance seemed bizarre, if not malevolent (Shin 2000).

It is not possible to know at this time if the jump in internal financing is temporary or permanent, but there are good reasons for concern. Since there has not been a pronounced rise in the net profitability of Korean firms, internal funds appear to have increased in importance *only because investment spending declined substantially*. Total real fixed investment in Korea was 20%, 17%, and 8% *lower* in 1998, 1999, and 2000 than the average level in 1995-97. Real equipment investment economy wide in 1998 and 1999 was 41% and 19% lower than the 1995-97 average, but rose 9% above this level in 2000. Unfortunately, growth ended in October 2000; equipment investment fell in each of the subsequent months (NSO web site). The government-owned Korean Development Bank does an annual survey of equipment investment by large and medium size firms. It shows that real equipment investment in industry was 35%, 34% and 10% *below* the 1995-97 average in 1998, 1999 and 2000 respectively. For manufacturing, which generates the lion's share of export earnings, real equipment investment was 60%, 57%, and 38% below the 1995-97 average these same years, and investment this year will be much lower than it was last year (KDB Survey of equipment investment; inflation correction uses the producer price index).

Restructuring has achieved the goal of increased reliance on internal funds to finance investment not by raising profits but by strangling investment spending. Investment has been crippled by a lack of finance. Profit flows are meager. Credit has been cut off on the supply side by financial market restructuring and blocked on the demand side by the government's mandate that chaebol firms slash their debt-equity ratios. Economists have long debated whether Korea's prodigious growth rate since

1961 was caused by rapid capital accumulation augmented by significant technical progress, or by rapid accumulation alone. *In either case, if restructuring leads to a substantial long-term decline in the rate of capital accumulation in Korea, as the evidence to date suggests, we can expect real GDP, real wage, and productivity growth rates to fall to a fraction of the levels achieved under the traditional model.*

One of the central goals of President Kim's restructuring program was to transform the chaebol. The Kim government promised to make the chaebol more financially transparent more specialized, less monopolistic, less indebted, and more efficient. Most important, it wanted to shift control from owner-managers to individual and institutional stockholders. Some successes can be claimed. Financial transparency has increased. Leverage ratios have dropped somewhat. The number of firms in the average chaebol dropped significantly after 1997, though it is rising again. The top 30 chaebol reduced cross-guaranteed debt by close to 90%.32 Moreover, by mid-1999 the proportion of outside directors on listed company Boards had doubled, though it was still only 23%. Finally, the forced sale of real and financial assets to outsiders, facilitated by post crisis deregulation, raised foreign ownership of the listed stock of Korea industry dramatically, as we show in section VI.

Nevertheless, though some chaebol owners have been removed from power through bankruptcy or equity dilution, most knowledgeable observers believe that insiders remain in control of most of the larger chaebol, a development that has contributed significantly to the collapse in public support for President Kim. While the number of outside directors has risen, they have yet to exercise substantial independent authority. A recent study by the Korea Stock Exchange found that "at 465 companies listed on the Korea Stock Exchange, only 66 percent of the outside directors participated in board meetings." Furthermore, "the outside directors of those firms voted affirmatively 99.3 percent of the time for company management decisions" (*Korea Herald*, November 30, 2000). Control of the Samsung chaebol recently passed successfully from father to son (though the financial maneuvers involved were questionable enough to trigger law suits attempting to invalidate the transfer of power). The Fair Trade Commission (FTC) announced that insiders currently control 45% of top 30 chaebol total shares (both listed and unlisted), an increase of 1.6% from last year. The *Korea Herald* reported that FTC data show that in the top 30 chaebol "ownership concentration has deepened, rather than weakened, since the financial crisis" (August 1, 2001). Even the Vice Finance and Economy Minister recently acknowledged that the chaebol "resisted [reform efforts] and didn't show any signs of improvement" (*Korea Times*, July 26, 2001). Of course, the oligopolies that chaebol insiders control have been severely weakened by government policy since the crisis, so that the range of choice available to them has narrowed considerably. Few if any attractive options are left. Nevertheless, it would appear that the same insiders are in position to choose among them.

The government's expressed desire to reform the chaebol probably was genuine. However, by implementing such a radical restructuring program in concert with austerity macro policy, the government caused the collapse of the economy and a crisis in both the real and financial sectors. This so weakened the chaebol that government threats to drive them into bankruptcy if they did not alter their

32 The top five chaebol, which had the highest credit ratings, made these changes primarily by shifting loans from cross-guaranteed to stand-alone status, but this involved higher interest rates they could ill afford. Lesser chaebol had to rely on asset sell offs and mergers between the guaranteeing and guaranteed affiliate (SERI 2000, p. 64).

governance structure became increasingly hollow.33 After mid 2000, the economy became so fragile that efforts at governance reform took a back seat to fear of a second crisis. *The paradox for the government is this: since the chaebol still dominate Korea's economy, efforts to force them to alter their governance structure by starving them of the credit they need to survive is as likely to destroy the economy and force a change of government as it is to dislodge the owner-managers.* This problem recently led the government to relax several of its anti-chaebol policies. For example, the government gave in to chaebol demands that they be given several additional years to comply with the requirement to reduce equity investments in affiliated firms to below 25% of their net assets. According to the *Korea Herald*, the current excess of such equity investments above this limit is about 20 trillion won. "Critics lambasted the government for backpedaling on its pledge for economic reform," the paper noted, "but the business community welcomed it" (June 1, 2001). Deputy Minister Jin Nyun recently announced that "authorities are also studying ways to abolish the regulation scheme to issue a list of the top 30 chaebol," even though it is this list "which provides the legal groundwork to control the mammoth groups" (*Korea Times*, Sept. 18, 2001).

V. Restructuring Financial Markets

Policy

In his 1985 book, President Kim stated that "financial markets must be allowed to operate completely free of government interference in credit allocation and interest rate determination" (1985, 44). The implementation of his philosophy would require the complete transformation of the traditional Korean state-guided, bank-based financial system, a truly radical undertaking.

The government's immediate objectives were to drive weak financial institutions from the market, clean up the large volume of non-performing loans (NPLs) generated largely by its own macro policies in early 1998, recapitalize viable financial institutions, apply much stronger prudential regulations to force banks to avoid excessive risk, assign one or two main creditor banks to monitor and control credit allocation to each important chaebol group, and induce foreign banks to take control of much of Korea's banking system in order to modernize its management techniques and raise its profitability (KDI 1999, pp. 87-104). Later, in 2000, the government decided to create huge bank holding companies it hoped would be capable of competing with the most powerful multinational banks in global financial markets.

The severe economic collapse in 1998 left only a few consumer oriented banks viable*; all institutions involved in corporate finance were in desperate shape*. The government was thus required to inject huge amounts of public money into the banking system to try to revitalize it. It established state-owned corporations called the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC) to clean up the NPLs and strengthen the

33 Meredith Woo-Cumings put the problem this way. "Here is the rub. To breakup the *chaebol* is to break up Korea, Inc. She also notes that "the power of the Japanese *zaibatsu* could not be decisively broken during the seven year American occupation of defeated Japan"; the *zaibatsu* were merely transformed into the post-occupation *keiretsu*" (2000, p.24).

industry's capital base (Financial Supervisory Commission (FSC) and Financial Supervisory Service (FSS) 2000, Root et al. 2000). Public funds spent on financial restructuring in the three years following 1997 totaled about 140 trillion won, helping raise central government debt as a percent of GDP from 9.1% in 1996 to 23.1% in 2000, or, if government guaranteed debt is included, from 10.9% to 37.6%.34 Expenditures made or announced through Spring 2001 brought public spending on financial restructuring to over 160 trillion won – about $136 billion at an exchange rate of 1200 won per dollar -- an astounding 31% of 2000 GDP. This huge infusion of public capital into a near bankrupt financial system gave the government control over almost all Korean banks. Korea banks were, in effect, nationalized. The de facto nationalization of the banking system in tandem with the main creditor bank policy gave the Kim government immense power over the debt-ridden chaebol: *the avowedly neoliberal state had put itself in control of the core of the private economy.35*

The government eliminated financial supervisory fragmentation by creating an all-powerful new Financial Supervisory Service (FSS). It then established stricter prudential regulations starting immediately, *in the midst of the economic collapse in 1998*. Insolvent commercial and merchant banks were required for the first time to meet the Bank for International Settlements (BIS) capital adequacy standards, which required that capital must be at least 8% of the full value of total loans. As rising NPLs and the collapse of asset values in the crisis shrank the value of capital, and the criteria for classifying loans as nonperforming were tightened significantly, banks were forced to sharply reduce the supply of loans. Similar measures were applied to non-bank financial intermediaries (NBFIs). Banks and NBFIs were forced to issue new stock (most of which was purchased by the KDIC, cementing government control of the banking system), refuse to renew expiring loans, end new lending, and lay off large numbers of workers.36 *The ill-timed application of the BIS standard dramatically cut credit flows to the business sector*. The FSS also selected 477 financial institutions (out of an original 2077) to be closed down in the three years following late 1997. The restructuring of securities firms and insurance companies was to be accomplished through the injection of foreign capital.

It should be stressed that prudential regulation of Korea's financial system *was* in dire need of improvement. The liberalization process of the 1990s in particular had led to many destructive managerial practices in banking. However, to implement such radical change in such a short period was extremely irresponsible. To do it in the midst of a severe economic and financial collapse, when most important financial institutions were already insolvent, was clearly malevolent. *IMF austerity macro policy had already created a serious contraction of the credit supply. Financial restructuring policy turned this into a severe credit crisis* (Kim 1999). This development was hardly a surprise; as Stiglitz put it: "If, in the midst of a downturn, we push banks too quickly toward 'prudent' capital adequacy ratios, we risk shutting down the flow of credit entirely" (cited in Kumar and Debroy 1999,

34 Critics of the financial restructuring program charge that the amount of public money needed to end the financial crisis was badly underestimated by the government. If the government had acted more aggressively, they argue, performance would have been better and costs lower over the longer run.

35 Though paradoxical, this outcome is hardly unique. For example, the neoliberal Pinochet government in Chile nationalized the banking system to avert a financial collapse brought on by deregulation and liberalization of the capital account.

36. Bank closings and a focus on cost cutting led to a 38% decline in bank employment from late 1997 to 2000 (*Korea Times*, Feb. 2001).

p.16). Banks were forced to drastically lower the credit made available to the corporate sector, causing firms to further slash investment, wages, and employment, thereby aggravating the ongoing deficiency in aggregate demand. Falling aggregate demand pushed more firms into bankruptcy, which increased the volume of NPLs in the banking system. This forced banks to lower credit even further in an attempt to raise capital adequacy to mandated levels. *This vicious cycle, in which real-sector problems cause financial-sector malfunctions that, in turn, further weaken nonfinancial firms, continues to plague Korea today*. Since a dramatic tightening of prudential regulation in the midst of a financial collapse cannot be justified on reasonable economic criteria, we can only conclude that its motivation was strategic. It put the government in position to impose its neoliberal revolution on Korea's economy.37

That these policies would have disastrous results was foreseeable at the time they were implemented. In 1998, Crotty and Dymski made the following observation about unfolding events.

> Korean banks have always operated with lower equity/asset ratios than are permitted by the free-market oriented Basle standards. When the loan defaults of the crisis left them near insolvency, the imposition of the Basle standards forced banks to drastically cut loans, especially to small and medium businesses. The resulting credit crunch then forced more firms into default, leaving banks even further away from compliance with the Basle standards. Together, these policies [of austerity and financial restructuring] created an ever-deteriorating cycle of bankruptcies, bank failures, declining production and rising unemployment. (Crotty and Dymski 1998a, p. 33)

Results

In the three plus years since the crisis, the Korean economy has experienced an ongoing credit crunch with two distinct phases. In 1998, financial markets were battered by the combination of an economic collapse and radical financial restructuring. This led to the first phase of the credit crunch, which lasted through early 1999 (even though interest rates fell in the second half of 1998, and remained relatively low thereafter).38 In the first half of 1999, credit flows to the real sector began to speed up. However, in mid 1999 a bond market crisis erupted. Credit flows dried up once again. Things improved somewhat in the first half of 2000, but in the latter half of the year credit flows plummeted yet a second time.

Bank profitability has risen since 1998, but only because of the huge injection of public funds. Nonperforming loans are still high, largely because the nonfinancial corporate sector remains weak – the vicious cycle at work. NPLs fell from 118 trillion won in mid 1998, before the main inflow of public funds, to 60.2 trillion won at the end of 98 and 51.3 trillion won at the end of 1999; but they jumped

37 There are alternative explanations for the adoption of these destructive policies by President Kim and the IMF: foor example, that they acted irrationally, or were unbelievably incompetent, or were blinded to the likely consequences of their acts by a zealous commitment to neoliberal ideology.

38 At near 10%, the interest rate on three-year corporate bonds, while much lower than the usurious rates on early 1998, could not be considered low in any absolute sense.

again in phase two of the credit crunch to 76.3 trillion at the end of 2000. NPLs as a percent of all loans are listed in Table 9.39

Table 9. Change of nonperforming loans in the financial sector

	96*	End 97	June 98	End 98	End 99	Sept. 00	End 00
NPL share	5.2	6.7	15.8	10.5	8.7	12.3	10.4

* 96 for commercial banks

Source: Financial Supervisory Service

Table 10. Total funds flow from the financial sector to the non-financial sector (trillion won)

	1996	1997	1998	1999 1/2	1999 2/2	2000 1/2	2000 2/2
Total	99.6	107.8	37.0	35.1	10.3	20.6	19.3
Credit	64.8	75.2	-32.6	-0.1	19.1	22.5	16.3
Securities	34.8	32.7	69.6	35.1	-8.7	-1.5	2.6

Source: Bank of Korea, Flow of Funds. Based on 2001 data.

The two phases of the credit crunch can be seen in Table 10, which shows the flow of credit from the financial sector to nonfinancial firms, individuals and the government. The data show that banks, which provided at least two-thirds of total credit flows in 1996 and 1997, were forced to slash lending in 1998 due to the combined effects of deep recession, bank closings, and tighter prudential regulation. NBFIs, which include the risk-loving Merchant banks created in the 1990s liberalization, were hit hardest by forced exit plus tighter prudential requirements. But commercial banks were in bad shape as well. As a result, total credit flows from commercial banks and NBFIs dropped by 108 trillion won from 1997 to 1998 – an amount equal to the total supply of funds from the sector in 1997. A credit crunch of this magnitude might be aptly described as savage.

Table 11 traces the evolution of the credit crunch faced by nonfinancial corporations. Total funds made available to highly levered real-sector firms dropped from 117 trillion won in 1997 to just 28 trillion won in 1998. This evaporation of the credit supply was a major cause of the collapse in investment spending and the rapid deterioration in the financial health of real sector firms – phase one of the vicious cycle. After getting loans worth 44 trillion won in 1997, business saw its credit from banks and NBFIs fall to 15 trillion won in 1998. Nonfinancial corporations were thus forced to turn to the capital market. They issued a record 46 trillion won in bonds, 14 trillion won of which carried the super-high interest rates of the first half of the year. Most bonds were bought by investment trusts, which increased their bond holdings by 108 trillion won from late 1997 to the end of 1998 (Ministry of Finance and Economy (MOFE), Report to National Assembly, May 18. 2000). They were able to buy such large quantities of bonds because about 110 trillion won in deposits fled the banks in 1998 in

39 NPLs dropped to 8.1% of loans in the first quarter of 2001 (*Korea Times*, March 22, 2001). Note that the definition of nonperforming loans changed after the crisis. Before June of 98 it was loans to bankrupt firms and debts unpaid for more than 6 months. After that, debts unpaid for more than 3 months were included, and since 2000, future ability to repay has become a criterion.

pursuit of higher returns available at NBFIs. Firms associated with the largest chaebol had easiest access to bond funds because chaebol-owned investment trusts attracted much of the new NBFI deposits in this period. For example, Hyundai Investment Trust attracted huge inflows into its new stock fund named "Buy Korea." The chaebol used these funds to purchase their own bonds and stocks. Small and medium companies have no access to securities markets; they must rely on the banking system to meet their credit needs. Thus, smaller firms, a group that President Kim claims to strongly favor, were crushed by the 1998 collapse of bank credit.40

Table 11. External financing of the corporate sector after the crisis (billion won, %)

	1997	1998 1/2	1998 2/2	1999 1/2	1999 2/2	2000 1/2	2000 2/2
Indirect finance	44362	-1780	-13223	-8431	10484	11698	-307
	(37.9)	(-19.2)	(-69.3)	(-23.0)	(62.1)	(26.9)	(-1.3)
Borrowing from banks	15116	8142	-8088	8606	6546	18601	4747
	(12.9)	(-87.7)	(-42.4)	(23.5)	(38.8)	(42.8)	(20.6)
Borrowing from NBFIs	28339	-10002	-5485	-17039	3998	-6903	-5094
	(24.3)	(-107.7)	(-28.6)	(-46.4)	(23.7)	(-15.9)	(-22.1)
Direct finance	43391	20388	29361	35232	-8446	8113	10883
	(37.1)	(219.6)	(153.9)	(96.0)	(-50.1)	(18.7)	(47.2)
Commercial paper	4773	450	-12128	6878	-23370	-200	-933
	(4.1)	(4.8)	(-63.6)	(18.7)	(-20.0)	(-0.05)	(-4.0)
Corporate bonds	26845	13958	31949	7722	-5989	-1583	-525
	(22.9)	(150.4)	(167.5)	(21.0)	(-35.5)	(-3.6)	(-2.3)
Stocks	8974	4964	8551	19863	19116	9279	11527
	(7.7)	(53.5)	(44.8)	(54.1)	(113.3)	(21.4)	(49.9)
Foreign borrowings	7162	-9571	-625	4223	5818	13666	2099
	(6.1)	(-103.1)	(-3.3)	(11.5)	(34.5)	(31.5)	(9.1)
Others	22704	246	3564	5676	9015	9977	10403
	(19.7)	(26.5)	(18.7)	(15.5)	(53.4)	(23.0)	(45.1)
Total	117041	9283	19077	36700	16871	43455	23076
	(100)	(100)	(100)	(100)	(100)	(100)	(100)

Source: Bank of Korea, Flow of Funds.
Note: Others include government loans and corporate credit.

The first half of 1999 showed a significant improvement in financial intermediation. Though banks and NBFIs continued to decrease their business loans, the total flow of money to industrial and commercial firms rose to an annual rate of 73 trillion won from January to June. Belief that the worst

40 Excluding asset backed securities, the share of big firms in the corporate bond market was 72% in 1991, 87% in 1994, 99% in 1998, 95% in 1999, and almost 98% in 2000.

was over spread; real GDP grew moderately in the first half of 1999 and the rate of unemployment began to decline. Financial markets became more optimistic. Stock prices doubled between November 1998 and June 1999 even as supply rose -- new equity issues jumped from 8.5 to 20 trillion won. Foreigners and domestic investment trusts increased their stock purchases. Meanwhile, foreign credit flows shifted from negative to modestly positive. And, after withdrawing credit from nonfinancial firms in 1998, the commercial paper market made an additional 7 trillion won available to them in early 1999.

In July 1999, the government decided to force the huge Daewoo chaebol into bankruptcy. Daewoo had been severely weakened by excessive debt-financed investment in the mid 1990s, the collapse of its domestic markets in 1998, ill-timed post-crisis investments, the demand for an immediate debt-equity reduction by the Kim government, and the first phase of the credit crunch**.** Daewoo owed an astounding 60 trillion won – over $5 billion at the prevailing exchange rate -- to domestic financial banks and bondholders. As Korea's third largest chaebol at the time, Daewoo was universally believed to be too big for the government to allow it to fail. Thus, its collapse triggered panic in the commercial paper and bond markets. Since even five months later, banks held 22 trillion won worth of Daewoo bonds and investment trusts had 24 trillion in Daewoo bonds and commercial paper, Daewoo's bankruptcy badly damaged the banking sector (SERI 2000, p. 74). Korea thus entered a *second phase* of the credit crunch as the cross-sector infection process continued. Stock issues and foreign borrowing remained steady, but there was a decline of 23 trillion won in outstanding commercial paper in the second half of the year; NBFIs refused to roll paper over as it came due.

Worried about the safety of chaebol bonds, and aware that large quantities of the bonds issued in 1998 were up for repayment, frightened investors withdrew 100 trillion won from investment trusts in the year following Daewoo's bankruptcy, crippling the bond market. They moved these funds back to commercial banks. Though they were flush with new deposits, banks increased loans at a modest 11 trillion won annual rate in the second half of 1999. Hampered by new capital adequacy standards and stricter prudential regulation, banks chose to increase their holdings of government bonds (issued to finance deficit spending and purchase NPLs) and increase lending to the more secure household sector, rather than finance industrial firms. Deposit monetary banks held 25 trillion won worth of such government bonds in 1996, 36 trillion won in 1997, 72 trillion in 1998, and 98 trillion in 1999. Holdings of securities as a percent of total assets went from 14.3% in 1997 to 25.7% in 1999. The ratio of loans to deposits in Korea's commercial banks, by far the most important traditional source of non-financial corporate finance, had averaged about 100% prior to the crisis. But rising securities purchase drove it down to 71% by the end of 1999, and a shrinking percent of loans went to commercial and industrial enterprises. *Firms were once again starved for funds*. The flow of funds to nonfinancial enterprise collapsed to a 33 trillion won annual rate in the second half of 1999, a mere 29% of the 1997 figure.

The year 2000 was similar to 1999 in that corporate access to finance improved significantly in the first six months, only to collapse again in the second half of the year. The early months saw a sharp rise in bank loans counterbalanced by a sharp drop in credit from NBFIs, which were plagued by bad assets and deposit outflows. The bond market remained weak, but the commercial paper market saw balanced inflows and outflows, a great improvement over its collapse in late 1999. Stock market issues slowed, but foreign borrowing picked up. Total flows to nonfinancial corporations proceeded at an 87 trillion won annual rate, the best performance since the crisis.

But neither the industrial nor the financial sector had been restored to health. Industrial production peaked in October, and declined thereafter; in the first quarter of 2001 it was 8% below its year-ago level. Machinery and equipment investment fell in both the third and fourth quarters. Chaebol profit rates fell substantially in the second half of the year. When Hyundai, the largest chaebol, experienced a serious liquidity crisis in mid-year, lending by banks and NBFIs dropped precipitously. Bank lending fell by 14 trillion won in the second half of the year, and the crippled NBFIs continued to withdraw funds from the credit market. The commercial paper and bond markets remained moribund, and foreign borrowing declined dramatically. *Total funds to nonfinancial corporations in the second half of 2000 dropped to an annual rate of 46 trillion won the worst performance since 1998.*

In December 2000, in response to the latest phase of the credit crunch, the government intervened again to try and stop the bond market collapse from pulling the entire financial sector down with it.41 The state-owned Korea Development Bank was authorized to use 20 trillion won to facilitate the rollover of shaky corporate bonds. According to this plan, the KDB was to buy 80% of the estimated 25 trillion won worth of nonperforming corporate bonds from financial institutions. Issuing firms would only be required to repay 20% of their face value; this would pull them back from the edge of bankruptcy. This new injection of public funds was urgently needed: even the IMF supported it. Some 65 trillion won in corporate bonds are due for repayment in 2001, but many of the firms who issued the bonds are too weak to repay them, and many of the NBFIs who hold the bonds might not survive their default.42 For example, the giant Hyundai chaebol has 7 trillion won in bonds coming due within the year. The *Wall Street Journal*, noting that the value of bonds coming due in the second half of 2001 is 30% greater than the amount that came to maturity in the second half of 2000, warned that "crunch time is approaching for South Korea, threatening a liquidity shortage similar to the one that nearly brought the country's economy to a standstill late last year" (June 4, 2001, A17). Government interventions such as these contradict the logic of radical restructuring, because they vitiate the process through which the 'strong,' -- primarily foreign firms -- are able to take over the 'weak.' They also create moral hazard.43 Yet, the perilous condition of both financial and industrial sectors made non-intervention too dangerous a policy stance for President Kim to adopt, especially in light of the serious deteriorating in his popular support. *The Economist* reported that only 20% of Koreans now support Kim, "down from a high not long ago of 80%" (September 1, 2001, p.38).44 In spite of the massive

41 The *New York Times* reported that South Korean banks accumulated $31 billion in nonperforming loans in 2000, "twice the figure for 1999 when the economy appeared to have rebounded from the 1997-1998 crisis" (February 27, 2001). In July, the *Korea Times* noted that "Korean financial institutions, including securities and financial firms, lost almost one trillion won in 2000" (July 2, 2001).

42 Morgan Stanley points out that an additional "60 trillion won of corporate bonds have been converted into bank debt in the past two years and banks are not willing holders of these loans" (*Korea Times*, March 4, 2001).

43 Moral hazard may have influenced Hynix, which refused to repay its corporate bonds when they came due in January 2001. Another problem associated with this policy is the ever-increasing indebtedness of the KDB, and its likely inability to get a high percent of face value much when it sells the NPLs it holds. Most estimates put the potential loss as high as 50%.

44 The OECD's Economic Survey of Korea: 2001 (August) demanded that the government "stop the Korean Development Bank's refinancing of maturing corporate bonds, citing that state rescue financing for ailing firms runs counter to market principles." It also urges the government to quickly sell its stake in commercial banks to private investors (*Chosunilbo*, August 2, 2001). Since no major Korean private investors have deep pockets, this is, in effect,

infusion of public funds into Korea's financial system, it is clear that Korea's financial institutions never recovered from the devastation they suffered as a result of the economic collapse brought on by austerity macro policy in 1998 and the imposition of tight prudential regulation in the midst of that collapse. As of mid 2001, there is no reason to expect that the vicious circle strangling the Korea economy will end anytime soon.

Market incentives have caused the large commercial banks that traditionally financed the bulk of Korea's capital accumulation to shift to a new mode of operation. *Lending to Korea's debt-ridden businesses is being de-emphasized in favor of more profitable loans to individuals, especially wealthy households*.45 Korean financial markets will soon be dominated by three giant conglomerates, the Shinan Holding Company, the merged Kookmin and H&CB banks, and the Woori Holding Company, presently owned by the state. Both Kookmin and Shinan have made clear their intention to concentrate on retail banking, with a main focus on wealthy households. The new Kookmin bank alone will control one-third of Korea's deposits and 54% of household lending. The *Far Eastern Economic Review* believes it will be in a position to "set prices"; "in the United States a bank with such market clout would be forced to divest". After a heated struggle, Kim Jung-Tae won the presidency of this merged super-bank. "Crucial to Kim's selection was backing from the major foreign investor in each bank." "Goldman Sachs and ING will be the biggest shareholders, furthering a trend which now sees foreigners as the biggest private stakeholders in five of Korea's top banks" (all quotes from *Far Eastern Economic Review*, August. 23, 2001).

These developments are likely to cause two important problems in Korea's evolving financial sector. First, the only one of these three giant banks planning to concentrate on commercial loans is state-owned Woori, but this policy will presumably last only until the government sells it to private interests -- which it intends to do as soon as possible. Second, new giant banks, especially those under foreign control, have no reason to cooperate with government policies they do not like. Kookman's new president Kim Jung-Tae is a good example: "He has an un-Korean warning for the government: 'I want to make my [own] way even if the government doesn't like the idea" (Quotes from *Far Eastern Economic Review*, August 23, 2001).

VI. Restructuring and the Rising Influence of Foreign Capital

Policy

President Kim Young Sam signed the first restructuring agreement between Korea and the IMF in December 1997. According to the *New York Times*, President Clinton telephoned the wavering Korean President and "told him he had no choice but to accept an international bailout." (Feb. 17, 1999). Incoming President Kim Dae Jung didn't need outside pressure to cooperate with the IMF. He

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a call for even greater foreign bank ownership.

45 Household debt totaled 49.1% of bank loans in June 2001, up from 39.9% at the end of 1999 (*Chosunilbo*, August 2, 2001).

believed the key to successful corporate and financial restructuring in Korea was a massive infusion of foreign capital and foreign know-how. This would solve Korea's foreign exchange problem, infuse Korean industry with modern managerial methods, and provide for the first time in modern Korean history the kind of vigorous competition needed to finally break the chaebol stranglehold on the Korean economy. "What we need now, *more than anything else*, are foreign investors," Kim stated in an address to the U.S. Congress in 1998 (Address by President Kim Dae Jung of the Republic of Korea at a Joint Meeting of the United States Congress June 10, 1998. Washington, D. C, emphasis added.)

The most pressing problem facing the incoming government in early1998 was the imminent collapse of the nation's banks. As we have seen, the government injected massive public funds into the banking system, effectively nationalizing it. President Kim then used state control of the banks to try to force the heavily indebted chaebol to slash leverage by 60% within just two years. Given the depressed state of domestic demand brought on by austerity macro policy and the havoc caused by radical restructuring of both financial markets and the industrial sector, Korean enterprises could meet this demand only through the extensive sale of real assets and the large-scale issuance of new stock. Since domestic firms were broke, foreign firms and banks were the only possible large-scale buyers. *This forced Korean economic assets to be put up for an international auction in which all bargaining power lay with the buyers*. The policies implemented by President Kim and the IMF were therefore guaranteed to dramatically increase foreign control of Korea's economy, provided that Korea's remaining laws restricting the inflow of foreign capital and its laws protecting labor were overturned – which they were. To close the circle, the crisis-induced collapse of the won – it was 844 per dollar in 1996, 1415 in 1997, 1207 in 1998, 1145 in 1999, 1259 in 2000, and near 1300 in mid-2001 - made Korean assets extraordinarily cheap in US dollars and other dominant currencies.

The liberalization of cross-border financial flows accelerated dramatically after the IMF agreement. The remaining restrictions on capital inflows, *which were still substantial entering 1997*, were quickly disposed of by the IMF and President Kim. A late 1997 IMF report outlined the new policy with respect to foreign capital.

> The government plans to accelerate substantially its ongoing capital account liberalization program… By end-February 1998, the present timetable for capital account liberalization will be accelerated by taking steps to liberalize other capital account transactions, including those restricting foreigners' access to domestic money market instruments and the corporate bond markets, and by further reducing restrictions on foreign direct investment… In order to instill market discipline a timetable will be set by end-February 1998 to eliminate restrictions on foreign borrowing by corporations (IMF 1997, p. 10).

The government raised the number of business categories open to foreign ownership in 1998, including security trading, investment companies and real estate. In a crucial move resisted by the chaebol, hostile foreign M&As were permitted for the first time. The Foreign Investment Promotion Law was enacted in November 1998 providing 10-year central government tax exemptions for high tech and related industries, and for investment projects in Foreign Investment Zones. The government also agreed to eliminate all restrictions on the foreign ownership of Korean banks and security

companies, thus giving giant US industrial and financial firms a prize they had sought in vain for decades.

Portfolio investment was, for the first time, fully liberalized. By May 1998, the government had removed all remaining curbs on foreign participation in Korea's stock and bond markets.46 It abolished the Foreign Exchange Management Act in 1999, eliminating most remaining restrictions on foreign exchange transactions. Regulations on capital transactions were to be completely abolished by the end of 2001. Foreigners were now allowed to borrow won in Korea, which armed speculators for a possible attack on the won if conditions warranted it. This frenetic pace of cross border capital deregulation was much more rapid than the one demanded by the OECD as a condition for Korea's entrance to that organization in 1995.

Results

Chart 2 shows the effects on equity flows of the cross-border financial liberalization process that started in the early 1990s. It does not include foreign bank loans. (As noted, the huge inflow of short-term foreign bank loans in the mid-1990s, and their subsequent outflow in 1997-98 were the proximate cause of Korea's financial crisis.) The initial phase, from 1992 through 1997, saw a significant rise in total inflows from around $1 billion to as much as $7 billion or $8 billion a year. The crisis and restructuring then accelerated total foreign equity capital inflows dramatically. A total of $62 billion entered Korea from 1998 through 2000.

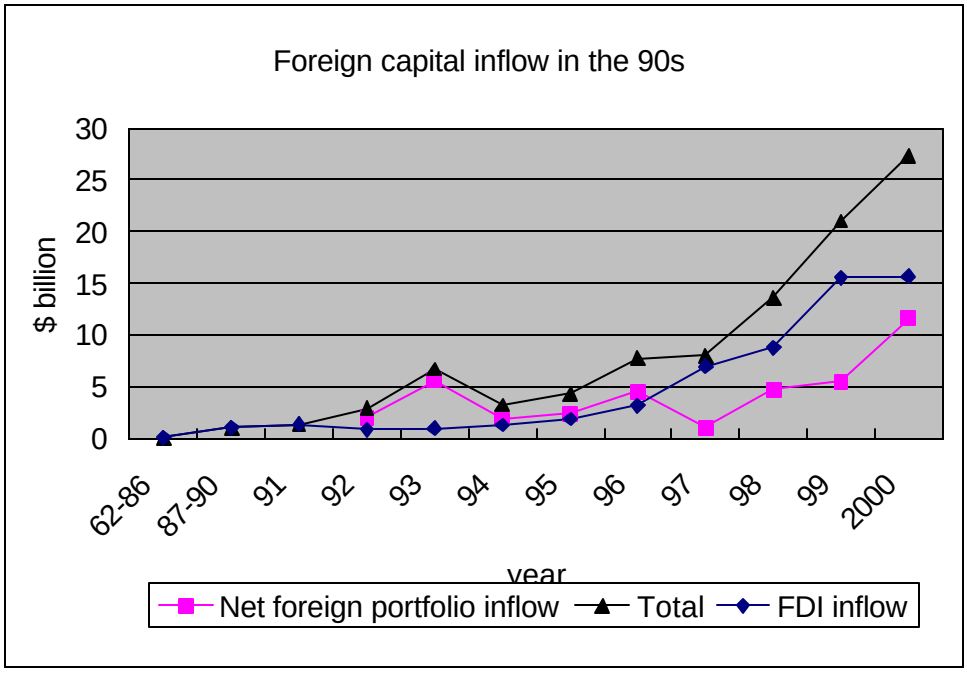
The role of FDI is especially important because of its profound potential impact on effective government guidance of the economy in the future. From the late 1980s through 1994, inward FDI averaged about $1 billion a year. (Net FDI was consistently negative as the larger chaebol built up their foreign base of operations.) It rose to $2 billion in 1995 and $3 billion in 1996. Post crisis liberalization let FDI jump to $7 billion and $9 billion in 1997 and 1998. The door was now wide open to outsiders, but the uncertainty caused by the collapse of late 1997 and 1998 and the tense tenor of labor relations caused potential buyers to bide their time. After 1998, both legal and economic conditions were ripe for an explosion of inward FDI. *Over the next two years FDI totaled $31 billion – a nominal sum 25% greater than total inward FDI from 1962 through 1997*. Even in the global slowdown of 2001, inward FDI is on track to reach nearly $12 billion (*Korea Times,* September 7, 2001). FDI as a percent of total fixed investment had been no more than 1% until the mid 1990s; it rose to 2% in 1996 and 4% in 1997. It jumped to 9% in 1998, then increased again to about 13% in 1999 and 2000. But even this dramatic, rapid rise in FDI is not enough to satisfy President Kim's unyielding determination to give foreign firms a dominant position in Korean industry and finance. *In July 2001, the Presidential Secretary for Economic Affairs announced that the government is committed to expanding FDI to the astronomical figure of $120 billion by 2003 – equal to 29% of GDP in 2000 and 20% of the value of GDP in 2003 as forecast by the government* (*Korea Herald*, July 7, 01).

*Inward FDI of the magnitude achieved in 1999 and 2000, never mind hoped for in 2003, would have been unimaginable prior to the crisis***.** The crisis and collapse were needed to open

46 The upper limit was raised to 12% in December 1994, 15% in July 1995, 18% in April 1996, 20% in October 1996, 23% in May 1997, and 26% in November 1997. As for individual foreign investors, the ceiling was changed from 3% in January to 5% in October 1996, 6% in May 1997, and 7% in November 1997.

Korea to foreign penetration of this scale. One tragic aspect of this great 'fire sale' is that the overwhelming majority of FDI expenditures involved foreign acquisitions of domestic firms, rather than new or "greenfield" investment (United Nations, 2000; Mody and Negishi, 2001)47. President Kim thus traded vast quantities of Korea's best economic assets, built over decades with the blood and sweat of Korea's working class, for money to pay back foreign bank loans that never should have been permitted in the first place.

Chart 2. Foreign Capital Inflow in the 90s



Source : Bank of Korea, Ministry of Commerce, Industry and Energy.

Net portfolio inflow varied between one and five billion dollars annually from 1992 through 1999, then leapt to almost 12 billion dollars in 2000. Table 12 shows that gross portfolio inflows have increased phenomenally, from little more than $10 billion a year to over $60 billion in 2000. But foreign investors are simultaneously withdrawing enormous sums from the stock market as well -- $48.5 billion in 2000. Gross flows of this magnitude create the potential for high instability in net flows and, therefore, in asset prices. The volatility of the Korean stock market rose dramatically during and after the crisis: the main Korean stock price index was 350 in late 1997, rose to near 1000 in mid 1999 just prior to the Daewoo bankruptcy, then dropped to 500 at the end of 2000. When investors jump into and out of stocks in pursuit of short-term speculative gains, stock market "turnover" – the total value of trades as a

47 Estimates of the percent of FDI represented by M&As are inexact, but the share was probably around 80% in post crisis Korea. Mody and Negishi state that "the much talked about resilience of FDI during the crisis was due entirely to the rapid increase in M&A rather than to traditional foreign in "greenfield" projects, those designed to build new means of production". (Mody and Negishi 2001, p.7).

percent of total market capitalization -- is high. According to Standard and Poor's, "South Korea was the emerging market with the highest turnover in 1999, at 347% of market capitalization" (*The Economist*, June 24, 2000, p. 122). Turnover in the second highest market was significantly lower. By comparison, turnover in the US stock market in 1999, when the stock price bubble was accelerating at record speed, was only about 120%. However, as global financial market integration increases, turnover is riseing in most markets. It increased substantially in the first four months of 2001 in the US, to a 188% annual rate. David Hale, chief economist for Zurich Financial Services, observed that "we are witnessing an unprecedented institutionalization of speculation without any anchor in traditional value measures" (*Business* Week, July 16, 2001, p. 26).

President Kim has proposed a form of shareholder capitalism for Korea, in which business decisions and the allocation of investment funds are to be guided by stock price movements. But the Korean stock market is extremely unstable, and its surges up and down are increasingly correlated not with Korean business indicators, but rather with movements in American stock price indices (BOK, 1999). Since the average share in the Korean stock market now changes hands three and one-half times a year, it is obvious that short-term speculators, not long-term investors, are the dominant force in Korea's stock market. In early 2001, 72% of listed Korean firms, and 7 of the 10 largest chaebol had market values well below their book or liquidation value (*Korea Times*, May 23, 2001). Shareholder capitalism would be dysfunctional in the best of conditions, but in present day Korea, *it would be disastrous*.

Table 12. Foreign stock and bond portfolio flows in Korea ($ billon)

	1995	1996	1997	1998	1999	2000
Inflow	10.2	12.6	13.2	16.5	41.7	60.1
Outflow	7.8	8.0	12.1	11.7	36.3	48.5
Net inflow	2.5	4.6	1.1	4.8	5.5	11.6
Total	18.0	20.6	25.3	28.2	78.0	108.5

Source: Bank of Korea. 2001. Trend and implication of foreign portfolio investment in 2000.

The IMF-Kim strategy to dramatically increase foreign ownership of Korean industry and finance has succeeded beautifully. Table 13 shows that the percent of Korean market capitalization owned by foreigners rose from a miniscule 2.7% in 1992 to 12.3% in 1997, then leapt to 32.4% in May 2001 as the liberalization accelerated.48

Table 13. Growth of foreign ownership in the Korean stock market (%)

Year	92	93	94	95	96	97	98	99	2000	2001.10
Share	2.7	7.6	8.0	10.0	10.5	12.3	16.4	21.9	30.1	35.5

Source: Korea Stock Exchange.

48 This data refers only to 'listed' shares. A substantial portion of chaebol shares are privately held or 'unlisted.'

As Table 14 indicates, foreign firms have gained major influence over some of Korea's most important industries, such as semiconductors, autos, electronics, telecommunications, petrochemicals, and finance. (The number is parenthesis next to the company name refers to its rank in total market capitalization.) The 1990s liberalization raised foreign ownership of the top seven firms on the list to an average of 20.6% just before the crisis broke out, but after just three years of restructuring it had more than doubled to 43.7%. The *Korea Times* reported that foreigners own 44% of Korean semiconductor shares and 21% of telecommunication shares (July 17, 2000).49 As of February 2001, foreigners owned 56% of the shares in Samsung Electronics, the number one firm, while the controlling domestic owner's share is just 11.7%. Foreigners own 42.2% of the listed shares of the top 10 chaebol (*Korea Herald*, May 25, 2001). Their holdings greatly exceed the shares of the dominant domestic interest in such giant firms as POSCO, the great steel producer (63% foreign owned by August 2001), and SK Telecom. Foreigners own 57% of the stock of Hyundai Motors (*Korea Herald*, June 25, 2001), while Hynix Semiconductor, the world's third largest producer of semiconductors, is expected to soon fall under foreign control.

Table 14. Change of foreign' ownership in major companies (%)

Company (stock value ranking)	97. 11. (before the crisis)	2000. 12.
Samsung Electronics (1)	24.2	54.2
SK telecom (2)	26.0	53.2
Korea Telecom (3)	--	19.4
Korea Electric Power Corporation (4)	10.6	26.1
POSCO (5)	20.8	49.0
Kookmin Bank (6)	25.8	58.2
Housing Bank (7)	37.0	65.4
Korea Exchange Bank preferred stock (9)	--	100
Hyundai Auto (12)	23.6	41.0
Shinhan Bank (13)	21.9	48.9
Samsung Electronic Machinery (15)	5.1	30.0
Hyundai Electronics (17)	7.2	35.5
SK (20)	13.7	25.3
Samsung Electronics preferred stock (21)	26.0	33.8

49 As of February of 2001, total foreign ownership exceeded that of the dominant domestic shareholder in 29 of the most important firms.

LG chemical (27)	17.4	28.0
Ko-Am Bank (30)	31.3	61.5
Shinsegye (39)	10.7	39.3
Korea Exchange Bank (42)	3.6	26.4

Source: FSS. Unpublished data. Dec. 2000.

The situation in autos is especially disastrous. In 2000, Daimler-Chrysler gained significant influence over Hyundai Motors through the purchase of over 10% of its shares. Worse, Kim Dae Jung ordered Daewoo Motors, Korea's second largest auto maker, to be sold to foreign interests by its creditor banks. In 2000, the government rejected an offer for Daewoo Motors of some $5 billion from GM in favor of Ford's $7 billion offer, which Ford eventually rescinded. But Daewoo Motors continued to lose value as government-controlled creditor banks deliberately starved it of funds needed to maintain its competitive position in Korea and elsewhere in order to force management to impose firings and wage cuts on its fiercely militant unions. They put in some $2 billion in total, just enough to prevent Daewoo's collapse, but not enough to allow Daewoo to maintain its share of key markets. GM refused to make another offer for Daewoo until the unions were broken. After November 2000, Daewoo did cut employment by 6,100, firings the *New York Times* says were designed "to make a deal more desirable to GM" (April 10, 01). But GM still refused to make a second offer until the government allowed it to break up the company, taking only those plants that it found most attractive. In particular, GM did not want to acquire the Bupyong plant in Inchon, with its capacity to produce 500,000 cars annually, because its 8,000 workers, about half the domestic workforce, had a history of militant unionism. By late 2001, the cash squeeze had caused Daewoo's share of key markets to collapse. Whereas in 1997, Daewoo had 33% of the Korean market, by the first half of 2001 it had only 12%. While Hyundai-Kia saw its US sales grow by 37% in the first eight months of 2001, Daewoo's sales fell by 20%; in August 2001 it sold 53% fewer cars than it had a year ago. The *Wall Street Journal* reported that "over the three years of on-and-off again negotiations it has taken GM to get the deal, Daewoo's position has eroded significantly. Sales are plunging in just about all Daewoo's markets" (Sept. 21, 2001, p. A21).

The government had thus maneuvered itself into a lose-lose position. Unwilling to advance Daewoo enough cash to remain competitive, and committed to selling it to a foreign company, it now was at GM's mercy. In September 2001 the government "backed away from its earlier stance that [Bupyong] must be included in any sale," letting GM take only those pieces of Daewoo it desired (*Wall Street Journal*, August 10, 2001, p. A6). In response, GM signed a memorandum of understanding to acquire Daewoo in the first half of 2002. It will take only two of the company's three domestic plants. Rick Schlais, president of GM's Asia-Pacific Division explained why: "The major reason why GM did not acquire the [Bupyong] factory stems from its concern about the unstable labor-management relations" (*Chosun Ilbo*, Sept. 21, 2001). It did agree to buy cars from the plant for several years and maintained an option to purchase it in 2006. But the *Korea Times*, noting GM's antagonism toward the plant's workers, said that "there is a rumor going around that it will be shut down after next year's presidential election (Sept. 21, 2001). GM will keep only two of Daewoo's 13 foreign plants, but will take all 22 marketing subsidiaries, giving GM "a sales network that spans the globe" (*Wall Street*

Journal, Sept. 21, 2001, p. A21).

GM paid $400 million for a two-third's share in Daewoo, which has the capacity to produce almost two million cars annually, less than it normally pays to build one new plant. It also agreed to take over $830 million of Daewoo's $12 billion total debt. In return, GM received a guarantee that creditor banks would offer $2 billion in new long-term loans and would be responsible for any additional Daewoo loans that GM discovers prior to sale, as well as any foreign exchange losses that might take place before the sale is completed. It will also receive huge government subsidies. GM will be free of all income or corporate taxes for seven years, will receive in addition the large subsidies offered to all foreign investors, and will be allowed to delay paying Daewoo's excise taxes for six months -- a substantial interest-free loan. In April 2001, the *Korea Herald* reported that a General Motors spokesman "demanded that Daewoo Motor be immediately sold to the U.S. car maker without charge," a demand that seemed outlandish at the time, but one that the government now appears to have accepted (April 4, 2001). Prior to the crisis, virtually 100 percent of cars sold in Korea were made by Korean-owned car manufacturers. In a few years, assuming that Daewoo's market share returns to its pre-crisis level, foreign-owned firms may produce close to half of the cars made in Korea, and Daimler-Chrysler will be part owner of the firm that makes the other half, while imports are likely to grow.50 The influential *Financial Times* in mid 2000 raised "the possibility that the entire [Korean auto] sector, the second largest in Asia, could soon be dominated by foreigners" (June 27, 00).

Note that the Kim government has used about 160 trillion won public money in a yet unsuccessful attempt to create a healthy financial system. The justification for this massive investment is that a healthy financial system is a precondition for, or means to, a productive and growing nonfinancial business sector that will be the source of rising real wages and incomes for Korea's workers. Yet in the case of Daewoo Motors and other crucial firms such as Hynix, the Kim government refused to provide the capital needed to sustain these companies as viable and competitive businesses.51 It could have invested several billion dollars in Daewoo Motors in a debt for equity swap, providing it with essential investment funds while eliminating much of its interest payment burden. It could have used the equity position acquired this way to carry out desired managerial reforms, and place representatives of labor and the public on the Daewoo Board of Directors so that stakeholder interests would have to be taken into consideration in corporate decision-making. Or, it could have sold its shares to domestic investors if and when the Korean economy became viable again. Instead, it chose to bleed Daewoo Motors until both management and labor were too weak to resist foreign takeover, even though in the process it ruined the company, starving it of funds needed both for capital investment and to retain its most talented managers. This inevitably produced plant closings, mass layoffs and the exodus of many of its key managerial and scientific personnel, and is likely to eventuate in the end of serious R&D activity. President Kim's Daewoo Motor strategy brings to mind the US General who said he had to destroy Vietnamese villages in order to save them.

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50 In 2000, Renault Samsung had 4.5% and Ssangyong Motors 7.4% of Korea's market. The first company is foreign owned, and the second is likely to be sold to foreign interests soon. Keep in mind that as of June 2001, foreigners owned 57% of the listed shares in Hyundai Motors.

51 In 1998, Daewoo was the second largest transnational corporation based in a developing country, with over $22 billion in assets and $30 billion in sales. (UN, *World Investment Report: 2000*, p. 82)

This dramatic rise in foreign ownership of the listed stocks of many of the most important Korean firms raises again the question of whether insider control of the large chaebol has been broken as the result of President Kim's policies. In particular, how can the thesis that insider control has been effectively maintained during the Kim administration be sustained in the face of the jump in foreign ownership just documented? The answer turns on two characteristics of the institutions of corporate control in Korea. First, only about a quarter of chaebol firms are listed on the stock exchange; the rest are privately held. However, listed firms own about 60% of top 30 chaebol assets. Second, owner-family and sister-firms together held about 65% of shares in these unlisted firms in late 2000, whereas they averaged only 30% for listed chaebol firms (FTC 2001). Early in Kim's presidency the government relaxed previous constraints on cross-firm shareholding. This allowed insider holdings to rise from about 44% of total shares in 1996-98 to 51% in 1999, as affiliate firms bought some of the new shares issued in response to the demand for lower debt-equity ratios. In 2000, insider control fell back to 43%, partly in response to the rapid inflow of foreign capital into Korea's capital markets during the second phase of the credit crunch. Latest estimates by the FTC put insider ownership at 45% and rising.

At this point in time, insiders appear to retain effective control over chaebol policy. But this may change in the future. Foreign interests have forced their way onto corporate Boards and in various other ways have constrained the set of feasible options available to insider decision-making.[52] Though only time will tell how much insider control will ultimately be reduced through the restructuring process, wide spread foreign domination of Korean firms and banks in the intermediate future is a possibility. Foreign control of Korea's banks is an especially dangerous aspect of restructuring since the Korean economy has been a bank-based system for four decades, with all major commercial and industrial firms dependent on financial institutions for the capital they need. *Since Korea's businesses are still heavily in debt, foreign control over key financial markets means a foreign stranglehold on Korea's future economic development*.

The speed with which the government arranged the sale of the financial institutions under its control is impressive; and more sales are in the works. Three years ago, foreign-ownership of Korean financial institutions was inconsequential. Today, foreigners are major shareholders in more than half of the nation's crucial commercial banks – they will soon own six out of nine -- and in many important NBFIs. By 2000, foreign financial institutions controlled 41.7%, 10.6% and 8.2% of Korea's banks, securities companies, and insurance companies.[53]

The sale of Korea First bank to the "vulture capitalist" Newbridge Capital is a good example of the dangers involved in this process. The government invested about 15 trillion won in Korea First to restore it to health. The sale price to Newbridge was a paltry one-half trillion won. So desperate was the Kim government to accelerate its program of foreign bank ownership that it accepted a notorious 'put-back' provision demanded by Newbridge by which the government was required to buy all assets

52 The *Korea Times* reported: "banks and large corporations have been inviting a growing number of foreigners to join boards of directors" (Feb. 19, 2001).

53 The government sold the Korea First commercial bank to KFB Newbridge capital in 1999. Since then, foreign investors control such important banks as Kookmin, Housing, and Hana, Foreign Exchange, and Kor-Am. Foreigners also are controlling shareholders in most securities companies, including Regent, KGI, Seoul, Goodmorning, and Meritz.

that turned sour in the two years following the sale. Purchased for a song, and with all short-term risk borne by the government, Korea First turned a profit in 2000. From January to May of 2001 alone, the government bought 572 billion won worth of bad loans from Korea First, allowing it again to turn a small profit. Other banks "grumbled that if they were given as large a bailout package by the government as Korea First," they would be profitable as well (*Chosunilbo*, June, 26, 2001).

But Newbridge showed no gratitude to the government for providing this sweet deal. When, in late 2000, the government announced its plan to rescue the faltering bond market, Korea First was the only commercial bank that failed to cooperate; it refused to roll its bond holdings over. A Korea First executive explained their position: "The Korean banking system needs a foreign player who can say no" to the government (*Business Week*, January 22, 2001, p. 53). This foreshadows a serious problem for future governments. When Korea's financial institutions are predominantly foreign controlled, they may refuse to provide adequate financing for Korea's economic development, and they may fail to cooperate with, and thereby block, future government economic policies. Moreover, though the government's major objective in pushing foreign control of Korea's banks was to increase the efficiency with which banks allocated credit to real sector firms, Korea First shunned corporate finance to focus on less risky and more profitable retail banking. Its announced policy is to cut the corporate share of its loans from 60% to 20%. This policy is the wave of the future in Korean banking. In the aftermath of failed neoliberal policies, industrial firms are too financially fragile and insufficiently profitable to be attractive to market-oriented banks, while the rising wealth at the top of Korea's income distribution makes niche consumer banking especially attractive. Market incentives will eventually force all banks not controlled by the state to shift from corporate to consumer banking.

VII. What is to be Done?

We have presented evidence to support the following conclusions

- The austerity macro policy of late 1997 and the first half of 1998 caused severe damage to Korea's weakened industrial firms and banks.
- The imposition of restrictive prudential regulation and large-scale bank closings in the midst of the 1998 collapse created a vicious credit supply crunch, while the requirement to drastically reduce leverage ratios left Korean corporations unable to demand desperately needed external finance.
- The collapse in aggregate demand coupled with the credit crunch led to a collapse in capital investment. Neoliberal restructuring may have created a permanently lower rate of capital accumulation in Korea.
- Korea's major corporations remain debt-burdened and unprofitable, while the attempt to break insider control of chaebol decision-making has yet to succeed.
- Though the injection of massive quantities of public funds did prevent the complete implosion of Korea's financial system in 1998, banks and NBFIs are unable to turn a profit

except where assisted by the state, they cannot provide adequate finance to the corporate sector, and their priorities are shifting from domestic business loans to consumer lending.

- The economic recovery in 1999 through late 2000 was unbalanced and unsustainable. Economic growth after the third quarter of 2000 slowed dramatically. The consensus forecast is that Korea's intermediate-term economic prospects are dim, and that the outbreak of another financial crisis is possible, this time triggered by internal financial shocks
- Foreign commercial and industrial firms, financial institutions, and portfolio investors have entered Korea's economy at a pace that would have been unimaginable prior to 1997. These agents have no allegiance to Korea's development and no reason to cooperate with government policies they do not like.
- If the government continues to force large numbers of unprofitable firms and banks to close, a new financial and economic crisis is likely to occur. But if it continues to use public funds to prop up weak enterprises, restructuring will fail.
- Neoliberal restructuring has led to increased inequality and economic insecurity.
- Contrary to the neoliberal ethos, it was the state, not the market system, that designed and executed the restructuring process. Three and one half years into the neoliberal revolution, the state continues to exercise substantial power over market processes and outcomes.

We should not be surprised by these results. Extreme neoliberal 'reform' has failed to deliver a better life for the majority of people wherever it has been imposed.54 The contrast between the failure of neoliberal restructuring in Korea and the great success of Korea's traditional model naturally raises the question of whether the Korean people would have been better off if the government had attempted to repair and reform the traditional model, adapting it to suit current economic and financial conditions. Alteration of the model's form to accommodate changing economic conditions would be nothing new; the structures and methods of state economic intervention in Korea have been changed significantly on numerous occasions over the past forty years.

The case for reform of the traditional model is strengthened by the lack of convincing empirical evidence that it had become *irreparably* inefficient by 1997. Even after the decline in the effectiveness of state intervention in the wake of the liberalization process, the economy still performed well enough to post reasonable GDP and productivity growth rates in the pre-crisis 1990s. For example, UNCTAD reports that between 1989 and 1996, labor productivity grew by 138% -- about 13% a year. This was twice as fast as the rate of growth of real wages (UN, *Trade and Development Report 2000*, p. 64). Operating profit as a percent of sales in manufacturing, though in slow decline, was adequate until the export shock of 1996 – higher than in the US, Taiwan and Japan from 1990-95 -- and it rose again in 1997. After a review of available evidence on comparative cross-country enterprise profitability in the late 1980s and 1990s (measured before interest payments), Chang and Park concluded that "Korean firms do not have low profitability by international standards and have done as well as, or even better than, the US firms which they are constantly asked to emulate (1999, p.11). Economists have presented

54 Mexico is often touted as an example of a country that prospered as a result of IMF reforms instituted after the peso crisis of 1994. However, real wages in Mexico remained some 20% below their pre-crisis level in 2000; they will presumably fall yet further due to the impact of the current US and global recessions.

conflicting estimates of the very malleable total factor productivity (TFP) index of efficiency for Korea, but in 1996 Collins and Bosworth found "improvement in TFP growth over the past decade [in Asia], particularly in Korea, Singapore, Thailand and Taiwan" (1996, p. 190). Radelet and Sachs estimate that Korea's TFP from 1990-95 was higher than in the late 1980s, and among the highest in the developing world (1998, p. 41). A recent IMF study of the Korean economy suggests that economic performance in the mid 1990s was about average for the post-1961 era: it estimates that the annual TFP growth from 1993 through 1996 was 2.5%, higher than the 1970-99 average of 2.1%, and only slightly below the 1980-97 average of 2.7% (IMF 2001, p. 8). But it also indicates a decline in efficiency compared to the expansion of 1983-89, in which average TFP growth was an extraordinary 4.6% per year, indicating that the1990s pre-crisis liberalization may have lowered Korea's productive efficiency.

Alan Greenspan said that state-led growth in East Asian countries was "successful for a time because they started from a low technology base... but there are limits to this process as economies mature" (1998). But even at its mid 1990s level of $11,000, never mind at the 1999 level of $8,500, Korea's per capita Gross National Income was only 38 percent of the US figure and just 30 percent of Japan's. Moreover, capital per worker in Korea is just 40 percent of US and Japanese levels, and its output per worker is only 45 percent of US labor productivity (Data from Collins and Bosworth, 1996, p. 189). Collins and Bosworth conclude that since the "data suggest that these countries have hardly exhausted the potential for catching up," there is no inherent reason why their traditional East Asia models could not continue to be successful (199, 190).

After the onset of the crisis in 1997, most Western commentators pointed to the many problems that beset the Korean economy as clear evidence that the traditional Korean resource allocation process was fatally flawed. Yet these critics *never* compared the effectiveness of Korea's resource allocation with that of any *actually existing capitalism.* Korea's performance in the 1980s and 1990s is not compared with Brazil's or Argentina's or Mexico's or Chile's. Rather, Korea's naturally imperfect economic performance is always compared to the perfect allocation process envisioned in neoclassical theory. Of course, major decisions were poorly made by the Korean government, by Korean banks, and by the chaebol, but to our knowledge, no one has presented credible evidence that Korea's economy was significantly less dynamically efficient thorough 1997 than any actually existing neoliberal developing country. Comparison with China or Taiwan, which would not show Korea in an unfavorable light prior to the crisis, are irrelevant because these countries are not neoliberal; the state intervenes in market processes in major ways in both countries. The Korean people have been pushed onto a dangerous economic path based not on the superior performance of actually existing developing economies that have adopted neoliberalism -- there are no such examples -- but on the marvelous characteristics of a fairy tale economy which has never existed anywhere but in the minds and models of conservative economists.

What should have been done in 1997?

A serious analysis of possible alternatives to neoliberalism in Korea would acknowledge that by the mid 1990s the traditional model had developed serious flaws -- over and above those created by

excessive liberalization. The problems that most troubled and angered the Korean public was the powerful, anti-democratic influence the owner-managers of the large chaebol had gained over the economic policies and priorities of the national government. Recently freed from military rule, Korea was becoming more an oligarchy than a genuine democracy. There was thus an urgent need to end the excessive influence of the chaebol over the Korean political system. This was also a precondition for the reconstruction of effective state guidance of economic activity.

The public would have supported extraordinary efforts by the government to strip the chaebol founding families of excessive personal wealth, dynastic control of Korea's most important economic assets, and disproportionate political influence. What they got from President Kim and the IMF instead was anti-chaebol rhetoric and economic policies that severely weakened chaebol firms and did great damage to the Korean economy, but left the owning families in effective control of decision making in the surviving chaebol. Without doubt, macro economic distress, increased FDI and foreign shareholding, and restrictive agreements forced on the chaebol by their main creditor banks have tightened the constraints facing owner-managers, but they have yet to dislodge them.

Chaebol diversification had also become quite extensive, though it is not clear that this was a major problem. Diversification was quite functional throughout much of the chaebol's history because it allowed the groups to enter important new industries and develop new technologies through risk spreading.55 By the mid 1990s, however, it may have reached excessive proportions as the largest chaebol added totally unrelated businesses such as hospitals, universities, and newspapers to their group. Moreover, chaebol firms often used their monopoly power to gouge consumers, a problem that could have been solved through effective anti-trust efforts.

Labor-capital and labor-state relations were badly in need of dramatic change. Though militant labor struggle had gained chaebol workers higher than average wages, management treated unions as mortal enemies, using every means at their disposal, including state power, to undermine their influence. The big chaebol went so far as to support the radical and destructive IMF agreement in large part because it entailed a major assault on union power. Moreover, the labor movement had no representation in, or influence on, national government. Economic policy was determined largely through government-business consultation. Both government and capital saw labor unions not as allies, but as impediments to the achievement of their objectives.

Finally, Korean financial institutions lacked the managerial and staff expertise needed to shoulder the increased responsibility for credit allocation that would be assigned to them under either neoliberalism or a reformed state-guided growth model. Korean banks were deficient in these areas because for several decades they merely executed credit allocation decisions made by the state bureaucracy. Moreover, many of the most important NBFIs were controlled by the chaebol, who used them as an unregulated source of group investment finance. *It should be kept in mind, however, that destructive bank performance in the pre-crisis1990s was primarily caused not by technical*

55 Early entrance into a new industry, especially if it involves new technologies, can be prohibitively risky for an unattached firm because of the assured losses of the early years and the high risk of failure, which results in bankruptcy. The big chaebol could withstand the early losses and the possibility of ultimate failure because they had numerous profitable companies and access to relatively cheap capital. They also had skilled and flexible workers and managers.

incompetence, but rather by the typical speculative, shortsighted behavior we see from time to time in all liberal financial systems.

Keeping in mind the key mistakes of excessive liberalization prior to 1997, the problems in the traditional model just enumerated that had developed in the 1990s, and the disasters of neoliberal restructuring, we offer some *general guidelines or principles* relevant to a debate over the choice of an alterative path for Korea's economy. These guidelines are designed to inform the debate about a 'progressive' reform of the traditional model, not the more ambitious question of a radical transformation to some form of socialism.

To minimize the costs of transition and build on the strengths of the traditional model, the new path should be built around the institutions and relations of the pre-crisis economy.

Neoliberal restructuring violated this norm and, by so doing, caused major damage to the Korean economy that could have been avoided. Reforms that build on existing institutions, institutional relations, and deep-rooted conventions have far lower transition costs than revolutions that attempt to destroy them. Woo-Cumings warned that "we must be sensitive to 'path dependency,' to a pattern of Northeast Asian development that has characterized the whole twentieth century" (2000, p. 61). Our set of reform guidelines was selected with this crucial point in mind.

Radical neoliberal restructuring was tried in Russia, where it is failing catastrophically. In both Russian and Korean cases, backers of the revolutionary approach argued that the existing system had collapsed totally. This claim is questionable in the case of Russia – the majority of Russians would be delighted if they could go back to 1989 and begin anew with reform -- and it cannot be credibly made about Korea (Kotz and Weir 1997, Chang and Evans 1999).

The model must continue to be state-guided, but both the political character and the economic functions of state must be transformed.

The Korean people acting collectively through the government must set guidelines and priorities for economic development, so that the broad contours of future economic growth are determined by society acting through a democratic political process. This principle has two important implications. First, state-guidance of economic development is essential for effective, progressive economic development, even if markets are to be relied on to a much greater degree than in previous decades. History instructs us that state-guidance and socially-embedded markets are necessary – though by no means sufficient – conditions for sustained development. No country has ever successfully developed using the neoliberal approach.

Second, *a second democratic 'revolution' is needed* to force the state to act in the perceived interest of the majority of Koreans, rather than in response to the demands of a domestic economic oligarchy and foreign economic powers. It is essential that the labor movement as well as emerging civic movements be represented by a political party powerful enough to defend their interests. *Labor must for the first time become a full partner in Korea's national political process.*

Herein lies the daunting challenge that confronts the Korean people. To create a viable and effective economic system capable of building widely shared prosperity, they must accomplish yet another progressive political revolution in circumstances that might be considered more difficult than the

ones they faced in the 'revolt' of 1987 because of the newly-strengthened anti-labor alliance between domestic and international capital.

The Korean government must re-regulate cross-border capital flows.

It was the deregulation of short-term capital flows, especially foreign bank loans, that brought Korea to its knees in 1997.56 In developing countries, the removal of government controls over short-term flows is almost invariably followed by currency and financial crisis; this pattern is well established in the literature (See Demirguc-Kunt and Detragiache 1998, Rodrik 1999, Stiglitz, 2000). As Rodrik put it: "There is plenty of evidence that financial liberalization is often followed by financial crisis – just ask Mexico, Thailand or Turkey – while there is little convincing evidence to suggest that higher rates of economic growth follow capital account liberalization" (2001, p. 7). Furman and Stiglitz agree: "capital account liberalization greatly increases the risk of capital surges, investment distortions, crises and collapses, especially in countries that lack robust financial systems" (1998, p. 32). The costs of unregulated short-term cross-border capital flows far outweigh their negligible benefits.

The elimination of controls over short-term capital flows in Korea was especially tragic because the country had a domestic saving rate that fluctuated between 30% and 40% over the past fifteen years. Except for trade credit, it had little if any need for short-term foreign capital. The government is quite proud to have accumulated almost $100 billion in foreign exchange reserves to use against a possible run on the won, but holding reserves of this magnitude carries a huge opportunity cost. What is the point of relying on short-term foreign funds if you do not need them and have to hold such a large percent of their value as relatively sterile reserves? We cite Rodrik again: "Peru's central bank holds foreign reserves equal to 15 months of imports as an insurance policy against the sudden outflows that financially open economies often experience. The opportunity cost of this policy amounts to 1 percent of gross domestic policy annually – more than enough to fund a generous anti-poverty program" (2001, p. 4). Capital controls are essential because the true costs of substantial short-term borrowing always exceed their benefits to the nation, though not necessarily to the individual – especially given the high saving rate in East Asia. Furman and Stiglitz summarized this situation as follows.

> In the case of East Asia, where the saving rate was very high, the benefit to the extra capital accumulation that followed liberalization may have been relatively low. ... [Moreover,] if one believes that countries should keep short-term debt below the level of reserves, additional short-term borrowing must be offset by equal or larger increases in reserves. From a [national] perspective, a developing country is borrowing from industrial countries' banks at high interest rates only to lend the same money to industrial countries' governments at much lower rates. Being a financial intermediary with a negative spread is probably not the most profitable line of business! (1998, p. 54)

The economic and political impact of FDI on developing countries is more complex. Nations such as China and Singapore have utilized inward FDI to their advantage. Where FDI played a positive role in national development, host governments invariably maintained control over the FDI process,

56 Most of the deregulation of portfolio investment occurred after the crisis.

relying on policies such as mandatory joint ventures with domestic firms and domestic content requirements to ensure that foreign capital enriched domestic economic capabilities. (See Crotty, Epstein, and Kelly 1998, Mardon 1990) To be successful, the evidence suggests, FDI must fit within a state-led development strategy. Simply opening the borders to foreign firms and banks without restriction, as occurred in Korea recently, is not a winning formula. Indeed, since the lion's share of FDI in 1999 and 2000 in Korea was M&A, not new investment, it is not clear that foreign capital made a major contribution to the recovery process or to long-term growth prospects.57

Excessive reliance on FDI has a serious political downside. Where FDI plays an important role in industry or finance, or where the home-country government is committed to attracting FDI, foreign businessmen often gain disproportionate political influence, and use it in ways which conflict with the public interest. Foreign firms and banks often have no particular commitment to the economic development of the host country and they ally with domestic capital to repress workers. Many firms use FDI to create export platforms; they therefore demand flexible labor markets, low wages, and minimal taxes or maximum subsidies. Domestic goals such as low unemployment (which strengthens unions and may raise inflation) or high wages conflict with these objectives. And foreign firms may refuse to cooperate in the implementation of important government economic policies. *They can be expected to do their best to undermine any future effort to create a progressive, state-guided Korean economy.*

Korea does not have to rely on foreign capital to finance its continued development. In 1999, gross saving was 32.9% of GDP in Korea. This is more than enough to finance a more rapid rate of capital accumulation than that experienced in the past three years solely with domestic funds. Short-term capital inflows should be kept to a minimum. Where there is a need for improved technology that cannot be efficiently developed domestically, licensing and joint ventures may be more helpful than FDI. Most important, FDI must conform to government guidelines designed to maximize its contribution to the development of the Korean economy, and minimize the political and economic influence of foreign firms.

To put the matter in dramatic terms, unless Korea restores effective capital controls, it is extraordinarily unlikely that the majority of its people will experience prosperity and economic security in the future. The arguments in favor of the use of capital controls in developing countries are compelling (Crotty and Epstein 1996); in light of the wave of financial crises in recent years, even mainstream economists have begun to appreciate their advantages. The eminent American economist Richard Cooper recently concluded an article titled "Should Capital Controls be Banished?" by observing that "liberalization of capital movements seems to be a good idea – if the conditions are right. But the right conditions are extremely demanding. And the arguments for liberalization … are not compelling even if the conditions are right" (1999, p. 124). China and Taiwan have maintained control over cross-border financial flows; as a result, they avoided the worst excesses of the 1997 Asian crisis. Malaysia successfully reintroduced capital controls a few years ago, and even mainstream economists applaud the "market-friendly" controls used by Chile and Columbia in much of the 1990s. Modern East Asian economic history proves that foreign capital will be made available to countries that maintain capital controls provided they generate good long-term growth and rapid productivity gains.

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57 Mody and Negishi argue that "the macroeconomic recovery [in Korea] has apparently not been helped by cross-border M&As" (2001, p. 7).

The chaebol governance structure must be changed

Before the 1990s, the record shows, the chaebol governance structure was reasonably effective economically because it facilitated quick and bold firm decision making in response to government initiatives and, as noted, permitted considerable risk-taking in new industries through the principle of risk-sharing across sister firms.58 Moreover, the chaebol specialized even as they diversified – a small number of firms located in a small number of industries dominated total sales in each chaebol. The founders were talented entrepreneurs, and the owner-manager structure helped reduce principle-agent conflict.59 However, as they grew to dominate the Korean economy, they began to dominate the political process as well. *We believe that the main problem created by the growth of the chaebol was political, not economic*. The "real threat of chaebols to the Korean economy lies in their social and political power resulting from their economic weight" (Yoo and Lim 2000, p. 105).

After the crisis, the belief spread that the chaebol system had become increasingly inefficient in the 1990s because of the growth in size and complexity of the large chaebol, the transfer of control to the sons and grandsons of the founders, and ever-greater diversification. There are only a few serious studies of chaebol efficiency, but unfortunately they reach no consensus. In a survey of studies that addressed the question of chaebol efficiency, Yoo and Lim concluded that "there seems to be no consensus on the real problem of chaebols" (2000, p. 68). The 1996 OECD economic survey of Korea addressed the issue and concluded that concern about chaebol inefficiency "is not supported empirically; the productivity of subsidiaries is higher on average than that of independent firms. … The managerial and technological capability within the groups generates a synergetic effect that promotes expansion into many new industries offering high returns in Korea's rapidly-growing economy" (OECD 1996, p.116). Chang and Park 1999 present a generally positive view of chaebol economic performance; for a negative view, see Jang 1999, Han 1999, and Joh 1999. Our best guess is that if the large chaebol did lose some degree of *productive* efficiency in the 1990s, the loss was not substantial. The overwhelming problem with 1990s chaebol decision-making was in the area of finance, not production. Freed from government restrictions on short-term foreign borrowing, they responded to a booming export market and cheap foreign loans the same way that US corporations responded to a booming ITC market and cheap equity capital in the late 1990s. Nevertheless, Korea's most important industrial and financial assets should not forever be governed through the principle of heredity and Korea's democracy must be freed from the corrosive influence of the owning families. *It is the excessive economic and political power of these families that should be destroyed, not the chaebol firms.*

The owning families should be forced by law to give up control of their conglomerates, not to minority shareholders, but to a Board of Directors composed of representatives of stakeholder interests. *The most pressing domestic economic reform issue in Korea is removal of owner-manager*

58 "Diversification into many industries can be justified through the gains from economies of scope (as versus scale) and dynamic back-and-forth synergy across firms. Furthermore, portfolio diversification reduces risk" (Woo-Cumings, 2000, p. 31).

59 Chang 1994 and Chang and Park 1999 provide useful information concerning the workings of Korea's traditional state-led model and the role played by the chaebol in the Korean economy.

control over the chaebol, and thus over the political process, not their break up or domination by foreign capital. Substantial labor representation is essential not only because workers are profoundly affected by company performance, but also because their relationship with management and their degree of firm loyalty affect productivity and the incidence and severity of labor-management conflict. Many European and Scandinavian countries mandate worker representation on company Boards, which is a major demand of the KCTU.60 Since government owned banks hold large quantities of chaebol debt, debt-equity swaps could be used to gain public representation on chaebol Boards. Surveys show that even after a massive media campaign designed to sell neoliberalism to the public, most Koreans still believe that large-chaebol firms are 'national' assets that should pursue social or stakeholder interests rather than private profit.61 According to Hwang and Seo, "In Korea, a firm is considered as a public entity that has social responsibility. Grafting Anglo-American shareholderism per se in Korean corporate culture may exacerbate the conflict of interest among stakeholders" (2000, p. 26). Woo-Cumings also cautions that "reform of corporate governance has to be plausible in the context of what *is* (not simply what ought to be) and resonant with larger social goals that enjoy broad support" (2000, p. 6).62 Only a drastic change in chaebol governance that eliminates founding family control, gives labor and society major influence over corporate policy, and ends founding family political influence can assure that large conglomerates operate in the national interest.

Production in the Korean economy should undergo a gradual shift in orientation from exports to domestic demand.

The rising dependence on exports in Korea in the 1990s, especially after 1995, was astonishing. Bank of Korea data, based on 1995 prices in won, show that in 1993, real exports of goods and services were 25% of real GDP. By 1995 this figure rose to 30%; in 1997 it was 36%. In the collapse in 1998, export dependence increased dramatically, to 45%. Recovery in 1999 and 2000 did nothing to stop this trend. In 2000, the figure rose again to 52%. If both numerator and denominator are measured in current won, the absolute values of this index of export dependence are lower – for example, the value in 2000 is 38.5% compared to 25% in 1996 -- but the trend remains the same. Both series show that export dependence in every year since the crisis is higher than in any year prior to the crisis.63 The

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60 In 1999, a KCTU spokesman complained that "workers are excluded from the whole decision making process of restructuring and severely disadvantaged in the burden sharing matrix." The only solution to this problem would be to "embrace employee participation in ownership and management" of the chaebol. (Yoon Youngmo, International Secretary, "Chaebol reform: the missing agenda in 'corporate governance'," March 1999, p.7)

61 In a 1999 survey only 3.1% of the "general" or non-professional respondents thought that Korean firms should pursue "shareholder value"; 51.4% thought employee welfare and "social benefit" the proper goals, while 45.5% thought the growth and development of the firm itself should be paramount. Only 28.5% of "professional" respondents selected pursuit of shareholder value as the appropriate firm goal. (Hwang and Seo 2000, p.26)

62 She emphasizes the complexity of chaebol governance reform. "The question of the *chaebol* is at the core of a whole complex of issues involving banking, medium and small-sized business firms, land, labor, income distribution, law and politics. It cannot be excised from the economic system by Korea and 'reformed'" (2000, p. 25).

63 Data used to construct the first series are taken from the Bank of Korea's *Monthly Statistical Bulletin* (July 2001, pp. 146-47). The difference between the two series is caused by the sharp decline in export prices relative to non-traded domestic goods prices since 1995 as the terms of trade turned against Korea.

The extraordinary growth in demand for Korean exports after the early 1990s helps explain why the chaebol

key problem is that export markets are excessively volatile, while the real capital invested in export production is highly immobile. Volatile demand combined with asset specificity is a recipe for economic disaster – especially when the state has given up control over cross-border flows of goods and money. By mid 2001 Korean economic growth dropped below 3% in large part because export demand, especially for high tech goods, was shrinking. Growth in domestic demand in Asia since the crisis "has been relatively week, making economies even more dependent on exports. … Asia is thus more exposed to a global slump than ever" (*The Economist*, Sept. 25, 2001, p. 23). The high tech bust in the US, the destination for 40% of the world's exports, brought sluggish growth or recession to most of East Asia.64 Global demand for the key items that Korea exports – such as semiconductors, electronics, autos and ships – fluctuates wildly.

The elimination of government regulation of capital flows and excessive dependence on imports has now been shown to be a double-edged sword. Korea boomed in the mid 1990s as cheap foreign capital flooded its financial markets and its export markets surged. It was staggered in 1996 by the slowdown in global export demand. The economy finally collapsed into crisis in late 1997 as foreign capital fled the country. The rebound in 1999 and the first half of 2000 was stimulated by the great American stock market bubble that induced massive investment in US high-tech industries and thus an export-led growth spurt in Asia. But the collapse of the US boom in mid 2000 dragged down both global growth and Asian export demand, especially in the electronic and telecommunication products in which area economies specialize. "Welcome to the first global recession of the 21st century" *The Economist* recently exclaimed (Sept. 25, 2001). The radical opening of its economy has put Korea at the mercy of global economic forces completely beyond its control. Worse yet, the tighter integration of national markets under neoliberalism has caused greater synchronization of national cycles. We appear to have entered the first global recession since the early 1970s in which growth slowed in every important area of the world.

Excessive export dependence is dangerous in part because inter-nation competition in key export markets is intense and unpredictable. Cost advantage shifts from country to country as volatile short-term capital flows push exchange rates up and down, and multinational corporations move productive capacity and technology from one country to another. This fierce competition stimulates over-investment, as firms in different countries try to keep up with each other's efforts to improve technology and achieve greater economies of scale. The excess capacity that results then leads to price wars and financial distress.65

Korea's government should emphasize domestic rather than export demand, and it should rely primarily on domestic firms and domestic finance to do so because foreign capital is much less likely to cooperate with government development plans. Domestic demand is more stable and predictable than

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made such large investments in productive capacity in the mid-1990s. They were reacting 'rationally' to positive market signals, even though they over-reacted. Of course their mode of finance of investment in this period was highly risky, perhaps even "irrational."

64 "Asia will be hurt very badly because Asian countries are the most export dependent economies in the world" (*Business Week*, Sept. 24, 2001, p. 44).

65 Crotty 1993 and Crotty 2000 present a theoretical framework for understanding these cycles of over-investment and destructive competition. Crotty 2000 shows how the rise of a neoliberal global regime has created a vicious cycle of demand stagnation and destructive competition.

export demand, and, most important, *it can be regulated by government economic policy*. There are many policy tools that can help accomplish this shift in demand. The government should end its traditional hostility to labor and act to strengthen rather than repress the labor movement; this will help raise the wage share and increase consumption spending. Moreover, the tax system should be made progressive, and export incentives should be gradually scaled back. The government should use industrial policy as necessary to smooth this transition. Since Korea can be expected to experience a gradual reduction in its average growth rate as it develops, investment as a percent of income will decline. Thus, incentives to save can modestly reduced to help raise the propensity to consume.

Many economists support an increasing emphasis on domestic demand in developing countries. Rodrik advises policymakers in developing countries "to forge a domestic growth strategy by relying on domestic investors and domestic institutions (2001, p.2). The United Nations Conference on Trade and Development also calls for a shift in production priorities.

> A strategy of greater reliance on domestic markets with stronger social dimensions of the kind that underlined the successful experience of the Western European periphery during the Golden Age offers a viable option. The elements of this experience are familiar: a rapid and parallel growth of real wages and productivity, strong growth in domestic demand including rising public expenditures largely financed by taxation, and increased intraregional trade. Emulation of this experience in the Republic of Korea should perhaps include a rise in the wage share, associated with a reduction in working hours, and an increase in public expenditures on health and education. Since the saving rate was already high prior to the crisis, … there should be ample room to raise investment from the crisis levels without relying on foreign capital of the kind which distorted economic development prior to the crisis. (*Trade and Development Report 2000*, p. 71)

Korea needs a bank-based system of corporate finance.

The transformation of Korea to a form of global shareholder capitalism is supported by all official international organizations such as the IMF, the World Bank, the OECD, and the Asian Development Bank, as well as by G7 government and multinational firms and banks. (IMF 2000, ADB 2000). Their goal is to have Korea's industrial and commercial activity guided by stock and bond markets largely dominated by foreign investors, and by giant multinational banks, a few of Korean origin, operating without any interest in national development or social well-being. In the IMF's capital-market based financial system, stockholders and bondholders provide the funds needed for corporate investment and, in so doing, monitor and control company policy. Falling stock and bond prices signal investor unhappiness with company performance. By raising the cost of finance, investors can force the company to change policy or face slow-death through declining investment. Hostile takeovers are another device through which investors can force their priorities on recalcitrant firms. 66

66 Of course in practice, business and government leaders will not let overall economic activity collapse because of rapidly falling stock prices. The Korean government has on several occasions interfered with market forces to try and stop falling stock prices through measures such as public pension fund stock purchases and proposed cuts in the capital gains tax.

There are three main reasons why it was wrong to attempt to impose this system on Korea.

First, it is an inefficient and even dangerous system of investment finance and corporate control because most stock and bond investors have short-horizons, significantly less information than firm insiders about future profit prospects, and seek quick capital gains rather than long-term growth (Crotty, 1990). Stock and bond markets are *inherently* volatile, subject to speculative booms and busts that create instability in the real sector. (See Crotty 1994, Minsky 1986, Keynes 1936, Schiller 2000, Radelet and Sachs 1998, and Poterba and Summers 1995.) As Rodrik correctly observes: "Financial markets are inherently unstable, subject to bubbles (rational and otherwise), panics, and self fulfilling prophesies" (2001). Consider again the recent performance of US high tech stocks (or the entire US stock market for that matter). The NASDAQ stock price index rose rapidly after 1994, then accelerated from a level of 1800 in late 1998 to 5700 in early 2000**,** only to fall below 1800 again in 2001. In the heat of the boom, the US information technology and telecommunications (ITC) sector was able to raise huge amounts of cheap money in the stock and bond markets to finance 'irrationally' large investment expenditures. Over-investment of this magnitude quickly led to large-scale excess capacity that in turn triggered an investment collapse after mid 2000. The collapse of the ITC sector was large enough to slow US and global economic growth, and cripple Asian exports.

American economists, business leaders and politicians told Koreans in 1997 and 1998 that the speculative financial boom and over-investment of the mid 1990s proved that their pre-crisis economic model was so inherently inefficient that painful radical restructuring was unavoidable. Koreans might now be forgiven if, tongue in cheek, they ask Americans whether the US economic model will have to be radically restructured in the aftermath of their own financial bubble and over-investment episode. It is not just Korea's chaebol who are prone to such excesses. In an article about over-investment in US telecommunications, the *Wall Street Journal* stated that "the telecoms' boom and bust has whipsawed the entire national economy." It also explained: "businesses spend enthusiastically on buildings and equipment when times are good and cut back sharply when times are bad" ("Telecom Sector's Bust Reverberates Loudly Across the Economy, July 25, 2001, p. 1).67

Opening Korea's financial asset markets to foreign individual and institutional investors (who are often poorly informed about the Korean economy) only served to raise economic instability and increase foreign economic and political influence in the country. Advanced country capital investment performance has been insulated to a degree from the effects of financial asset price instability because internal finance in the US and UK covers 70% and more of the cost of investment. In pre-crisis Korea, on the other hand, internal funds covered less than 30% of investment spending. Thus, implementing a capital-market based financial system in Korea should have been expected to either substantially lower investment spending, cause investment to become extremely vulnerable to financial market instability, or both.68 *In fact, it did both.*

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67 The US not only engaged in substantial over-investment in the late 1990s, it also experienced excessive enterprise and, especially, national debt as well. The cumulative current account balance from 1996-2000 is over $1.2 trillion. The US has for some time been the world's largest debtor; as if year-end 2000 it's net debt to the rest of the world measured at market value was $2.9 trillion – 22% of US GDP. One reason why the US has not suffered the kind of financial crisis experienced by Korea is that because of the reserve currency status of the US dollar, its foreign debts are denominated in its own currency.

68 Investment as a percent of GDP is also much lower in advanced countries than in Korea and other East Asian

Second, the Korean economy relied on a state-guided bank- based financial system for over three decades. Stock and bond markets as modes of corporate finance were, by US-UK standards, seriously underdeveloped, and there was no market for corporate control. Imposition of neoliberalism after 1997 thus required a structural revolution in Korean financial markets and in the mode of corporate finance, one that could not fail to generate huge transition costs.

Third, bank-based financial systems are most conducive to effective state economic guidance. It is much more difficult for the state to regulate the size and allocation of national saving, sustain full employment, and achieve an egalitarian income distribution in a capital-based financial system (Zysman 1983, Pollin 1995, Schaberg, 1999).

The desire to shift more micro allocative responsibility to markets and away from the state bureaucracy as the country became more developed could have been accomplished within the bank-based structure without crippling state economic guidance of the broad outlines of economic growth. The government could have stopped making micro-level decisions about credit allocation – as President Kim's government continues to do -- and focused instead on setting general priorities and guidelines for banks to follow in their loan decisions. Large firms and even chaebol groups have already been assigned one or more main banks. Given sufficient time and adequate investment in the human and physical capital available to the main banks, they could adequately monitor and control the firms they served, minimizing information-asymmetry problems. The state would decide which sectors, products or technologies should receive needed credit at reasonable interest rates, taking externalities, coordination failures, and the social good into account.69 But the main banks would determine which firms should receive credit on a priority basis, and whether favored firms ultimately used this credit effectively enough to deserve credit renewal. If Korea had moved in this direction after the crisis, it would have avoided the current fiasco in which public money is used to rescue banks, which then, under domestic or foreign ownership, refuse to fund needed capital investment because it is not as profitable as consumer finance.

The government would have to maintain a bureaucracy with the expertise, information, and authority needed to intelligently evaluate main bank performance ex post, a challenging but hardly an impossible task. Korea "has one of the oldest and finest traditions of civil service and, counting the colonial period, a century of state-directed growth" (Woo-Cumings 2000, p. 48). And it would have to develop effective mechanisms of control over the country's main banks, a task that would be made easier if the government stopped selling so many of the banks under its control to foreign firms. The retention of significant bank equity would facilitate state control of the banking system.

Korea is not yet an advanced country; it is at an intermediate level of development where the advantages of bank-based systems are greatest (Shin 2000, Allen and Gale 2000). Bank-based financial systems can monitor firms, finance small and medium enterprises, and sustain high and stable national investment rates better than capital-market systems. The East Asian experience demonstrates that long-term or patient capital is best suited to sustain a high-investment, high-growth regime as long as

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nations. It may be that even where internal funds are large, capital-market based financial systems are unable to support high-investment regimes.

69 The state could also follow policies designed to achieve a target national rate of saving, so that the amount of funds available to finance investment was both of the right magnitude and allocated sensibly.

financial capital is allocated with reasonable efficiency.70 It is the responsibility of the state to see to it that banks do not slide into cronyism and corruption, and to ensure that foreign banks operate in the national interest. (See Lee et al. 2000, Takagi 2000) As Singh and Weiss observed: "Developing countries would do better to reform the institutional structures of their banking systems rather than create stock [and bond] markets which require sophisticated monitoring systems to enable them to function effectively, quite apart from their intrinsic shortcomings" (1998, p, 617).

Summing Up

Pre-crisis liberalization plus radical post-crisis neoliberal restructuring have dismantled or badly weakened many of the policy tools the government traditionally used to impose social control over the Korean economy in the decades before the crisis. Indeed, contrary to President Kim's belief that free-market systems promote democracy, neoliberal restructuring requires the replacement of at least potentially democratic political control over the economy with market processes dominated by rich individuals and powerful companies. *If Korea completes its transition to: "flexible" labor markets and weakened unions; free cross-border capital flows; investment guided by speculative, volatile stock and bond markets; corporations and banks guided only by the pursuit of private profit and shareholder whim, and emerging foreign domination of finance and industry -- what policy instruments will be available to future progressive governments to guide Korean economic development so that it meets the needs of all the country's people?* This may be the most serious long-term problem facing the Korean people.

The destruction of the institutions of state economic regulation is not an easily reversible political process. State-regulated economic systems, whether in the West during in the Golden Age of the 1950s and 1960s or in the East Asian "miracle" economies, were created in the aftermath of depression, revolution, military coups or war. In the absence of a severe economic crisis, it would be extraordinarily difficult to put together the domestic political coalitions necessary to create such a system from scratch, even in the absence of external pressures and constraints. For a country as embedded in the global neoliberal system as Korea will be if the U.S. government, the IMF, President Kim, and their supporters have their way, it might well prove impossible.

The battle for a progressive future for Korea has not yet been lost. On its forced march toward neoliberalism, the Kim government found it necessary to increase state control over Korea's financial institutions, which gave the state additional tools with which to influence economic affairs. If a progressive government took office in the intermediate future, it could take advantage of this situation to reassert social control over Korea's economy. Meanwhile, the democratic union movement, though bloodied, remains militant, and public support for neoliberal restructuring, and for President Kim himself, has declined dramatically. In May 2001, the *Far Eastern Economic Review* reported that "Kim now presides over a political disaster zone" in which "70% of the people oppose him" (May 24, 2001). Not long after, the *New York Times* reported his approval rating at 19% (September 9, 2001). But time is running short. The further down the neoliberal path the economy is dragged, the greater the costs of transition to a reformed traditional

70 We would expect that over time, as Korea successfully develops, the national rate of investment and growth will slowly decline from the spectacular levels achieved in the early decades.

model. To have a reasonable chance of success, a national offensive to defeat neoliberalism must begin soon.

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