FINANCIAL CRISIS AND GOVERNMENTAL BEHAVIOUR IN SOUTH KOREA

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PREFACE

The purpose of this thesis is to examine three ways of understanding the financial crisis in South Korea. I chose the topic after completing the first half-year of a political science *hovedfag* in Korean politics and economics at Kyung Hee University and also after studying East Asian financial markets while doing an MBA in finance at Griffith University.

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# TABLE OF CONTENTS

1.0 INTRODUCTION ..................................................................................................................... 5
   1.1 RATIONALE ............................................................................................................................. 6
   1.2 THEME .................................................................................................................................. 7
   1.3 THEORY .................................................................................................................................. 8
   1.4 QUESTIONS ............................................................................................................................... 14
   1.5 ACTORS ................................................................................................................................... 17
   1.6 CURRICULUM .......................................................................................................................... 18
   1.7 CALENDAR OF DISTURBANCE ............................................................................................. 19

2.0 THEORY ...................................................................................................................................... 21
   2.1 DEVELOPMENTAL STATE .................................................................................................... 21
   2.2 CORPORATE SOCIETY ......................................................................................................... 25
   2.3 GOVERNMENTAL BEHAVIOUR ............................................................................................ 27
      2.3.1 Principal-Agent Relationship ....................................................................................... 29
      2.3.2 Moral Hazard .................................................................................................................. 30
      2.3.3 Fraud ............................................................................................................................... 31
      2.3.4 Government Who? ........................................................................................................... 32
   2.4 FINANCIAL CRISIS AND REGULATION ............................................................................. 34
      2.4.1 Currency Crisis ................................................................................................................ 35
      2.4.2 Political Regulation ........................................................................................................... 38

3.0 SOURCES AND DATA .............................................................................................................. 39
   3.1 SOURCES ............................................................................................................................... 39
   3.2 METHODOLOGY .................................................................................................................... 40
      3.2.1 Dependent Variables ....................................................................................................... 44
      3.2.2 Independent Variables ..................................................................................................... 45

4.0 CHARACTERISTICS OF THE KOREAN ECONOMY ............................................................... 47
   4.1 KOREA AS LATE-LATE INDUSTRIALISED COUNTRY .......................................................... 47
   4.2 KOREA AS DEVELOPMENTAL STATE ................................................................................ 48
      4.2.1 The State .......................................................................................................................... 48
      4.2.2 The Policymakers .............................................................................................................. 49
      4.2.3 The Businesses .................................................................................................................. 50
   4.3 KOREA’S FOREIGN CAPITAL IMPORT ................................................................................. 50
   4.4 PAVING THE ECONOMY WITH RELATIONSHIPS ............................................................... 52
      4.4.1 Investor Relations ............................................................................................................ 52
      4.4.2 Labour Relations .............................................................................................................. 54
      4.4.3 Regional Relations ........................................................................................................... 57
   4.5 DECISION-MAKING HERITAGE .......................................................................................... 58
      4.5.1 Rhee versus Park .............................................................................................................. 58
4.5.2 Boards and Plans ........................................................................................................ 60
4.6 WHEN TO CHANGE A WINNING TEAM ...................................................................... 62

5.0 ACCOUNT FOR THE CRISIS ......................................................................................... 65
  5.1 BALANCE OF PAYMENT ............................................................................................... 67
  5.2 CRISIS OF UNDER-REGULATION ............................................................................... 72
    5.2.1 Debt ...................................................................................................................... 73
    5.2.2 Governmental Behaviour ..................................................................................... 75
  5.3 MORAL HAZARD AND BUBBLES .............................................................................. 79
  5.4 CONTAGION AND FINANCIAL PANIC ........................................................................ 82
    5.4.1 Panic ..................................................................................................................... 86
    5.4.2 Foreign Investors’ Behaviour .............................................................................. 90
  5.5 DISORDERLY WORKOUT ............................................................................................. 91
  5.6 REFORMS ................................................................................................................... 94
    5.6.1 Big Business .......................................................................................................... 94
    5.6.2 Changing a Winning Team .................................................................................. 99

6.0 CONCLUSION .............................................................................................................. 102
  6.1 THE THESIS ................................................................................................................ 105
  6.2 LESSONS ..................................................................................................................... 106
  6.3 SCHOOLS ..................................................................................................................... 108
  6.4 DEVELOPMENTAL STATE .......................................................................................... 111
  6.5 GOVERNMENTAL BEHAVIOUR ................................................................................. 113
  6.6 CORPORATE SOCIETY ............................................................................................... 114
  6.7 THE QUESTIONS .......................................................................................................... 115

REFERENCES .................................................................................................................... 117
1.0 INTRODUCTION

The financial crisis in Asia came as a surprise to many. Academics, international institutions, and investors did not foresee what was to come, according to some critics (Wade 1998:1537).

On June 2, 1997, the Central Bank of Thailand allowed the baht to float (or dive), allegedly becoming the source of Asia’s financial crisis contagion. The baht’s trading level in the market at the time was 50% below the level at which the central bank tried to peg it. However, it was not until the end of that year that South Korea (hereafter referred to merely as Korea) realised it was part of the crisis and that it would have to receive assistance from the IMF (International Monetary Fund), thus becoming the largest rescue operation in IMF history.

This paper attempts to identify the fundamental causes of the financial crisis in Korea. Three approaches will be assessed. First, the developmental state approach will look at external and internal factors that can explain the crisis. External factors include international investors and speculators, the international financial system, as well as the IMF and other international institutions. Internal factors include under-regulation and the way Korea under Kim Yong Sam drifted away from the relationship between the state and the economy, characterised as the developmental state. Second, the corporate society approach will examine the power of the unions and the conglomerates (chaebols). The corporate society approach claims that the unions and the chaebols in Korea outmanoeuvred the government and its reforms. Finally, the governmental behaviour approach will examine the domestic features of an economy with few powerful and influential conglomerates and a political system facilitating voice from business. The governmental behaviour approach looks at the close relationship between government, banks, and chaebols. The governmental behaviour approach assumes that government was in the driver’s seat, while the corporate society approach claims that government was not.
To this day, conventional economics concentrates on macroeconomic figures to examine the health of an economy. One can argue that this financial crisis could not have been caused by Korea alone. It takes two to tango. Korea’s currency was attacked, and it is not far fetched to imagine the importance of contagion from neighbouring countries. Korea’s economy was going strong just prior the crisis. Low unemployment, substantial GDP growth, and low budget deficits proved that macroeconomic fundamentals were sound. What appears to have been less healthy was production and its underlying figures in the industrial sector. Korean industry was poorly funded, return on investment and equity were poor, profits were exceptionally low, and debt was exceptionally high. This paper will take a closer look at governmental behaviour, not only in light of macroeconomics as fiscal and monetary policy, but also in light of microeconomics as industrial and financial policy, to determine if this approach can shed light on finding the cause of the crisis. By analysing governmental behaviour we can understand how political tasks were carried out by elected politicians and non-elected officials.

1.1 Rationale

History may repeat itself, but it cannot be copied. Even with all the empirical material and theories that have been derived from historical events, neither political scientists nor economists can predict the future. However, there are always elements from prior situations that can be applied to emerging situations. Experiences from Mexico’s ‘tequila crisis’ in 1995 were utilised in Asia. Hopefully, the experience of Asia’s financial crisis can help newly emerging economies to avoid the same pitfalls.

Few academics foresaw the crisis, but many have since contributed to the debate on the subject. Two of them that describe the shortcomings of growth in Asia are Woo Jung-en, in *Race to the Swift* (1991), and Paul Krugman. Until now few people have questioned their views, except the extent to which their approach enlightens the situation, whether it is extensive enough, and whether it has explained how to prevent and resolve future financial crises. Other academics are more focused on the role the
IMF played and how its involvement might have worsened the situation. This paper will not go into the IMF debate, but rather focus on the cause of the crisis. (The IMF has hence been excluded as a fundamental cause prior to the discussion). Contributors focusing on the Korean economy’s attributes and obstacles are given extra consideration, and the theories employed are mainly from political economics and finance.

1.2 Theme

Can Korea’s financial crisis be attributed to governmental behaviour, or was it beyond the government’s control? Was the international financial system the cause or merely the messenger of the financial crisis? These are the central questions that this paper will try to answer. Governmental behaviour is the focus of this paper since it was primarily responsible for Korea’s success prior to 1997. Another reason why governmental behaviour is so important is that financial markets, and the world in general, react to a nation’s governmental behaviour. The theories employed here explain the likeliness of the different scenarios that are given.

Defining a financial crisis is a good place to start when searching for the causes. One loose definition can be: a financial disturbance that has the potential to have a serious impact on the real economy (Corrigan 1991:44). Financial disturbances can be unusually volatile in equity, money, and other financial markets.

The economic problems that occurred, and indeed became visible, during the Asian financial crisis in the last half of 1997 eventually led to social and political problems. The crisis appeared in the form of decreased exchange rates, difficulties in repaying short-term foreign-denominated debt, bankruptcies, lack of foreign reserves, high debt-to-equity ratios, low profits, and poor returns on investment (RoI). The causes of these phenomena could have been overinvestment and overemphasis on growth. The notion of a 'crisis' seems to be appropriate in view of the IMF's decision to approve a $58 billion bailout of Korea in late 1997. The purpose of this paper is to explain the
causes of the crisis, more precisely to explain why the exchange rate worsened, why the credit rating of Korea worsened, and why the chaebols were so leveraged. The phases of the crisis will not be discussed due to the lack of controversy on the subject.

1.3 Theory

An ambitious goal for this paper is to discuss three dominant approaches to the Asian crisis debate in light of currency crisis and regulation. Currency crisis was chosen due to its crucial role in the financial crisis, and regulation was chosen due to its key role in Korea’s success prior to the crisis.

This paper has categorised the Asian crisis into three main groups using the approaches and theories that frequently appear in literature. The main arguments are as follows: The developmental state approach sees Korea as an economy that successfully balances state and private capitalism. The government has significant influence on how private enterprises conduct business, and there is constructive dialog between business and government. The level of conflict between government and private enterprise is limited and is rather characterised as cooperative. Private enterprises have actively been used as tools to develop the economy. The approach sees the international financial system as the initial cause of Korea’s financial crisis. What did the financial system do? There was a sudden shift in market expectations. Investors panicked. Detection of fundamental imbalances triggered the currency and financial crises. Individual rationality became collective irrationality. Laurids S. Lauridsen (1995, 1998), Robert Wade (1998), and other political scientists that have explained Asia’s success focus on the interplay among the international financial system, external pressure, and Korean financial liberalisation as contributing factors to the crisis. Linda Weiss (1995) focuses on the effect of Korea’s opening up its capital account. International investors who refocused the risk from macroeconomic to microeconomic factors eroded capital credibility (Wade 1998:1542). The collapse of Hanbo Steel in January 1997 signalled to investors that chaebols can default, that indirect governmental guarantees were not to be taken for granted, and that chaebols’
performance was important to the Korean economy as a whole. Detection of certain behaviour by international institutions that had influenced the Korean economy supports this approach. One way to reject this approach of explaining the cause of the crisis is to detect the financial institutions’ motivation to behave the way they did. The approach becomes even stronger if we can prove that financial markets acted unreasonably, that the capital account worsened substantially, and that the chaebols were competitive, profitable and innovative.

In a contrast to Wade, Ha-joon Chang asserts that it was the Korean government that made Korea vulnerable to foreign investors, and it was the significant financial sector liberalisation, exchange rate management, and lax investment coordination that were the causes of the financial crisis (Chang 1998:1557). The developmental state theory emphasises financial irrationality in the market. The government’s most important failure was the financial liberalisation that made the economy vulnerable to foreigners (Wade 1990:367). Robert Wade maintains that the government had to “maintain a certain cleavage between the domestic and international economies with respect to financial inflows.” Without control over financial flows, the government’s ability to regulate money supply and cost of capital was reduced. Korea chose to peg the won to control the cost of capital. Global interaction in the form of vigorous exporting requires governmental involvement. The economy was opened and hence had to take into account what Stopford and Strange (1991:32) call the new diplomacy, which is dynamic interaction between international actors and state governments in a global economy. External pressure on the liberalisation that took place in the banking sector between 1980 and 1983 had to be followed by appropriate regulation. “Even in countries where the earlier state-led industrialisation was quite successful, the regulatory regime did not necessarily adapt effectively to the changes in domestic economic conditions (which were caused in part by the success of the state-led industrialisation) and to the changing state of the world economy” (Chang 1997:709). Newly industrialised countries are weak, embryonic, and hence have to be ‘built’. ‘Developmentalism’ views the state as the main mechanism for handling the constraints embedded in the domestic structure and the international environment
(White and Wade 1988:2). The alternative to compensating for this is not direct regulation or production, but rather influencing the market so that enterprises seek profits in the areas desired by the state (White and Wade 1988:5).

In a corporate society there is a close relationship among government, business, and labour. Political decisions are made together with the corporate sector. Corporate society implies tripartite cooperation between government and civil organisations, especially workers’ unions and businesses. In Korea’s case, we shall see that cooperation was mainly between government and business, while the unions were left out. The corporate society has embedded democratic pitfalls. The balance of power can move from government to other organisations. This pitfall is the corporate society’s primary explanation of the financial crisis. The corporate society approach has been chosen as a compromise to the developmental state approach and the governmental behaviour approach. This means that the approach does not have the propensity to necessarily find shortcomings with either the government or the market. The financial crisis in Korea was initially caused by corporate behaviour. What did the corporate society do? It contributed to structural and political distortion through its lack of willingness to reform. Jungryn Mo and Chung In Moon (1999:190-192) represent the corporate society approach. The government was not able to dispose of developmental state policy due to its close relationship to business as a result of pressure from the chaebols. The corporate sector was one of the underlying causes of the crisis. One way of verifying this hypothesis is to identify the issues that were important for the elected government to implement, but which were manipulated by the corporate sector through their influence on the chaebols. We can also look at the issues that were important to the corporate sector but overruled by the elected government.

The logic of corporate society and government is as follows. The success of Korea’s economic growth can be attributed to internal factors and the economy’s structure. The developmental state was successful until the 1990s. Internal factors caused the economy to fail, just as they had caused it to succeed. It is counterproductive to
remain with the developmental state for too long, even though it may be appropriate for an emerging economy – doing so will result in rent seeking. The perception of having implicit government guarantees on liabilities may lead to moral hazard (Krugman 1998:3). It is not very humble to claim that Korea did succeed (development) on its own and did fail (crisis) due to others. The lack of response to environmental changes contributed to the loss of credit worthiness. This paper can be perceived as an espousal of the first hypothesis. It is not a general critique of the developmental state as such, rather it is questioning its viability as an economy over time. Chang (1998) argues that the crisis was not a result of developmental state policy since this policy was abandoned during Kim Young Sam’s presidency. This will be discussed later.

Governmental behaviour is a more liberal economic approach. Liberals have more faith in the market and they often see governmental behaviour as an obstacle to a well-functioning market. This stands in contrast to the developmental state approach, which has more faith in government’s role of correcting market failure. According to the governmental behaviour approach, Korea’s financial crisis was initially caused by governmental behaviour. What did the government do? There was a lack of transparency due to poor regulation and surveillance that prevented outsiders from behaving appropriately. Foreign investors contributed funds because of impressive rates of return that they could not find in any other world market. When investors started to realise the economic realities, they got cold feet and withdrew from the market. Paul Krugman (1994, 1998, and 1999), The Economist, and the rationalists advocate this view. Rationalists understand economic actors as individuals searching for adequate information in order to achieve clearly defined goals. The financial crisis was caused by the late abandonment of policies prescribed by the developmental state approach in Korea. In addition, by pegging the won for far too long, the underlying assets in the economy were no longer represented. The developmental state approach is characterised by governmental intervention. The classic developmental state monetary policy was to undervalue the won to facilitate export. However, during the 1990s, the won was overvalued to help the chaebols pay back foreign-denominated
debt. When the implications of the developmental state policy became clearer, the financial market acted collectively irrational and individually rational. The consequences were government intervention gearing business, accepting poor investments as a consequence of political dictation, guarantees and insulation from competition, and hence moral hazard. A way of testing the governmental behaviour approach’s explanatory power is to examine the attributes of developmental state policy and see if some vital ones contributed negatively to sustainable economic growth. Were inappropriate political decisions made due to rent seeking, moral hazard, fraud, or mere ineptitude? The absence of moral hazard and poor investment resulting from politically initiated funding disputes the governmental behavioural understanding of the crisis.

To reduce the economic concentration and power of the chaebols, the government had to open the economy by providing foreign exchange for investment. This exposure was critical to the Korean economy (Wade 1990:367). It was the opening of the capital account that led to a crisis of under-regulation. However, Wade’s overall argument was that liberalisation was unnecessary and dangerous since Korea was an archetypical high household-saving, high-debt economy that had to be shielded from international financial volatility through capital controls. This is vital in a developmental state approach. Governmental liberalisation contained great risk due to gearing. Gearing (high debt) in a bull market (positive expanding market) can give substantial gains. With high gearing, larger projects give larger returns on equity. A simple example: A house costs $100. You have $10 and have to borrow $90. With a 30% price increase, you earn $30. If you had $20 to begin with, you only earn $20. The more you borrow, the more you earn in good times. In bad times, however, you lose more. If the market falls 30%, and you have to sell, you have a $20 debt in the first case, but only a $10 debt in the second case, on which you have to pay interest. As long as the loan is guaranteed, you think more about the good times than the bad times. That is why the chaebols may have had the incentive to invest in riskier projects since there was a high potential for gains and a relatively small potential for losses. They could lose $10, but they could win $30. The consequences of this
behaviour are compounded by globalisation. Risky projects become more tempting because interest rates are kept low due to guarantees. If investment had to rely on domestic savings, excessive and/or risky investments would result in higher interest rates (Krugman 1998:6)

The three approaches to the financial crisis in Korea: developmental state, governmental behaviour, and corporate society will be assessed against Steven Radelet and Jeffrey Sachs’ (2000) classification of five currency crises and Wilson’s typology of political regulation. According to Radelet and Sachs, the five currency crises are macroeconomic policy-induced crisis, bubble collapse, moral hazard, financial panic, and disorderly workout. Wilson’s typology (1980) describes the evolution of regulation, which is the evolution of politics in general. It considers how and why politicians respond to pressure from interest groups.

Problems that occurred in Korean industry and especially in the chaebols, such as high foreign-denominated short-maturity debt, poor corporate governance, and low profitability, are vital to all three approaches. If Korean policies towards industry had been adequate, the chaebols would not have made so many poor investments, return on investment and equity would have been sustainable, and debt would have been manageable. According to the moral hazard argument, it was a common belief among foreigners and Korean businesses that the Korean government indirectly guaranteed financial institutions’ and chaebols’ foreign debt. The number of bailouts of distressed entities and the method of valuing entities tell how realistic these expectations were. There were few bailouts and valuations were focused on assets, not liabilities, thus supporting the expectation of indirect guarantees.

Figure 1 illustrates how this paper will establish a possible connection between the theories. The independent variable in the governmental behaviour approach is governmental behaviour (II). The intermediate variable in both the governmental behaviour and corporate society approaches is collective irrationality by the financial market (III). The independent variable in the corporate society approach is corporate
society (I), which also makes governmental behaviour intermediate. Financial irrationality is the independent variable in the developmental state approach. Especially for Chang, the government’s irrationality was seen in its drift from the traditional developmental state, in its liberalisation of the financial sector, and in its movement of capital across borders. The dependent variable for all the approaches is the outbreak of the financial crisis (e.g., currency depreciation and bankruptcies).

Governmental behaviour: Independent variable = II
Intermediate variable = III
Dependent variable = IV

Corporate society: Independent variable = I
Intermediate variable = II and III
Dependent variable = IV

Developmental state: Independent variable = III
Dependent variable = IV

Fig. 1.1: All approaches integrated

1.4 Questions

Foreign investors and financial institutions had an impact on the real economy before, during, and after the crisis. The three approaches differ in the logic used to derive a cause out of this correlation. The developmental state approach emphasises the outcome of foreign investors’ actions, meanwhile the governmental behaviour approach emphasises foreign investors’ rationale for their actions and how the
government had caused them. The corporate society approach stresses the lack of appropriate action and the failed implementation of articulated policy. This paper will address the questions listed below in light of the three approaches.

Question 1: *Was Korea’s financial crisis a balance-of-payment crisis?* The balance-of-payment crisis in Korea refers to the depreciation of the won, the depletion of the BoK’s foreign-exchange reserves, and the collapse of the pegged exchange rate. It is reasonable to assert that domestic credit expansion in Korea was inconsistent with the pegged won. The real exchange rate was 100 in December 1990, appreciating to 88 in September 1997, before then depreciating to 157 in December 1997 (Radelet and Sachs 1998:Table 10). In November 1997, the BoK abandoned its defence of the won and the exchange rate broke through the W 1000 level. The pegged exchange-rate regime collapsed. The fixed-parity regime was not combinable with Korea’s real economic strength. The overvalued won contributed, through foreign borrowing and the multiplicative effects of these loans, to an indefensible domestic credit expansion.

Question 2: *Was there financial panic in Korea during the crisis?* Financial panic occurs when short-term debt exceeds short-term assets, when no single private creditor is able to supply all the credit necessary to pay off existing short-term debt, and when there is no lender of last resort. The financial crisis hypothesis does not include the stock market, which will be discussed later. Short-term debt can exceed short-term assets without financial panic occurring. The relationship between financial panic and the debt-to-asset ratio is not deterministic of the law of weight. However, a system with these characteristics is unstable and is sensitive to psychological effects, which may induce the majority of lenders to call in their debt simultaneously. Financial panic can really be a self-fulfilling prophecy.

Question 3: *Did a bubble burst during Korea’s financial crisis?* A financial bubble occurs when an asset is priced above its fundamental value. An economic bubble is not a very distinct notion. How high does a price have to be above its fundamental value before we can call it a bubble? And what is the fundamental value of real
estate, for example? To obtain a reasonable understanding of a bubble, the gap between an asset’s price and its fundamental value have to be substantial.

**Question 4:** *Was Korea’s financial crisis a moral hazard crisis?* A moral hazard crisis implies that Korean banks were able to gain access to domestic and foreign deposits by implicit or explicit state guarantees of bank liabilities. An understanding of state guarantees for corporate debt (chaebols) was also present. That was one reason why Sammi Steel’s failure provoked fear of a looming corporate debt crisis.

**Question 5:** *Was Korea’s financial crisis the result of disorderly workout?* Disorderly workout implies that an illiquid or insolvent borrower provoked a creditor to liquidate even though the borrower was worth more ongoing. It was a liquidity crisis more than a structural crisis. Total debt was not necessarily the problem, but rather the large amount of short-term debt that had to be rolled over within a limited time.

**Question 6:** *Was Korea’s financial crisis the result of contagion from neighbouring countries, especially Thailand?* Contagion implies that financial disturbance is bi- or multilateral, that it spreads from one country to others. Financial disturbance is seen as depressed currency and/or reassessed creditworthiness. Contagion can be perceived as a kind of borderless financial panic. Panic is not triggered by domestic conditions alone, but has to be seen in relation to the situation in neighbouring countries such as Thailand. A contagion crisis is also a phenomenon where trading partners reduce their purchasing power or increase their competitiveness by depressing their currencies. When the baht depreciated, Thai products were cheaper than similar Korean products, and Thailand’s ability to sustain imports from Korea was reduced. Another possible explanation for contagion is that creditors came into a liquidity squeeze in Thailand and therefore chose to call in their loans or sell away their assets in Korea.

**Question 7:** *Was Korea’s financial crisis the result of government’s inability to implement necessary reforms due to pressure from the chaebols?* Such crises occur
when governments are unsuccessful in making economic reforms due to stiff resistance, as was the case in the 1990s when the Korean government attempted to reduce the economic concentration of chaebols. This implies that the Korean state had insufficient state autonomy vis-à-vis special interest groups, such as big business.

Question 8: Was Korea’s financial crisis a crisis of under-regulation? Under-regulation implies that the absence of governmental coordination of domestic investment after the opening of the capital account led to the use of short-term foreign debt in sectors with overcapacity and long-term yields. Financial liberalization was ill managed and exchange rate management was poor.

1.5 Actors

The financial market involves domestic and foreign investors, fundraisers such as mutual banks and other international financial institutions that trade currencies, commodities, and other securities.

The financial market embraces both capital and money markets. The capital market is strictly a primary and secondary market for securities with an initial maturity of over one year. It is also referred to as the overall financial sector and as all forms of financial institutions and instruments. The money market refers to the market for debt securities with an initial maturity of less than one year (Naughton 1998).

An example of a foreign investor is a mutual bank. Chaebols used foreign-denominated debt due to high domestic interest rates. Higher domestic interest rates could have been due to the desire for a strong won. Foreign investors characterised the Pacific Rim, including Korea, as one of the fastest growing markets in the world. As for Korea, the only obstacle for foreign investors was investment restrictions. They were only allowed to lend short-term since there were strong restrictions on foreign direct investment (FDI). FDI includes foreign-controlled entities. Before the IMF’s reforms, foreigners could not own more than 49% of companies. Portfolio
investments with minority ownership were therefore dominant. Portfolio investment is more of a passive ownership.

Traders in currencies and securities were just as involved in the Korean market as in most other parts of the world. Their motives for such involvement is hedging, diversification, and speculation. The distinction between profit-seeking and speculation is vague. Speculation can be defined as trading for profit when an actor believes it has more, and exclusive, information than others.

Balance of payment is a very important concept in the discussion of Korea’s financial crisis. There are two primary types of international transactions recorded in the balance of payments (Krugman and Obstfeld 2000:314):

1) Transactions that involve the export or import of goods and services are classified in the current account balance. The current account balance is the difference between the export and import of goods and services.

2) Transactions that involve the purchase or sale of assets are classified in the capital account. The capital account balance is the difference between a country’s export and import of assets. An asset can be any one of the forms in which wealth can be held, such as money, stocks, factories, government debt, land, and even treasured items.

Balance of payment = current account balance + capital account balance

1.6 Curriculum

Chapter Two of this paper will describe theories that are frequently referred to when explaining Asia’s ‘miracles’ and Korea’s growth and crisis. The term ‘developmental state’ has been used to label Korea in helping to understand the exceptional growth that has taken place since the 1960s. Critics of the Korean economy and the developmental state are the governmental behaviour and corporate society approaches. ‘Governmental behaviour’ is the most general approach when criticising
the attributes of Korean society. It stresses potential threats that all economies have to fight deliberately: conflicting interests, fraud, and moral hazard; therefore, these threats are not unique to Korea. Assessing various types of crises is useful in understanding the implications of the developmental state and governmental behaviour approaches. In Chapter Three, Claudio Cioffi-Revilla’s “Politics and Uncertainty” from 1998 is used as a methodological tool to illustrate the political status in Korea between 1960 and Kim Dae-jung’s articulated reforms. As a background, Chapter Four describes Korea’s characteristics as a late-late industrialiser and how governmental behaviour was conducted in developmental state fashion. Government’s attempt to curb the economy is emphasised together with Korea’s decision-making history. To address the eight questions, Chapter Five proposes which applied theories are suitable and what had a serious effect on the crisis. This paper gives its concluding remarks in Chapter Six.

1.7 Calendar of Disturbance

The main economic events of Korea’s financial crisis (OECD 1998:179-180) were:

1996
- February: The Ministry of Finance and Economy (MOFE) announces a new plan for capital market liberalization.
- April: Foreigners are allowed to indirectly buy Korea’s emerging growth stocks on the over-the-counter-market (OTC).
- June: The Deposit Insurance Corporation is founded.
- October: Korea is invited to join the OECD in December.

1997
- January: Hanbo Steel collapses under $6 billion in debt, becoming the first bankruptcy of a leading chaebol in decades.
- March: Sammi Steel fails, provoking fear of a looming corporate debt crisis.
- **July:** Thailand abandons the baht’s peg to the US dollar. Kia, Korea’s third largest carmaker, asks its creditors for a workout agreement to avoid receivership of its $8 billion debt.

- **August:** In spite of strong intervention, the Bank of Korea (BoK) is unable to defend the exchange rate at the level of W 900 per US dollar. The government announces the possibility of guaranteeing foreign liabilities of Korea’s financial institutions, if necessary.

- **September:** As a follow-up to the government’s financial market stabilisation measures announced in August, the BoK provides W 1 trillion in special loans to Korea First Bank and W 1 trillion to the financially-troubled merchant banks.

- **November:** As the BoK abandons its defence of the won, the exchange rate falls through the W 1000 to US dollar level. The new MOFE announces that Korea would seek a rescue package from the IMF. Standard and Poor’s lowers Korea’s foreign currency long-term credit rating from AA+ to A-.

- **December:** The Korean government and the IMF agree on a record $57 billion rescue loan. The won plunges to a new record low of W 1962 following the downgrade of Korea’s credit rating. Kim Dae-jung is elected president on the 18th.
2.0 THEORY

There are many views on Asian crisis theories. This paper has categorised the views into three approaches. The paper will examine the 'Developmental State', 'Governmental Behaviour', and 'Corporate Society' approaches and assess how applicable each of them are in Korea’s case. The developmental state approach, as illustrated in the developmental state model, has an institutional understanding of the financial crisis; while the governmental behaviour approach, as illustrated in the governmental behaviour model, has a liberal understanding of the crisis. The corporate society approach is a hybrid between the two as illustrated in the corporate society model. The IMF’s role in the Asian crisis has been a subject of discussion as well, but this paper does not consider the IMF as one of the fundamental causes alone; however, the IMF will to a certain degree be a part of the discussion.

2.1 Developmental State

A developmental state allocates resources to the core businesses it wants to emphasise. The Korean state was developmental when it made huge investments in the automobile, steel, shipbuilding, semiconductors, and other preferred industries. One way of influencing decision-making in business was through allocating cheap funds to certain projects through banks that were owned or effectively controlled by the government. In the developmental state approach, banks receive privileges if their actions are aligned with government and policymakers’ preferences.

Governmental behaviour in Korea is represented by the policies initiated by non-elected officials, the elected government, and the president. Power is centralised. There is no parliamentary system, rather an executive one. The reason for a strong president is the perception that centralised power is necessary due to the threat from North Korea. In President Kim Dae-jung’s first year, he proposed reducing the president's power and making the prime minister the head of the government. His
proposal was not accepted because the national assembly had more faith in a strong president for the reasons mentioned above.

In “Developmental State and the Asian Miracles: An Introduction to the Debate”, Laurids S. Lauridsen (1995) divides the ‘developmental state’ into categories. The neo-classical explanation of the Asian miracle is a weaker version of the developmental state approach, while Lauridsen and others have a stronger version of the approach. This paper does not intend to discuss the extent of the developmental state in Korea; therefore, only the strong version will be used.

The state, government, and policymakers have had a close relationship with business in developing national, as well as economic, policy. They have been very active in regulating the economy. “State intervention was critical to the economic success of Japan and the East Asian NICs” (Lauridsen 1995:24). However, how top-down the command structure has been from central government to business will be discussed in this paper. According to United Nations Committee on Trade and Development (UNCTAD (1994:50), the primary purpose of the governments in East Asian economies was to promote the interest of the business sector as a whole (Lauridsen 1995:24).

East Asian NICs were gifted with efficient macroeconomic and export-oriented policies. The World Bank (1993:69) mentions three characteristic institutional mechanisms. Two of them are: 1) the wealth-sharing program that was designed to include the non-elite in economic growth, and 2) the fact that economic technocrats were insulated from narrow political pressure. Strategic industrial policies were stimulating a high level of productive investments, directing more investments in key industries, spreading and socialising investment risk, and taming international market forces to domestic needs (Lauridsen 1995:26). Institutional characteristics are a high degree of state autonomy, a well-developed collaboration between state elite and business elite, high administrative and technological capacity, and developmentally oriented state elite (Lauridsen 1995:27). Peter Evans describes the societies in East
Asia as having an “embedded autonomy” where a strong state means strong business. Policymakers are insulated from particularistic societal pressure and a network of societal ties. Even though Peter Evans uses Korea as an example of ‘embedded autonomy’, he also emphasises that co-operation is between state and chaebols and does not include broader societal interests.

The theory of the developmental state claims that the state-business relationship and the state-directed capitalism are the success factors in Korea’s economic development. Few disagree. Public choice theory did not have much explanatory power in this region, and East Asia was perceived to be the antithesis or the exception to public choice. “The market-led version of East Asia’s success has failed to withstand the test of carefully marshalled counterevidence” (Weiss 1995:41). The governed interdependence model of Linda Weiss emphasises the formal and institutional channels of co-operation and communication between policymakers and industrial organisations. Weiss’ propositions that the East Asian capacity for co-ordination has an institutional basis and that governed interdependence between business and government co-operation and co-ordination goes hand in hand. The adoption and implementation of projects are disciplined and monitored by the state (Weiss 1995:43-45).

Regulation aligned with the developmental state is both ‘balanced growth’, where industry gets a ‘big push’ from government, and ‘unbalanced growth’, where development is created from complimentary industries in a disequilibria situation. Due to scale economies and demand complementarities, entrepreneurs with a small industrial base in developing countries do not have the incentive to invest in modern facilities, unless there are extra market guarantees through investment planning by the government. The unbalanced growth (Hirschman 1960:69) focuses on complementarities between industries. The government has two industries linked within a sector, which will lead to spontaneous growth in related sectors (Chang 1997:707). Korea’s export-led production did not require a big push or balance in industrial supply.
Wade’s developmental state mainly identifies an external cause to the crisis: the international financial market. Ha-joon Chang, who is also an advocate of the developmental state approach, puts more emphasis than Wade on the internal causes of the crisis. Chang asserts that it was the liberalization of the financial sector, and especially the capital account, that lead to the crisis. Chang differs from the other approaches in that he has more faith in the developmental state system. Korea’s big mistake was to drift away from it. The two other approaches also attribute the crisis to internal reasons. Governmental behaviour attributes it to the government’s ineptitude and obsolete concept of the ‘developmental state’, while corporate society attributes it to the chaebols’ resistance to the government’s political changes. Political solutions or reforms that are suitable for the imperfections of the developmental state is the relaxation of detailed regulation of business in regard to investment and production, rather than the regulation of rules and standards as accounting standards, liquidity requirements, and so forth.

The developmental state approach by Ha-joon Chang describes the Korean crisis as a crisis of under-regulation and as misunderstood (Chang 1998). While the corporate society and governmental behaviour approaches attribute the crisis to governmental behaviour, Chang attributes it to the abandonment of the developmental state. He stresses that it was a financial crisis and not a crisis of the real economy as Korea’s manufactured products were still in demand around the world, and most of the foreign borrowing was financing investments in the tradable sector. In other words, the Korean economy was rather sound. The government’s major mistake was loosening control of foreign borrowing after liberalising the financial sector. There were virtually no restrictions on borrowing abroad. A second mistake was using the exchange-rate regime to make appreciation of the currency more acceptable leading up to the crisis than it had been in the past. And finally, Korea stopped coordinating investments, which resulted in overinvestment in certain sectors.
2.2 Corporate Society

In this paper, corporate society mainly refers to big business represented by the chaebols and marginalised labour unions. Business’ leverage vis-à-vis the government comes from politicians’ reliance on campaign funding. The unions’ leverage is the threat of strikes and social unrest.

As mentioned above, the 'jungkyung yuchak' (political-business relationship) has been perceived as one of the main reasons for successful development in Korea and East Asia. As Korea became more developed, the need for change in the relationship between business and government and for reforms in the financial sector was perceived necessary. However, according to Mo and Moon (1998, 1999:192), the failure to restructure industry was related to a combination of the gradual loss of political power in the national economy, and the political-business bond that resulted in political gridlock. The gridlock involved labour as well as the state and business. This worsened labour reform efforts. Big business attacked what it called the government's ambivalent policy posture, and both business and labour turned their backs to the government. During Kim Yong Sam’s presidency, he put an end to the vicious circle of political contribution and leadership patronage that had characterised the traditional Korean symbiosis between policy and business (Moon 1999:21). But the initiative turned out to be half-hearted. Kim was not able to break the power of the chaebols. As Kim’s predecessor, he started his presidency trying to undertake reforms to weaken the vested interests of the chaebols, but was eventually forced to align with them. The beneficial attributes of the developmental state suddenly became detrimental when the government attempted to reduce the economic concentration of the chaebols. However, breaking these ties was not a walk in the park. The political consequences of economic failure forced the government to accept big business’ demands and was thus not able to restructure industry to face global competition. The Kim Young Sam government did not enact enough decisive measures to implement the structural adjustments that it had intended to. This suggests that the power and influence of corporate society, in addition to governmental failure, caused the
The prescribed structural adjustments were obstructed by the unions and the chaebols. As long as the acute crisis was occurring, economic adjustments in the 1990s could not have been successful. The chaebols did not co-operate when the government asked them to improve efficiency and competitiveness, to make their financial statements more transparent, and to focus on profits through viable investments. Well-performing macroeconomics overshadowed structural deformities in the Korean economy. Financial distress and poor state governance was the result of either decreased state power induced by strong unions and chaebols or a weak president and political system. Korea was facing major internal and external challenges and constraints, resulting in malady in the developmental state paradigm that was based on dominant political coalition. The developmental state was subject to the law of diminishing returns (Moon and Lim 2002:71). Kim Yong Sam’s failed attempt to undertake necessary reforms can be attributed to a deep-seated relationship with big business (chaebols) and the government’s detachment from labour organisations (Hveem and Nordhaug 2002:214). What makes corporatism in Korea special is that rather few sectors in Korea’s civil society had a well-functioning dialogue with the government. Business had developed such a dialogue while workers had not. Corporate society in Korea is in contrast to corporate society in Western Europe, which is characterised by single peak associations from most sectors of civil society influencing government. The latter is called neo-corporatism (Sciulli 1992:179).

The gradual loss of state power can also be explained by political culture. Professor of political science at Yonsei University, Shin Myong Soo, argues that the political culture in Korea calls for a centralisation of power. The politicians are not used to compromise, which is so crucial to the success of coalitions (FEER Jan 8, 1998). This was a comment on how successful Kim Dae-jung would be in a coalition with the United Liberal Democratic Party and Park Rae Jung. As mentioned earlier, the Grand National Party used the argument of the need for strong political power against Kim Dae-jung’s proposition of making the prime minister the head of the government, not the president as it is today. The Grand National Party opposed the suggestion because
of the need for a strong president caused by the threat of North Korea. The strong version of developmental state (Lauridsen 1995:27) also says that Korea had a high degree of state autonomy. To strengthen corporate society approach, it has to identify the corporate sector’s political power.

The paradigm of the developmental state articulated certain values that the whole Korean nation could gather around. In the 1960s and 1970s, the focus was on growth, productivity, exports and security. The corporate society approach also emphasised how these well-defined materialistic values were less important for the Koreans during the 1990s. Korean opinion became less homogeneous. NGOs flourished while the environment, women’s rights, economic justice, and the war against corruption occupied the minds of more Koreans after the 1980s (Moon and Lim 2002:77).

2.3 Governmental Behaviour

According to the governmental behaviour approach, developmental state policy leads to unintended market behaviour in the form of rent-seeking. This in turn leads to moral hazard, fraud, and cronyism. The problem with the principal-agent relationship is rent-seeking by policymakers and businesses. The government is the principal of the policymakers, and in the case of the developmental state, of the business sector as well. Policymakers are the principals of the business community, while policymakers and businesses are the agents for the government.

Some scholars warned that economic growth among the Asian Tigers was not sustainable. Few others could pinpoint anything in the economy or how funds had been allocated. In the spring of 1997, the IMF actually honoured what the Asian Tigers had achieved in 1996. The Asian Development Bank (ADB) foresaw some of the problems that were embedded in the economies, but could not say much due to its mandate and its ownership (Strøm ADB 1999).
According to Paul Krugman (1998), the role of financial intermediaries is often neglected when analysing currency crises like the one in Asia. (Whether the crisis was solely a currency crisis is another issue.) Poorly regulated intermediaries are often associated with moral hazard. Moral hazard occurs when, for example, a chaebol speculates on high-risk projects knowing that high returns can be achieved while losses can be placed on a financial institution or the government. Conventional banks in Korea borrowed too extensively in the short term while lending funds for speculative investments by highly leveraged corporations. From this perspective, the currency crisis was more a symptom than a cause of the underlying malady. The cooperation among various social institutions is not as straightforward as it may seem. It is suggested that it was a team spirit among the elite and policymakers where everybody worked towards the same goals: prosperity and growth in Korea. This noble culture can be questioned. The principal-agent problem will always occur, even in disciplined ‘Confucian’ bureaucracies. Individuals and groups may co-operate while attempting to maximise their own utility, which is not always in the community’s best interests.

Governmental interference in the economy causes rent-seeking behaviour. The government gave implicit or explicit guarantees after instructing domestic banks whom to grant funds. As a result, the banks did a poor risk/return assessment and gave loans at too low interest rates. The government-bank relationship and the problems that may stem from it are indeed a traditional principal-agent pitfall. Press reports suggest that most of those who provided Korean banks with funds believed that they would be protected from risk if the banks went bankrupt. This impression was reinforced by the strong political connections of the owners of most such institutions (Krugman 1998:3). Market liberals have used the Korean crisis as an example of how government as lender of last resort can lead to excessive risk taking. This paper explains later how lenders of last resort can prevent financial crisis.

This approach suggests that we have to broaden our focus or horizon in measuring vulnerability in an economy. Korea’s problems were off the balance sheet. Easily
measurable variables such as a high domestic savings rate, a low current account deficit, and an export surplus do not adequately explain the soundness of an economy. The underlying policy mistake was not a part of the government’s visible liabilities until the crisis was a fact (Krugman 1998:5). This approach has to use vital indicators to prove that the government’s interference in business was damaging for the economy. Investors must have had a reason to be concerned.

2.3.1 Principal-Agent Relationship
A principal-agent relationship is a situation where one or more parties acts on behalf of another (others), or attends to another’s (others) interests (Hagen 1990:4). A person (principal) allocates the responsibility of a job to someone else (the agent), and the outcome (yield) depends to a large extent on the effort of the agent (Biswas 1997:91). The one that acts is the agent (businesses and policymakers), and the one the agent acts on behalf of is the principal (government). The principal wishes to set the contract in a way that maximises his utility (Biswas 1997:93). The principal-agent problem arises when the principal (government) designs a compensation system or a contract to motivate the agent (businesses and policymakers) to act in the principal's interests (Stiglitz 1989:241).

According to the developmental state approach, there was a close agreement between the state and companies in Korea to achieve the common goals of economic growth and wealth. Companies, especially the chaebols, were the agents and the government/state was the principal. The problem occurred when the two parties did not have convergent interests. Did the chaebols strive to accomplish what was in their own best interest or of Korea’s best interests as a nation? Industry and government have conflicting interests. The role of government could have been far more limited if that was not the case. The reason why so few people believe in the popular invisible-hand concept – no need for governmental regulation – is the very belief that industrial preferences do occasionally conflict with public and governmental interests. Several

1 Also Robert Wade (1998:1543) seems critical to the reliability of Korean statistics. When he describes debt to GDP ratio he put “published” in brackets.
people will agree that Korea managed to avoid principal-agent problems many years after designing the contract between state and industry. However, the contract did not seem to weather the 1990s. Policymakers are also agents for the state. Did policymakers always act in the state’s best interests? Allison’s (1969:63) organising concept for the bureaucratic politics paradigm describes ‘players in positions’ in the ‘political bureaucracy’ as individual agents with individual priorities and perceptions. It is not a unified group. Conflicting interests between principals and agents should hence not be rare. The incentive system has to be designed in a way that agents cannot use private information to reap monopoly profits at the expense of principals.

2.3.2 Moral Hazard
Moral hazard implies that actions by economic agents (businesses) maximise their own utility to the detriment of others (government) in situations where they do not bear the full consequences of their actions due to uncertainty and incomplete contracts that prevent the assignment of full damages to the agent responsible (Kotowitz 1989:207).

Moral hazard is misusing the support or insurance of other parties. The risk of moral hazard is present when support is articulated or insurance agreed upon. When insured, an entity or a person may not take adequate steps to reduce the risk and probability of failure to a level compatible with that of not being insured (Biswas 1997:41). To reduce or prevent moral hazard, parties must constantly be aware of the problem. In ‘Does IMF-Financing Encourage Imprudence by Borrowers and Lenders?’, Lane and Phillips (2002) ask if IMF-financing produces moral hazard and illustrate the IMF’s awareness of the problem. International creditors knew that the IMF would help if the loans went sour and that Korean taxpayers would have to foot the bill. It was the same with the chaebols. If their investments failed, it was the government that paid for the feast. What makes moral hazard a problem is the need for third-party support. In Korea’s case, the chaebols took advantage of government guarantees to undertake risky projects. Risk goes along with reward, but there is no reward without risk. One reason why the Korean government only gave indirect guarantees could have been
due to the fear of moral hazard. Moral hazard occurred among the chaebols when risky projects were disproportionate to reward and the chances for success were marginal. Another question is how much risk is acceptable. It has been said that the chaebols did not employ appropriate risk management in their investments due to the government’s very implicit guarantees. They focused instead on growing profits. They knew from the other chaebols’ experience that government would help them if financial problems occurred. The immorality of this has to be modified by adding that the government also wanted the chaebols to concentrate on growth, and some even claim that the government facilitated cronyism (McNeill and Bøckman 1998:1531). One example of such cronyism is Hanbo Steel's ties to the government and former president Kim Young Sam's son, Kim Hyun Chul (The Economist May 24, 1997). Still, there are good reasons to believe that several of the chaebols’ financial dispositions were not in government’s best interests. The government was not interested in conglomerates ending belly-up. There is ample reason to believe that the chaebols committed fraud.

2.3.3 Fraud

“An agent is said to have committed fraud when s/he misrepresents the information s/he has at her/his disposal so as to persuade the principal to choose a course of action s/he would not have chosen had s/he been properly informed” (Karni 1989:117).

One of the IMF’s criteria for helping Korea was that the chaebols had to adopt international accounting standards, i.e., the chaebols were using unconsolidated accounting procedures instead of consolidated ones. By using unconsolidated accounting procedures, they were able to give a false impression of an entity’s wealth. Consolidated accounting gives a more accurate picture of an entity’s liquidity and solvency. The main problems faced by the chaebols prior to the crisis were high debt-to-revenue ratios. Many of the projects were not viable and were therefore risky. There are reasons to believe that the chaebols committed fraud against the government because they did not undertake reasonable risk/reward projects. As an agent, a chaebol misrepresented private information towards the principal, the
government, by holding back information vital to the principal’s interest, i.e., a project’s risk. Chaebols committed fraud when they withheld information from the government to prevent unwanted action.

2.3.4 Government Who?
In ‘Conceptual Models and the Cuban Missile Crisis’, Graham T. Allison (1969:689-718) applies three approaches to understand governmental behaviour. This paper will discuss the application of this concept to Korea and its development. The rational policy model uses the nation as the basic unit of analysis. Policy is a national choice. Political outcome is deliberate. The government is a unitary rational actor. Action is a direct response to a problem. Goals and objectives are clearly defined as well as options of action. Rational choice is value maximising. The second model is organisational process. Government consists of several organisations with a fixed set of standard operating procedures and programs. The basic unit of analysis in this model is policy as organisational output. Government is not monolithic, but a constellation of loosely allied organisations. Actors are organisations. Problems are cut up and divided into appropriate organisations. The organisations therefore have fractioned power. Actions are hence organisational output and the output is often a result of standard operating procedures. The last paradigm is bureaucratic politics. The basic unit of analysis is policy as political outcome. Organisational concepts are ‘players in position’; individuals are agents. Priorities and perceptions are determined by individual propensities brought in with position. The less socialising and disciplinarian an organisation is, the more present individual propensities are.

Foreign investors have been perceived as members of a homogeneous group with similar preferences. Their business goals are practically the same: to maximise profit. The way of doing that is very much similar. They are financial actors in a global economy. This paper will not further assess their composition, but rather focus on the government. Who then is the Korean government? The Korean government is the government in Korea. It is elected politicians, ministries and departments, boards and commissions, mostly Messrs. X and a few Misses Y. Is the Korean government
simply a unified national entity with one defined utility function and one set of preferences, or is it a mosaic of preferences? As mentioned earlier, the concept of government can be heavily fragmented. Korea as a developmental state apparently managed to act unified in working towards the clearly defined political and economic goals of economic development and growth by encouraging domestic saving and investment. Its success can give this impression. When an economic slowdown announces its arrival, we have to expect a political willingness to evolve and improve the situation by bringing the economy into a well-defined track again. After several decades of cooperation between governmental institutions and private enterprise, as well as among public institutions, the government developed standard operating procedures. Changing these procedures within a limited time span, combined with organisations’ embedded resistance to change, made reform a difficult task. The description of a successful Korea as having a unified and rational government working towards the same goals, the same preferences, and with standard operating procedures seems rather foolhardy. Critics of the Korean miracle have focused on individual actors. They have assessed the agent-principal conflict, moral hazard, and cronyism. The rational actors with clear preferences have stepped down from government level to individual level. The unit of analysis is different. The governmental state approach assesses the beneficial cooperation between the government and private entities, while the governmental behaviour approach assess the conflicts between principals and agents and between governmental preferences and individual preferences. The agent is not only industry, but also policymakers.

The developmental state treats the Korean government as a unitary entity. Policymakers are well educated and know their positions and roles. They follow political goals initiated by the government. The governmental behaviour approach finds these assumptions problematic. It believes individual policymakers can have conflicting goals with their principals. The elected government as principal has both economic actors as well policymakers as agents. The corporate society approach centres on the chaebols as the agents acting in conflict with the government. The governmental behaviour approach adds policymakers to chaebols as the agents acting
in conflict with the government. According to Heo and Tan (2003:26), the direct consequences of a battle for jurisdiction between the Ministry of Finance and the Bank of Korea resulted in failed financial reforms.

2.4 Financial Crisis and Regulation

The alleged source of Korea’s advantage of their economic growth is the co-operation between the various agents/actors in the social structure: business, government, the unions, etc. Korea’s intention to organise its society was precious; however, critics claim that the system did not account for individuals that took advantage of the system. Krugman describes it this way: 1) Economics is about what individuals do, not what classes do. 2) Individuals act in self-interest. 3) Individuals are intelligent. 4) We are concerned with the interaction of such individuals (Palan 2000:8). These assumptions can be hard to accept; however, they are useful to keep in mind when dealing with economics, especially when we want to find out why economic actors behaved as they did in Korea’s case. This is what Allison (1969:708) calls the bureaucratic politics paradigm with players in position. Actors are individual players. Contagion and financial panic will be discussed later in light of economic actors being individual players, and how individual rationality can become collective irrationality.

The theme for this paper is Korea’s financial crisis. The question I am trying to answer is: Was the financial system the cause or merely the messenger of Korea’s financial crisis? My hypothesis is that governmental behaviour was the main cause of the financial crisis and that the financial system was only the messenger. The three approaches place the cause like this:

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<tr>
<th>Approach</th>
<th>Cause</th>
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<tr>
<td>Developmental state</td>
<td>The financial system</td>
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<td>Governmental behaviour</td>
<td>The government</td>
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The discussion will be based on how well the approaches explain the cause of the financial crisis in accordance with currency crisis and political regulation.

Steven Radelet and Jeffrey Sachs (2000:108) describe five different currency crises. But how many occurred in Korea, and which of the approaches covers the currency crisis best? To answer these questions, we have to make some assumptions.

1) Currency crisis was a major part of the financial crisis. Hence the question: Who was responsible for the weakened won?
2) The currency crisis is covered by one or several of Sachs’ currency crises.

2.4.1 Currency Crisis
The five first hypotheses presented in the introductory chapter are derived from different understandings of currency crises other than Korea’s. How we assess the strength and importance of the currency crisis in Korea’s case can partly give the cause of the crisis and determine the remedy. First, we have to make sure the views accept the fact that these financial crises occurred in Korea.

1) The macroeconomic policy-induced crisis is a Krugman model. The balance-of-payment crisis occurs when there is a mismatch between credit expansion by the central bank, i.e., investments are higher than savings, and the pegged exchange rate (Obstfeld and Krugman 2000:702). A substantial fall in foreign reserves creates vulnerability to a sudden run. In Korea’s case, funding after 1990 was based more on foreign lending than on domestic saving; still, the won was pegged as it was in the 1980s. Balance of payment is more officially called the official settlements balance, which includes the balance of the current account, the balance of the non-reserve capital account, and the statistical discrepancy. We can see from this that a balance of payment crisis can occur even with absence of a current account deficit. Foreign reserves in Korea were larger than domestic

2 Do not shoot the postman if you do not like the message.
reserves. The current account balance is hence an inadequate measurement for distressed economies.

2) The Bubble Collapse by Blanchard and Watson (1982). This is a look at the destiny of IT stocks at the beginning of this millennium. A bubble is the discrepancy between market value (expectations) and book value (fundamental value). Whether or not a bubble exists is subjective, because a bubble only exists when the discrepancy is substantial or the belief in the future is unrealistic. The bubble bursts when the unrealistic expectation is realised by a substantial part of the market or by an actor with placing-power (one large actor significantly influencing the market by its movements). In Korea, the chaebols were highly in debt and their profitability was low. Foreigners were allowed to hype the equity market though portfolio investment, as well as the purchase of ‘shares’ in the economy as a whole by buying won, the domestic currency. Currencies are a liability to a country’s balance of goods and services. Portfolio investment can be more irresponsible than FDI due to the lower implied stakes. A whole economy can be a dot.com bubble when its currency is stronger than its fundamental economy. The bubble bursts when the market realises that the currency is too strong or that it’s pegged too high.

3) Moral Hazard Crisis by Akerlof and Romer (1994). This occurs when lenders, i.e., banks, do not accept the real risk of lending funds. They expect the government or others to assume any potential losses. In this case, the risk is too high for the return or the return is too low for the risk. The risk is asymmetric. Moral hazard is also called crony capitalism, which is when private gain comes at the expense of the economy (Krugman 1999:37). A person in a company or a bank decides how much to risk, while somebody else bears the cost if the project goes sour. In Korea, the big borrowers were the banks controlled by the chaebols that dominated the economy. Banks provided easy government-guaranteed credit to their closely allied companies. Intervention when a project fails promotes moral hazard. A way of limiting moral hazard is hence to prevent situations that call for
intervention by introducing proper regulatory and supervisory systems. Astronaut and businessman Frank Borman vulgarly puts it this way: “Capitalism without bankruptcy is like Christianity without hell.” Capitalism is dependent upon symmetric risk. To win something, you have to risk something. If somebody helps you when you’re failing, you are given the incentives to take great risks.

4) Financial Panic by Diamond-Dybvig (1983). Short-term creditors withdraw their loans from solvent borrowers. Short-term debt exceeds short-term assets, no creditors in the market are large enough or willing enough to supply all the necessary credit, and there is no lender of last resort (Radelet and Krugman 2000:108). The lender of last resort can be the government, the IMF or another international institution. Financial panic can be individually rational and, at the same time, collectively irrational. It is the borrower’s responsibility to prevent irrational behaviour by the creditors by being open, honest and transparent for the purpose of pleasing and calming the lender.

5) Disorderly Workout by Sachs (1992). This is very closely related to the crisis above. An illiquid and insolvent borrower provokes a creditor to force liquidation, even though the borrower is worth more as an ongoing enterprise. It is obvious that rescue is better than bankruptcy. Creditors will go for that alternative; however, individual creditors will have to judge the time limit for binding funds to a certain project. It can be more tempting to realise a loss than to spend the leftovers on an alternative venture. A dollar this week can be preferred to several dollars weeks later. Credit co-ordination via bankruptcy laws or the existence of a lender of last resort can remedy a disorderly workout. However, if the IMF is going to co-ordinate the creditors or be the lender of last resort, it has to be reliable and give creditors what they want. If the creditors do not trust the IMF, they will not want to go along with its program either. That can be one of the reasons why the IMF worked out profound solutions and requirements for the Korean economy, instead of only granting it loans.
2.4.2 Political Regulation

According to Stigler, companies are willing to influence politics to increase their profits (Wilson 1980:358). This can be done in two ways: by obtaining subsidies or by lobbying governmental regulation that restricts entry to an industry. Subsidies encourage others to enter an industry. The result is a smaller share of the subsidy pie as well as of the market. Creating barriers to entry through governmental regulation sustains subsidies or potential profits in the sector. Korean business was characterised as having few large entities (chaebols). Facilitating development in technology and creating economies of scale in certain industries was reason enough to emphasise few large firms. However, government’s licensing of entry into its favoured sectors of automobiles and steel resulted in overinvestment and delinquent firms (Hveem and Nordhaug 2002:214).

Companies are able to influence regulation due to their number and power. Companies in an industry know each other and are fewer than potential starters. It is hence easier for them to organise into political influence to obtain status quo, than for potential starters to alliance. Industry has also the power to influence politicians and bureaucracy. Governmental officials seek to maximise votes and wealth. Companies help them with both. They can provide election campaign contributions to maximise voters, and they can offer gifts or employment during or after the bureaucrat’s governmental career.

I will discuss how well Wilson’s typology applies to the Korean case, whether industry granted favours to government officials and vice versa, and if governmental regulation created barriers to entry. An even more crucial question is how helpful or harmful such interaction between government and industry is. Several people have singled out this interaction as Korea’s success factor.
3.0 SOURCES AND DATA

The models are used in this paper as an attempt to describe an unambiguous relationship between the variables. A qualitative causal analysis is the methodology found to best suit the models because it gives important empirical implications when explaining the theme. To conduct empirical tests we have to have models that are constructed as simply as possible. The assumption is that the utility of causal analysis increases with simplicity and empirical accuracy. This paper does not attempt to find the sole explanation for the whole financial crisis, but rather to find a causal model that could explain what happened and that could be used as a future guideline.

3.1 Sources

This paper attempts to identify the dynamics and interactions in different ways to understand the crisis in Korea. In order to do this, all types of written material are used, such as magazines, newspapers, and academic literature found in books and articles. The time frame of the material is from mid-1997 until today. Most of the popular literature is of economic character. The use of public literature and official national documents is limited due to their nature. One argument in the debate on the financial crisis is the lack of reliable information and economic transparency; therefore, this paper will mainly use secondary documentary sources to describe the economy. One reason for using only readily available sources is the limited amount of resources available to write this paper. Qualities among writers’ values and attitudes are not observable (Hellevik 2002:357). The challenge of using magazines and newspapers, as well as academic articles, is the difficulty in assessing the validity and reliability by detecting hidden agendas and by interpreting the writer’s motivation for writing the articles. Hence, this paper uses mostly the descriptive parts of the articles and leaves the normative parts out. In addition, most business periodicals used are well-known and market-oriented such as the Economist.

3 The Economist have advertised for a better developed institutional framework in case of financial crisis in South Korea.
BusinessWeek. The interviews that are referred to are conducted in a way where the respondent is an informant.

Theories referred to in this paper frequently appear in finance and political economics. The theories explain empirical findings in varying degree. By testing the theories’ explanatory power, some of them appear to be more able to predict future financial crises than others. All of the approaches are far from useless; however, some of them examine the crisis more thoroughly without prejudice. The importance of prejudice is considerable due to the approaches’ politically polarised bias.

3.2 Methodology

Even though financial crises occurred prior to East Asia, and will happen again, our analysis has to be counterfactual. All we can do is experiment with our thoughts (Førland 102:1996). The experiments should be based on existing knowledge and experiences from this crisis and earlier ones; however, we cannot change what has happened, we can only imagine changes or the absence of factors. What would the result be if actors involved in the crisis behaved differently? Such cognitive experiments are what make international politics fascinating and challenging. The uncertainty that characterises political economics is handled differently. The general approach in this paper is rationalistic in an attempt to reduce uncertainty. Human beings are considered rational. They seek to maximise their interests, not necessarily selfishly, using defined goals. They seek long-term utility through utility functions. Politicians’ goals may be to introduce their own policies in order to be re-elected or to further their political careers. Chaebols can be run by empire-building leaders who seek growth and power through mergers, acquisitions, and other investments. Policymakers think about their careers in some form or another, in addition to the power of their ministries. Their personal prestige increases when their ministries grow bigger and more powerful. Policymakers, politicians, and industry leaders know what to do to achieve their goals. They maximise their utility by assessing their behaviour and the potential outcome of such behaviour. A long political career
requires certain behaviour. Few actions are motivated by altruism alone. Chaebols cooperate with government because they believe that it will improve their situation. The government cooperates with the chaebols to implement its policies of growth and prosperity. Facilitating prosperity is altruistic if the behaviour is independent of politicians’ personal objectives. Co-operation within society is rational for the units analysed.

The units analysed in my discussion are both governmental and non-governmental, both institutions and individuals. Treating individuals as rational aids in predicting behaviour under uncertainty. Simplifying politicians, industry leaders and policymakers by giving them utility functions makes it easier to understand why they behaved the way did under the particular circumstances and to understand how they might behave in the future. Behaviour motivated by utility functions reduces uncertainty. Individuals have different utility functions depending on which role they are playing. They are socialised. Politicians maximise votes and investors maximise wealth. One individual can have both utility functions, which are challenging to combine.

Several people find this approach far too simple and derogatory to individuals, and even more so to institutions, by reducing them to units with well-defined preferences and utility functions. This paper is not intended to advocate any of these perceptions per se; therefore, it chooses Claudio Cioffi-Revilla’s “Politics and Uncertainty” (1998) as a methodological tool as a compromise between rational and non-rational approaches. In a world of uncertainty and inadequate information, we have to assume that individuals are rationally limited in their behaviour. The methodological framework of qualitative causal analysis is based on Ottar Hellevik (2002). The hypothesis of this paper is that either the political system, governmental behaviour, corporate society, or international investors facilitated the financial crisis. Ultimately, we want to explain the financial crisis (explanandum), but in order to do so it can be useful to understand governmental behaviour. (See fig. 1). By using causal analysis, we examine why a connection between independent and dependent variables exists.
(Hellevik 2002:280). How did the pegging of the won in 1995 and 1996 affect the likeliness of a speculative attack on the won thus causing the financial crisis? Or how did the chaebols’ resistance to change affect the implementation of industrial reforms? The spurious effects of the alternatives will be discussed in Chapter Five.

Causal mechanisms link explanandum Y to explanans X. \( Y = f(X) \)

\( Y = \) explanandum. Well-defined dependent variables will be explained. In alternatives 1 and 3, Y is a financial crisis consisting of the chaebols’ distress, investors’ behaviour, investors’ withdrawal, investors’ panic, bankruptcies, and a depressed currency. In alternative 2, the dependent variable is governmental behaviour, including poor regulation and supervision, and the pegging of the won. \( X = \) explanans are independent variables that represent the cause of the financial crisis or governmental behaviour. Speculators are foreign-currency and equity traders. Corporate society is the chaebols’ resistance to change and its active work against reforms initiated by the government. Alternative 1 is the liberal way of understanding the financial crisis. Governmental behaviour as an independent variable is pegging the currency or guarantees and support to non-viable chaebols or projects. This all led to a disturbance in the financial system resulting in financial crisis. Financial crisis is a direct result of governmental behaviour. Alternative 2, the corporate society explanation, goes a bit further and tries to explain why the government acted the way it did. The corporate society approach supports alternative 1; however, it wants to add alternative 2. Financial crisis, governmental behaviour, and corporate society are parts of a causal chain. The independent variable is corporate society. Corporate society manipulated the political system resulting in poor governmental behaviour, such as pegging the currency for too long or not implementing needed regulation and supervision. Poor governmental behaviour leads to disturbance in the financial system, eventually ending in financial crisis. The last alternative is a causal model for the developmental state approach. The independent variables are the financial liberalisation that took place under pressure from American-influenced neo-liberal institutions such as the World Bank (the “Washington consensus”) and foreign
speculators, both of which independently caused the disturbance in Korea’s national economy that led to financial crisis.

Dependent variables of financial crisis and governmental behaviour have certain properties. Financial crisis and governmental behaviour are multidimensional. Financial dimensions are investors’ sudden withdrawal, a depressed currency, and industrial distress. Governmental dimensions are a pegged currency, subsidised loans, and guarantees. Dimensions of financial and governmental behaviour are measurable when operationally defined using systematically recorded data. For example, companies that receive favoured loans have better conditions than companies that
don’t, or currency crisis occurs when a currency depreciates more than 10% in one day. Dimensions are also observable when they occur as investors or as governmental decisions.

3.2.1 Dependent Variables
This paper does not intend to, nor will it, be able to quantify the variables’ association to each other. The following description is a framework for understanding the relationship between the variables. The core of the discussion is uncertainty: Why did the financial crisis occur? We would like to reduce uncertainty by explaining how the financial crisis and governmental behaviour were caused, by detecting any regularity or certain mechanisms in financial crisis and governmental behaviour prior to the crisis. Foreign investors were uncertain of how the government would resolve the crisis or how the situation was in Korea after the Thai crisis. The Korean government and its central bank were uncertain of how foreign investors would react to its use of foreign exchange to purchase won. Uncertainty is given by probabilistic causality of Y. Each value of Y has an associated probability. Governmental behaviour (X) as failed supervision or regulation gives financial crisis (Y) as industrial distress, with a probability of for example 0.60. Financial crisis Y has a set of values: y1 (sudden withdrawal), y2 (depressed currency), and y3 (industrial distress).

\[
Y = (y_1 + y_2 + y_3 + \ldots + y_n)
\]

Governmental behaviour has the same set of values: y1 (election), y2 (governmental reform), and y3 (conflict). Each value has an associated probability \(P(Y=y)\) of financial crisis, which is sudden withdrawal, depressed currency, and industrial distress in an interval between 1 and 0.

The cumulative density function cdf(y) indicates the probability of the increasing value of Y. Investors’ sudden withdrawal, y1, adds a value to financial crisis Y. More small y’s give a stronger large Y. Industrial distress as a small y can, but does not necessarily, create financial crisis as large Y. The probability density function, cdf(y), uniquely specifies the value of Y. Election, y1, gives a certain value to governmental behaviour Y.
When Y is a matter of *when*, the variables are temporal (diachronic). Financial crisis and governmental behaviour have duration (How long was the crisis or the certain governmental behaviour?) and onset (When did the crisis or certain political behaviour begin?). Governmental behaviour prior to the crisis is of special interests. The Asian financial crisis started after the baht depreciated and ended when the Korean economy stabilised. When financial crisis and governmental behaviour is a matter of *what*, the variables have intensity (synchronic). What happened during the crisis and what did the government do prior to the crisis? Y has size and magnitudes. The financial crisis was not only a banking crisis or a currency crisis, it was both, and the crisis was profound. In our case, Y is both diachronic and synchronic. Financial crisis and governmental behaviour as dependent variables in the various models are measurable. What the government did, or did not do, towards the industrial and financial sectors is possible to assess. We can also measure the financial crisis by examining interest rates, currency valuation and industrial performance.

Causal forces have three properties. 1) They can be numerous. A policy of industrial development can be caused by nationalism, or by domestic and international forces (pressure). Investors’ behaviour is a result of routine, principals, owners, and national law. 2) Causal forces vary from one politician’s or investor’s behaviour to another. Korea’s financial crisis was caused by forces other than those of the peso crisis in Mexico. 3) Causal forces have a direct causal effect on the distribution of observed values. Industry’s pressure on the government directly influenced governmental creation and the implementation of industry reforms (or lack of such). Causal forces are not deterministic. The force producing political and investor behaviour is the rationale of the probability that behaviour has a value. When the corporate sector tries to influence governmental behaviour, the result is not deterministic. Investors and government behave differently under uncertainty.

### 3.2.2 Independent Variables

The effect variable financial crisis is determined by the cause variables. There is a statistical connection between speculative attack, currency crisis, governmental
behaviour, industry’s resistance to change, and manipulation of governmental
behaviour. The dispute is first and foremost about the chronology of the variables.
The corporate society model holds the chaebols’ resistance to change to be a crucial
element in explaining why the government did what it did, or did not do, leading to
foreign currency traders’ and creditors’ behaviour. The chaebols’ resistance to change
comes earlier in the chronological order than governmental behaviour. Both the
corporate society and liberal models hold the speculative currency attack and panic to
be the result of governmental behaviour, while the developmental state model gives
speculation the status of a fundamental cause together with the push for liberalisation.
The corporate society approach does not consider liberalisation to be an independent
variable, because liberalisation was a necessary move by the government following
its regulation and supervision. The developmental state describes governmental
behaviour as liberalisation, which made Korea vulnerable to an unstable international
market thus resulting in financial crisis. The corporate society and governmental
behaviour approaches give speculators and liberalisation an intermediary effect.

There is a statistical coherence between the variables in all models, but there is not
always necessary and sufficient cause. It is necessary, but not sufficient, that currency
traders attacked the won causing it to depreciate against the Korean authorities’ will.
It is not sufficient because the strength of the Korean economy and its foreign
exchange reserves determined whether the speculative attack would result in a
financial crisis or not. I will argue that liberalising the financial sector without
regulation and supervision is not necessary, but sufficient to facilitate a financial
crisis. Corporate society argues that the chaebols’ resistance to change and
manipulation of governmental reforms is sufficient, though not necessary, for a
financial crisis. The neo-liberal model does not find any financial crises after the
Second World War that didn’t have a considerably negative governmental
contribution and that found governmental behaviour definitely sufficient, but also
necessary, to have a financial crisis.
4.0 CHARACTERISTICS OF THE KOREAN ECONOMY

4.1 Korea as Late-Late Industrialised Country

According to Gerschenkron’s hypothesis (1962:44), the later a country industrialises, the larger of a role the state should play in facilitating the industrialisation. The industrial revolution evolved first in Great Britain around 1750; hence Great Britain is considered an early industrialist. Great Britain is therefore expected to have a more passive government than, for example, Norway, which was industrialised one hundred years later. It was another hundred years before Korea’s industrial revolution and, according to Gerschenkron, the country should have an even more active state. Crucial obstacles that have to be resolved to industrialise are lack of infrastructure, capital for investment, capitalists, a business class, and necessary technology. The Korean government has actively contributed to all of this.

1) Lack of infrastructure
Proper infrastructure is necessary for economic growth. Late industrialisers lack this infrastructure. Due to infrastructure’s character of being a public good, the private sector has no incentive in its production. Park Chung Hee’s highway between Pusan and Seoul is said to be the start, and major contributing factor, to Korea’s emerging economic growth.

2) Lack of capitalists and a business class
A government can gather the expertise to help industries without the entrepreneurial skills and trading experience necessary to more effectively compete with foreign competitors and trading partners.

3) Lack of necessary technology

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4 Lecture two and four autumn 1998 in International Dimensions of Corporate-Government Relations. Graduate School of Management, Griffith University.
R&D is expensive, making it difficult for a small entity to finance on its own. Without proper technology it can be difficult for a domestic industry to break into the international marketplace. Pooling expertise and building publicly funded national ‘brain-parks’ can produce the necessary know-how for smaller entities.

4) Lack of capital for investment and inputs
Limited capital and foreign reserves for investment called for export-oriented production to earn income. The government accumulated capital to invest in industries they believed had an export market. Producing products for export is the only way to pay back the foreign debt amassed for the purchase of inputs. Excessive investment in, for example, real estate offers no opportunity to create foreign exchange. Governmental guarantees for the debt gave cheaper funding for their infant industry.

In resolving the four points, Korea created a strong and developmental state to pick winners they could support and emphasise. The intention of the developmental state is to support encouraged and facilitated businesses to grow more rapidly than they would without governmental intervention.

4.2 Korea as Developmental State

Korean economic development was engineered through the management of macroeconomic fundamentals such as money supply, fiscal policy, interest rates, and exchange rates. Korea’s export-led industrialisation was a strategic implementation of a synergistic and cooperative relationship with businesses where the businesses followed government directives (Adelman and Yeldan 1999:5)

4.2.1 The State
One of Korea’s strong national leaders was Park Chung Hee. He was a dictator according to some, and a saviour according to others. It was during his presidency that Korea’s impressive economic growth emerged. He managed to mobilise political support for rapid industrialisation. The political authoritarianism maintained labour
discipline and suppressed consumption to promote export and to spend foreign exchange on necessary production factors instead of on consumer goods to increase exports. High level of socio-economic equality through housing programs, subsidised food and public education and health, reduced the potential for political tension. Socio-economic equality has contributed to skilled and productive workers.

4.2.2 The Policymakers
Korean policymakers have been the developmental elite who were well educated and employed on the basis of merits. Corruption was said to be low and commitment to the nation profound. It has been the policymakers’ task to execute industrial policy. The pilot agency was Korea’s Economic Planning Board that created four- and five-years plans. Korea assumed the character of a command economy; however, in contrast to state capitalism, Korea had private enterprises and a close relationship between them and the government. The government guided the businesses towards political goals, they protected infant industries from international competition by subsidies, import and ownership regulation. At the same time, they promoted competition in the home market.

Policymakers’ insulation and coherence contributed to a strong and developmental state. Insulated policymakers can make hard and painful decisions and can plan for the long run without having to worry about political fallout. Ideally, cronies and well-connected rent-seekers are not just a phenomenon. Some people claim that corruption took place in the ministries that did not matter much for economic development (except from waste of resources), while the major economic policy-making bodies were ‘clean’. Policymakers were insulated from external forces. Coherence implies that policy decisions are consistent with each other. Korea’s Economic Planning Board was an agency that co-ordinated policymakers’ activities, preventing one department from working against another.
4.2.3 The Businesses

Gary Gereffi’s (1990:92) explanation of Korea’s industrial structure is based on size, ownership, and the industrial sector. Korean industry is dominated by chaebols, which are conglomerates involved in a wide range of industries, similar to the pre-WWII Japanese zaibatsus. For example, Lucky Goldstar contained 62 companies in 1988, and Samsung consisted of 37 related firms (Gereffi 1990:95). In 1987, Samsung employed 160,000 people, which was more than half the total employment of the ten biggest companies in Taiwan at the time. The chaebols were first and foremost involved in heavy industry before later diversifying into a wider range of products. They are privately owned, and control has been kept in the hands of the founding families. The authoritarian structure in Korea is also called corporate patriarchy, where industrial empires had a centralised command supported by the state. The government guided them closely. The government controlled credit, and regulated the purchase of raw materials, energy, foreign exchange, price controls for selected commodities. Capital markets, stock offerings, and external shareholders were avoided to keep domestic entities as tools for industrial policy. Jung-en Woo (1991:148) explains the ‘big push’ as the government’s selection of entrepreneurs to receive bank loans. They had good export records and were risk takers in heavy and chemical industries. They had to be gigantic. Size was a determining factor against default (‘too big to fail’ was an established notion). Due to this extreme leverage, government and business would sink or swim together. The companies were monopolists or oligopolies.

4.3 Korea’s Foreign Capital Import

Korea’s capital import was dominated by American assistance after WWII. It was during General Park’s presidency that Korea started to borrow abroad. Korea’s debt policy had three aims (Woo 1991:150-151):

1) Increase American and Japanese stakes in Korea through debt. This was insurance against hard times.
2) Economic interdependence as collateral to secure American commitment in Korea.

3) Finance industrialisation.

The primary reason Korea became attached to the USA was the close geo-political alliance that arose from the Korean War. Korea imagined that if a financial crisis were to occur, the Pentagon would lobby the Treasury Department to arrange an orderly workout by giving Korea emergency credit or by pressuring its ally, Japan, to give assistance. The latter worked during the debt crisis of the 1980s when Japan was pressured by the USA to give a large emergency credit in consideration for North East Asian security. High finance is also high politics (Woo 1991:154-155). Countries that are of strategic importance to the USA, and where the USA has substantial interests, are practically immune to default. If exposed banks in Korea go belly-up, there is a great risk that the home (USA’s) economy (BankAmerica, Citibank, Chase Manhattan, etc.) will encounter large losses. USA’s economic interaction with Korea is also motivated by national security interests. USA perceives distressed economies as more likely to drift away from national security cooperation. Korean opinion was more discontent with American presence during the crisis than prior to it.

As a result of Korean economic policy, foreigners had to invest in Korea mainly through indirect investment by Korean middlemen instead of through direct investment. There were limited opportunities for foreign direct investment (FDI) due to political constraints, but also due to foreigners’ ability to assess risk and profitability in the Korean market. Instead, investment took place as lending to Korean investment banks and other financial institutions. Korean financial institutions assessed the investments in Korea, while foreigners only had to assess the fundraisers. It was also generally assumed that Korean financial institutions were guaranteed by the government. Indirect investments are preferable to a developmental state government because it wants to maintain control over industrial policy. It is not able to do that with strong foreign ownership. Another way foreigners invested in
Korea was through portfolio investment, which is limited/constrained ownership in Korean companies. This is called hot money. Such investment is fluctuating in nature and can cross borders rapidly. Investors are eligible to own parts of an entity, but not enough to have a major influence on decisions. Several countries are sceptical of large amounts of portfolio investments in inbound capital flows due to the uncertainty of where the invested money will be tomorrow. If a Korean company gets into trouble, it is easier for a foreign investor who owns 10% to sell and leave the company than it is for an investor who owns 51%. Selling small proportions can easily be done without too much attention from the market, than larger sell-offs. If an investor sells a larger share of an entity, it will attract attention and the market will react. Owning larger proportions is motivation for more involvement in a company.

4.4 Paving the Economy with Relationships

It is tempting to peg an economy. Central banks constantly intervene in their own currencies by selling or buying, even though they are not practicing pegging. Then the government knows the variables much better in forming policy. The value of a currency, the power of workers, and the development of a region are influenced by the government. Pegging a currency is fixing its exchange rate within a range against other currencies. Prior to the crisis, the value of won was more or less fixed to other selected currencies such as the USD.

4.4.1 Investor Relations
Currency is a liability to a country’s balance of goods and services and hence, currency is a kind of share in an economy. The value of the currency depends on the condition of the economy. Good investor relations are therefore as important to a government as to entities with convertible shares. If a country such as Korea wants a stable currency and wishes to participate in the international trading arena, it has to take care of, and include, all involved actors in its policymaking. An open economy has to be aware of the fact that external factors affect the economy as much as internal factors. It is therefore important that a country knows the behavioural pattern
of allies such as foreign financial institutions and does not frustrate them by negative surprises such as consciously hiding weaknesses.

Another weakness in the Korean economy was conflicting goals. Facilitating export-oriented industry with a weak won was difficult to combine with increasing foreign-denominated debt, which causes less troubles with a strong won. A low interest rate in Korea would have weakened the won, facilitating export and making it less tempting for chaebols to borrow abroad, albeit, it would result in less saving in Korea among Koreans and foreigners. The crisis that occurred in Korea indicates four features in the economy:

1) Korea had apparently not chosen the right exchange rate regime. The domination of short-term loans and the current account balance did not justify pegging the currency in the 1990s.

2) The financial sector was not properly regulated. Distressed banks cut the channel of credit. Nobody was able to rescue the banks or the enterprises.

3) Liberalisation in the financial sector was not followed-up by setting liquidity standards to prevent reckless lending.

4) Financial trouble is contagious. It started in Thailand and continued beyond Korea.

A perfect exchange rate regime is not easily adapted. Krugman and Obstfeld (2000:713) sketch what they call the political trilemma for open economies.

![Fig. 4.1: The exchange rate trilemma.](image-url)
To a certain extent, developed countries often desire exchange rate stability, monetary policy autonomy, and freedom of capital movement. The certain extent is because freedom of capital movement reduces a county’s capital control, exchange rate stability does not necessarily align with a floating exchange rate regime, and a currency board does not give monetary policy autonomy. Which part of the triangle to emphasise depends on the economy’s state and developmental stage. Freedom of capital movement was less important for Korea in the 1960s than in the 1990s. Exchange rate stability and monetary policy autonomy were more important in the early stages of development than the later ones.

4.4.2 Labour Relations
In the literature, similarities between the Japanese and Korean economies are often drawn, and one of the similarities is the abundance of well-educated workers. However, the level of conflict between employers and employees is not at all comparable. The workers in Korea have been far more in opposition. Korean wages were much lower due to low agricultural prices and a ban on larger unions. It might have been the administered prices of labour and the ban on unions that created the profound tension. The workers, and to a certain extent the students, created underground movements. This tension surfaced under president Chun of the Fifth Republic, who provoked the new movement in 1980-1987 that culminated in the Great Struggle.

The abundance of well-educated workers was one of the major assets Korea had from 1965 (Kuznets 1994:55); therefore, it was extremely important to properly control this asset. One way of reducing the tension between employers and employees was by reducing the bargaining power of the latter (Dae Hwan Kim 1997:37). The workers were thus suppressed throughout the General Park period until a certain change appeared after the Great Worker’s Struggle in 1987. The discrimination favouring capital over labour was a necessity due to the politicians’ relationship and attitude towards chaebols (capital) and perhaps a result of a militaristic and authoritarian
leadership. This close relationship between capital and government, instead of a
trilateral cooperation among labour, capital and government, curbed the labour force
and led to numerous riots among workers and students. The absence of strong unions
contributed to labour market competition (Kuznets 1994:71) and did not improve the
workers’ situation. Unemployment was not an issue during the 1980s. Capital
absorbed the workforce during the industrialisation. With an abundance of skilled
workers, spent capital does not contribute much to effectiveness. This becomes a
problem in bad times when capital is rationalises and costs cut. The abundance of
labour and the imbalance of power between capital and workers placed capital in a
sort of oligopoly situation. In other oligopoly and monopoly situations, we know such
entities run inefficiently. Stronger unions imply higher labour costs, which in turn
would force chaebols to treat workers more preciously.

Even though less than 11% of the Korean labour force is unionized, labour unrest is
substantial. The battles between riot police and workers on strike have been violent,
and the atmosphere between management and workers is tenser than in both the USA
and Europe. To describe Korea as a homogeneous economy, where everybody is
working towards the same goal, is a poor description of its industrial relations.
According to workers, they have paid the disproportionately high price of forfeiting
bargaining power for economic growth. To improve the situation, Kim Dae Jung’s
government wanted to ensure industrial democracy through labour-capital-
government corporatism that would compensate for the lack of a fully flexible labour
market (Yong Cheol Kim 2002:159). Neither liberals nor radicals welcomed such
corporatism as a compromise. Neo-liberal economists argued that Korean
infrastructure was not ready for social corporatism and that active labour intervention
would delay the economic restructuring program. The radical economists saw social
corporatism as a guise of continued labour control by the state. The workers’ position
in the labour market would be even more exhausted. So far, reforms succeeded in
relaxing labour market rigidities and labour has formally become an equal social
partner of capital in negotiations. Labour has also become a significant political force.
Along with the IMF’s $58 billion rescue package, there were stipulations that involved the labour market. Lifetime employment, strong labour unions, and a rigid labour market were seen as barriers to foreign equity investment, which needed to be increased after the crisis. In addition, the government found flexible labour market conditions important for successful corporate restructuring. Kim Dae Jung was in a good position to cooperate with the parties in the economy. He was not responsible for the eruption of the crisis, and he possessed long-held ties with labour (Yong Cheol Kim 2002:163). Neo-liberal conditions initiated by the IMF and the president’s ties to workers brought Kim Dae Jung into a situation where compromise had to be achieved to succeed. The social corporatist road was one way to go. Businesses promised to restructure by minimising layoffs. Labour promised to focus on productivity and cooperate on wages and working hours. Finally, government promised to improve corporate transparency and competitiveness, to protect basic labour rights, and to develop a social safety net (Yong Cheol Kim 2002:165). The impact of the economic restructuring was a GDP growth rate that went up 5% in 1997, down 6.7% in 1998, and up a whopping 10.9% in 1999. The impact of economic restructuring on workers was an unemployment rate of 2.8% in 1997, increasing to 7.6% in 1998, falling to 6.9% in 1999 and to 4.4% in 2000. Real income increased at a rate of 2.5 in 1997, decreased 9.3 in 1998, 11.2 in 1999 and 5.6 in 2000. In retrospect, the structural reform favoured capital and made workers the victims. Unions claim that the government funded the economic restructuring by placing the financial burden on workers.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of strikes and lockouts</th>
<th>Workers involved (1,000 persons)</th>
<th>Working days lost (1,000 days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>88</td>
<td>50</td>
<td>393</td>
</tr>
<tr>
<td>1996</td>
<td>85</td>
<td>79</td>
<td>893</td>
</tr>
<tr>
<td>1997</td>
<td>78</td>
<td>44</td>
<td>445</td>
</tr>
<tr>
<td>1998</td>
<td>129</td>
<td>146</td>
<td>1452</td>
</tr>
<tr>
<td>1999</td>
<td>198</td>
<td>92</td>
<td>1366</td>
</tr>
<tr>
<td>2000</td>
<td>250</td>
<td>178</td>
<td>1894</td>
</tr>
</tbody>
</table>

Workers’ political influence has increased; however, it is far from the significance found in several European countries. The political landscape in Korea lacks pro-labour parties, a fact that can be explained by a predictable voting pattern rooted in durable regional cleavages (Yong Cheol Kim 2002:169). There has been a tendency towards new, less regionally motivated voting since 2000. The reform has contributed to economic recovery and growth in all sectors of the economy. The cost of the reforms, such as decreased income levels and loss of job security, seems to have hit workers. Apparent tasks for the government are once again to improve labour and capital relations, to strengthen a comprehensive social safety net, and to centralise unions. Regional cleavages do not strengthen democracy or workers’ wealth.

4.4.3 Regional Relations

After the Korean War, Korea’s infrastructure was a severe obstacle to economic growth. General Park’s construction of a highway between Seoul, the capital, and Pusan, where the major port is located, is said to be the beginning of Korea’s great growth. However, regional disparities were not wiped out by improved communication and infrastructure. The importance of regions can be illustrated by Kim Dae Jung’s counterpart, Kim Young Sam, who came from Youngnam (the area north of Pusan and Ulsan). They were allied in major political issues; however, when region became a political factor, they split up their political cooperation. The favoured regions were Metropolitan (Seoul and Inch’on) and Youngnam, whereas Honam (area around Kwangju and Mokp’o), Middle (rural areas around Taejon) and Taebaek (between Wonju and Pukp’yongdong) were left behind. The favoured regions provided political leaders while the others were less represented. To reduce the regional disparities, Kim Dae-jung appealed to regional loyalty in Honam during the 1987 election for the purpose of ending underrepresentation in the region. His regional appeal is also said to have intensified the regional conflict (Kim Dae Hwan 1997:47-48).
4.5 Decision-Making Heritage

Korea’s trademark and success factor as a developmental state is the interdependence between government and private initiative. This crucial element facilitated implementation of governmental policy. This is also why Korea is said to be the antithesis of liberal economic theory. Implementing economic policy is how “decision-makers in production units are induced to act in accordance with the preferences of government planners” (Jones and Sakong 1980:39). The political capacity was strong, authoritarian, and had an exclusive dominance to industry. Through credit, taxes, regulation and administrative intervention, the Korean state was able to co-opt, discipline and coordinate the private sector (Moon 1999:4).

4.5.1 Rhee versus Park

Did Korea stick to a certain policy for too long after the war? And was the developmental state approach too ‘Confucian’ by being conservative and not able to change in accordance with the environment? It is argued (Jones and Sakong 1980:41) that modern Korea’s first president remained in power too long. President Rhee saw
what Korea needed in the future: protection of infant export-oriented industries. However, he did not face the technical and administrative challenges that the new society demanded. It was on the administrative level that one of the major distinctions between Mr. Rhee and General Park was found. Park’s military government was strongly goal oriented and was aware of the importance of institutions as means for carrying out those goals. Institutions were therefore expanded and emphasised. The ability to delegate responsibilities came naturally to a military officer such as General Park. He also proved a great willingness and ability to replace inappropriate means with alternative means independent of a conventional political ideology or platform. Mr. Rhee was more of a politician than General Park, which means that the latter emphasised the end more than the process. General Park’s reliance on institutions seems natural in light of Korea’s Confucian heritage. The well functioning superior-subordinate relationship gives a smoothly operating hierarchy.

General Park set the standard for business-government relationships immediately after becoming president. One of the first acts he implemented was ‘Law for dealing with Illicit Wealth Accumulation’ (Jones and Sakong 1980:69). The government would exempt most businessmen from prosecution, and with the notable exception of commercial bank shares, existing assets would not be confiscated. Businessmen would instead pay off their assessed obligation by establishing new enterprises and donating the shares to the government. The new law was also a part of the government’s economic policy. The 13 businessmen with the largest fines received permission to go abroad to raise foreign capital. They returned with several policy recommendations, such as establishing Ulsan as an industrial port (Jones and Sakong 1980:70). The businessmen became influential and they were aware of it. Their influence and awareness of it appears in a poll asking managers of the largest chaebols (Jones and Sakong 1980:73) “to what extent can you (or your company) influence government policies affecting your business?” “Frequently” was chosen by 27 percent, “sometimes” by 43 percent, and “seldom” by 23 percent.
President Rhee’s period was more of a zero-sum accumulation compared to President Park’s positive-sum period. Zero-sum accumulation implies a redistribution of wealth instead wealth creation. Most of the chaebols were established during the first 20 years after liberation, even though there was not much new saving or investment. “…these newly created entrepreneurs and their wealth accumulation must indicate redistribution of existing national wealth and/or foreign wealth transferred through aid rather than new wealth accumulated through their productive activities” (Jones and Sakong 1980:271). This 20-year period also includes the Park period; however, Park emphasised productivity more than the former president. Another contrast was that Mr. Rhee distributed foreign exchange and aid while General Park distributed credit. Credits demand positive-sum behaviour from the involved entities. It was the heritage from General Park’s presidency that continued to dominate Korean economic policy, with special regard to finance and credit, until the 1990s.

4.5.2 Boards and Plans
A new agency of great importance that saw daylight in June 1961 was the Economic Planning Board (EPB). The head of the board was the deputy prime minister. The agency took over the planning responsibility from the Ministry of Construction and absorbed the Bureau of Budget from the Ministry of Finance and the Bureau of Statistics from the Ministry of Home Affairs. Park Chung Hee’s first five-year plan was constrained by data availability and inadequate planning techniques. However, it showed the people that the government was seriously committed to the country’s development, and the administration gained useful experience for future planning. The second five-year plan was much more accurate and focused on strengthening the planning machinery, implementation, and translating the plan into an action program. Macroanalysis dominated the third five-year plan. Though, according to Westphal and Adelman “planning closer to the ministerial level of the organisation chart tended to be more window dressing then anything else…” (Jones and Sakong 1980:51). Another major change was the emphasis on policy planning, on how to formulate policies that will achieve their goals. The change in planning techniques was a result of a more complex economy and agencies other than the EPB gained confidence in
their planning capabilities. The fifth five-year plan was very similar to the forth except that it developed decentralised policy planning procedures.

Was ‘Korea, Inc.’ comparable to ‘Japan, Inc.’? To certain extent, yes. It was a partnership between business and government based on mutual interests. The difference is that, at least before 1990s, the Korean government was the dominant partner while the opposite can be said in Japan. Improved governmental power can be a factor in explaining why Korea recovered relatively fast after its financial crisis even though it received outside economic help. Japan’s economic problems have been more long lasting. However, Korean business concentration in its chaebols has given it political influence, privileged access to credit and foreign exchange (Jones and Sakong 1980:259). Chaebols are very similar to the Japanese zaibatsus from the Meiji constitution prior to American occupation. The main difference is that zaibatsus had their own financial institutions while chaebols had to rely on government-controlled credit institutions. Hence, chaebols have far less economic power than zaibatsus except for their leverage, which could cause the national economy to sink or swim. Jones and Sakong (1980:269) argue that business concentration in Korea through its chaebols has been relatively low compared to the rest of Asia. However, business concentration has increased since their study. They also emphasise that chaebols have had varying political power under different political regimes. The situation under Mr. Rhee was more dominated by non-rational capital accumulation such as speculation, price-fixing, tax evasion, etc., than under General Park.

In retrospect, it is tempting for Westerners to describe the actions of chaebols and individuals as venal. What seems venal in the West does not have to be venal in Korea, and the ethical state requires a framework in Korea as it does in the West. Moran (1989:49) defines venal conduct in markets as “competition by means which happen to be illegal to some cultural proscription”. However, independent of cultural proscription “effective functioning of competitive markets depends on the creation of moral order capable of disciplining and restraining the capitalist appetite” (Moran 1989:50). Western capitalists might be craving revenues or profits while Korean
industry is craving growth. Max Weber (Moran 1989:50) holds unscrupulousness pursuit of selfish interests as characteristic of capitalist countries that have failed or remained backward. Korea is the eleventh largest economy in world, and its development over the last thirty years is remarkable. Its decision-making heritage will remain a success story.

4.6 When to Change a Winning Team

Institutional and political interference often have a positive impact on economic development in emerging markets. The Asian Tigers support this claim. Emerging markets have simple and transparent economies that make it possible to have a command economy where the state dictates what the country and industry shall emphasise and where to allocate scarce funds. When an economy develops and becomes more complex, transparency fades. According to some non-institutional political economists, it becomes harder for politicians and policymakers to always know which investment or project is best, and hence support it. How successful it is with an active state will also depend on the country’s culture. Korea had proud policymakers and a general attitude to work for the nation’s best. Apparently the government cannot rely on public trust in the long run. The problem of rent-seeking occurred even in Korea. Rent-seeking implies opportunistic behaviour and agents not acting solely in the interest of the principal.

Korea only allowed foreigners to make indirect investments so that the government was still able to channel most of the finance. Companies were encouraged to grow rather than focus on profit. Growth kept the unemployment rate low. Selected sectors and chaebols received low-interest loans to enter the areas the government wanted. Cheap loans fostered overcapacity and soured the relationships among the chaebols. The ‘straight’ connection they had with the government became less ‘straight’. As a consequence of the financial inflow, asset prices rose, especially property prices.
Problems arose when foreign funds invested in property did not generate enough foreign exchange to enable investors to pay back the funds.

Poor governmental behaviour and a weak national economy can lead to action from external forces. Actors from the international society examine governmental behaviour and the market punishes poor behaviour. Governmental behaviour will always provoke positive or negative reactions from the market. Korea is an export-oriented economy and member of the OECD. Korea’s government is exposed to the international financial market and hence is not shielded from its brutal market forces.

A bold description of Korean resistance to change as The Economist (Sept. 27th 1997) puts it: “… financial markets find it much easier than governments to admit their mistakes, and to retreat out of them. That is because one of the unsung beauties of markets is that, unlike governments, they have no pride.” Korean pride takes measure to meet the IMF’s demands. The government makes the Korean economy more transparent and accountable, and owner-managed chaebols will have to report consolidated financial statements (Jongryn and Moon 1999:172).

Financial crisis occurs in most economies, industrialised ones too. However, they use to be more expensive (i.e., reduce more of GDP) in developing countries (Morris 1999:206). It was expensive in Korea, but the economy recovered rather quickly.

Korea was newly industrialised. A depreciated currency facilitated exports and made domestic commodities cheaper than foreign ones. It was not only the literature that generalised the ‘Asian Tigers’. Foreign investors did the same when assessing the effect of contagion. What was surprising about the Asian crisis was not the attack on the baht, but rather how fast the attacks on other currencies spread to the other ‘Tigers’. Due to Korea’s gold medal in macroeconomics prior to the 1990s, it worked as a powerful magnet for capital seeking high returns. The capital inflow was far greater than what could be spent profitably. Gross domestic investment among the Asian Tigers was between 35 and 42 percent of GDP, triple that of big industrialized countries (Morris 1999:218).
It is tempting to use the Chinese character for crisis, which means both a dangerous situation as well as an opportunity. Opportunities were present in the Korean financial crisis. The crisis created a push to implement the reforms already initiated by Kim Young Sam, which involved synchronising Korea’s economy with the global economy of which it is a major part. Being an export economy made the opportunity part even more present. A depressed domestic currency facilitated Korean exports and made it easier to undergo reforms, in contrast to South American countries where depressed domestic exchange created larger problems because exports were far less significant. Another reason why Korea was in a great position to make reforms was its emphasis on economic development. Weren’t other developing and newly industrialised countries? Yoon-Shik Park (2002:146) describes a school explaining the “Miracle of the Han River” not as a product of superior and unique talent of the Korean people, but rather of clever exploitation of the geo-political condition of the times. Korea’s security challenge from the North Korean military-political threat gave opportunities for nation building and survival through rapid economic growth facilitated by funds and military subsidies from the USA. Korea has been the gem of the USA’s eyes for years.
5.0 ACCOUNT FOR THE CRISIS

The questions from the introduction will be discussed in this chapter in light of the three approaches. Some of the hypotheses will be discussed together due to their interwoven nature. Three central actors in Korea’s financial crisis will be discussed: foreign investors, chaebols, and the Korean government. The IMF’s diagnosis of the crisis, and hence its understanding of it, will also be briefly assessed. I have described how the developmental state approach emphasises foreign investors’ less-than-flattering contribution to the crisis and the result of abolished cooperation between business and government, how the corporate society approach mercilessly points to the chaebols’ power, and how the governmental behaviour approach criticises the Korean government’s behaviour. The symptoms of the crisis are foreign investors’ sudden change of sentiment to the Korean economy, from generously providing substantial loans, to becoming obstinate when rolling over and renegotiating underperforming loans and massively selling won. It was the depressed won that caused payment problems. The size and form of the chaebols’ debts became the focus. Too much debt was of too short maturity, and reckless foreign lending resulted from liberalisation of the financial sector. Unfavourable governmental behaviour came in the form of pegging of the won, indirect guarantees, and reluctance to undertake corporate reforms. Overall, the Korean government did not pay enough attention to the misconduct of Korean businesses.

What happened prior to and during Korea’s financial crisis is not controversial; however, what caused what under which circumstances is. The purpose of this paper is to outline the events of the crisis to better understand the pitfalls for emerging and developing economies. Prior the crisis, Korea attracted profound foreign funding as one of the most promising countries in terms of economic growth. Its development was perceived as a miracle, and Korean companies became leading manufacturers in their sectors. The Korean workforce was well educated and the government had apparently found the right mix of private enterprise and public conduct. The few dark clouds on the horizon were the deeply indebted chaebols, the potential for moral
hazard, and low profitability and efficiency in terms of return on equity and investment. Liberals were the first to have these objections. In spite of high debt and low efficiency, confidence was present due to an understanding of public guarantee of debt and of continued growth in spite of low efficiency. As for what triggered the crisis, few people doubt that the behaviour of such international actors as currency traders and investment funds was responsible for putting pressure on the won, for supplying too much of it, and for being rigid and nervous about the short-term debt of Korean enterprises. The issue of deep-seated structural causes is far more disputable. It started with the currency. Due to the depressed won, borrowers saw their loans deteriorate. Without a sudden depression of the won and a nervous breakdown among creditors, short-term debt could have been renegotiated, giving Korea enough foreign exchange reserves to serve foreign-denominated debt and continue pegging the won.

Minsky and Kindleberger (Krugman 1991:87) are critical about dividing crises into subgroups (industrial, banking, currency, etc.). According to them, there is a standard story behind every crisis where naïve investors in an asset market believe they can gain from rising prices. By doing this, they reinforce the rise and then head out the door when prices start to decline, leading to a price crash. This sounds familiar in Korea’s case. Still, this paper finds it useful to break down the financial crisis into the eight categories articulated as questions in Chapter One, in accordance with the type of crises that frequently appear in the literature on the subject. They are not necessarily mutually exclusive – financial panic, contagion, and disorderly workouts are somehow complementary in several ways. These categories are: 1) macroeconomic policy-induced crisis, 2) the bubble collapse, 3) moral hazard crisis, 4) financial panic, 5) disorderly workout, 6) contagious crisis, 7) crisis of under-regulation, and 8) failed reforms. One can argue that Korea experienced all eight forms of financial crisis, which is why there is so much written about it. The disagreement is not necessarily about whether elements of the different crises were present, but rather how significant they were. Developing countries can be more vulnerable to financial crises; however, macroeconomic policy-induced troubles, bubble collapse, moral hazard and financial panic are also pitfalls in developed
economies. Disorderly workout, which implies that the absence of a lender of last resort, a “Chapter 11”, under-regulation, and failed reforms is less likely due to established legislation than longer experience with the financial regulation that follows a process of financial liberalisation. That being said, contagion will often be a real threat to economies being woven together. Few OECD countries will be unaffected by a recession in the USA, for example. The more present the aforementioned elements are, the greater the likelihood of a crisis.

5.1 Balance of Payment

In Korea, the won depreciated in spite of attempts at pegging it by open market operations. The ensuing loss of foreign exchange by the central bank was followed by the collapse of the pegged won. A balance-of-payment approach to the Korean crisis would relate this outcome to a situation where the domestic credit expansion by the central bank was inconsistent with the pegged exchange rate. This would explain why foreigners started to sell Korean currency in buckets. The resulting decline of foreign exchange reserves made the Bank of Korea (BoK) vulnerable, increasing the risk of keeping won-denominated assets.

A currency crisis originates in international financial markets, although it does not have to be international in scope. Currency crises can be divided into first- and second-generation currency crises. In the first generation, pioneered by Paul Krugman (1979), the crises were related to exhaustion of foreign reserves in the attempt to prevent the currency from depreciating. Hence, the government is no longer able to defend fixed parity (Krugman 1979:311). A government that wants fixed parity has to intervene when economic fundamentals change. When such a change takes place, the exchange rate floats implicitly. Due to changes in economic fundamentals, the Korean government had to intervene in the foreign exchange market. Investors perceived the won as being too strong compared to its economy.

5 “On currency crisis – a case of South Korea” is written by professor Hak K. Pyo for graduate students in Division of economics. [http://www.leebrs.com/chiwoong/occ.html](http://www.leebrs.com/chiwoong/occ.html)
The Bank of Korea had limited foreign reserves to defend the won from depreciating. Limited reserves stemmed from a geared industry with little foreign exchange available. According to the BoK, net foreign debt exceeded foreign exchange reserves in 1995 (Pyo p. 4), and Korea’s large investments in real estate did not pay off in foreign exchange.

The second-generation currency crisis theory consists of three assumptions. 1) The government can borrow foreign reserves to prevent exhaustion. 2) The trade-off between inflation and unemployment (Phillip’s curve) is valid. 3) The cost of changing the exchange rate regime from fixed to floating is known (Pyo p. 3). According to Assumption 1, the Korean government had the possibility and ability to appreciate the won by supporting demand. According to Assumption 2, the government could have increased unemployment to appreciate the won, and according to Assumption 3, the government would not have pegged the won if it became too dear. Therefore, the second generation suggests that Korea’s currency crisis was not caused by economic fundamentals, but rather on investors’ expectations. A currency crisis cannot be expected in the second-generation model as it can be in the first-generation model. However, Korea’s government did not have unlimited access to foreign reserves, and the Phillip’s curve is not always valid. Countries experience stagflation, and the cost of changing regimes is not known. A second-generation currency crisis is doubtful when analysing Korea’s financial crisis.

Hak K. Pyo has developed another version of the currency crisis theory to explain the Korean crisis, focusing on the large influx of foreign capital. Some of the reasons for the large influx of foreign capital since 1990 (except for 1993) were: 1) The Korean economy seemed strong. Most macroeconomic indicators saw Korea as a low-risk country. According to this statement, Korea did not experience a macroeconomic crisis. 2) Strong supervision of domestic financial institutions was absent, and the government was perceived as a guarantor of the lent capital. In other words, there were elements of moral hazard. The perceived government guarantee and the fixed exchange rate prevented domestic institutions from hedging their positions. The
conditions for moral hazard were present. 3) The Korean market was also tempting
due to its low international interest rates. This third-generation explanation suggests
that the rapid influx of foreign capital created a bubble economy. When a bubble
bursts, bad debt increases, and if the government simultaneously increases credit and
introduces a fixed exchange-rate regime, implicit exchange-rate devaluations take
place and a currency crisis appears. It did not help that much of the capital inflow was
of short maturity. When the Korean economy becomes tempting due to its low
international interest rates, its economy is also likely to become tempting when
international interest rates increase or the risk premium on loans to Korea increases.

When looking at the Korean pegging regime, we see that the US dollar was the most
important currency. However, the USA’s position as a trading partner was declining
while Japan’s was becoming more important. When the yen appreciates against the
dollar, yen-denominated debt will increase, and vice versa. In general, we can say
that the risk of currency crisis increases together with the deviation between the
nominal exchange rate (the price of foreign currency in terms of domestic currency)
and the real exchange rate (the price of a foreign basket of goods and services in
terms of a domestic one).

An example: E=nominal exchange rate, P*=foreign price level, P= domestic price
level, Q=real exchange rate.

\[
Q = \frac{EP^*}{P} = \frac{(900\text{won}/$)(2400\text{won/korean basket})}{(2\text{$/US basket})} = 1200
\]

Before the liberalisation of the capital account, the pegging regime strove for an
undervalued rather than an overvalued exchange rate to facilitate exports. This regime
had to be revised when the chaebols started to borrow more from abroad. Korea had
to take into consideration the chaebols’ ability to pay back foreign-currency
denominated loans in addition to exports. An undervalued exchange rate to facilitate
exports was no longer an unqualified good thing for the chaebols. The pegging
regime faced a dilemma. What facilitated exports made loans in foreign-denominated currencies harder to serve, and as the capital account worsened, the dilemma became more pronounced. It is therefore tempting to believe that this was the reason why the BoK lost its foreign exchange reserves and why the exchange rate regime collapsed – because liberalisation of the financial sector and capital account occurred without proper surveillance but rather as a consequence of a traditional developmental state policy. The developmental state approach believes that the governmental behaviour of liberalising financial sector created a balance-of-payment crisis, while the governmental behaviourists believe that it was the government’s lack of regulation and surveillance of the capital account that caused the balance-of-payment crisis.

The three approaches interpret the Korean balance-of-payment crisis differently. The developmental state approach agrees that the crisis was something other than a macroeconomic crisis, but it holds the rapid influx of foreign capital responsible for the financial disorder. The reason for this rapid influx was the liberalisation of the capital account. The government no longer dictated the chaebols’ access to foreign capital in the same way as before the reforms. Governmental behaviour explains the salient point as the absence of capital requirements as indicated by the Bank of International Settlement (BIS). Even with the necessary requirements, there are reasons to believe that formal (affiliations) and informal connections between chaebols, financial institutions, and monitoring agencies made supervision difficult due to cronyism and the lack of transparency.

The developmental state approach stresses that the crisis was a financial crisis and not a ‘real economic’ crisis. That implies that the current account was ‘intact’, while the capital account suffered from deregulation of the financial sector. The current account deficit was relatively modest in spite of a won that had appreciated by 10% to 20% in the years prior to the crisis. Chang asserts that even the worsening of the capital account can be defended by investment in tradable sectors (Chang 1998:1555). The governmental behaviour approach focuses more on the unsustainable trend in the balance of payments. With the exception of 1993, Korea has had current account
deficits every year since 1990. The financial sector’s claim on the private sector was 102.5% of GDP in 1990 and 140.9% of GDP in 1996 (Radelet and Sachs 1998:Table 11). When exports slowed down significantly along with the sizable current account deficit in 1996, there was speculation that the exchange rate was overvalued. The won was pegged to the USD, and when the dollar appreciated against the yen, the won did the same. According to Hong and Lee (2000:207), the won did not change much in value against the yen or the dollar during the 1990s, even though the won was more stable against the dollar than against the yen (OECD 1998:34). The overvaluation of the won against core currencies, such as yen and dollars, was not significant and therefore cannot be the reason, per se, why exports slowed down prior to the crisis in 1997. If the exchange rate was the cause of Korea’s reduction in exports, it had to be Korea’s competitors’ exchange rate that was depressed. Japan increasingly became Korea’s competitor in automobiles and semiconductors, and the won appreciated against the yen between 1992 and 1995. However, the won depreciated against the yen from 1995 through the financial crisis in 1997 (OECD1998:34). Korea’s real exchange rate was 102 in December 1988 and 88 in September 1997. In December 1997, it was 157 (an increase means depreciation and 1990=100) (Radelet and Sachs 1998:Table 10).

We have seen that Korea’s financial crisis was a balance-of-payment crisis. The won depreciated, the BoK became short on foreign exchange reserves, and the pegging regime was abandoned in November 1997. What is of interest to the developmental state approach is how Korea came into this situation. Its answer to this more fundamental issue was liberalisation of the financial sector and the opening of the capital account. According to all the approaches that have a different understanding of regulation, it was under-regulation that caused the macroeconomic policy-induced balance-of-payment crisis.
5.2 Crisis of Under-regulation

When BusinessWeek’s (June 10\textsuperscript{th} 2002) Asia Economic Editor Brian Bremner and Seoul Bureau Chief Moon Ihlwan asked President Kim Dae-jung what his biggest accomplishments were, Kim answered the breaking of the collusive ties between government and business, especially between chaebols and banks. Another of his successes was attracting foreign investment. Due to changes in regulation and business practices, Korea attracted $52 billion in foreign investment after President Kim Dae-jung took office. Over the previous 35 years, Korea attracted only $24.6 billion. President Kim Dae-jung admits that only profitable and competitive companies survive in a globalised world. There is no room for nationalism. Foreign investment is a crucial factor in strengthening the competitiveness of local companies, says Kim Dae-jung. When studying the IMF’s proposed plan of action for Korea, it is narrow-minded to think that the IMF initiated the reforms. On the contrary, we shall see that various Korean governments have tried to reform chaebols and the economy since the beginning of the 1990s. What president Kim perceives as a proud achievement is the very cause of the financial crisis, according to the hypothesis of under-regulation. The debt crisis was a result of hasty liberalisation of the financial sector. The Korean market was not mature enough to enjoy such freedom without having new rules – few countries’ financial sectors are. Even liberals agree that regulation and supervision are needed. All three approaches are in favour of regulation in some form or another; they only differ on its form. The developmental state approach blames the neo-liberal pressure for liberalisation, while the liberals and the corporate society approach give government the responsibility of appropriately regulating a liberalised sector. Regulation in a developmental state is a political tool. Regulation gives the government power, and regulation of participation in business prevents overcapacity. In the governmental behaviour and corporate society approaches, regulation is restricted to correcting market imperfections and misconduct among participants. For them, regulation is not a decision tool for market participation. That was in line with some of the reforms that the Kim Yong Sam government attempted to implement by abolishing licensing and facilitating entry and
exit in sectors. Overcapacity in a sector is positive rather than negative because it pushes inefficient entities over the brink. They believe that the Korean government’s history of using politics to decide who will participate in an industry was what made Korean industry inefficient. The question of under-regulation is derived from the developmental state’s understanding of regulation.

The developmental state approach emphasises how the liberalisation of merchant banks and the chaebols’ ability to borrow abroad was indefensible and how it led to overexposure. Foreign borrowing used to be most tightly controlled by the government before being liberalised with virtually no restrictions. The total number of Korean merchant banks prior to 1994 was five. After liberalisation by the Kim government, it was nine in 1994 and fifteen in July 1996 (Chang 1998:1558). The governmental behaviour and corporate society approaches do indeed agree on the mistake of not supervising and monitoring the financial sector appropriately after liberalisation. However, they believe that the Korean economy was overdue for liberalisation, as was the financial sector, while the developmental state is more reluctant to admit to the necessity of liberalisation. The corporate society approach attributes the failure of liberalising the banking sector to the sectors dependent on governmental decisions. The banks had no incentives to develop a capacity to evaluate projects since the government allocated all the credit. The risk was also minimal because the government gave explicit guarantees for depositors and bailed out the failed companies it supported (Mo and Moon 1999:183).

5.2.1 Debt
Liberalisation changed the debt pattern profoundly, and according to Chang (1998:1558), the chaebols could hardly have been aware of the huge mismatch in the maturity structure between their borrowing and lending. In 1996, total borrowing was $20 billion with 64% of it being short-term and 85% of it being long-term. Prior to the 1990s, the majority of Korean funding came through domestic saving. After the 1990s, foreign-denominated debt increased. International claims held by foreign banks amounted to $103.4 billion in mid 1997 and $77.5 billion at the end of 1995
This worried a few economists due to its similarities with Mexico’s peso crisis in 1994. The depressed won made it hard to service foreign debt, and using high domestic interest rates as a remedy would have distressed won-denominated loans. The financial crisis that followed the won’s fall resulted in a profound economic depreciation. Korea had to ask the IMF for help. A depressed currency increased exports and decreased imports. Due to Korea’s, and the other Asian Tigers’, reduction in imports, the crisis impacted other economies that exported to the countries with depressed currencies. Developed countries (such as Anglo-American) exports to the region were not served by the financial crisis as Wade (1998:1535) suggests holding a Western alliance responsible for setting up the conditions for crisis.

Korea’s outstanding foreign debt on December 30, 1997, was $153 billion. Short-term debt was $80.2 billion and long-term debt was $72.8 billion (Pyo 1999:153). Korea experienced an unusually large debt increase between 1992 and 1997. The Korean government and the IMF confirm that during this five-year period, foreign debt increased almost threefold, Korean assets abroad increased almost twofold, and net foreign liabilities increased nearly fivefold. After Korea agreed to use the Western definition of foreign debt, it amounted to nearly $175 billion, up from 160.7 in 1996. (According to the old definition, it was 104.7 billion dollars. In 1993, it was less than 50 billion dollars). During the 1990s, short-term debt increased more than long-term debt (OECD 1998:21). Financial institutions’ claims on the private sector as a percentage of Korean GDP was 56.5% in 1990 and 65.7% in 1996 (Radelet and Sachs 1998:Table13). The number of incorporated and unincorporated insolvencies increased from approximately 10,000 in 1993 to 17,000 in 1997 (OECD 1998:25). According to Pyo (1999:154), this significant worsening of the situation during one presidential term calls for other explanations than only the failure of economic management or moral hazard. Pyo (1999:155) holds that it was a combined political (foremost) and economic failure; hence, the crisis could have been prevented if the Korean government were politically stronger and the economy more efficient. However, Pyo misses adjustments in Korea, but finds it too premature to discredit the
East Asian model of a developmental state in its entirety. High debt was a crucial element of the crisis, and Korean authorities’ liberalisation of the financial sector hardly contributed to reduce the debt. Korea’s financial sector and its industry were apparently too immature to join the world’s financial playground without proper regulation. The banking sector may have been inefficient, backward, and dependent on the government (Mo and Moon 1999:183), but the turmoil that came after liberalisation was not necessarily caused by the Korean model. The United States also confused deregulation and supervision when liberalising its banking sector early in the 1980s (Mo and Moon 199:184); however, it was not of the same magnitude.

5.2.2 Governmental Behaviour
The remedies chosen to help the economy recover explain our understanding of the crisis. The brutal way of handling insolvent banks is to close them down and focus on cultivating viable entities instead. Undercapitalised banks should be recapitalised to meet international capital standards promoting transparency, and, in contrast to developmental state suggestions, foreign ownership in the financial sector should be liberalised. A recent World Bank study found that relatively high foreign participation in the emerging-market banking sector (ratio of foreign banks to total banks) gives lower intermediation costs (ratio of overhead costs to total assets) and lower levels of fragility as measured by Goldman Sachs’ index of fragility (Goldstein 1998:23). A less controversial step in improving the financial sector is to significantly upgrade regulation and supervision. A liberalised financial sector is not the same as the absence of regulation and supervision. Korea should not maintain a fixed exchange-rate regime when foreign exchange reserves become short. Even though the Korean economy was not characterised by transparency, currency traders expected the depletion of foreign exchange reserves, which implies that they made the right bet. The developmental state approach does not place much focus on remedies and problem resolution, but rather on emphasising the lessons from the crisis: how liberalisation of the financial sector made banks insolvent and how poor exchange-rate management put the BoK in a foreign-exchange shortage position.
Reassessing the developmental state approach in Korea does not mean that the government had to play a more passive part in the economy, rather the opposite. The role of a regulator should be different. From being an interventionist state, Korea could become a regulatory state. The state has to be in the centre of the economy to enhance transparency and accountability and to safeguard against market imperfections (McNamara 1999:140). Korea’s membership in international organisations such as APEC, OECD and the ILO calls for coordination between state, capital and labour (McNamara 1999:148). Korea has a history of co-operation between state and capital; its new obligation is to focus more on labour now than before and to alter the relationship between state and capital through regulation and monitoring. Developmental states have to have an embedded autonomy that is a combination of corporate coherence and connectedness (Evans 1995:12). Embedded autonomy gives a structural fundament for successful state involvement in industrial transformation. Policymakers are not insulated from society as Weber suggested, but rather embedded in a set of social ties that binds the state to society. Goals and policies are negotiated and renegotiated in institutional channels (Evans 1995:12). It can be this negotiation and renegotiation that caused the failure of Kim Young Sam’s implementation of structural and industrial reforms. The state was too weak in comparison to industry. If the ties between state and society developed to be dominated by discretion rather than rules, transparency paid the price. A combination of roles due to an embedded autonomy (Evans 1995:126) creates adaptable policymakers, which can be productive in the early stages of development. However, blending roles is dangerous in advanced economies.

Regulation is critical to the developmental state, corporate society, and governmental behaviour, but they all differ in the form of regulation. The developmental state sees regulating big business and the financial sector as politically productive. It places importance on the government’s decisions about which sectors to emphasise, which products to produce, and who the participants will be. The reason for such detailed regulation is to prevent overcapacity and crony capitalism (Chang 1998:1559). Chang even calls the government’s decision to allow Samsung to enter the automobile
industry a scandal, because the industry was already overcrowded. Chang is not convinced that President Kim Yong Sam was the big reformist he thought he was. His son was implicated in Hanbo’s high-level corruption scandal when Hanbo entered the steel industry despite its problems, and loans were extended. The Hanbo bankruptcy does not become less of a scandal in light of Hyundai’s attempt to enter the steel industry some years prior. Hyundai was denied entry, and the licence, with its additional financing, was granted to a minor chaebol with a dubious record of manufacturing capability (Chan 1998:1556). This move was in line with the Kim government’s articulated goal of reducing the number of chaebol subsidiaries, but it was not sufficient enough to make Korean businesses more competitive. It was the Hanbo scandal that transformed the state-business relationship in Korea. The major manufacturing sectors were no more insulated from corrupt political exchanges than they were before (Chan 1998:1557). According to the corporate society approach, macroeconomic parameters such as foreign-exchange policy were the only necessary conditions for the crisis. The trigger for the crisis was the failure of the corporate sector and dismal microeconomic policy by the government. It is often said that it was the bankruptcy of the Hanbo Group in January 1997 that was the immediate cause of the Korean crisis (Mo and Moon 1999:175). Hanbo Group was close to bankruptcy as early as the second quarter of 1996, and in spite of a series of emergency loans from creditors, Hanbo had to throw in the towel. Hanbo Group became a political scandal, not only because the president’s son was involved, but also because other politicians were charged with bribery and peddling influence.

Governmental behaviour and corporate society also have the perception of under-regulation as a determinant for the crisis, but for them, regulation and liberalisation have to go hand in hand and do not have to contradict each other. According to these approaches, the financial sector had to be liberalised during the 1990s because of the sector’s embedded tendency toward moral hazard and its ties to the chaebols. The problem was that the sector did not have proper rules to follow. Even a liberalised financial sector has to follow certain rules; it is the same for the business sector. According to the governmental state and corporate society, regulation did not entail
telling the chaebols what to emphasise or what to produce, but rather how to conduct their businesses and report their financial status.

Joseph Stiglitz (2002:103-107) sketches five general propositions for better government alignment within the corporate society and governmental behaviour approaches. 1) The government should not intervene in areas where there is evidence of systematic and significant influence of special interests. Benefits of intervention have to exceed probable rent-seeking. Stiglitz focuses not only on expected outcome and intention of intervention, but also on the process of intervention per se. A government has to choose a path from among several, and it is not always worth walking the easiest path. 2) One shall not expect a government to restrict competition. Even several years before the crisis, the chaebols were far from infant. Protecting infant industries can be necessary when competition is international or limited resources such as capital have to be distributed with care. Industrial economies are seldom in such situations and hence governments should promote competition instead. 3) Government should be strongly in favour of openness and against secrecy. Open decision-making processes reduce parties’ suspicion. Mistakes and improper procedures are easier to detect and correct when the process is open. The probability of influence from special-interest groups is reduced by openness, and governmental performance is more likely to improve. 4) Government should encourage private companies or non-governmental organisations (NGOs) to provide public goods. NGOs can be adequate substitutes for both government and private companies when profit maximisation is not easily attached to the provision of public goods. When government encourages other actors to provide public goods where possible, competition can give efficient provision and voice can effectively be conveyed. 5) Governments have to achieve a balance among expertise, democratic representation, and accountability. Expertise has a profession to account for. Democratic representatives have political agendas that can be less accountable than expertise. A central bank has defined parameters within which to work – in which case it is accountable. However, the parameters are given by democratic representatives. A certain degree of expertise autonomy, even with politically defined tasks, gives
accountability due to the length of time political processes take to alter tasks. Ensuring quality of output is a strong reason to make expertise politically independent.

5.3 Moral Hazard and Bubbles

Moral hazard and bubbles both evolve from a state of under-regulation or at least from inadequate regulation; therefore, this section is an extension of the previous one. What was sparkling in Korea? Real estate could have been one bubble candidate. The deviation between asset prices and fundamental prices is hard to specify due to the uncertainty of fundamental real estate values. The major problem investing in Korean real estate was that the investment did not generate the foreign exchange necessary for serving foreign debt. Foreign institutions’ stake in indebted chaebols and financial institutions might have been a bubble. The chaebols’ liabilities were so great that it should have been reasonable for foreigners to ask how able they were to pay back large debts with such low profitability. According to international and domestic creditors, the expectation that the Korean government guaranteed bank liabilities ruled. Such expectations can easily lead to moral hazard. Any banking sector as under-regulated as Korea’s will always be tempted to undertake risky projects being aware of back-up in the event of failure. A third bubble was Korea’s currency. At least it burst like a bubble. There was a mismatch between Korea’s economy and its currency. Between 1997 and 1998, the Korean won depreciated almost 90 percent while Taiwan’s dollar depreciated 22 percent (Heo and Tan 2003:22). It was the government that created a bubble in its currency to help the chaebols to service their foreign debt. Before liberalising the capital account, the government undervalued the won to facilitate exports.

One financial-sector weakness in Korea prior the crisis was the credit boom that was directed in real estate and equities (Goldstein 1998:7). Real estate does not generate foreign exchange. Neither do equities if returns on equity among companies are low. According to estimates by the Bank of International Settlement, the share of bank
lending to the property sector was between 15% and 25% at the end of 1997 (Goldstein 1998:8). Land purchases were -5 billion won (more sale than purchase) and 88 billion won in 1987 and 1988, and 969 billion won in 1996 (OECD 1998:194). The numbers are not dreadful per se; however, if the sector’s financing was done by short-maturity debt denominated in foreign currencies, there are reasons to think twice. The large credit expansion in Korea made the country vulnerable to shifts in credit and to cyclical conditions. A revaluation of the won is critical to foreign-denominated loans and when the export market is weak or supply is too large, non-performing debt will be a challenge when the debt-to-equity ratio is against you and the maturity is short-term. The chaebols’ vulnerability to debt and Korea’s exchange rate motivated speculative attacks. Properly developed financial and banking supervision would have limited overexposure of credit. In addition to supervision, insider lending to bank directors, related businesses’ risk/reward evaluation, and crony capitalism, had to be abolished. Banks were also used as tools by the government to help struggling industries through indirect payments. Another major mistake was that foreign institutions exaggerated their willingness to channel funds to the region because of its favourable conditions, without ever considering where the funds would finally end up. It seemed like the source of credit was never-ending. However, few markets around the world had a growth record like Korea’s. When currency traders got wind of a possible malady or bubble in Korea’s economy, without observing any reaction in exchange rates, they sensed a potential for profits.

The desire to insulate Korean businesses from foreign investors and competition brought out moral hazard (Park 2002:147). Not all financial institutions in Korea received explicit guarantees from the government, but press reports (Krugman 1998:3) suggest that foreign investors who provided funds to Korean banks believed they were protected against risk. The expectation of risk protection was reinforced by the strong political connection among the owners of the financial institutions (Krugman 1998:3). It was also the apparently tight connection between big business and government, and especially the politically delegated funds, that corporate society and governmental behaviour see as the source for moral hazard. Connectedness and
guarantees are traditional ingredients of moral hazard. The chaebols’ low returns on investment and equity and the number of non-performing loans (non-viable investments) indicate that the chaebols speculated with cheap credit provided by the government. To the contrary, the developmental state asserts that under the big reformer, Kim Yong Sam, crony capitalism reached its peak when Hanbo steel went bust and Samsung attempted to enter the automobile industry. The reason it peaked was the transformation from a generalistic state-business relationship to a particularistic relationship. The abolition of five-year plans also made it easier to bend rules for political reasons (Chang 1998:1559). Albeit, to claim that the manufacturing industry was largely insulated from fraud prior the reforms in the 1990s because of the absence of scandals in the newspapers can rather explain how common or tolerable it was or how they were insulated from criticism. When the conditions for moral hazard are present, and the phenomenon is still absent, it gives an image of how visible or transparent Korean society was. Stories of corruption became far more frequent when irregular behaviour got more attention after the crisis. Two examples are the policymakers’ role during deregulation of the automobile industry when Samsung wanted to enter and how the Financial Supervisory Service (FSS) was involved in allegations, kickbacks, and bribes from financial service firms under its supervision (Noland 2002:117).

Disclosure of irregular conduct by financial actors is not enough to make all parties happy. In addition to disclosure, it is necessary to have proper controls and standards together with ethical standards for what is and is not acceptable. Ethical attitudes and consciousness surrounding principal agent problems are among the most well-known ways of preventing moral hazard. Moral hazard within the corporate sector materialised through institutional investors’ need to follow others’ voting patterns by only employing neutral shadow voting, except in the case of mergers and business transfers, which prohibited voting power outside external financial institutions. In many cases, institutional investors were affiliated with the chaebols, which reduced the incentives to monitor company management (Park 2002:151). The chaebols’ safety valves were first and foremost governmental guarantees and preferential
policies. Their political influence was based on political funds, the politico-economic forum, and public relations. The formal channel was the politico-economic forum established in 1968 and succeeded by exclusive talks between the heads of the chaebols and the president in 1993. Chaebols obtained leverage in mass communication since they were the largest advertisers. Except for a few exceptions, Korea’s mass media have had an anti-labour attitude (Kim and Kong 1997:55). The chaebols managed to sustain their power because the Korean economy was characterised by concentration among a few chaebols. The chaebols’ immensity made it easy to speak with one voice and their political power allowed them to affect regulatory policy by controlling entry into a sector, for example. By reducing the possibility of newcomers entering markets, the efficiency of existing participants will decline.

5.4 Contagion and Financial Panic

Two reasons why the financial crisis struck Korea so quickly after Thailand are contagion and competitiveness. The wake-up call hypothesis groups East Asian countries, giving investors a reason to reassess their investment in the whole region when one country is failing (Goldstein 1998:18-24). Apparently, investors did a poor job in Thailand, making it necessary to reassess other East Asian countries such as Korea. Based on the contagion assumption, currency traders had a good reason for heavily selling the won. The financial crisis was contagious, and devaluation could have been too. When the baht loses value, Thailand’s competitiveness increases compared to other countries in East Asia. In that respect, Korea’s competitiveness worsened compared to Thailand when the baht depreciated, and Korea’s competitiveness improved again after the speculative attack on the won. Without a large export industry, an economy’s suffering from a crisis could be far more severe and longer lasting.

The contagion argument implies that the probability of a financial crisis in Korea would have been lower without a financial crisis in Thailand. Selected crisis
indicators (Radelet and Sachs 1998:Table 13) can tell whether Korea’s financial condition was poorer closer to the crisis than before it, or poorer compared to neighbouring countries that were less affected by the financial crisis. The percentage of financial institutions claims on private sector to GDP was 56.8% in 1990 and 65.7% in 1996. The ratio of short-term debt to reserves was 1.6 in June 1994 and 2.1 in June 1996. How decisive these changes are to a financial crisis is not evident. However, they can indicate a worsening of the situation and an increase in the likeliness of a financial crisis. Albeit, a worsened financial situation in Korea does not have to contradict the assumption that Thailand served as a wake-up call. What happened in Thailand could have been a determinant for investors in Korea to take decisive acts based on information they already had. In 1996, Korea’s current account to GDP proportion was –4.8% its capital account to GDP proportion was 4.8%. The situation was the other way around in Taiwan, which was not affected much by the financial crisis; its current account to GDP proportion was 4.4% and its capital account to GDP proportion was –4.0%. The differences between Korea and Taiwan weaken the contagion assumption. Taiwan, just as Korea is a neighbour to Thailand, is also an ‘Asian miracle’ and trading partner. However, Taiwan’s better score on selected crisis indicators rates Taiwan as a financially stronger economy and it was therefore less affected by the financial crisis. The weak crisis indicator for Taiwan was the proportion of its financial institutions’ claims on private sector to GDP. It was 97.0% in 1990 and 165.0% in 1996; however, the ratio of short-term debt to reserves was 0.2 in June 1994 and 0.2 in June 1997.

Before characterising action as irrational or unnecessary, we have to understand investors’, traders’, and creditors’ way of thinking to understand their behaviour. The Asian Tigers were seen as a single phenomenon. An economic miracle was present in Korea, Thailand, Indonesia, Malaysia and Taiwan. When something unexpected appeared in one of the Tigers, it could appear in another. The shortcomings in Thailand could be shortcomings in Korea. When the baht took a nose-dive, the won could have done the same. Currency investors and traders are a mob walking like sheep in a herd. They all thought the same and did the same thing, resulting in an
extremely suboptimal outcome for all parties, especially Korea. A lender of last resort can be a saviour in such episodes. When currency traders started the avalanche, their behaviour was individually rational and collectively irrational. A lender of last resort can then work as an avalanche barrier. However, as long as open countries are aware of a bandwagon effect from foreign investors and of the risk of a depressed currency due to investors’ loss of confidence in the currency’s government, a lender of last resort may not be decisive. At least not that frequent. The absence of a lender of last resort cannot fully explain Korea’s financial crisis. There has to be another, more comprehensive, safety catch for a crisis. We have to understand the outbreak to the extreme. According to Krugman, contagious crisis involves a loss in confidence in asset prices, not a loss of confidence in a currency. Central banks are inevitably involved in currency crises, while in contagious crises, central banks’ role is limited. The BoK was a victim of governmental policies rather than of foreign investors. The contagion from Thailand took place because the economy in the region was perceived as macroeconomic and financially similar (Glick and Rose 1999:286). The economies were similar in respect to being export-led, and growth was relatively synchronised even though the growth rates and levels were different. Economies were miraculous because the growth rates were astonishing. When Thailand disclosed weakness, foreign investors feared weaknesses elsewhere in the region. In this manner, the crisis was contagious. Asset prices in Korea were as swollen as in Thailand. The won was a liability or a claim on Korea’s total goods and services. It was not the currency per se that was attacked by currency traders, but the assets represented by the currency. If currency traders had a reason to sell off won, other than pure speculation, the financial crisis in East Asia was contagious.

Excess capital in Korea was channelled through the banks to favoured chaebols to finance unprofitable projects in steel, chemicals, automobiles, and semiconductors, still creating GDP growth. What is rather unique with the Korean (and Asian) currency crisis (compared to the peso crisis in Mexico and USA’s thrift crisis) is that it originated in the banking sector rather than in governmental fiscal or monetary
policy. The latter is more common in currency crises. An explanation can be the infamous ties between government and the financial sector. Local industry expected that won-denominated loans would be sufficient to fund continued rollovers of foreign-currency loans and that exchange rates should be stable. Foreign investors expected the government to implicitly guarantee Korean banks and that the government would always have enough foreign exchange to keep the guarantee. The baht experience signalled to foreign exchange traders that some Asian governments did not really know the size of their foreign exchange reserves. Asian commercial banks did not withstand much pressure before governments had to help them, even though the banks had small surpluses on their local businesses. It appeared that foreign investors were overexposed in the region. Great exposure gave significant deflection in Korea’s cash flow. This is an example of how Sachs and Woo (2000:17) characterise financial crisis in emerging markets as an abrupt and significant shift from net capital inflow to outflow from one year to the next. The crisis evolved into three stages. The won became overvalued due to internal and external macroeconomic factors. The won had to be defended at great cost. Depletion of foreign reserves and devaluation as a potential tool triggers panic by foreign creditors holding short-term claims (Sachs and Woo 2000:17). Domestic misbehaviour included everything from loose fiscal and monetary policy, a mismatch between a country’s foreign reserves and debt commitment, politically directed investment, and encouraging real estate or stock market bubbles. The currency crisis originated in the banking sector and strengthen the developmental state’s assertion that the liberalisation of the sector was a contributor to Korea’s financial problems. Restriction on the capital account could have prevented the mismatch between foreign reserves and debt commitment. The governmental behaviour approach emphasises the tight connections between the government, financial institutions, and companies with political loans that were all subject to moral hazard.

6 Semiconductors have had its booms and busts.
5.4.1 Panic

Financial panic explains the attributes of an economy. Panic occurred in Korea when short-term liabilities exceeded short-term assets. Korea had no single private market creditor large enough to pay back short-term debt, and there was no lender of last resort. The Korean government was not qualified to do the job that was required. The crisis occurred before international institutions such as the IMF entered the economy. Sachs and Woo (2000:19) sketch three main types of panic, and it seems that all three can be utilised in Korea’s case. Creditors suddenly discover that reserves are less than previously expected. Information about the reserves may not be new, but its importance or the danger it represents may have been reassessed. That goes well with a second type of panic: contagion. When foreign creditors saw what happened in Thailand, they transferred properties of the Thai economy to Korea. A vulnerable Thai economy made creditors reassess the Korean economy by discovering inappropriate reserves that could lead to devaluation. Thailand acted as a wake-up call for investors in Korea. Without proper procedures through legislation, disorderly workout occurs when an insolvent and illiquid entity provokes a creditor to liquidate even though the entity is worth more ongoing than liquidated. Foreign direct investment was limited in Korea. When speaking of bankruptcies in Korea, the subject is more often how seldom it takes place rather than how often it takes place. Consolidating certain industries, preventing chaebols from becoming too large to dominate the domestic market, and allowing non-viable companies to exit the market were more common in Korea after the crisis than before. Establishment of exit schemes for non-viable firms was, for example, a fundamental principle for further reforms in February 2001 (Jung and Jeong 2002:135). The third type of panic comes from devaluation, which again is derived from the size of reserves. The BoK’s depletion of reserves in autumn 1997 led to the expectation of devaluation. If the three types of panic are interwoven, then panic is more comprehensive.

If we imagine panic as something irrational (which it literally is), then weakness in the Korean economy does not have to be the reason why foreign investors left. Investors’ motives could have been psychological, as the fear of being the last
investor to withdraw from the market and face the largest loss. This herd phenomenon is a result of the principal-agent problem between the fund managers and the owners of the funds. If the fund managers did not invest in Korea (and the other Tigers) during the 1990s, they could have lost their reputations if others invested in the region and made lots of money. By not following the herd, fund managers can lose funds to manage. The same herding occurs when investors flee the region. Hence, the herding phenomenon also explains why investors invested in Korea despite the low level of transparency and other maladies of the Korean economy as suggested by a few people early in the 1990s. According to Sachs (Dagens Næringsliv September 4th 2001), the market is superior to the government in channelling funds into the best investments. The problem, however, is that financial actors are more like sellers than analysts and economists. Financial institutions profit from exchange, floating, and re-investments – simply by moving capital. Financial institutions are paid by the transaction and not by how an investment performs. The only way financial institutions lose money is through the absence of reward, i.e., when a customer incurs losses due to bad investments and the investor flees. Institutions’ motivation to perform well and invest wisely is keeping customers. A fund manager has to perform well compared to other fund managers and not to an absolute standard to remain the owner of the funds. Herding can therefore be more important than the real economy.

Panic among creditors did not last for long and contributed to a fast recovery (Hong and Lee 2000:221). Kim Dae-jung showed his ability and willingness to consider all necessary means such as lowered interest rates, more extended credit to small and medium enterprises, and a widened fiscal deficit. The IMF’s conditions also sounded fair to creditors. The IMF demanded comprehensive changes in the financial system and improved corporate governance and transparency (Hong and Lee 2000:210). In addition to domestic changes, the new economy, where Korea was heavily represented with its semiconductor industry, experienced a bull market throughout the industrialised world. The USA’s federal funds effective interest rate fell 87 points between August and December 1998. Both the IMF and Kim Dae-jung wanted to
restore confidence in the won; however, the IMF found it more urgent to increase interest rates to restore confidence, while Kim Dae-jung had to consider the conflict between high interest rates and indebted industry, because industry is the engine for recovery after all. A rise in the cost of capital from both an appreciated won and higher interest rates seemed unbearable. Industry had to have working capital to avoid a stop in production. The IMF’s eagerness to restore confidence in the won by increasing interest rates reflected its diagnosis of the crisis, which is different from the developmental state. The latter holds the overvaluation of the won together with high interest rates as the very dilemma. Liberalisation of the capital account forced the chaebols to borrow more from abroad due to interest rates that were lower than in Korea. Strengthening the won by increasing interest rates would encourage further borrowing abroad. The domestic loans that dominated the chaebols’ debt would also become more expensive. Another reason attributed to the crisis was reduced exports. An appreciated won would not facilitate exports either. Sustained exports after the crisis proved that several chaebols still were viable. This appears to manifest the fact that foreign creditors panicked or overreacted and that the contagious effect from South Eastern economies was present.

It is often mentioned how short-sighted foreign investors were in Korea’s case. However, Corrigan (1991:50) holds it as a myth that market participants and even central banks can distinguish liquidity problems from terminal financial problems. Investors’ panic is a simple explanation of a large event. Robert Wade presents two rival interpretations of the Asian crisis (1998:1535). One is ‘death through Asian state capitalism’ and the other ‘panic triggering debt deflation in a basically sound but under-regulated system’. Wade is sceptical to the first as a cause to the crisis and a proponent of the second. Statement two claims three things: panic triggered debt deflation, the system was sound, and it was under regulated. Panic triggered by debt deflation does not leave much controversy. Yet, we have no authorities in the international financial system that can enforce what American financial authorities’ have in their Chapter 11, which protects entities from having payment problems, ensuring orderly workout and even continued operation. Such legislation was meant
for domestic situations such as Korea’s, namely preventing destructive panic and correcting market imperfections. Without similar international legislation and authorities, participants in the international financial system have good reason for being especially wary of international exposure. Financial liberalisation in Korea did not consider international exposure to merciless creditors and market imperfections as financial panic. Being kind to Korea, its macroeconomy was sound. The co-operation between economics and politics was productive and impressive for a long time, as well as the way the system enabled economic growth and prosperity for society as a whole. What was rather unsound was the corroborative ties within and between sectors: the way chaebols were run, the affiliation between finance and industry, and the misuse of political influence, guarantees, and funds. When government liberalised the financial system without a proper framework of accounting standards and asset requirements, the malady system escalated into crisis. Yes, international society pressured Korea to adopt Western accounting standards and to facilitate imports because OECD countries wanted to participate in East Asia’s success. Some people advocate a conspiracy theory among UK and US financial firms, the WTO, the IMF, and the OECD (Wade 1998:1535) where international institutions wanted Korea’s economy to break down is not clearly evident. A breakdown of a developed market and a decrease in its imports harm the international economy.

Morris Goldstein (1998:14-16) outlines five financial sector problems in Korea. First, the quality of investment was less impressive than the quantity. The return of equity and investment was rather poor among chaebols and they emphasised growth instead of profitability. The second problem was that the won was pegged to the US dollar giving a false impression of the economy. The real effective exchange rate deteriorated competitiveness when the won appreciated against the US dollar. Third, Korea experienced a slowdown in exports in 1996. Growth in merchandise exports was less than 4% in 1996, compared to more than 30% the year before. The picture looks even more dismal when considering that imports increased disproportionately. This worried investors. It was a slowdown in their investment as well. A fourth problem was competition from China. Shipbuilding and semiconductor production
was far cheaper in China than Korea. The last problem was overproduction of Korea’s specialities that reduced prices and intensified competition within semiconductors (fortunately for Korea, the market for semiconductors improved again from 1998 to 2000). Increased competition resulted in decreased margins due to lower prices. The factor leading to these emerging problems was industrial policy, which was not changed when market conditions changed and industry performance worsened. This was also a source of financial crisis (Corrigan 1991:46) prior to 1997. Industry grew large in too few sectors and Korean industry’s debt was too exposed to foreign borrowers. When foreign confidence subsided, Korean industry had a problem. Foreign investors jumped on the bandwagon, just as Korean industry did. The chaebols had a policy increasing their share in certain industries. Competition in the industries made it difficult to keep sufficient surpluses in financial statements. When profit margins fall due to competition, investor realise it and run. The Korean market was overcrowded. For a time, East Asia was the most lucrative market to invest in despite its poor transparency. If authorities and investors had properly supervised the Korean market, the party could have lasted longer.

5.4.2 Foreign Investors’ Behaviour
There was no financial panic among foreign investors on the Korean Stock Exchange. A study done by Choe, Kho, and Stulz in 1998 seeks to determine if foreign investors destabilize economies. Foreign investors may be positive-feedback traders, which means that they buy when the market increases and sell when the market falls (Choe, Kho, and Stults 1998:7). Positive-feedback trading among foreign investors does not have to destabilize equity markets. Greater foreign ownership lowers risk premiums on stocks, because a stock’s risk is better shared internationally. Their study showed that foreign investors sold more when the market was doing well then when the market preformed poorly. That means that foreign investors sold most when domestic demand was highest. Hence, their behaviour cannot be perceived as destabilizing (Choe et al 1998:10). A critique of foreign investors was the bandwagon effect that made the situation worse. Choe, et al., found strong evidence of herding prior to the Korean crisis and much weaker evidence during the crisis. Prior to and during the
Korean crisis, herding was lowest among small company stocks. During the crisis, herding was mostly weak except for the larger companies’ stocks\(^7\) (Choe et al. 1998:14-15). Their study tells us whether or not opening markets to foreign investors destabilizes economies. Their conclusion was that it did not. A positive attribute of an equity market is its built-in mechanisms that make foreign equity investors stay when creditors do not. If the market is efficient, asset prices fall to reflect new adverse public information even when trades are absent. When prices reflect new information, the price is fair and the incentives to sell are weakened (1998:21). Albeit, the significance of the Korean stock market’s behaviour towards the crisis or a crisis considering the stock market’s low capitalisation as a percentage of GDP might be limited. Korea’s stock market capitalisation was just above 25% of GDP, while the OECD average was 60% of GDP (OECD 1998:97). The Korean stock market seemed to follow the real interest rate, as it should have, during the crisis. The KOSPI fell to 45 (lowest) while the real interest rate increased to 18% (highest) in December 1997. When the real interest rate fell to 10% in February 1998, the KOSPI rose to 60. However, the KOSPI fell again to just above 40 while the real interest rate hovered at around 10% (OECD 1998:47).

5.5 Disorderly Workout

The Korean market did not benefit from a creditor coordinator; however, the IMF’s help and the business’ strength in exports made the workout of the crisis only moderately disorderly. The IMF, as lender of last resort, proposed guarantees for Korean debt. However, providing liquidity is no guarantee for solving financial disruption (Corrigan 1991:52). Corrigan’s conclusion is that a lack of ethical conduct, both among policymakers and businesses, is important and that malady in the overall macroeconomic and structural policy may be the root of several financial crises. Financial disruption must have a root cause, and ample liquidity will not remove the cause. Without examining the cause of the crisis, fresh liquidity from the IMF can be

\(^7\) Larger stock means stocks to companies with larger capitalization. Small stock means a stock to a company with lower capitalization.
wasted. This is one of the most likely reasons why the IMF demanded so much in accordance to their bailout. If that was the case, the IMF’s claims were not that inappropriately intrusive. Institutions providing help to distressed economies should therefore dare to attach propositions to funds. The IMF enters when a financial situation is in disorder, to create order. On the other hand, the IMF has a good reason for being humble. The IMF’s traditional role has been short-term stabilisation. The timing is not appropriate for long-term institutional reforms in the middle of a finance or currency crisis. That is a job for the World Bank. Prior to 1997, it was the IMF that pushed especially hard for capital-account opening in Asia (Wade 1998:1545), and there is doubt that the lack of an adequate regulation framework was one of the main reasons for the crisis. Even few neo-liberals see liberalisation without regulation as positive. In retrospect, the IMF can say that it took regulation for granted when asking for liberalisation of the capital account. Wade and others are not convinced that the IMF expected comprehensive regulation. Krugman (1998:3) also emphasises how under-regulation is subject to severe moral hazard problems. Whitefield (2001:27) describes the IMF’s work, with neo-liberal heritage from Thatcher and Reagan, as intruding. By supporting countries in debt crises, it most often supplies structured adjustment loans consisting of public spending cuts, high interest rates, and credit restraints. Another reason for foreign white knights being humble when presenting propositions to restore a troubled economy is simply to assess what Korea had achieved in the decades prior to the crisis. It is harsh to dismiss thirty years of success because of five years of failed regulation. In retrospect we can also say that Korea’s recovery was as exceptional as its industrialisation. The IMF’s motive for strengthening the confidence of the won by increasing interest rate appears is blurry. Worsening the situation for indebted companies is not an obvious strategy to choose.

To meet the IMF’s demands, the Korean government was required to make the economy more transparent and accountable, and the chaebols’ financial statements had to be consolidated. The IMF’s demands and propositions were a mirror of its understanding of the crisis. Critique of the IMF has been that 1) it gave a relatively healthy person the wrong medicine. Korea faced a liquidity problem and the IMF
treated it as a structural institutional problem. The financial sector was weak while the chaebols were leveraged. 2) Others say that the IMF only delays adjustment in economies. The IMF’s provision of conditional financing to help balance-of-payment problems has earned it international prosperity, say others (Goldstein 1998:32). 3) The complaint is whether the IMF was too intrusive or not intrusive enough. Goldstein asks rhetorically (1998:33), “Could Korea regain the confidence of investors without altering the way in which the government, banks, and chaebols conduct business with one another and without reducing the extremely high debt to equity ratio?” Foreign investors used to have confidence, even though the quick asset ratio among chaebols used to be 60% as compared to more than 100% in Western companies (OECD 1998:29). However, stock market indices in Korea fell when the Korean government announced negotiations with the IMF on November 21, 1997, and it continued to fall after the conclusion of the IMF agreement. The turning point for the indices was when the IMF announced the payment of funds out and the push for restructuring (Radelet and Sachs 1998:fig.8). Korea did not become a less interesting destination for FDI. FDI remained remarkably stable during the crisis (OECD 1998:35). An explanation of the stable FDI inflow can be that the foreign investors had more control than Korean middlemen. 4) The IMF worsened the situation by prescribing excessively tight fiscal and monetary policy and closing some banks and financial institutions. The IMF is indeed sincere in its concern for maladies in distressed economies. The perpetuating fear of moral hazard is omnipresent. Not only in Korea, but also in the IMF’s financing of economies. In a pamphlet from 2002, Timothy Lane and Steven Phillips, both working for the IMF, discuss how likely it is that moral hazard occurs when the IMF provides help. Their conclusion is that there is still no empirical evidence that IMF financing creates moral hazard as some have stated, but it is appropriate to always have the IMF in mind due to the nature of its activity of providing financial support when needed.

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8 [http://www2.cid.harvard.edu/hiidpapers/bpeasia2.pdf](http://www2.cid.harvard.edu/hiidpapers/bpeasia2.pdf)
5.6 Reforms

Even though developmental state policies worked well in the time span between General Park’s rule and the end of the 1980s, it is reasonable to expect that certain adjustments in the ruling political economic regime were needed, due to both internal and external pressure. Korean industry developed from infancy to world leaders in certain industries. Public opinion changed as well, from focusing on ‘growth first’ policy and security, to focusing more on wealth not necessarily derived from growth. An increasing number of interest groups in Korea opposed the quasi-internal organisational relationship between policymakers and the largest chaebols. Externally, the WTO regime and the integration of advanced capital markets made it more difficult to manipulate domestic exchange rates through pegging (Pyo 1999:157-158).

5.6.1 Big Business

“Too large to fail” is a Korean saying to describe the chaebols. The argument is not that the chaebols cannot fail, but that the consequences of failure are so profound that the government is willing to pay for their mistakes and save them. The understanding of the proverb is stumbling close to moral hazard. “Too large to fail” is both right and wrong. It is right because when a large institution fails, it hurts economically and politically. More effort is made to keep it running. The statement is wrong because they can also fail (Corrigan 1991:48). The failures may have to be larger to be critical; however, they can fail and they do fail. When the economy is based on a few large entities, it is especially vulnerable to bankruptcies. In Korea’s case, a few chaebols were dominant and were also highly financially interdependent through cross-share holdings and cross-loan guarantees (Hong and Lee 2000:209). If one chaebol failed, the others would be severely affected. Taiwan is another miracle economy in East Asia that was not that much influenced by the Asian financial crisis. One reason is its fragmented industry. The Taiwanese economy had many more feet to stand on compared to Korea.
The chaebols are central in the critique of Korean industry. They were too diversified into different sectors, too indebted, and lacked transparency. Actions to remedy this were already taken during Roh’s presidency in March 1991. Lasfer, Sudarsaman and Taffler (1996:57) find empirical evidence that share prices significantly increased by a divestiture of assets. That is explained by improving the fit and focus for healthy firms and the reduction of the cost of financial distress for troubled firms. A divested asset has a better fit for the buyer than for the seller, and the asset sold can give negative synergies to the divesting entity. Financially distressed firms generate sufficient cash by divesting to meet debt obligations. Shareholders in distressed firms can expect higher returns by divesting than can shareholders in healthy firms (Lasfer et al 1996:59). Healthy firms get net present value (NPV) when selling off assets, while wealth exceeds NPV for distressed firms when the probability of liquidation is lowered and expected liquidation costs are reduced. The more a company is leveraged, the more of an agency-monitoring role debt has, and the more likely it is that divestments are value enhancing. These findings give chaebols a plethora of reasons to diversify less and to improve focus more. Entities have to provide a certain level of information to benefit from divestment. The limitation of information possessed by investors can be important to understand economic behaviour. Limited information induces people to alter behaviour (Thakor 1991:71). In non-cooperative game theory it matters who moves first between the informed manager of a company and the uninformed shareholder. The informed manager knows how the uninformed shareholder will respond to various signals. The capital market offers the manager a menu of choices combining the debt level to the price of the firm, and the manager will choose a mix that maximises his/her preferences (Thakor 1991:73). A manager can be tempted to cloud the debt level, because the manager may prefer a high debt ratio and a high share price while the combination may not correspond with the shareholder’s preferences during a recession, for example. A high debt ratio was certainly preferred by the chaebols; however, the shareholders didn’t seem to mind either. Gearing is usually a good thing during growth and is a nightmare during recession. The developmental state also uses this argument. Gearing is necessary in late industrialisation, but it requires control over the domestic financial system and
especially of the capital account to ensure that capital is productively invested. In Korea’s case, it seems like regulation of the capital account was inadequate and investments made by the chaebols were not all productive. Its gearing was no longer insulated from foreign attack after liberalisation of the capital account.

According to Mo and Moon (1999:174), the origins of the crisis started to appear in 1995. The international market pushed for a devaluated won; however, the government tried to improve its competitiveness by restructuring companies rather than by devaluing the currency. Devaluation would have undermined the restructuring process and threatened the price stability that had been prioritised. The corporate sector wanted a strong won to serve foreign debt. A strong won seemed more convenient than restructuring industry. The banking sector was extremely weak with too few performing loans. The number of non-performing loans is unknown due to the lack of reliable data (Mo and Moon 1999:180). According to some, we are back to the core of the crisis: lack of transparency and accountability. The official average return on assets on the banking sector between 1990 and 1993 was 2%. In 1994, 1995, 1996, and 1997 it was 1%, 0.9%, 0.2%, and -0.9%, respectively. Return on equity was 6% in 1994, 3.4% in 1995, 1.2% in 1996, and –31.6% in 1997 (OECD 1998:62). In 1996, domestic savings reached its lowest point since 1987. Hence, Korean firms had to use international institutions to finance investments at home and abroad (Mo and Moon 1999:186) to keep up the investment pace despite lower domestic savings compared to the investments. Claims on the Korean private sector in the form of domestic credit was 120 billion won in 1988 and 747 billion won in 1997 (OECD 1998:198). The share of GDP claims on the private sector increased by 40% from 1990 to 1996 (Radelet and Sachs 1998:Table 11). Jung and Jeong (2002:132) hold the depletion of foreign currency reserves as the immediate cause of the crisis. The Korean economy had an inherent structural weakness (measured by the capital-output ratio) of low industrial competitiveness (production was not efficient compared to competitors), the economy was dependent on an open sector (which was a blessing with the depressed won during the crisis), and the economy was dominated
by a few large chaebols where one poorly managed chaebol could have a substantial impact on the economy.

The shortcomings of the economy were apparent for the government, and Kim Yong Sam articulated reforms as a continuation of his predecessors’. Chun Doo Hwan, who wanted to reduce the economic consternation among the chaebols, started the reforms by restricting cross-equity sharing among the chaebols’ subsidiaries and by limiting the chaebols’ preferential access to financial resources by implementing a comprehensive credit management system. However, these actions had a limited effect (Moon 1999:20). To prevent real estate speculation, the Roh government ordered the country’s 49 largest business groups to sell their land within six months of May 1990. To improve international competitiveness, the top 30 chaebols were required to nominate up to three of their subsidiaries as ‘core businesses’. The Roh government strengthened the legal, administrative, and taxation systems to detect and prevent cross-investment, cross-subsidisation, cross-payment guarantees, illicit concession, and inheritance of corporate stocks among the chaebols’ owners. The Kim Yong Sam government intended to continue strengthening the regulation of the chaebols and undertook extensive deregulation in the areas of licensing, market entry, prices, and administrative intervention (Moon 1999:23). Financial transparency was improved by requiring bank accounts to be held under real names, and political contributions and policymaking patronage between chaebols and political leadership was to be broken (Heo and Tan 2003:25). However, the tragedy was in the lack of proper implementation of all the initiated reforms. Kim Yong Sam did not succeed in reforming the economic concentration among the chaebols. We expect the chaebols to have resisted by several means such as lobbying and Chung Ju-Young, Hyundai’s chairman, attempt to win the presidential election failed. Chung intensively criticised the government’s anti-chaebol policy. (Moon 1999:21). The top 30 chaebols had an internal ownership\(^9\) of 45% in 1990 and 44% in 1996, the family had 13% in 1990 and 10% in 1996, and the subsidiaries had 31% in 1990 and 33% in 1996 (OECD 1998:94).
A developmental state has harmonious cooperation between capital and government where goals are articulated by politicians and the capital represented by the chaebols is used to fulfil the goals. When we see how President Kim Young Sam and Kim Dea-jung struggled to implement reforms, it is tempting to anticipate capital, as represented by the chaebols, as the dominant factor. However, Amsden (1989:8) sees Korea as a special case of a late industrialiser, due to the discipline the government seems to have exercised over the chaebols. It is not very uncommon for a late industrialised government to give subsidies to industry; however, the Korean government imposed performance standards on the chaebols. The subsidies were not giveaways, but rather ‘dispensed on the principles of reciprocity’. The reciprocity faded away though. Kim Yong Sam did not succeed in regulating the economic concentration among chaebols. In some areas, the chaebols’ cross-equity ownership was diluted, but the chaebols’ economic concentration has continued. The attempt to limit the amount of the chaebols’ idle land also failed, and the government credit-management system became less effective due to the chaebols’ access to funds overseas (Moon 1999:22). Kim Yong Sam’s extensive deregulation in the areas of licensing, market entry, prices, and administrative intervention enjoyed mixed success. Samsung’s attempt to enter the automobile industry also faced opposition instead of encouragement from policymakers. Samsung lost that battle. Once an economy as large as Korea’s derails, it is apparently very difficult to get back on track.

Success was also absent in the government’s exchange rate regime. A daring exchange rate regime without supervision of financial institutions allows Korean companies to become overexposed in foreign-currency denominated loan without considering the potential repricing of domestic currency. The fixed parity of the won gave a false illusion of stability to foreign creditors in Korea. The largest investment mistake was the expectation of governmental guarantees that encouraged bankers to finance risky projects, believing that they could reap the gains while the government

\[9\] Internal ownership is the shares owned by family, relatives, and subsidiaries.
would take the losses (Jung and Jeong 2002:133). The close relationship between the chaebols and government was not longer fruitful during the 1990s. Overinvestment was financed by borrowed money leading to high debt-to-equity ratios. In spite of attempted reforms, the chaebols were characterised by lack of financial transparency, poor corporate governance, too diversified business, and low competitiveness in the global market during that period. Low competitiveness was the price they had to pay for growing large in the view of the Western corporate ideals of being profitable and of maximising shareholder wealth. By all means, imperialistic conquerors among executive officers are often problematic for shareholders in the Western hemisphere as well.

5.6.2 Changing a Winning Team
Economies are indeed a product of political decisions. Jong Won Lee (2002) is only half controversial when he states that Korea’s developmental policy functioned well in the early stages and became obsolete after Korea became developed. By compromising the neo-classical doctrine and developmental state approach, he suggests an ‘advanced state model’ for Korea and other newly industrialised countries. Lee does not criticise Chalmar Johnson’s emphasis on a small group of elite decision makers playing the role of the pilot agency or Amsden’s major support of a strong interventionist state. Lee’s advanced model advocates a clearly defined market and government. The chaebols have to adapt the concept of globalisation. Industry is no longer in an infant stage and has to be prepared for unlimited competition. Korea has a large economy in GDP-per-capita terms, is a member of the OECD, and has entered a new international economic order. Korea’s industrial structure of the chaebols’ favoured position has to be upgraded by correcting the industrial disequilibrium to improve productivity as well as equity and welfare. The primary role of the government is to correct market failure. Fast and quantitative growth has to be replaced with sustainable and qualitative growth through sound investment. The centralised management system has to be decentralised. The corporate society has to become more democratic. Privatisation and liberalisation have to include governmental regulation and supervision. This will improve
economic efficiency and create a fairer society. Korea deserves equity- and welfare-oriented principles as a substitute to the long-lived growth-first principle. Lee is in favour of an active state, not a paradigm shift for the way Korea runs its economy. He is not asking for a strong version of neo-liberalism; however, Lee does not find it controversial to define government’s role. The Korean government has to “concentrate on its original role of supplying public goods (…), correction of market failure and embodiment of the welfare state”. Such capitalism has more in common with Western Europe than Anglo-America, even though the USA has been Korea’s soulmate for decades. Moon (1999:6) describes the situation differently. Keynesian politics could not handle the structural crisis Korea was in. Internally and externally, neo-liberal prescription was perceived as the only remedy for structural change. The hegemony of the USA, the IMF, and the WTO pushed for neo-liberal reforms. Influential American-trained economists, such as Kim Jai-ik and Kang Kyung-sik, were centrally positioned in the economic decision-making machinery that also pushed for neo-liberal reforms. Few people questioned whether or not to change a winning team. They questioned the type of succession regime. In a prepared comment on ‘National Democracy and Global Capitalism’, Bent Sofus Tranøy (1999) describes globalisation as a framework. A country such as Korea is a democratic actor and global capitalism is the framework. When the framework is altered, the members of global capitalism have to follow up by altering their policy. Globalisation is often treated as an omnipotent explanation that can dismiss a government’s responsibilities. It is tempting to talk about globalisation instead of assessing the complexity of international trade and multinational companies that are involved in most developed countries, such as Korea. Korea is host to several multinational companies and is a major player in international trade. Globalisation is therefore not an adequate explanation for the problems that occurred in Korean industry. Global capitalism is more of a threat to underdeveloped or developing countries playing in another league. The Asian miracle was the result of a developmental state policy that insulated national infant industries and resisted competition and pressure from foreign capitalism. To adapt a company or an industry to changes in the business

http://www.fafo.no/pub/rapp/928/demo12.htm
environment should be as natural as making a profit in order to survive – call it
globalisation. The chaebols are no longer in their infancy. As market leaders in
several areas, they had to alter their business conduct from being protected infants to
becoming dominant players. Their resistance to change can be explained by the
convenience of being insulated.
6.0 CONCLUSION

Korea’s economic development has been a showcase for both liberals and institutionalists, in different epochs. Since the 1960s, Korea as a developmental state has experienced economic growth through a market-oriented economy with an active state to support and supervise it. The state has been absent as an owner of business, but it has had a tremendous impact on the conduct of business. During the financial crisis in 1997, the liberals rhetorically asked, “what did we say?” Theoretical schools and disciplines gathered and assessed approaches to describe the circumstances surrounding the outcome of the crisis. Liberals emphasised the cronyism and moral hazard that appeared in Korea’s institutional system, while institutionalists emphasised the capitalist recklessness that has an embedded tendency of leading into fatal panic among investors in the international financial system every now and then. Liberals want more markets, and institutionalists want a lender of last resort and bodies that regulate substantial shifts in economies. Regardless, the Korean economy has gone through a comprehensive transformation since the crisis. More Western principles have been implemented. The intention behind the IMF’s demands for change has hopefully been for Korea’s best; however, several people view it as an imperialistic way of implementing Western schools of thought. It is worth mentioning that reforms to reduce the chaebols’ power had already been initiated by President Kim Dae-jung’s predecessors, Roh Tae Woo and Kim Yong Sam, in the beginning of the 1990s. The chaebols’ dominant role has been decreased and the focus has shifted from the cost of growth to profit. Transparency, corporate governance, and accounting are now conducted by Western standards, and liberalisation has been followed by monitored regulation. However, the pace of chaebol reform has slowed down since the crisis in 1999 when the abolishment of cross-ownership had a cosmetic character. The statement that liberalisation and regulation are not contradictions has been repeated all too often. Regulation is a way of conducting business and post-crisis liberalisation has widened the list of participants in the Korean economy, domestically and among foreigners. Kim Dae-jung has articulated faith in market forces and in a ‘free’ market without necessarily believing that
markets regulate themselves for unintended externalities. The latter had an unpleasant presence during the crisis. It has also been said that a free market is based on cultural conditions. Capitalist liberalisation does not necessarily imply a passive state having a strong belief in a market that can perfectly control itself. Most capitalist- and market-oriented Western countries regulate competition, environment, personal protection, and human rights.

The outcome of the financial crisis has been the implementation of both liberal and institutional principles. The market is now more transparent and open for foreign investors, business is less political, and newly established institutions are making sure that political directions are being followed in accounting, conduct of business, and corporate governance. Prior to the crisis, Korea emphasised institutions that facilitated growth. After the crisis, Korea created institutions for ensuring that the chaebols sustain growth and adapt the accounting standards necessary for Korea to be a part of international political and financial spheres. Both international investors and domestic conditions contributed to the crisis, and all parties have much to learn from it. When explaining the crisis, there are reasons to stress the shortcomings of the Korean economy. However, it is important to keep in mind its success and not throw away all that was learned from the economic growth that the country experienced decades earlier. Korea had done something right to go from a country with famine up to the 1960s to become the world’s eleventh largest economy in the 1990s. Prior to the crisis the education level was high, wealth was relatively well distributed, unemployment was low, and few people were poor. A fundamental strength was also demonstrated during Korea’s rapid recovery. In retrospect we see that an overly general critique of Korean society does not hold water.

This paper has questioned whether investors were the messengers or the cause of the crisis. It has been contented that they were the messengers and that governmental behaviour, or lack of it, was the main cause. Investors and creditors triggered the crisis, but they had a reason for doing what they did. When an entity goes bankrupt, it is often the creditors’ claims that cause it; however, it is a direct consequence of the
entity’s performance. Determining the cause of bankruptcy cannot stop with the creditors. Following a larger bankruptcy, the discussion often revolves around how necessary or wise it was, of both entity and creditor, to declare bankruptcy and even if the bankruptcy should have happened earlier. The reason for bankruptcy is the reduction of investor losses; however, bankruptcies are often a lose-lose situation and not always the best option. An example of a non-bankruptcy to reduce losses is the fish-farming industry in Norway. Technically, the largest operators have been bankrupt for a long time; however, creditors know they will not gain by letting them go bankrupt. Bankruptcy may give them nothing more than the hope for an industry recovery in the future. When reality becomes too unpleasant, an entity can be too big to fail for the investors and too embarrassing to fail for the government. Orderly workout did not occur in Korea’s financial crisis, and primary blamed should be placed on the Korean government rather than on the IMF or foreign investors.

This paper has discussed maladies in the Korean economy, and several ways of understanding financial crisis have been articulated and discussed as hypothesis. Political leadership has been weak and has not managed to implement initiated reforms. Korean businesses, namely the chaebols, have proven weak as well. The government had the willingness to reform, but not the ability. The business had the ability, but not the willingness. This paper did not discuss whether investors’ behaviour in conducting their business was right or wrong— that belongs to another discussion. In contrast to the chaebols, foreign investors have never been political actors in Korea. Still, after the crisis we can observe that a certain overreaction took place. This paper chose instead to discuss the reasons why currency traders, investors, and creditors behaved the way they did. The assumption that governmental behaviour was the fundamental basis for the behaviour of foreign actors that resulted in a crisis is right in the sense that the government was obligated to adapt the economy to changes in the economic environment, even though domestic businesses have been rigid. Tendencies toward moral hazard and cronyism have certainly been present; however, their extent can not have been so great because Korea actually achieved fantastic results over a longer period of time and it recovered amazingly quick thanks
to its export-led economy. On the other hand, it is worth asking if Korea’s speciality, the co-operative society as a developmental state, contributed to the recovery or if Korea was too developed to maintain the politics of the developmental state, and it was this absence that helped it to recover after the crisis. Korea is already developed and cannot expect the same rapid growth it experienced in earlier decades or that its successful politics would last forever. This paper evaluated how the corporate society model found it necessary for Korea to implement radical liberal principles. Time was up for incremental adjustments.

6.1 The Thesis

In the theory section, I dared to categorise several interpretations of Korea’s financial crisis into three main approaches and models. The simplification is daring due to the relatively large cleavage between moderate (weak version) and more faithful (strong version) advocates of the developmental state model. The latter group has fewer objections to the model than the moderate one. The same cleavage exists within the governmental behaviour model, which is the liberal one. The moderate one has less faith in the market than the faithful advocates that want governmental intervention to be marginalised. In some respect, moderate institutionalists and liberals have more in common than they do within their own traditions; however, the main difference is in the way they analyse political processes – hence the purpose for differentiating the schools in this analysis. According to the liberals, governmental behaviour’s primary role is to facilitate a well-functioning market, while institutionalists assess the importance of institutions, also non-governmental, in facilitating a market-oriented economy. The corporate society model is more homogeneous and more directly attached to Korea’s financial crisis, although it has also been used to understand political development and processes in other corporative economies. Several Western European countries have elements of corporatism in their economies and have much to learn from the incremental power slide among dominant players in society. The discussion is based on which independent variables caused the crisis, and hence causal analysis has been used a methodological tool. After describing the different
aspects of Korean society as background information, this paper discusses the main points of view of the models and how the approaches assess the symptoms of the crisis embedded in the eight hypothesis.

6.2 Lessons

What have we learned about preventing crisis, providing support during crisis, and orderly workout? The most obvious is the importance of preventing the fundamentals of crisis. The attributes of Korea’s financial crisis were quite traditional in terms of balance of payment, financial panic, moral hazard, and contagion. The economy was relatively weak compared to earlier expectations of its strength among foreign investors and in comparison to exchange rates, stock market indices, real estate prices, etc. Businesses were leveraged with high levels of debt to equity and profitability was low. The value of the won was not in line with the economy. The desire for industrial omni-growth was stronger than the desire for profit and efficiency. Most of the various subgroups of financial crisis were present in Korea. The government has to have the ability to govern in order to prevent a crisis. If the government is weak, confidence in the economy becomes weak and necessary means to prevent crisis become hard to carry out. Warning lamps must have been blinking when the government lost its ability to govern, in this case its trouble with implementing reforms. Democracy was literally threatened. A corporate system is a trade-off between democracy, in the sense of politicians receiving power through popular election, and the influence of organisations representing groups in the population. In Korea’s case, it was first and foremost the chaebols that had the influence and not the labour unions. Korea’s government had to fight two fronts: the chaebols’ speculation with cheap credit provided by the government and the currency traders’ speculation in won. Weapons suitable for both fronts are not easily combinable. A float of won would ease currency traders, but worsen the chaebols’ foreign-denominated debt. The governmental behaviour model finds the way in which the government pegged the currency as a cardinal mistake. Or was it rather a dilemma? It was restrained in its means. The continued pegging of the won seemed to
be the only option considering the high debt of domestic industry. Still, a pegged currency has to have an appropriate value whatever that may be (it is said that the market knows). If a currency has an appropriate value, it can no longer be pegged. As long as the currency is convertible, it is more vulnerable to speculative attacks. Valuation is artificial when pegged, and when assets are artificially high or low, there is money to be made by speculators. A central bank has limited room in which to adjust the exchange rates for the economy’s competitiveness. Strong liberals assert that ‘getting prices right’ has to happen with limited governmental activity, while moderates assert that governmental policies do not have to counteract the relative prices that would have occurred under free competition and also that the government can actively intervene to facilitate such an adjustment. A convertible currency cannot have a fixed price dependent upon other countries’ performance and currency valuation such as yen and dollars. What is appropriate pricing for the Korean government does not have to be appropriate for foreigners. To obtain desirable trade in every good and service, the price has to be right.

The regulatory lesson has been to be cautious when liberalising the financial sector. Improper surveillance and regulation have resulted in several financial crises prior to Korea’s. During the 1980s, the financial sector in Chile collapsed. The buzzword there was also extensive foreign debt. Financial crises in the USA were the collapse of the junk bond market, the thrifts, and real estate in Texas. The developmental state emphasises the mistake of not regulating cross-border movements of short-term debt when liberalising the capital account in Korea.

The intention behind an orderly workout is to make a situation less dramatic by preventing panic and improving Pareto imperfections. After the crisis, it becomes easier to observe whether or not the market correction was an overreaction. Asset prices in Korea stabilised quickly at a level high above its lowest. During the crisis, there was a fire sale on Korean assets. An orderly workout could have prevented the unnecessary fire sale. However, an international institution with supranational
authority over others (Korea did not have sufficient capacity to play this role) must be willing to take such great responsibility. So far, no such institution exists except for the IMF, which provided funds to Korea – with conditional ties. There are several reasons behind the opposition to the IMF’s initiative. Those that have great faith in the market describe such help as unnecessary intervention during market correction. The result of the crisis will be even worse with IMF intervention than without it. Another opinion is that the conditions attached to the funds are imperialistic. The receivers know best what to do, and sovereign democratic nations have to decide for themselves which move they want to make. Sachs and Wade’s critique of the IMF revolves around why the IMF started heavy negotiations of institutional reforms and policy-tightening instead of organising renegotiations of debt. The question is how important it was to articulate institutional reforms there and then, or whether these reforms only made foreign investors even more nervous. One response is that crisis is often the result of nationally conducted economic policy and that the IMF has an opinion on what went wrong. It is also the provider of the funds’ right to govern their use, even though it is of political character. The IMF does not provide aid as alms, and the motivation behind its intended help does not have to be of an altruistic nature. The Asian crisis influenced the world economy, and the Korean economy, as the eleventh largest at the time, was not to be neglected. In contrast to Wade’s anticipation of the crisis, it was not in the developed countries’ interest that the financial crisis occurred.

6.3 Schools

Several schools focus on different aspects of the Korean economy when assessing what went wrong. Approaches that have been assessed are developmental state, governmental behaviour, and corporate society. The developmental state has an institutional understanding. It is a compound approach consisting of the one that believes the Western world deliberately created the crisis and the one that the developmental state is more or less infallible (strong version) except for liberalisation

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11 Pareto imperfection is present when one party can improve its situation without deteriorate another party’s situation.
of the financial sector, to the one that embrace institutions’ role in the economy. The last group, the institutionalists (weak version), have more faith in market forces than the first, and they advocated transparency, improved corporate governance, and liberalisation in Korea. However, institutions are necessary to correct negative externalities and to supervise and regulate imperfect markets. The strong version has been the representative for the developmental state approach in this paper. The weak version has occasionally merged the understanding of the crisis with the governmental behaviour approach. The main difference is that the weak version of institutionalism does not share liberal principles. Advocates of the weak version in this discussion of financial crisis are Joseph Stiglitz and Jeffrey Sachs. Advocates for the strong version are Chalmers Johnson, Robert Wade, Laurids Lauridsn, and Alice Amsden. I have called Moon Chun-in and Mo Jongryn’s approach corporate society, which is a hybrid between institutionalism (developmental state) and liberalism (governmental behaviour). The corporate society’s focus is on the government’s ability to carry out political decisions. Liberals such as Paul Krugman are more critical of the developmental state approach than of corporate society and stress the risk of the moral hazard, fraud, and cronyism that it implies. Institutionalists and the corporate society also find moral hazard and cronyism as negative attributes of Korea’s economy in the 1990s, but believe that the ‘developed developmental state’ does not have to lead to moral hazard and cronyism as long as regulation and supervision are appropriately present.

![Diagram showing the relationship between Institutionalists and Liberals]

Fig. 6.1: How the approaches are related.
The developmental state approach focuses on who started the crisis and pinpoints international financial players as jumping on the bandwagon that is often collectively irrational. Destructive movements have to be tamed by institutions, also international ones. Domestic political regulation is not always sufficient. Governmental behaviour looks at the motive for action. Why did the crisis occur or why was the confidence in the Korean economy suddenly lost? The governmental behaviour approach finds attributes in the Korean economy as motives for individual rationality that lead to collective irrationality. Such irrationality occurs in most markets and is a part of the game. A transparent economy is the best remedy against irrational manoeuvres by investors. Transparency reduces uncertainty and asymmetric information. For example, when a company announces negative results, its share price falls. It is rational for one shareholder to sell, but is it collectively irrational for several to sell? The new information gives the true value of a company, even if no one sold the share, the share would have kept its value but no one would have bought it at the old price either. Corporate society, as institutionalists, see the institutions of the developmental state as responsible for the success of Korean development in the past; however, the balance of power and influence on policy moved from government towards capital, in the form of the chaebols. The ones that advocate the developmental state model hold international financial players responsible. If the Korean economy was less liberalised, and hence less dependent of international financial players, the crisis could have been prevented. Focusing only on transparency is insufficient. The problem was the nervous capital movement caused by liberalisation of the capital account and the missing framework for how to behave. Institutionalists see an international ‘Chapter 11’ as a way of taming international capitalism and irrational behaviour. Corporate society holds that proper reforms initiated by the government and implemented by chaebols would have protected Korea against contamination from regional financial crisis. Confidence would have remained intact and Korea would not have been a victim of contagion from neighbouring countries. The governmental behaviour approach sees the Korean government as the player that was too eager in the growth game for not paying attention to the price collaboration with
industry in the form of fraud, cronyism, and moral hazard prior to the 1990s. During the 1990s, the fractionated government failed to implement policies and reforms to mend the negative externalities from the ‘growth first’ policy. The one-sided focus of the government was not sustainable in the long run.

6.4 Developmental State

The arguments that the developmental state model uses are of great importance. Liberalising financial sectors was a trend in the developed world, and the benefits of having an independent central bank\textsuperscript{12} and liberalised financial sector was taken for granted as being the right steps toward a robust economy. Currency traders’ ability to influence the economies of sovereign states is also a contemporary subject. Currency traders’ power goes beyond national democracy and sovereignty. This paper found the developmental state’s arguments about liberalising partly to be appropriate and currency traders panic inappropriate, in response to the question of what the fundamental cause of the financial crisis was. The developmental state explanation is not very original; however, its arguments are well discussed and hence prove its importance. The assertion is mostly clear and suitable for discussion, except for its use of the notion ‘speculator’. It is a rhetorical manoeuvre and is not very precise. It has a negative connotation in contrast to ‘investor’. A speculator cynically seeks quick profit while an investor creates work, growth, and prosperity. An investor also speculates for profit, and the use of the terms speculator and investor are seldom well considered, except for being polemic. All people generally agree that currency trading is necessary in international trade and that currency derivatives are useful as a hedging tool to reduce currency risk. The largest shortcoming of the developmental state has been the lack of extensive assessment of the crisis’ symptoms, except for liberalisation under external pressure. No maladies were found domestically. One reason why the developmental state approach does not discuss the symptoms like the governmental behaviour and corporate society approaches do can be that the symptoms are given on liberal premises, namely the malady of developmental state
policy in a developed country. The alternative premises given by the developmental state approach is how Korea drifted away from its successful policy of the developmental state through the liberalisation of the financial sector.

According to the developmental state model, the liberalisation of the financial sector, which was a liberal obsession under pressure from the ‘Washington lobby’, led Korea into financial crisis. This paper finds it appropriate to introduce liberalisation unaccompanied by proper regulatory arrangements as a main cause of the financial crisis. External pressure for liberalisation was present. The question is how strong the pressure was, and if the government had enough time to facilitate liberalisation properly. An objection to liberalisation as a cause to the crisis has been that the government failed to liberalise properly. Liberalisation with sufficient supervision and regulation has worked fine in most other OECD countries, compared to what happened in Korea. This paper argues that the pressure for liberalisation is not a reason for under-regulating the financial sector. According to the developmental state approach, a second cause of the financial crisis was reckless speculation from foreign currency traders and panic among foreign creditors. This paper does not share that point of view. Creditors acted collectively irrational and individually rational. Their reaction was based on new information and conditionality. The chaebols’ financial situation was worse than expected and the government was not a guarantor of the loans. Currency traders’ behaviour was in accordance with the existing currency regime in Korea and among its trading partners. Korea’s foreign-exchange management facilitated speculation that deteriorated the won and caused problems for the Korean economy. Every country with a convertible currency and extensive trade with other countries has to be aware of the currency’s vulnerability to currency traders when developing its economic policy and currency regime. How fortunate it is to have an international currency regime that is vulnerable to currency traders with substantial power, in this case, is an appropriate question, but not a part of this discussion about the fundamental causes of the financial crisis.

12 Several market oriented economists as Joseph Stiglitz doubt this dogma though.
6.5 Governmental Behaviour

The assertion of the governmental behaviour model is that the Korean government facilitated fraud and moral hazard by not appropriately considering principal-agent problems in their policy, and by pegging the currency too extensively. The more general critique of the economy is also clear. The business sector did not emphasise solidity and profitability enough, focusing too much on growth. From the perspective of a depreciated currency, it is always easy to criticise a country’s currency regime. The governmental behaviour model always emphasised the danger of pegging the currency. Its objection to Korea’s economic and industrial policy was appropriate. Both the corporate society and governmental behaviour models have described how the chaebols betrayed the government by misusing credit (trust). Growth and investments in industry were speculative and not sustainable. Hence, the credit channelled by the government was misused. Another problem that occurred during the 1990s was the increase in foreign-denominated loans invested in projects with low profitability and projects with long-term returns while the loans were short-term. Based on the national economic fundamentals from the years prior to the financial crisis, the won was over-appreciated. The importance of choosing an appropriate currency regime and assessing moral hazard in relation to the principal-agent theory is relevant in all economies. Criticism by advocates of the governmental behaviour model was highly original prior the financial crisis. Most scholars and institutions such as the World Bank praised the way Korea organised its economy. Since the crisis, the governmental behaviour model has gained disciples.

Referring to Korea’s Confucian heritage is popular. The heritage of a conservative attitude was also present in the state regime. The government maintained its success recipe for too long. It was the governmental behaviour that was the fundamental cause of the financial crisis. Foreign creditors’ and currency traders’ reaction were based on new information about a deceased economy. In regard to the won, it is seldom possible to obtain a unified understanding of one right exchange-rate regime. Even in retrospect, it is hard to agree on whether the Korean exchange rate regime in
the mid 1990s was appropriate or not. However, the governmental behaviour model finds that in Korea’s case, keeping the currency pegged to facilitate repayment of foreign creditors was wrong. Korea’s exchange rate regime may have been inappropriate during the years prior to the crisis, but did the government have any choice considering the high debt level within domestic industry? This leads back to credit liberalisation in financial sector. The pegging of the won gave only a short-term gains, postponing what was to come: a speculative attack on the won due to its artificial strength.

6.6 Corporate Society

Even though the corporate society model consists of elements from the developmental state and governmental behaviour models, it is an original explanation of the crisis. The model does not only assess what the government did or did not do, but also why. The model is less dogmatically insistent than the other two on whether more or less market orientation would have prevented the crisis. In contrast to the governmental behaviour model, it describes how the government was actually willing to change and reform the economy without success. The model identifies the power position of the chaebols as crucial and points to the chaebols as being obstinate toward the government and unwilling to cooperate by undergoing restructuring. The corporate society approach has been an important and fresh contribution to a debate that has the character of being rather dogmatic.

Like the governmental behaviour model, the corporate society model addresses most of the symptoms related to the financial crisis. Its finding is that governmental behaviour was an important contributor to the financial crisis. Together with implicit governmental guarantees, the government appreciated the won for too long and liberalised the financial sector, while the chaebols recklessly borrowed abroad in foreign-denominated currencies with short maturity. The appreciation exhausted foreign reserves, resulting in repayment problems for entities with short maturities of their foreign-denominated loans. On top of it all, accounting standards blurred the
chaebols’ financial situation. What distinguishes the corporate society model is its explanation of why the Korean government acted the way it did. The explanation of the chaebols’ influence on national politics gives the approach an edge in its explanatory power. The developmental state model has pinpointed important elements and problems in international finance. Its shortcoming has been its explanation of Korea’s financial crisis in particular. The corporate society model’s impartiality has been a fruitful contribution to the causes of Korea’s financial crisis. The model coincidentally originates from Korea.

6.7 The Questions

Even though several of the questions can be applied to Korea’s financial crisis, it is not necessary to give the full explanatory power. All three approaches agree that lack of regulation was core to the financial turmoil, albeit they have a different understanding of regulation. In the developmental state model, financial regulation is control and decision-making based on political preferences and goals. Regulation in the governmental behaviour and corporate society models is surveillance and standards of conduct. The approaches’ understanding of the crisis also have a touch of ideological shade (liberal vs. institutional) and hence the discussion is characterised by trench argumentation: what was the fundamental cause of the crisis, what came first, and what led to what? What is less controversial is whether or not certain crises occurred.

- The financial crisis in Korea was a balance-of-payments crisis. We have seen that the won depreciated at the end of 1997, that the BoK lost its foreign reserves, and that the pegged exchange-rate regime collapsed.
- Financial panic materialised in a situation where outstanding short-term debt exceeded short-term assets, resulting in bankruptcy. No single private creditor was able to supply all the funds necessary to pay off existing short-term debt; nor did Korea have a lender of last resort.
- Disorderly workout occurred as illiquid or insolvent borrowers provoked creditors to liquidate even though the borrowers were worth more ongoing.
Foreign investors were provoked to stop rolling over short-term debt and currency traders were provoked to sell won. The foreign investors could have been better off by rolling over short-term debt or not massively selling won. Disorderly workout and financial panic are very similar. The main difference is how the disorderly workout explanation articulates measures for orderly workout to prevent financial panic.

- If there were any bubbles in Korea, they were not obvious. The bubble phenomenon is rather subjective. If the price of an asset is above its fundamental value, it can be a bubble, but it does not have to be a bubble. Fundamental value is not evidently clear either. Suggested candidates for bubbles have been real estate, the won, and corporate debt.

- When guarantees are offered and a principal-agent relationship is present there are also chances for moral hazard. Governmental guarantees were given implicitly and explicitly, and business was the agent for the principal, the government.

- Contagion can be used as an explanation for why the crisis happened when it did. The asserted maladies with the Korean economy were not only present during the second half of 1997. They had been associated with the Korean economy for a longer period of time. That would imply that regional contagion was a necessary condition for the outbreak of the crisis.

- The question has not only been whether or not the government managed to implement the initiated reforms, but also how appropriate the reforms were. The developmental state model’s main argument is that the liberalisation of financial sector, and especially of the capital account, caused the crisis. Corporate society holds that it was the failed reforms that caused the crisis.

- According to the developmental state, it was the very under-regulation from financial liberalisation and poor exchange rate management that caused the financial turmoil. The government put itself into a dilemma after opening the capital account. The exchange-rate regime had to choose whether to facilitate exports or the repayment of foreign debt.
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