Chapter 18

Financial liberalisation, crisis and recovery: Changing state-business relations in South Korea

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1. Introduction

The South Korean (henceforth Korean) economic growth track came to be known as one of the East Asian miracles. The Korean economic model did mainly build on import substitution and export promotion strategies, where the state actively intervened in economy. The state, which controlled the banks, chose specific industrial producers to fulfil specific export goals and it helped them with cheap state guaranteed loans, gave them subsidies and protected them from the outside with taxes. Skilled bureaucrats were apparently at place. State-business relations were institutionalised with Monthly Export Promotion Meetings taking place in the presidential residence, the Blue House, and Korean industrial policy was praised by revisionist economists.[132]

In the early 1990s South Korea turned, however, into an economic squeeze. On one hand, China and less industrialised low-wage countries in Southeast Asia were out-competing Korean industry. On the other hand, Japan was still superior in technological terms. Coincidentally, Korea experienced declining terms of trades in its main export sectors.

To redress economic difficulties Korea set out on a path of financial liberalisation which became dreadfully unbalanced. Short term foreign borrowing was fully liberalised whereas long term foreign loans were controlled. The result was a bulk of short term foreign loans invested in long term domestic projects: loans which soon became non-performing and triggered a financial crisis.

The question is what happened to the efficient and development oriented state-business coalition? And why this happened? Was the malaise

[132] The revisionist economists, in the literature on economic growth in Asia, are a group of economists arguing that state – not free markets - played a crucial role in the process of economic and industrial development in the East Asian high performing economies. Most prominent among these economists are Alice Amsden (1989) and Robert Wade (1990).

set off by pressure from international, especially US, capital interests? Or was the Korean economy collapsing due to cronyism? Were state-business relations dismantling or had they rather become too strong in a very inappropriate (cronyist) manner?

To shed light on these questions, we first go through the different crisis explanations in order to position ourselves in the debate. Secondly, we analyse the specific track of financial liberalisation in Korea and at interests influencing this process. Thirdly, we look at restructuring tendencies in the post-crisis economy.

We argue that foreign trade partners do influence Korean policy-making but still inter-Korean interests have a say, especially the chaebols, which have become an even stronger faction during the 1990's. The democratisation has further made it more difficult for the government to elaborate and implement a coherent economic policy, and it has put the government in an even weaker position into the chaebols.

We further argue that the rationalist way state and state-business relations are handled in the greater part of the literature is too narrow to give an adequate understanding of the changes in Korea. Institutionalised power structures, culture, habits, mistakes and unforeseen events play significant roles.

2. Financial crisis in 1997

In 1997-98 Korea was hit by its second economic crisis since it moved from a slow, debt ridden economy to a fast-lane regional economic power in the course of three decades. Since Park Chung Hee took power in 1961 following a coup d'état the economic records of Korea were astonishing prosperous and the country gained reputation as one of the fastest growing economies of the world.[133]

A leaked report from the central bank, Bank of Korea (BOK) in 1996 may be the first to flag recession as a realistic threat to Korea (Oh 1999: 197). Hanbo Steel Industry, the country's second largest steelmaker, went bankrupt in January 1997 and later came the liquidity problems of Kia Motors, the country's third largest car producer (Chang 1998). By all major criteria, Korea had followed a conservative macro-economic policy; but the macro-economic performance masked the structural weaknesses. During 1997 the negative structural weaknesses became all too apparent. The

[133] The country faced, however, two other economic crises: A debt crisis in 1969/70 and a crisis in 1980 following the global recession and triggered by excess industrial capacity and inflation (Woo 1991; 109 and 182). The second crisis happened at a time where also the internal political situation was chaotic after Park Chung Hee was murdered.

average debt-equity ratio of the 30 largest chaebols[134] was in 1997 519% (Lee 2000: 64). Some of the chaebols among top 6-64 had debt-equity ratios up to 1800% (IMF 2000: 98).[135]

In October 1997 the debt crisis became a bank crisis when two major chaebols went bankrupt or near bankrupt. Soon the exchange rate came under pressure and the bank crisis developed into a currency crisis when the Korean government failed to reassure speculators through intervention in the exchange market. The government tried to protect the Won by inducing foreign reserves into the system; in so doing, it drained out the reserves.

In November 1997 the foreign reserves had shrunk to 9 billion US$, or less than one months worth of imports (Kim Y.T. 1999: 467). The Korean state was practically bankrupt, and the need for emergency financing was obvious. In late November the government sought an IMF bailout and within seven days a reform package was negotiated and ratified.

The IMF package contained harsh macro economic reform measures and restructuring of the financial and corporate sectors. The principal measures included a twenty percent increase in the call rate, a substantial decrease in the stock of net domestic assets until year 2000, a raise in the ceiling on foreign ownership of Korean companies to 50%, liberalisation of import items (IMF 1998). According to the IMF, liberalisation of the financial sector and greater degree of transparency in financial transactions, not at least government's withdrawal of any involvement in the commercial banking system, were supposed to give way for a lift to the economy (IMF 1998).

According to the IMF, the organisation itself had not been aware that an economic crisis was in its outbreak since official data provided incomplete information on the external debt position and the stock of foreign reserves (IMF 2000a: 6).[136] Many Korean companies founded their industrial ventures by relying on short-term foreign loans. At the edge of the emerging crisis only, this micro-economic weakness was converted into macro-economic unbalances (falling reserve position and declining exchange rate) The crisis was a surprise to just about everyone.

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[134] A chaebol is a Korean industrial conglomerate that operates in a variety of sectors and normally is managed by the founding family. The chaebols have a special position in the Korean economy and in Korean economic history as the Korean government, in order to obtain economic growth, traditionally favoured some of them and helped them realising their goal by guaranteeing loans, subsidising taxes etc. This process made some of the chaebols extremely big and gave them thereby a very big influence in society.

[135] In most developed countries the ratio stays inferior to 200% (Shim 1998: 14).

[136] Illiquid deposits at offshore Korean banks were included in its foreign reserves and debt contracted by offshore entities was not shown in Korea's external debt position

3. Crisis explanations

In the aftermath of the crisis the literature flooded with explanations of causes of the crisis. The contributions to the debate can be divided in two camps: Those who emphasize too much liberalisation *financial panic theory* and those who emphasize a lack of liberalisation *crony capitalism and excessive state regulation theory*. It should be mentioned, that these camps are the most extreme positions and that other positions are combining arguments from the two or that authors from one position in later contributions have softened their views.

3.1 Financial panic theory

The first type of explanation is dubbed *financial panic theory*. Some of the strongest advocates of this position were Frank Veneroso and Robert Wade (1998). They claimed that high levels of domestic savings and the government's wish to make an assault on major world industries constituted an impetus for massive lending. As the Korean government removed controls on company lending the debt-equity only soared. Veneroso and Wade argue that the most crucial element in the whole process is the external (US) pressure to liberalise and open up e.g. the Korean economy. They assert that an IMF-Treasury complex is present and that the IMF is favouring US interests, though, it officially is a non-political organisation.

Paul Krugman, however not an advocate for the IMF-Treasury complex, writes that in the run up to the crisis all forms of investments were booming even the non-guaranteed (Krugman 1999a), and any sudden depreciation of the domestic currency could tip the firms on the brink of bankruptcy; an effect large enough to outweigh the direct effect of the depreciation on the export competitiveness (Krugman 1999b). So the foreign short-term debt should have been forestalled in the past is the conclusion from the proponents of the financial panic theory.

The financial panic theory points to one of the most important factors triggering the financial crisis: The volatility of foreign investment especially short term loans and the vulnerability this foreign capital creates. However, it fails to understand why Korea ended up in an uneven liberalisation process or it simply explains this as a result of external pressure.

3.2 Crony capitalism and excessive state regulation theory

Contradictory to the financial panic theory, the *crony capitalism and excessive state regulation theory* emphasise the role of internal Korean matters, especially the blurred form of corporate governance and the close relationship between big business and government.[137] It does not see extensive liberalisation as a problem in it self. On the contrary, it sees the limited liberalisation as part of the problem. According to this explanation, lenders (first and foremost chaebols) did not run any risks before the crisis, because the government would have to rescue them in case of financial distress. The largest chaebols were so big that bankruptcy in one could trigger a national recession (hereby the expression 'too big to fail'). Furthermore, chaebols were buying government favours (concessions, cheap state guaranteed loans and permission to entry specific sectors) through political contributions (money for the election campaigns). Deteriorating export prices aggravated the situation to which should be added the ill wised practice of Korean financial institutions to make risky investments abroad (IMF 1998 and 2000a). All this led, according to this approach, to excessive lending and the inflating asset bubble which set off the crisis.

The main problem with this market-oriented interpretation of the crisis is that the economic success of Korea for so many years is difficult to explain, if government intervention in corporate investment decisions is singled out as the main culprit. Why did the Korean model not break down before 1997 during times when government intervention was at its highest?

Our own position lays emphasis on the fact that a more nuanced approach is necessary to explain a crisis outbreak in an open national economy, which is interacting with and depending on global actors and global capital. The level of liberalisation or the level of state intervention itself does not have adequately explanatory value. It might be that the financial liberalisation was not very advanced in certain respects, although, it might have been too advanced in other respects. It might be that the institutionalised state-business co-operation was very effective in the past but lost its functionality when the Korean economy started to open up. It might be that the structural aspects of the state-business relation was moulded to fit a protectionist trade regime, although, it might have negative effects on the more liberal form of management. Thus, to elaborate an adequate model we stress the need for looking at the specific process of financial liberalisation and the specific interaction of state-business relations combined with an analysis of the powers of respectively national and international interests.

[137] See for example IMF 1998 pg. 4.

4. The process of financial liberalisation

4.1 The concept of financial liberalisation

The way financial liberalisation is designed and carried out varies from country to country, and financial liberalisation processes are very dissimilar. Despite the fact, that financial liberalisation is mentioned in tons of books and articles, abstractly or in relation to specific cases, it is rarely specified. On the whole, the concept is used haphazardly, or it is obliviously used as synonym for deregulation of inbound foreign direct investments (FDI).

Financial liberalisation, though, is a concept covering a wide range of economic policies. To draw any linkage or causality between financial liberalisation and other societal processes, events or conditions, it is important to clarify the specific deregulated sectors and policies. In the policy-process some policies are singled out, for one reason or another, and implemented gradually. This generates different societal outcomes according to context and implementation approach.

In our analysis we will build on a delineation which outlines three elements within the process of financial liberalisation: The first element is liberalisation of the domestic financial system. This refers to deregulation of laws preventing domestic and foreign financial institutions from setting up in the market. The second element is capital account opening. This refers to deregulation of the accounts on the balance of payments which are not bound by trade, interests, currencies, wage etc. Thus, opening up the capital account implies deregulation of capital movement in and out of the country i.e. lifting bans preventing FDI from flowing into the country and deregulating laws preventing domestic financial agents from operating independently on the international capital and loan markets. Additionally, refraining from controlling the exchange rate fluctuations renders the capital account position more unstable and prevents the government from protecting the balance of payment by currency control. The third element is (Anglo-American) institutional convergence. This refers to changes in both mentality and organisational structure (Nordhaug 2002: 3). However, it is beyond the scope of this paper to go into depth with this topic.

In the Korean case, another pertinent policy area is the rejection of industrial policy and credit allocation. Previous to the process of financial liberalisation, the state owned most Korean banks, including BOK, and controlled the financial market.

4.2 Abandoning industrial policy and credit allocation

Industrial policy coupled with credit allocation was until the early 1990's one of the main features of the Korean model of state-led capitalism. The Economic Planning Board (EPB)[138] was a central player in pointing out core sectors and core producers. From the mid 1960's and onward EPB chose specific chaebols to fulfil specific export goals. To help the conglomerates to obtain the targets, domestic savings and foreign capital were canalised to the favoured producers as cheap state guaranteed loans. Furthermore, they got subsidies and tariff protection (see Amsden 1989 or Cho and Kim 1991). In the beginning of the take-off period Korea had absolutely no creditworthiness internationally and the American government guaranteed all foreign loans to Korea. For cold war reasons USA had an interest in facilitating economic development in Korea (Korean economic adviser, interview 2001)

From 1994 the credit allocation system was gradually abolished; however, the state maintained control with long-term loans. The selective industrial policy was abolished in 1995, and in 1997 the five years planning system, which had been coordinating the investments since 1962, came to an end (Chang et al. 1998 741).

By abandoning the hitherto state-led industrial planning the chaebols got the opportunity to expand in whichever sector they liked. The state still controlled As a result, many of them settled in already saturated markets e.g. the automobile industry or electronics. Soon profit rates started to decline. This was especially critical because the mentioned sectors generated the highest rates of growth in the conglomerates and in the country as a whole (Thurbon 2001: 246).

4.3 Deregulation of the currency

From 1966 to 1980 the Korean won was pegged to the dollar. In 1980 it changed into a multiple currency basket system where the exchange rate was decided according to three factors: 1) The SDR basket; 2) An independent basket consisting of currencies of the major trade partners; 3) A political factor. The political factor was meant to be used in times of crisis or if the won was overvalued and the competitiveness threatened. In the late 1980's the USA started accusing the Korean government for manipulating the political factor. According to the US trade representatives the Koreans were

[138] The Economic Planning Board was meant to be an economic super bureaucracy. It was established in 1961 by the Park Chung Hee government in order to initiate, plan, upgrade and monitor the economic and industrial development. The director of EPB was at the same time vice prime minister, which shows the importance of the bureaucracy (Hwang 1996; 308)

consciously undervaluing the won and thereby creating a trade surplus. As a result, Korea changed into a market average exchange rate system in the late 1980's. In this system the won was principally floating to the dollar but still pegged to the basket when it came to other currencies (Chung and Yang 2000: 10).

The negative consequences of the liberal currency policy became obvious in 1995 when the yen started a long period of depreciation to the dollar. As the Korean main export goods were also produced by Japan, the Korean products became costlier relatively to the Japanese (Thurbon 2001: 244). The export slowed down at a time where also world market prices were decreasing, and the trade balance moved into red. A further consequence was the drain of the foreign reserves (Chang et al. 1998: 736).

4.4 Liberalisation of the Korean financial sector

Through to the outbreak of the crisis in 1997 all financial institutions (bank and non-bank / domestic and foreign) had to obtain government permission to settle into the Korean market. Generally, until 1990 only state owned banks existed except from six joint ventures between foreign banks and Korean banks, which had been established in the 1970s (Thurbon 2001: 247). Between 1994 and 1996 EPB and Ministry of Finance (MOF) let 24 domestic non-bank financial institutions establish themselves in the market. Many of these institutions were put up by the big chaebols, which wanted to specialise in short-term financial transactions and to operate in international markets. Foreign financial institutions were still not permitted into the Korean market, though, this opening was scheduled to 1998 (Hwang and Shin 2000: 16).

The newly established financial institutions were seemingly contributory to the destabilisation of the Korean capital market. They were inexperienced in analysing and assessing risks and unskilled in trading stocks and foreign currency. Especially they failed because they reinvested short-term loans in long-term projects, and in the run for high profits made too many risky investments. When the national market was saturated they started to reinvest the money in even riskier project in Southeast Asia (Thurbon 2001: 247).

Part of the problem was that the Kim Young Sam (YS) government conducted markedly *hands off* policy concerning these new institutions. The government did not supervise the new financial institutions, and EPB and MOF, which had in 1996 merged into Ministry of Finance and Economy (MOFE) did not assess their financial soundness or performance (Thurbon 2001: 247).

4.5 Liberalisation of the capital account

Before YS came to power in 1993 the banking system was almost entirely controlled by the political system. EPB was the administrative entity raising loans abroad and assessing domestic projects and businesses applying for loans. A special law assured that all foreign currency was handed by BOK. Another law limited the use of the foreign currency, e.g. by ceilings on the amount of capital which could be transferred to foreign countries (Chang et al. 1998: 736). To avoid capital flight there was in a certain period even death sentence for undertaking this kinds of transactions (KS Chang, interview 2001).

From 1993 the system was gradually changed. The Korean government authorised Korean financial institutions and companies to borrow money directly from suppliers abroad, and from 1995 they were even allowed to raise short term loans without any permission. This distortion between control with short and long term loans created a punch to the economy (Hart-Landsberg and Burkett 2001: 411). The huge number of newly established financial institutions was, as mentioned above, allowed to carry out arbitrage and to reinvest capital abroad. It is again worth noticing that this liberalisation measure only embraced the activities of domestic financial companies. Even though foreign companies might have benefited when Korean institutions started to borrow abroad, they were still not allowed to operate themselves inside Korea. Similarly, access to the Korean stock market was limited. In 1992 ten percent of a company's stocks could be sold to foreign companies (8% for state-owned companies).[139] Through to 1997 the level rose to 26% for total foreign ownership of a company's stock (21% for state-owned) (Hwang and Shin 2000: 15-17). With the IMF package accompanying the financial crisis, though, all ceilings and re-strictions were abandoned (Government of Korea/IMF 1997). This might seem as a major concession but actually this measure was already scheduled to be completed in 1998 in the original Korean liberalisation plan (Hwang and Shin 2000: 17-17).

The consequences of the sudden and uneven liberalisation of the capital account turned out to be severe. The IMF bail out package focussed on the chaebols high debt-equity ratio. However, some scholars argue that it was not the debt ratio itself but its unevenness which triggered the crisis. In the early 1990's the share of short to long term borrowing stood at 25-30%. In 1996 it had risen to 57% (Mo and Moon 1999: 185 and SERI 2000: 23).

[139] To restrict influence from foreign stakeholders, a foreign investor could buy up to 3%. At least four different foreign investors were required to buy 10% of a Korean company.

4.6 The political economy of Korean financial liberalisation

If we look behind the formal changes outlined above, we can identify both foreign and domestic interests influencing the process. Chaebols and the YS government were for various reasons advocating liberalisation, and the deregulation responded furthermore to a broader critic from the USA, Japan and other trade partners combating the highly protective trade regime in Korea. Added to this, miscalculations within the bureaucracy and the government might have deepened the economic viciousness.

The major chaebols, which had been nurtured by the state for decades, had become extremely big and powerful, and by the late 1990 they started to campaign against state intervention in the market. They clearly wanted to decide themselves what to invest and what to produce. They did not want to have their industrial strategies lined out by a domineering state anymore and they needed capital to get out of the troubles caused by the declining terms of trade and the unfavourable exchange rate situation. Thus some chaebols or some chaebol branches opted strongly for an economic 'hands off' policy (even though others might still have benefited from protection). In the FKI building (Federation of Korean Industry) the liberal icon Friedrich A. Hayek was worshiped and books and videotapes about him and his economic theories were found everywhere on the shelves (Nordhaug ???).

For the state it was equally important to switch to a more liberal and market based regime in order to get out of the industrial squeeze and generate growth on a national scale. The idea, on a more overall level, was to generate a financial catch up and make Korea the new financial hub of Asia (Chandrasekhar and Ghosh 2002). To use a catch-up strategy to cope with crisis had been used successfully in 1979-80 when the state generated the HCI drive (Heavy and Chemical Industries). Another cardinal motivation for the government was to prepare the country for entering the OECD. A goal, which was fulfilled in 1996.

Thus, with good intensions and a skilled bureaucracy, how could the economy derail completely?

One frequently asked question is why the YS government did not take measures against the appreciating won when it got aware of the declining competitiveness and the huge trade deficit. Such a measure could have deflected the fatal course. In spite of experts and businessmen warning the government before the crisis nothing happened.

In the literature there are plenty of explanations for this: Firstly, the IMF pressurised Korea to control the inflation by letting the won appreciate. Exchange rate control was, furthermore, against good (liberal) macroeconomic management (Thurbon 2001: 248, Chang et al. 1998: 736).

A second reason might have been that the government feared the per capita income to sink below 10.000$ a year. This would hinder the entrance in the OECD (Chang et al. 1998: 736). A third explanation was that the Korean government wanted Korea to become the new financial hub of East Asia. To make Korea a financial centre the economic environment had to be liberal. A fourth incitement might have been that the government wanted to force the chaebols to restructure their industrial activities and become more rentable. By intervening in the exchange rate the government would help them getting a distorted price for their export goods and leave them with no incitement to restructure (Mo and Moon 1999: 175). Sixth and lastly, bureaucrats might have obscured the bad condition of the foreign reserves. Later state officials were sued for hiding the actual amount of foreign reserves (Thurbon 2001: 245).

Hence, there were not only concrete obstacles and forces working against the devaluation, there was also a mental barrier to overcome, as both the policy-elite and parts of the business elite benefited from a strong won.

Another frequently asked question is: Why did a large amount of non-bank financial institutions suddenly get permission to establish? And why did the government not supervise them?

To answer the first question, the chaebols, but also the government had, as before mentioned, reasons for prioritising an enlargement of the financial sector. The chaebols needed capital to catch up in technological and financial terms. By starting up financial business they could acquire capital; get high returns of financial business; and at the same time get rid of the state as an intermediary and troublesome partner.

To the state it was a rational strategy to let domestic institutions settle into the financial market and still keep foreigners out. It was meant to make the financial system more liberal but still protected to a certain degree. They were not aware of the fact that Korean financial institutions were not experienced. Concerning the lacking supervision most observers ascribe the phenomenon to the lack of economic competence within the YS government and the economic bureaucracies.

A third and essential question is why the government abandoned control on short term borrowing but maintained control on long term foreign loans and thereby nurturing over borrowing?

Firstly, the government simply had to raise money somehow and to loosen control on borrowing was one way to speed up the process. Asking Korean scholars why control was given up on the most volatile share of foreign loans, the best answer is, that the YS government and their bureaucrats thought that it was more important to control long term loans because they used to constitute the largest share of the loans and because this kind of loans traditionally were those facilitating long term projects and long term growth. The short term loans were, by mistake, not understood as equally important. In the eyes of the government, they were not meant to finance long term projects (Lee, interview 2001). Another informant argued that people, especially the Korean people, see YS and his government as terrible incompetent but that it actually is a very difficulty task to conduct an open liberal economy in a global environment. According to this informant, monitoring and adjusting the economy is much more bigger challenge to the state officials and the government today, than it was during the 1960's, 1970's and 1980's, where the Korean economy was closed and highly regulated (Korean economic adviser, interview 2001).

Secondly, another explanation for the huge over-borrowing is that chaebol founders had a markedly 'empire building complex'. This led to over investment in already saturated but high status markets e.g. the automobile industry (UM 2001: 18).

Another aspect influencing the whole process and often mentioned by Korean scholars is the alteration of the state-business relation in the 1990's. They emphasise that state-business relations have become more decadent in the 1990's. The 'cronyism' of the 1990's is best seen as a legacy from the developmental state, where the highly praised institutionalised state-business relationship was considered a main pillar. But what had one day been admired as a bright bureaucratic establishment was the next day deemed as corrupt. According to some of our Korean informants there is, however, some truth to this as two societal processes had paved the way for distortion: 1) First, when selective industrial policy was abandoned, funds were not earmarked for specific sectors or producers any longer. This created an opportunity for politicians to allocate resources for political reasons, which were not necessarily rational from an economic point of view;[140] Second, at the same time, the democratisation process made political survival dependent on funds for electoral campaigns – and thereby on alliances within the business sector to exchange financial support in return for political favours (Chang et al. 1998: 741).

[140] An example is the establishment of Samsungs Motors in the Pusan district. As the story goes, president YS had appeared in a TV-emission in a pair of Nike snickers. This was perceived as treachery in Pusan which was his main support base. The unemployment rates in this district had skyrocketed because producers from Southeast Asia had out competed, among others, the Pusan shoe producers. In an attempt to kill two birds with one stone (satisfy his support base and help or create an industrial ally) YS gave Samsung Motors permission to set up a production site in Pusan (Mo and Moon 1999; 25). Economically, this trade-off was irrational, as the automobile market and production was already saturated.

Furthermore, state officials informally continued to control the financial means of the state, which aggravated the cronyism tendency. Some scholars argue that bureaucrats from the economic ministries had come to act like a clan or a mafia, due to the very powerful position they held during the developmental state period (which might or might not have finished) (Lee and KS Chang, interviews 2001). In spite of democratisation and liberalisation this group of people is still extremely powerful. The reason is that chief bureaucrats from the economic ministries normally finish their carrier as bank directors. Many Korean banks have therefore retired state officials in leading positions and the powerful network in the economic ministries operate through these contacts. Officials from the economic bureaucracies did not willingly elaborate or implement measures that would minimise their own power or influence. This was another factor influencing the unevenness of the liberalisation process (Lee and Chang, interviews 2001).

Thus, looking at the political economy perspective of the Korean financial liberalisation makes the process non-transparent, but more importantly, it shows us that there were many factors and processes occurring simultaneously which led to the derailment of the economy. It further shows us, that it might not be adequate to explain the out burst of the crisis as generated by exclusively international (US) pressure, by financial panic, by cronyism or by excessive state intervention. All of these subjects mattered to some degree but the reality was a complex mix of these causes added domestic lobbyism, a sudden and fast decrease in economic soundness and mistakes and miscalculations.

5. Post-crisis trends of the Korean economy

In this section we will look at the Kim Dae Jung (DJ) government's[141] attitude towards the IMF package. We will try to show whether Korea became a mere slaughter lam in times of crisis or if Korea maintained some influence while confronted by demands from international financial institutions?

Comparing the Korean recovery after the crisis with 88 other countries that received stand-by or extended arrangements of the IMF, Jong-Wha Lee and Changyong Rhee (2002: 549-550) demonstrate that the magnitude of the

[141] DJ was elected in November 1996 at the same time as the crisis was escalating. DJ was a former dissident who had been jailed for years and he was the first from the opposition to be elected as president in Korea.

initial contraction in GDP growth rate (12 % in 1998) and the speed of the recovery (17% in 1999) was far greater than in other IMF contracted countries. Highly leveraged companies (based on short-term external lending) made Korea more vulnerable to depreciation and interest rate increases. Implementation of financial restructuring in conjunction with traditional stabilisation policies probably added to the extraordinary economic contraction. Initially, IMF insisted on raising the interest rates bringing the debt burden companies on the brink of bankruptcy. By mid-1998 both the interest rates were lowered and the tight fiscal policy was eased. Even during this intense IMF monitored economic policy phase, the Korean government got away with a rather expansive economic policy. The traditional IMF view that a country raising interest rates makes it attractive to foreign capital to flow into the country and subsequently stabilise the exchange rate and the country in general, was never confirmed in the Korean case. On the contrary, foreign investments (though not in the form of green field investment) only returned to Korea by November 1998, when the economy began picking up (Shin and Chang 2003: 61). At that time interest rates were inferior to the pre-crisis level, not higher. Does this indicate that Korea was back to normal after just one year of economic downslide?

In an assessment of the post-crisis economic achievements, Jang-Up Shin and Ha-Joon Chang depict a rather bleak picture. Out of three main pillars in the government financial restructuring programme: 1) Reduction in corporate debt-equity ratios. 2) Big deals and a workout programme for the top five chaebols.[142] 3) Changes in governance structure of the chaebols, only the last initiative was crowned with partial success.

The Korean companies actually reduced their debt-equity ratios, but this mainly by revaluing their assets. Due to high transaction costs involved Korea's manufacturing sector improved its pre-crisis profitability by only 1%. One objective of the big deals for chaebols was to force them to concentrate their resources in areas of 'core competence'. Though empirical evidence lacks to show that diversification of the chaebols was a negative fact, this was one of the main points in the IMF package. The average number of businesses run by the five largest chaebols was reduced from 30 to 23 in four years. So, some success was after all achieved under pillar two. According to Shin and Chang the only positive result of the reform programme was, however, the new compulsory measure for chaebols to issue 'consolidated financial statements' (Shin and Chang 2003: 85-112).

[142] *Big Deals* are compulsory mergers between some of the top five chaebols branches producing the same items. *Work Out* programs are state supervised restructuring processes.

Successful or not, how do we interpret the post-crisis reform? Is dismantlement of the Korean developmental state the right term to characterize Korea by the turn of the century? Who gained from the financial restructuring programme and has globalisation altered the relative strength among the main actors: international agencies, the Korean government and the chaebols?

We agree with Stiglitz that IMF engineered a simultaneous contraction in demand and supply (huge nonperforming loans leading to increasing firms in difficulties and weakening the banks further, Stiglitz, 2002: 111). Surprisingly for an institution praising the virtues of the free market forces, IMF accepted a recapitalization and resulting state control of the two largest commercial banks: Korea First Bank and Seoul Bank (IMF Stand-by Arrangement, December 1997). Stiglitz observes the difference between the IMF approach in Indonesia, where all non-performing banks were closed down, and the attitude adopted towards the Korean government. (Stiglitz 2002: 117). Even at the height of the implementation of the IMF package, the Korean government was never reduced to a mere slaughter lam signing up with every request from the IMF. But then, is the developmental state still intact? No, globalisation and its liberalisation effects put the chaebols in the front seat. In the mid-1990s the chaebols opposed any attempt to force them to concentrate in core businesses instead of diversification, and they pressured the YS government to shift his highly proclaimed democratisation policy including economic democratisation to a more narrowed focus on increasing global competitiveness of the chaebols (Kim 2000). Later, while the chaebols had to comply with the big deal requirement of the IMF and reduce its average number of businesses, insider ownership of the top chaebols rose just *after* the crisis to 80% of all bond issuing in 1998 (Ahn 2001: 468). The chaebols despite attempts by two consecutive Korean governments and the IMF, lost maybe economic power in the time of crisis, but they were rapid to reinforce their position.

Nevertheless, foreign companies profited from the crisis package adopted by the DJ government. By 2001, many major Korean companies were controlled by foreigners. In one respect, though, the chaebols did loose out, since multinational firms have seized some of their businesses (40% of total shares of the Stock Exchange are in foreign hands, Shin and Chang, 2003: 108). In the Korean case the economic crisis and the IMF stabilisation programme paved the way for a foreign inroad into the previous highly protected manufacturing sector, not before. Chaebols not foreign companies benefited from the financial liberalisation in the mid-1990s, including control of former state-owned enterprises (like Korea Electric Power, Telecom and Gas; Tsai 2003: 307).

The financial liberalisation process demonstrated not only the relative strength of the chaebols vis-à-vis the government, but it rested with increasing diversity in objectives of the various government agencies. BOK was in favour of interest rate liberalisation and decrease in policy loans but with a cautious approach to opening the external capital account (Zhang 2002).

6. Discussion and concluding remarks?

From the analysis above, we get a picture of a state-business relation which has changed a lot within the last 10-15 years. Not only has the power constellation between the two factions changed, the state-business relation has also changed its relation to the outside.

Bringing the *financial panic theory* back into discussion, we have shown that financial panic certainly was contributory to the severity of the crisis but that an IMF-Treasury complex did not solely pressurize Korea to liberalise. There was indeed a strong pressure from the trade partners and especially the USA but domestic lobbyism and internal political considerations played an even bigger role. An IMF-Treasury complex might exist, we can not tell, but we can conclude that if it did, it was not strong enough to pressurize Korea to complete the financial liberalisation. However, a point to make is that the ideology of the Korean state and business elites was very much in line with the dominant neoliberal paradigm. Korean state and business both opted for liberalisation, though; economic policies were never entirely liberal as developmental state legacies continued to influence Korean economic policy. The Korean market was until the crisis kept protected to a certain degree and the state implemented major re-regulation measures in the post-crisis period. But by clinging to liberal solutions the state might in the first run have hindered timely intervention to prevent the crisis.

We do neither agree fully with the arguments within the *cronyism and excessive state intervention theory*. Cronyism actually was more likely to occur in the 1990's than before but, though it might have contributed, it did not trigger the crisis itself. Concerning state intervention, we argue that it was too excessive in some aspects (e.g. austere control with long term loans) and too moderate in other aspects (e.g. complete liberalisation of short term borrowing).

Regarding the state-business relation, we see a markedly difference in the distribution of powers compared with earlier periods. State and business have all the time been interdependent but the state had, however, a stronger say, during 1960-1990. First, the large chaebols have grown bigger and have thereby strengthened their position economically as well as politically. Secondly, the opening of the economy gave the chaebols opportunity to make international alliances and to operate outside state supervision. Third, the democratisation made it more difficult for the state to implement compulsory reforms. This was vividly easier during times of military governance. However, when the financial crisis culminated the state was back in control. Negotiating with chaebols which were principally bankrupt put back the state back in its former strong position. Obviously president DJ tried to take advantage of this position, which for example the 'Big Deals' reform shows.[143] Yet, this reform never really succeeded, and as the economy recovered relatively fast, chaebol regained power.

Looking into the future, we see three possible but mutually excluding scenarios of Korean economic development: First scenario: A slower and more deliberate liberalisation. All parties support a gradual concentration in core areas of the chaebols with SMEs and multinationals moving into 'loopholes' rendered for 'free bids' by the chaebols. Policy lending through the banking system dwindles gradually away and foreign borrowing increases. The most unlikely scenario, mostly because Korea is a case in point that internal and external forces engage in a persistent battle with each other.

Second scenario: An intense period of conflicts between foreign companies and chaebols over funding resources with a non-interventionist government simply contemplating the battle at the sideline. This is the free-market scenario with the Korean government being subdued to the untamed forces of globalisation. Also an unlikely scenario, mostly since part of the crisis and post-crisis period was characterised by new forms of government intervention.

Third scenario: A period where the Korean government, however divided it stands, lines up with the chaebols once again. Using another arsenal of instruments than policy lending the Korean government takes up the challenge to corner foreign companies. A more likely out come, provided the Korean history of firm nationalism.

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[143] One of DJ's cardinal objectives was to tame the chaebols and this agenda was equally a main reason for his electoral victory.

A final point to make is that circumstances encouraging strong and efficient state-business collaboration are not so straight forward to line out. The case of Korean state-business relations in the 1990's do not show evidence to the hypothesis saying that in times of threats and vulnerability strong collaborative relations will emerge (chapter 3 of this book). During the 1990's the Korean economy have been threatened to the brink of national bankruptcy but state-business relations turned relatively weaker. A weakening which can be ascribed to the change of regime (democratisation), the legacy of developmental state structures (strong state-business collaboration distorting into cronyism) and the simultaneously liberalisation (softening the dependency between state and business). But, the efficiency of the state-business collaboration was equally affected by simple mistakes, miscalculations and misinformation. And furthermore it was affected by the speed of economic changes within and outside the Korean borders and by the fact that both state and chaebols were unfamiliar with financial business. Thus, according to the hypothesis, Korean state-business relations ought to be even stronger than before because circumstances were highly vulnerable but they actually became feeble because of structural legacies and contingencies.

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