The Political Economy of the Korean Financial Crisis

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The political economy of the Korean financial crisis

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ABSTRACT

Much attention has been paid to the economics of the Asian financial crisis, but less to its politics. In this article we examine two clusters of domestic political factors that contributed to Korea’s difficulties. First, a combination of selective liberalization with close government–bank–business relations contributed to the investment boom and excessive leveraging that made the Korean economy vulnerable to external shocks. Second, we examine how politically generated uncertainty in an election year, compounded by features of the party system, resulted in a delayed response to problems in the financial sector and in dealing with the IMF. These delays, in turn, contributed to the length and depth of the crisis.

KEYWORDS
Korea; financial crisis; Asian financial crisis.

INTRODUCTION

Discussion of the causes of Asia’s economic crisis has been dominated by a focus on economic, and especially international economic, factors. ‘Fundamentalist’ accounts place particular emphasis on the commitment to fixed or heavily managed exchange rates, and the related problems of overvaluation, current account deficits, loss of investor confidence and pressure on the exchange rate that can ensue (Corsetti et al., 1998). Critics of the fundamentalist account have underlined the way that premature capital account liberalization increased vulnerability to crisis, and how initial problems were compounded by self-fulfilling speculative attacks and contagion (Radelet and Sachs, 1998).

There can be little doubt that all of these factors operated to some extent, but a number of countries in the region suggest important anomalies in these accounts. Export growth slowed in all countries in the region in 1996, but current account deficits in Korea, Indonesia and Malaysia...
did not deviate substantially from levels that had been financed by private capital inflows in the past. Recent research on the extent of overvaluation suggests that it has been exaggerated, and that, by some measures, the Korean won was even slightly undervalued at the time the crisis broke (Chinn, 1998). And while it is certainly true that Indonesia and Malaysia were affected by events in Thailand, and Korea was affected by contagion from the stock market crash in Hong Kong during the week of 20–24 October 1997, there were signs of vulnerability in all of these economies prior to the onset of the crisis; nor is it true, as Radelet and Sachs (1998) argue, that these warning signs were not visible. Most dramatically, Korea witnessed a number of major corporate failures in the first half of 1997, well prior to the onset of the foreign exchange crisis of early November.

As widespread financial and corporate distress became apparent in 1998, attention has increasingly shifted to a third line of analysis: the domestic factors that generated vulnerability to short-term capital movements, including macroeconomic and other policies that permitted credit and investment booms and weak regulation of financial markets (for example, World Bank, 1998; Krugman, 1998). Behind these policy problems stand important political questions which have received surprisingly little attention (but see Krause, 1998; Pempel, 1999). In this article, we extend this third line of analysis by showing how both structural features of business–government relations and short-term political constraints influenced the onset and depth of the crisis in Korea.

The first question we address is the role the government played in the investment boom that preceded the crisis and resulted in a dramatic increase in corporate indebtedness and deterioration in the portfolios of the banking sector. Critics of the East Asian model, and of Korea in particular, have suggested that some combination of industrial policy and corruption generated fundamental problems of moral hazard; firms invested at high rates because risk was effectively socialized (Krugman, 1998). The banks were willing accomplices in these strategies since they were effectively still under government control.

We examine the causes behind the investment boom of the 1990s. We argue that the role of industrial policy and corruption is exaggerated and that greater emphasis needs to be given to the politically motivated conduct of macroeconomic policy and to risks associated with deregulation. Nonetheless, we show that a number of structural features of business–government relations did generate moral hazard problems, including particularly the continuing involvement of the government in the financial system and the expectations that involvement generated in the financial markets.

The second set of political questions center on how the government responded to impending signs of corporate and financial difficulty and
emerging problems on the external account once they became apparent. Neither the arguments of the ‘fundamentalists’ nor those emphasizing self-fulfilling speculative attacks have addressed the role of political factors in the onset of financial crises. This lacuna is somewhat strange, because the new generation of models of currency crises, pioneered by Obstfeld (1996), placed substantial weight on expectations about the future course of government action. If relevant economic parameters are deteriorating, and investors believe that the policy status quo will persist because the government is prone to delay corrective action, those investors have incentives to exit quickly.

With a fixed term and substantial powers of legislative initiative, the Korean president would appear well-positioned to respond aggressively to potential crises. Moreover, the Kim Young Sam government enjoyed the benefits of unified government, with a clear majority in the unicameral National Assembly. However, policy making in presidential systems depends on the electoral cycle and whether the president and party leadership have control over their own party. Electoral pressures can generate delay and uncertainty, as can circumstances in which the president’s party is internally weak, divided or undisciplined (Haggard and McCubbins, 2000). Cross-national statistical work on the political economy of currency crises confirms the role that electorally generated uncertainty can play in triggering crises (Leblang, 1999; Mei, 1999).

The Kim Young Sam administration first fell victim to electoral pressures in 1995–6, when commitments to the small and medium-size enterprise sector limited the government’s effort to slow the boom. In 1997 divisions surfaced both within the party and between the executive and the legislature. The source of these divisions was the no-reelection rule, a succession struggle within the party for the presidential nomination, and subsequent efforts of both the presidential candidate and the party in the legislature to differentiate themselves from a failed incumbent. An examination of the management of important corporate bankruptcies and financial reform legislation shows that as weaknesses in the financial sector became apparent over the course of 1997, the government was periodically paralyzed by these political constraints. This paralysis, in turn, had a powerful influence on investors and helps explain both the timing and the depth of the crisis.

Our analysis has important implications for the understanding of the ‘Asian model’, and particularly those variants that emphasize the role of the developmental state (Amsden, 1989; Wade, 1990; Evans, 1995; Woo-Cumings, 1999). The developmental state had advantages in spurring rapid capital accumulation, but also rested on a close business-government relationship that carried a number of political dangers, including socialization of private risk taking. Moreover, the political underpinnings of the developmental state have clearly changed
with the transition to democratic rule (Mo and Moon, 1999), and the capacity of the government to discipline business, to use Alice Amsden’s (1989) astute characterization, has declined. An understanding of business–government relations in developing Asia after the crisis must embrace both these political risks – which have spurred national reforms of business–government relations – and the constraints associated with democratic rule.


The roots of Korean firms’ heavy indebtedness and subsequent insolvency are to be found in the investment boom of 1994–6. During those three years, facility investment in manufacturing rose by 38.5 percent per year.¹ Investment was particularly robust in 1994 and 1995, when it grew at rates of 56.2 and 43.5 percent respectively. Korea had not seen this kind of investment expansion since the famed heavy and chemical industry promotion drive of the 1970s.

The investment boom was not uniform across sectors, however (see Table 1). In contrast to Thailand, where property investments played an important role in the subsequent crisis, Korea’s investment boom was led by manufacturing. Within manufacturing, surveys show that the bulk of the investments (65.7 percent) went to expand existing production lines; relatively small amounts were allocated to corporate restructuring and rationalization (15.5 percent), pollution abatement (2.5 percent) or research and development (6.2 percent). Moreover, investments in heavy and chemical industries grew at the annual rate of 43.1 percent while the rate of growth for light industries was only 15 percent. In terms of firm size, large firms rather than small and medium-size firms set the pace; investments by large enterprises grew 45.7 percent while small and medium-size enterprises increased their investments by 17.7 percent. In sum, this was a boom dominated by real manufacturing investment on the part of the large chaebols in heavy industries: autos, petrochemicals, steel and electronics.

For students of Korea, this pattern sounds familiar. Compared with the two previous episodes of rapid investment growth (1972–9, 1983–91), however, the 1994–6 period displays two distinguishing features. First, the emphasis on manufacturing and large enterprises was even more marked than in the past. Second, dependence on foreign currency borrowings was substantially higher in 1994–6 (20.4 percent) than it had been during 1972–9, when it accounted for only 12.9 percent of the total investment, or 1983–91, when it financed 12.1 percent.

Both longer-term structural and short-term economic factors help explain increased facility investments by Korean firms in the mid-1990s.
Table 1  Cycles of facility investments

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<tbody>
<tr>
<td>Average growth rate (%)</td>
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<td></td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>All industries</td>
<td>41.8</td>
<td>1.3</td>
<td>20.0</td>
<td>-1.0</td>
<td>30.1</td>
<td>-18.8</td>
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<tr>
<td>Manufacturing</td>
<td>41.3</td>
<td>-11.3</td>
<td>29.6</td>
<td>-8.9</td>
<td>38.6</td>
<td>-29.0</td>
</tr>
<tr>
<td>Heavy and chemical industries</td>
<td>39.9</td>
<td>-11.2</td>
<td>32.0</td>
<td>-10.8</td>
<td>43.1</td>
<td>-28.6</td>
</tr>
<tr>
<td>Light industry</td>
<td>46.8</td>
<td>-8.2</td>
<td>22.5</td>
<td>0.9</td>
<td>15.0</td>
<td>-32.0</td>
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<tr>
<td>Large enterprises</td>
<td>39.6</td>
<td>0.3</td>
<td>28.7</td>
<td>-7.6</td>
<td>45.7</td>
<td>-11.6</td>
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<tr>
<td>SMEs</td>
<td>53.2</td>
<td>-22.0</td>
<td>24.0</td>
<td>-10.5</td>
<td>17.7</td>
<td>10.5</td>
</tr>
<tr>
<td>Non-manufacturing</td>
<td>42.7</td>
<td>21.8</td>
<td>10.0</td>
<td>15.5</td>
<td>17.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Reason for investment (manufacturing) (%)</td>
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<tr>
<td>Capacity expansion</td>
<td>62.9</td>
<td>62.9</td>
<td>69.6</td>
<td>61.2</td>
<td>65.7</td>
<td>66.5</td>
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<tr>
<td>Rationalization</td>
<td>20.7</td>
<td>20.7</td>
<td>17.3</td>
<td>20.1</td>
<td>15.5</td>
<td>14.7</td>
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<td>Pollution control</td>
<td>4.1</td>
<td>4.1</td>
<td>1.1</td>
<td>2.5</td>
<td>2.5</td>
<td>1.7</td>
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<tr>
<td>R&amp;D facilities</td>
<td>3.6</td>
<td>3.6</td>
<td>4.3</td>
<td>6.6</td>
<td>6.2</td>
<td>8.4</td>
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<td>Others</td>
<td>8.6</td>
<td>8.6</td>
<td>8.5</td>
<td>9.7</td>
<td>10.1</td>
<td>8.9</td>
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<tr>
<td>Sources of funds (manufacturing) (%)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>External financing</td>
<td>76.4</td>
<td>76.4</td>
<td>65.8</td>
<td>68.7</td>
<td>71.7</td>
<td>72.7</td>
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<tr>
<td>Bank loans</td>
<td>20.1</td>
<td>20.1</td>
<td>31.0</td>
<td>31.5</td>
<td>29.5</td>
<td>32.6</td>
</tr>
<tr>
<td>Foreign currency borrowing</td>
<td>12.9</td>
<td>12.9</td>
<td>12.1</td>
<td>10.3</td>
<td>20.4</td>
<td>11.4</td>
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<tr>
<td>Internal financing</td>
<td>23.6</td>
<td>23.6</td>
<td>34.3</td>
<td>31.3</td>
<td>28.3</td>
<td>27.4</td>
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</table>

Sources: Korea Development Bank, Survey of Facility Investment Plans (Seoul), various issues.
Increased investment was in part a response to the decline of Korean firms’ competitiveness, associated with rapid increases in labor costs in the late 1980s, in turn a function of the country’s democratization (Mo and Moon, 1999). As in the past, declining ability to compete in labor-intensive segments contributed to increased purchases of capital equipment, much of it from abroad (Cha, 1998). Cyclical factors also played a role. The country was coming out of two years (1992–3) of negative investment growth, the first time investment had fallen since 1980, and particular sectors, such as semiconductors, were enjoying unprecedented growth. Finally, the yen began to appreciate against the dollar in 1993. This development appeared to provide an opportunity to Korean exporters to take market share from their Japanese competitors. In fact, although the yen continued to rise against the dollar until the second quarter of 1995, it then started an equally rapid descent.

Despite the importance of these economic factors, the government also played a central role in igniting the boom. The first way was through macroeconomic policy. When Kim Young Sam took office, his advisors were concerned that his ambitious economic and political programs would not succeed without a robust economy. Growth was sluggish by Korean standards and the government put priority on ‘recovery’ through an economic stimulus package (the so-called New Economy 100–Day Plan) announced on 22 March 1993. The package consisted of interest rate cuts, increased supply of facility investment funds, and early implementation of government projects. As Table 2 shows, the money supply (M2) increased rapidly in 1993 after the stimulus package was announced.

But investment activity was also affected by a more complex array of liberalization initiatives, supported by market reformers at the Economic Planning Board and Korea Development Institute. These policies included a combination of deregulation of corporate entry and of the financial system. In 1993, the Kim Young Sam government introduced the ‘business specialization policy’ under which the chaebols were asked to designate core industries and phase out their non-core businesses. This policy was designed to curb increasing chaebol concentration, but in return, the government offered exemptions from credit and equity investment controls. The credit control system, which was introduced in 1974 and strengthened in subsequent years, was designed to control chaebols’ expansion through the so-called basket control of credit supply, regulations on entry, investments, acquisition of assets and real estate holdings, and the capital requirements in investment projects.

Because the government had limited entry into a number of sectors in the past, deregulation led to rapid increases in facility investment in some key industries. In 1995–6, the government struggled to deal with the over-capacity in petrochemicals brought by the temporary end of investment controls in 1990. In 1994, the government was pressured to
Table 2 Macroeconomic management, 1993–1996

<table>
<thead>
<tr>
<th></th>
<th>Yen–dollar exchange rate&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Money supply (M&lt;sub&gt;2&lt;/sub&gt;)&lt;sup&gt;b&lt;/sup&gt; (%)</th>
<th>Interest rates</th>
<th>GDP (rate of growth) (%)</th>
<th>Equipment investment (rate of growth) (%)</th>
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<tr>
<td></td>
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<td></td>
<td>Overnight call rate&lt;sup&gt;c&lt;/sup&gt; (%)</td>
<td>Yields on 3-year corporate bonds&lt;sup&gt;c&lt;/sup&gt; (%)</td>
<td></td>
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<tr>
<td>1993</td>
<td></td>
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<tr>
<td>1</td>
<td>117.07</td>
<td>16.7</td>
<td>10.86&lt;sup&gt;a&lt;/sup&gt;</td>
<td>11.44&lt;sup&gt;a&lt;/sup&gt;</td>
<td>4.1</td>
</tr>
<tr>
<td>2</td>
<td>107.34</td>
<td>18.9</td>
<td>13.02&lt;sup&gt;a&lt;/sup&gt;</td>
<td>12.37&lt;sup&gt;a&lt;/sup&gt;</td>
<td>4.9</td>
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<tr>
<td>3</td>
<td>105.28</td>
<td>21.5</td>
<td>12.41&lt;sup&gt;a&lt;/sup&gt;</td>
<td>14.04&lt;sup&gt;a&lt;/sup&gt;</td>
<td>6.9</td>
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<tr>
<td>4</td>
<td>109.70</td>
<td>17.3</td>
<td>11.50&lt;sup&gt;a&lt;/sup&gt;</td>
<td>12.21&lt;sup&gt;a&lt;/sup&gt;</td>
<td>6.7</td>
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<td>1994</td>
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<tr>
<td>1</td>
<td>105.14</td>
<td>15.8</td>
<td>11.29</td>
<td>12.16</td>
<td>8.9&lt;sup&gt;d&lt;/sup&gt;</td>
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<tr>
<td>2</td>
<td>102.72</td>
<td>15.8</td>
<td>12.12</td>
<td>12.39</td>
<td>7.9</td>
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<td>3</td>
<td>98.81</td>
<td>14.8</td>
<td>13.34</td>
<td>13.18</td>
<td>7.8</td>
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<td>4</td>
<td>100.12</td>
<td>17.6</td>
<td>12.92</td>
<td>13.39</td>
<td>9.4</td>
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<td>1995</td>
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<td>1</td>
<td>90.79</td>
<td>16.5</td>
<td>14.17</td>
<td>15.06</td>
<td>10.0</td>
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<tr>
<td>2</td>
<td>84.53</td>
<td>15.9</td>
<td>13.03</td>
<td>14.75</td>
<td>9.8</td>
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<td>3</td>
<td>100.49</td>
<td>13.9</td>
<td>11.50</td>
<td>13.43</td>
<td>9.8</td>
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<td>4</td>
<td>101.81</td>
<td>13.7</td>
<td>11.20</td>
<td>11.93</td>
<td>6.7</td>
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<td>1996</td>
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<tr>
<td>1</td>
<td>105.82</td>
<td>14.6</td>
<td>10.52</td>
<td>11.88</td>
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<td>108.86</td>
<td>16.2</td>
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<td>109.75</td>
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<td>113.76</td>
<td>17.8</td>
<td>13.84</td>
<td>12.27</td>
<td>7.2</td>
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Sources: Economic Planning Board, Ministry of Finance and Economy, Economic White Paper (Seoul, various years); National Statistics Office Major Statistics of Korean Economy (Seoul), various issues.

Notes:
<sup>a</sup> end of quarter
<sup>b</sup> annual increase in end–of–quarter average balance
<sup>c</sup> average over the period
<sup>d</sup> estimates
relax entry and investment restrictions in steel and semiconductor industries. After a long controversy, the government granted Samsung a permit to build a passenger car factory in December 1994. Samsung had made many attempts to enter the passenger vehicle industry against strong opposition by incumbent firms and bureaucrats at the Ministry of Trade and Industry. What appeared to break the stalemate in favor of Samsung was political: the decision to locate the plant in Pusan, the economically struggling hometown of President Kim Young Sam.

The chaebols' motivations for capacity expansion represent the demand side of increased corporate borrowing; we also need to understand the question of why banks lent. As Table 3 shows, the expansion of investment during the 1994–6 period relied heavily on borrowings, especially short-term debt. Again, domestic and international liberalization plays a key role in the story. On the domestic front, the government deregulated the commercial paper market in 1994 by lifting administrative controls on the yields and supply of commercial papers (CP), offering an attractive financing instrument for companies and a profitable market for the CP-discounting merchant banks. The liberalization of the CP market led to the rapid expansion of short-term financing (Cho, 1998).

The Korean government also tried to solve the problem of weak short-term finance companies by offering them new business opportunities instead of forcing them to restructure or close. The government converted 24 financially weak short-term financing companies into merchant banks in two separate rounds, nine in 1994 and 15 in 1996. Most of these new merchant banks aggressively pursued new businesses, including risky foreign exchange transactions. Among the sixteen merchant banks whose licenses were revoked by the government in 1998, 15 were new entrants in 1994–6.

Liberalization of the financial market was not limited to the domestic arena. In the name of globalization, the Korean government eliminated many restrictions on the movement of capital, allowing Korean banks and firms to borrow from abroad and international investors to invest in Korean assets. The foreign supply of capital was plentiful and foreign banks were happy to lend to Korean banks and firms in 1995 and 1996. After Korean joined the Organization for Economic Cooperation and Development (OECD) in February 1996, Korean banks were able to borrow even more easily because of the confidence OECD membership inspired. Between 1994, when Korea's entry passed its first test, and 1996, when it officially joined, foreign banks more than doubled their lending to South Korea, from $52 billion to $108 billion. According to one estimate, about $60 billion of total foreign debt outstanding as of November 1997 were used to finance chaebols' direct investments abroad. Korean banks also invested in foreign assets with funds borrowed from foreign banks in the range of $23 billion.
### Table 3 Funds raised by the corporate sector

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<tbody>
<tr>
<td></td>
<td>Amount (billion won)</td>
<td>%</td>
<td>Amount (billion won)</td>
<td>%</td>
</tr>
<tr>
<td>Total funds raised</td>
<td>89,045.5</td>
<td>100.0</td>
<td>100,016.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Borrowings from banks and NBFIS</td>
<td>39,649.6</td>
<td>44.5</td>
<td>31,854.8</td>
<td>31.8</td>
</tr>
<tr>
<td>Direct finance</td>
<td>33,939.9</td>
<td>38.1</td>
<td>48,070.6</td>
<td>48.1</td>
</tr>
<tr>
<td>CP</td>
<td>4,405.0</td>
<td>4.9</td>
<td>16,096.2</td>
<td>16.1</td>
</tr>
<tr>
<td>Borrowings from abroad</td>
<td>4,407.3</td>
<td>4.9</td>
<td>8,392.3</td>
<td>8.4</td>
</tr>
<tr>
<td>Others</td>
<td>11,043.6</td>
<td>12.4</td>
<td>11,698.5</td>
<td>11.7</td>
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</table>

The idea that Korea’s financial market liberalization was misguided because of the lack of appropriate regulation has now become a leit-motif of the literature on the crisis (Goldstein, 1998; World Bank, 1998). Merchant banks come in for particular scrutiny because of the fact that inability to roll over their short-term foreign borrowings was an important trigger to the crisis. However, the claim of inadequate regulation begs the deeper issue of whether, despite the apparent move to deregulation of both corporate activity and the banking sector, lending was effectively encouraged and supported by government policy, which in turn generated moral hazard.

One argument in the popular press was that industrial policy was the culprit. Certainly, there can be little doubt that the government allocated credit to favored sectors through policy loans and administrative guidance in the past (Cho and Kim, 1995). However, one has to be careful about linking the economic crisis to the moral hazard problem through the route of industrial policy (Chang, 1999). First, the problem of moral hazard in the banking sector had always existed, so we have to ask why it became particularly serious in the mid-1990s. Second, explicit industrial policy had been abandoned beginning in 1986 and, as we have already noted, the government’s push in the direction of deregulation was a theme of the Kim Young Sam administration.

Nonetheless, there are at least four reasons to believe that the nature of business–government relations did in fact contribute to problems of moral hazard during the investment boom of the mid-1990s. First, despite the nominal abandonment of targeted industrial policies, the government did act directly in the financial markets through the Korea Development Bank (KDB), whose main function is to provide long-term investment funds to companies. Since corporate borrowings in 1994–6 were driven by facility investment and the KDB provided a large percentage of facility investment, the private financial institutions may have used KDB lending decisions as signals of government support or of government displeasure. KDB was one of the lead banks with respect to Hanbo, and investigations of the company’s bankruptcy case revealed that commercial banks followed KDB’s lead in increasing their lending to Hanbo in 1993.

Hanbo is arguably a special case of corruption; we return to that issue below. But during the 1994–6 period, the KDB increased credit supply at rapid rates, 26.1 percent in 1994, 24 percent in 1995 and 18.3 percent in 1996. It is noteworthy that the rate of increase in KDB lending surpassed that of facility investment in manufacturing in 1996. At the time, the KDB was supporting the government’s investment promotion policy. Certainly, the KDB had the capacity to influence private financing of investment projects. KDB loans accounted for 11 percent of total financial credit in 1995. More tellingly, the KDB’s equipment investment loans
outstanding as of the end of 1994 (18.2 trillion won) were 45.7 percent of the total outstanding loans of the KDB and all deposit banks (39.9 trillion won). In 1994, the KDB accounted for 44.2 percent of the increase in equipment investment financing by the KDB and all deposit money banks. In short, KDB lending was significant enough to constitute a signal of government policy and commitment.

The second source of moral hazard resides in the incentives for monitoring corporate behavior on the part of banks. The fact that the government still exercised control over the banks reduced incentives to monitor lending, particularly when macroeconomic policy was accommodative. Since the risk for the banks was minimal, the banks became inefficient, backward and dependent. Korean banks are notorious for maintaining an excess number of workers and branches. They also lagged behind in modern financial techniques, emphasizing collateral rather than the merit of investment proposals and cash flow.

Moreover, liberalization created additional incentive problems with respect to Korea’s non-bank financial institutions. The chaebols’ hold on non-bank financial institutions (such as merchant banks) increased following the move toward greater financial deregulation. Since these institutions were used by the chaebols to finance their investments, it is not surprising that they did not carefully monitor their loans to their parent companies. This problem worsened during the 1990s because financial deregulation allowed the non-banking financial sector to expand its market share rapidly. With the rise of non-bank financial institutions with a questionable governance system, the banking sector as a whole became more vulnerable to the moral hazard problem.

Third, there is evidence that the moral hazard problem with respect to corporate failure worsened in the 1990s. In Korea, the government had been the only effective mechanism of corporate discipline because of the underdevelopment of financial markets, including the market for corporate control, and the weakness of internal discipline (such as minority shareholders). During the periods of rapid growth, the Korean government periodically intervened to force insolvent firms out of the market – 1969, 1971–2, 1981–2 and 1985–9. But since the late 1980s, the government had not intervened to force weak firms out of the market. The government did not intervene because it did not want to pay the political costs associated with forced corporate restructuring and because such actions would be incompatible with the policy of deregulation that it tried to promote.

Finally, influence-peddling in the banking sector may have increased, or at least continued, in the mid-1990s. Because of political relationships between politicians, the banks and their clients, the banks had fewer incentives (and weakened information) in managing their loan portfolios. The investigation of the Hanbo bankruptcy revealed the presence of an
influence-peddling network in which the firm lobbied not only bank officials but government officials and legislators to maintain credit lines to Hanbo. All principal actors in the Hanbo lending scandal were members of Kim Young Sam’s political faction including the president of Korea First Bank (Hanbo’s main creditor), key officials in the Ministry of Finance and Economy and the Blue House, and the superintendent of the Bank Supervisory Board (the agency responsible for banking regulations). Chang (1999) dismisses the role of corruption on the grounds that it was limited to a few cases, but Hanbo’s significance to the banking sector should not be underestimated. As we will see, the effects of corruption are not limited to the moral hazard it engenders; corruption also affects the credibility of government policy more generally.

Explaining the pattern of investment during a short time frame is necessarily a risky business, since market forces as well as government policies come into play. A combination of politically motivated macro-economic policy and, particularly, deregulation contributed to the burst of facility investment in the mid-1990s. However, the nature of government intervention in the economy and, more profoundly, ongoing characteristics of business–bank–chaebol relations also contributed to the moral hazard problem in the banking sector. These characteristics included direct government involvement in lending, weak incentives for banks to conduct due diligence and monitoring functions, the expansion of the chaebols into the non-bank financial sector, unwillingness to force corporate bankruptcies, and outright corruption. These distorted incentives in the financial sector allowed the chaebols to raise and invest unprecedented amounts of capital in 1994–6.

II GOVERNMENT RESPONSES: THE POLITICS OF ADJUSTMENT

Assessing how governments respond to emerging economic problems is always difficult and necessarily involves counterfactual analysis. When did the government become aware of problems? What options were technically feasible? How did politics shape such information and the nature of the choice set? Is it reasonable to expect that alternative actions might have been taken? Here, we present brief case studies of three issues on which the government itself was aware that some corrective action was required. We first look at periodic pressures before 1997 to stabilize and slow the pace of growth. We argue that these efforts were defeated by other political objectives, including the belief that strong growth was needed to pursue other reforms, political commitment to the SME sector, and electoral constraints. The government also failed to deal with the more pressing issues of how to manage emerging corporate and
financial distress and the deterioration of the external account in 1997. We show that pressing political problems associated with the election and fragmentation within the ruling party inhibited a coherent government response.

**Slowing high growth**

It is difficult to pinpoint an exact moment when the balance of concerns among policy makers shifted from accelerating to stabilizing the economy, but warning signs emerged early. The current account shifted into deficit in January 1994. The appreciation of the yen ended in the second quarter of 1995 and its depreciation quickly followed. As early as February 1995, some analysts issued warnings about the level of facility investment (Marvin, 1998) and voiced fears that further investments would lead to larger current account deficits, overcapacity and lower corporate earnings.

To induce a soft landing, the government introduced measures to control corporate investments. On 14 February 1995, the MOFE asked the chaebols to adjust their investment plans. The government then tried to slow money supply growth. Indeed, the money supply (M2) increased at a relatively low rate (12–16 percent) and interest rates rose in the first half of 1995. After allowing Samsung’s entry in the passenger car industry in December 1994, the government decided to put further deregulatory actions on hold. Plans for relaxing entry barriers and investment controls in power-generating equipment and semiconductor industries were scrapped in April 1995, generating criticism that the government was reversing its commitment to deregulation. Finally, the government moved to discourage large firms from using foreign borrowings to finance their facility investments. Some of the steps announced in May 1995 included lowering the maximum amount of foreign currency loans that a firm could obtain and strengthening banks’ foreign currency reserve requirements.

But these efforts were only half-hearted, and one reason was the performance of the small and medium enterprise (SME) sector. Since democratization began in 1987, each government had responded to a strong anti-chaebol sentiment among the public by promoting SMEs; the Kim Young Sam administration was no exception. When initial political reform efforts lost momentum and appeal, Kim Young Sam initiated the globalization campaign, but with important compensatory elements (Moon and Mo, 1999). Government support programs for SMEs mushroomed and SMEs, along with the farmers, became the biggest beneficiaries of government programs (Kim and Mo, 1999). While large firms were adding capacity after 1994, SMEs were slow to recover from the 1992–3 slowdown, and officials cited the difficulties of small and
medium-size enterprises as one reason for not taking strong stabilization measures.  

Government efforts to reduce surplus capacity even weakened in 1996 in anticipation of the National Assembly elections of April 1996. The government used its regulatory powers to restrict investments; for example, it tried but failed to induce petrochemical companies to negotiate a voluntary ‘investment adjustment’ agreement among themselves and rejected Hyundai’s application to enter the steel industry. But concerns about a slowdown dominated, and even with the election behind it, the government went back to promoting facility expansion in the second half of 1996. By the end of 1996, another electoral cycle – the race for the presidency in 1997 – began to influence macroeconomic policy.

On coming to office, Kim Young Sam placed priority on growth; part of the reason for this was a quite traditional response to the business cycle, but it also stemmed from concerns about the performance of the SME sector. With sluggish performance among the SMEs, there was little political incentive for stabilization in 1995, when warnings about overexpansion first appeared. Once the government lost the chance to stabilize in 1995, the political opportunities for doing so after that time were lost to the electoral calendar.

Managing bankruptcy: the Kia case

President Kim Young Sam’s political decline and lame duck status can be traced to the Hanbo scandal which broke in January 1997. Although there were several failures of smaller chaebols in the second half of 1996, Hanbo was the country’s fourteenth largest industrial group. The government denied allegations of impropriety following the announcement of Hanbo’s collapse. However, a series of subsequent bribery arrests, and above all the arrest, National Assembly testimony, and conviction of the president’s son, Kim Hyun Chul, substantially weakened the president’s standing. Kim Young Sam’s withdrawal from the political arena accelerated in the period prior to his party’s nominating convention in July 1997. Unlike his predecessors, and partly because of his own political liabilities from the Hanbo scandal, Kim refused to actively participate in the process of choosing his successor.

Kim’s apparent personal conflicts with the leading candidate, Lee Hoi Chang, contributed to dividing the ruling party before the election. Lee was able to capture the party’s nomination on 21 July, showed a substantial lead in the polls and appeared to be on his way to victory in December 1997. However, his popularity plummeted when it was revealed that his two sons had avoided military service for being underweight. A debate within the party quickly opened on whether he should be replaced.
While the ruling party faced defections, Kim Dae Jung’s position was strengthened by an unlikely alliance with conservative candidate Kim Jong Pil; the combination of the ruling party’s blunders and the alliance of the two Kims opened the possibility in the early fall that Kim Dae Jung might actually win the presidency.

In sum, the political background to policy making in this period includes a severely weakened president and a divided ruling party headed by a candidate desperately trying to differentiate himself from the incumbent. Ruling party legislators naturally had concerns about the party’s fate as well, and, as we will see, were disinclined to take actions that would damage the party in the run-up to the presidential elections.

The disposition of the Hanbo case sent mixed signals about the government’s intentions with respect to failing enterprises and exacerbated uncertainty about the health of the banking system. The government made no effort to save Hanbo’s management; the firm was effectively nationalized. But new money was also injected. When two more of the top 30 chaebols folded – Sammi in March and Jinro in April 1997 – 35 commercial and state banks announced an ‘anti-bankruptcy’ pact, under which they would continue to extend credit to any top 50 chaebol at risk and defer debt payments for 90 days as long as the company was ‘basically sound’ and came up with a ‘self-rescue’ package. Since the anti-bankruptcy pact necessarily called the position of the banks into serious question, the government had to supplement the concerted lending and rescheduling effort with a new initiative to inject liquidity into the financial system.

Beginning in July 1997, Korean financial and foreign exchange markets entered a period of marked turbulence and uncertainty, and the government’s management of the Kia bankruptcy was clearly a major cause. Unlike other highly diversified conglomerates, Kia had attempted to focus its business strategy in the automotive sector, but its entry into autos threatened substantial surplus capacity in the sector. The Kia crisis broke on 23 June, when Kim Sun-Hong, chairman of the group, appealed directly to the government for assistance in persuading creditors not to call maturing loans. What ensued was a highly politicized battle over the future of Kia, in which its management sought to blackmail the weakened government, locked in a tightening presidential race, into providing a bailout. Refusing to resign, the group’s chairman mobilized support for the company from suppliers, employees, competitors and the public at large. On 21 July, a coalition of over 60 social groups, including such unlikely partners as the anti-chaebol Citizens’ Coalition for Economic Justice and the independent Korea Confederation of Trade Unions, formed a ‘save Kia’ movement (Korea Newsreview, 26 July 1997, p. 16). On 4 August the banks postponed their final decision on the bailout package until 29 September and withheld further lines of...
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credit in the interim. Kia’s management quickly threatened that many of Kia’s suppliers would fail, and appealed to the government to intervene.

According to Kim Sok Tong, chief of the Ministry of Finance and Economy’s Foreign Capital Section, a number of the major Korean commercial banks were technically insolvent after Hanbo’s collapse, but the government was doing everything in its power to stave off outright bankruptcy (Cho and Pu, 1998: 126). On 25 August the government announced measures to shore up the financial system, with a target of providing at least $8 billion of liquidity for the banking system (Newsreview, 30 August 1997, pp. 24–5). At the same time, the government began to signal its impatience with the open campaign for intervention and support that Kia was waging, and with the entire anti-bankruptcy pact on the grounds that the uncertainty and delay over the future of the firm had become a major source of financial market uncertainty.

The Kia management sought to exploit legal loopholes to avoid bankruptcy. But one powerful weapon the government maintained in trying to force the company toward receivership was the threat that it would not guarantee the foreign obligations – $687 million – of the firm. The final meeting of creditors on 29 September delivered an ultimatum to Kia Motors and its subsidiary, Asia Motors, but it took a full month, until 22 October, the day before the biggest stock market fall in Hong Kong, before the government intervened to definitively settle the Kia issue.

Thus by late October, the Korean banking system had been severely damaged not simply by the string of corporate bankruptcies themselves, but by a highly politicized and uncertain process which left the ultimate disposition of Kia and its creditors in limbo for months. Korea’s tottering financial system was thus already in severe distress when the shock from Hong Kong hit on 23 October. On 28–30 October, the government halted trading of won after it depreciated by its daily limit of 2.5 percent, despite heavy market intervention to support it (Newsreview, 1 November 1997, p. 15). On 28 October, the government announced yet another package designed to induce an infusion of foreign capital by marginally raising foreign ownership limits on the stock exchange, at a time when investors were rushing for the exit. Moody’s and Standard & Poor’s downgraded the credit rating of Korean banks on 1 and 3 November, respectively. Foreign banks began to refuse to roll over the short-term foreign debt of Korean financial institutions and the foreign press began to issue reports that the Bank of Korea’s foreign exchange reserves were evaporating and that it had committed to extensive forward contracts to defend the won for the rest of the year (Cho and Pu, 1998: 91).
Managing the balance of payments crisis

Whether a full-blown crisis could have been averted after the shock from Hong Kong constitutes an important counterfactual, and there are certainly good reasons to think that it could not. Deputy Prime Minister and Minister of Finance and Economy Kang Kyung Shik’s strategy included passing the financial reform legislation the government had introduced in August 1997, initiating financial stabilization measures, seeking alternative financing from the USA, Japan and elsewhere, and then only after these efforts failed, turning to the IMF. Yet Korea’s appeal to other lenders as well as its negotiations with the IMF were going to be heavily influenced by the government’s ability to undertake a credible reform program. In secret discussions with the Korean economic team, the IMF understood clearly that the issue was not simply one of acting decisively, but of guaranteeing legislative commitment to the program that would make it credible as well.

At the end of the second week of November 1997, it appeared that the package of financial reform bills was headed for passage. A subcommittee under the National Assembly’s Finance and Economy Committee passed the package by a vote of 6–2 and passed it to the full committee for a vote on the 14th. However, one of the contentious issues in the reform package was the creation of a new Financial Supervisory Board (FSB) which would consolidate a number of existing regulatory agencies, and whether it would be under the direct control of the Prime Minister or the Minister of Finance and Economy, where the National Assembly believed it would have more supervisory powers.

The issue had a long history and involved a conflict between the Ministry of Finance and Economy and the BOK over central bank independence and the placement of regulatory authority. The BOK wanted to increase its independence while maintaining its authority to regulate commercial banks. The Ministry of Finance and Economy wanted the Bank to give up its regulatory power in return for more independence. After many months of negotiation, at first at the Presidential Commission for Financial Reform and later within the government, the heads of the Ministry of Finance and Economy and the BOK agreed to a financial reform package on 16 June 1997. But officials of the BOK revolted against their governor and rejected this compromise.

The labor unions representing the Bank of Korea and the four agencies targeted for elimination were particularly opposed to the potential impact on agency employees. Bank of Korea workers demonstrated in front of New Korea Party headquarters on 13 November, and employees of the Securities Supervisory Board and the Insurance Supervisory Board protested in front of the National Assembly and Bank of Korea on the 14th (Korea Herald, 15 November 1997). The employees all threatened...
to strike immediately after the National Assembly passed the reform legislation, and a group of former central bank governors held a press conference to voice their opposition to the bills.

In principle, the ruling party could have passed the bills on its own, but Lee Hoi Chang’s supporters were rightly concerned about the political cost of doing so. Kim Dae Jung did not want to alienate labor just before the election and could easily make an issue of the legislation; the ruling party thus preferred to consult with the opposition to secure their support. However, the opposition had few incentives to cooperate. If they signed on, they would be associated with potentially costly reforms, while if they postponed their assent, any negative economic effects of postponing the reform package would most likely rest at the feet of the president and the ruling party candidate, Lee Hoi Chang. Kang Kyung Shik and his staff tried in vain to persuade the National Assembly to pass the financial reform legislation on the last day of the session, but the Finance and Economy Committee didn’t bother to send the bills to the floor for debate. The markets were clearly negatively affected by the failure to pass the reform legislation, and the only hope of avoiding the IMF was to secure bilateral support from Japan or the United States, perhaps with some relatively small amount of additional IMF support.

Kang recognized that it would be difficult to secure such support in any case, but given the central bank’s loss of reserves and open disagreement within the government on how to respond, some policy initiative was required. Kang proposed to the president a package consisting of some measures for dealing with insolvent financial institutions and a widening of the trading band for the won to 15 percent, but the president at this juncture decided to dismiss Kang and several other economic advisors. By this point, it is difficult to disentangle the economic from the political; if the dismissal of Kang was designed to restore confidence, it hardly succeeded. On the 19th and 20th, the BOK lost $1.6 billion and $1.1 billion of reserves, and on 21 November a new Minister of Finance and Economy announced it was going to the IMF.

As in Indonesia, there is substantial debate about whether the IMF program in Korea was appropriately designed or not, both with respect to the demands it placed on fiscal and monetary policy and in the closing of failed banking institutions. We find it plausible that both of these criticisms are justified, and that the failure of the IMF program to stem the decline of the won was related to problems of program design. However, it is also important to point out that the initial response of the markets to the announcement that Korea was going to the Fund was positive, even though the foreign exchange and equity markets were characterized by substantial turbulence in the two weeks during which the program was being negotiated. Moreover, while it is true that the finalization of the program did not stabilize the markets, the period of
further deterioration between the time the program was announced on 3 December 1997 and its revision and augmentation on 24 December overlapped with the final weeks of the election campaign. Too much attention has been given to Kim Dae Jung’s remarks that the program might require renegotiation; in fact, his remarks did not have that implication and in any case he quickly retreated from that position to pledge his support. Nonetheless, political uncertainties continued to operate during this period, as is evident from the closeness of the final presidential vote; Kim Dae Jung won by only two percentage points of the vote, and only with a plurality, given Rhee In Jae’s capture of 20 percent of the vote.

However, the most telling evidence of the effects of the impending election on policy comes from what transpired after it was over. The very bills which the National Assembly failed to pass as a package in November passed in special sessions of the National Assembly during the transitional period between Kim Dae Jung’s election and inauguration, with the exception of institutional changes that appeared to expand presidential power.

III CONCLUSIONS

Financial crises are clearly complex events, and a series of international and domestic economic and policy factors combined to generate Korea’s difficulties. However, we believe that inadequate attention has been paid to the domestic political sources of the crisis, both in the long and the short run. We have shown how a countercyclical macroeconomic policy and deregulation increased Korea’s vulnerability to short-term capital movements. However, ongoing features of the government–banking–chaebol relationship played an important role as well. Weak monitoring of bank and corporate activity contributed to the investment boom, the high leveraging of Korean corporates, and the deteriorating quality of banks’ portfolios. Given the increasing openness of the economy to foreign capital, this combination was a dangerous one.

Furthermore, we emphasize the weakness of the government in responding to incipient signs of crisis. We certainly do not mean to fault democracy per se; authoritarian governments in Korea – including Park Chung Hee’s in 1978–9 – have also proven reluctant to impose adjustment costs and authoritarian Indonesia experienced the worst crisis in the region. Moreover, democracy proved advantageous in allowing a failing administration to be replaced. Nonetheless, it is clear that a variety of new political commitments, including support for SMEs and concern with legislative elections, blunted pressure for stabilization prior to 1997. In that year a complex of political problems undermined the coherence of government policy and generated profound market uncertainties even
before the effects of regional contagion became manifest. Only with the election of Kim Dae Jung reform efforts began in earnest, underlining that it is politics, and not crises per se, that determines the timing and shape of reform efforts.

Our analysis has implications for understanding the future of the ‘Asian model’, and particularly those variants that emphasize the role of the developmental state (Amsden, 1989; Haggard, 1990; Wade, 1990; Woo-Cumings, 1999). Close business–government relations were a central feature of the developmental state model (see particularly Evans, 1995), but as Evans and others recognized, the salutary effects of such relations depended heavily on the ability of the government to act as a counterweight to private economic power. In the absence of such a counterweight, whether political or bureaucratic, there was little reason why such relations could not degenerate into rent-seeking (Maxfield and Schneider, 1997). A return to the advantages of close business–government relations thus also requires that the government retain the independence to manage those relations in such a way as to avoid capture (Haggard et al., 2000).

NOTES

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1 Facility investments refer to equipment, machinery and vehicles.
2 Testimony of Park Jae Yoon on 4 February 1999 at the National Assembly hearings on the economic crisis.
3 Interview with Taeho Bark, a former economist at the Blue House.

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