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The Triumph of the Rentiers?
The 1997 Korean Crisis in a Historical Perspective

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1. Introduction

The causes of the 1997 Korean financial crisis, together with those of the recent crises in other Asian countries, have been, as we all know, hotly debated. Especially in the early days of the crisis, many commentators argued that the crisis was caused by fundamental institutional deficiencies of the Korean economy that encouraged inefficiencies and excesses by systematically protecting the investors from the negative consequences of their poor decisions.[1] However, others, including surprisingly many mainstream economists, have argued that the crisis was largely the result of a premature and ill-managed financial liberalisation (and the dismantling of other "traditional" policies) in the context of an increasingly volatile international financial market.[2]

The present paper aims to shed some new light on this debate from a historical perspective by comparing the three episodes of foreign debt crisis in modern Korean history (1970-72, 1980, 1997) and the evolution of the country's financial system before and after these crises. Through this comparison, the paper shows that the 1997 crisis is distinguished from the previous crises in many ways, but most importantly in the way it has been managed in the interests of the financial rentier class, rather than of industrial capitalists. It is argued that the changes in the country's financial system and corporate governance system that have been made

[1] Examples include Krugman (1998a, 1998b), Frankel (1998), Brittan (1997), and McKinnon & Pill (1998).

[2] The mainstream works that argue along this line include Corden (1998), Furman & Stiglitz (1998), Radelet & Sachs (1998), and Stiglitz (1998). Non-mainstream works along this line include Kregel (1998), Singh (1998), Taylor (1998), and Chang (2000).

during the crisis management process are likely to dampen, rather than enhance, Korea's future growth dynamic.

The paper is organised in the following manner. The next section (section 2) describes the main characteristics of the "traditional" Korean financial system that was behind the country's economic success until the late 1980s. The following section (section 3) discusses and compares the three episodes of foreign debt crisis. Section 4 describes the institutional "reforms" following the 1997 crisis, which aim for an even greater degree of financial liberalisation and opening-up and analyses (and speculates about) what this means for the future of the Korean economy. Section 5 sums up the discussion and concludes.

2. The Korean Financial System during the High-Growth Period

As it is well known by now, one of the most striking features of the Korean economy during its high-growth period was the "repressive" and closed nature of its financial system. The main elements of the financial policy regime that lasted until the early 1990s (although in a more muted form since the late 1980s) were the following.

First of all, financial policy was run as an accessory to industrial policy. Although the Korean government had a great aversion to running public debt, it ran a relatively loose monetary policy in order to maintain a generally expansionary macroeconomic environment. Expansionary macroeconomic policy was regarded as crucial in sustaining the "investors' confidence" necessary for continued investments, which in turn were regarded as crucial for industrial upgrading (Chang, 1993). In this process, the interests of the financial rentier class were "repressed", as reflected in the low profitability of financial institutions, and as most dramatically exemplified in the government-declared moratorium on curb market loans in 1972 (see section 3.1).

Underlying such regime of “financial repression” was the view of the then ruling elite, who came to power through the 1961 military coup, that financial rentier class was at best a “necessary evil” and at worst a parasitic group damaging “genuine” entrepreneurs engaged in production. Such view is well reflected in the following commentary on the pre-1961 financial system made by the official Summary of the First Five Year Plan (published in 1962):

"[O]nly the privileged few who had access to bank credits were able to enjoy profit from production activities …. Instead of making creative and honest efforts to improve management and techniques of production, many entrepreneurs went into unsavory league with politicians and bureaucrats seeking to amass easy fortunes …. Industries were compelled to resort to high interest private loans, and, consequently, usurious lending activities flourished .... The degradation of banking not only discouraged development but also distorted or corrupted the ideals underlying national institutions and distorted the sense of social justice." (pp. 11-12; translation by Kim, 1995).

Although such view softened over time and eventually (from the late 1980s) gave way to monetarist thinking, which essentially puts the interest of the financial sector before that of the industrial sector, it will be difficult to make sense of Korea’s financial system before the mid-1990s without recognising that the government basically saw finance as a servant to industry.

Secondly, the country’s financial system was a “bank-based” one, and a government-dominated variety of it at that. In the 1962 revision of the central bank act, the Bank of Korea

Act, the Minister of Finance was made the head of the Monetary Board (later re-named the Monetary Policy Committee) of the Bank of Korea, thus depriving the central bank of its independence.

Moreover, the banks were, regardless of their ownership status, practically run as public enterprises. A substantial proportion of the banks were “special purpose banks” that were 100% owned by the government - such as Korea Development Bank, Korea Exchange Bank, Korea Housing Bank, and the Bank for Small and Medium-Sized Firms. Even in the case of the other banks, where the government did not have the majority stake, the government maintained its absolute control through the “temporary” law introduced in 1961, which limited private shareholders' voting rights, and subsequently through the 1981 provision in the Banking Act that replaced the “temporary” law, which set a 8 percent ceiling on bank share ownership for any individual or a group of related shareholders.

Thirdly, through its control of the banking system, the government implemented various directed (and usually subsidised) credit programmes, known as “policy loans”. As it is well known, these loans were the key instrument in the industrial policy regime of Korea.[3]

The regime of policy loans was perfected when the Korean-style “main bank” system was introduced in May 1974, following the 1970-2 crisis (see section 3.1), on the recognition that a tight monitoring is necessary in order to ensure efficient use of policy loans (and the foreign debts that usually accompanied them). By appointing one of the largest lending banks to

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[3] The importance that was attached to policy loans is testified by the fact that, even in times of macroeconomic stabilisation, the amount of policy loans was actually *increased* at the expense of other loans (see Itoh, 1982).

each of the *chaebols* (which took the lion's share of policy loans) as its "main bank", the government made it sure that there was someone who took an active interest in supervising the use of policy loans. If the main bank was not satisfied with the performance of the recipients of its policy loans, it had to report it to the government, which then would decide on the punishment for the lax performance (e.g., refusal to extend new loans).

Fourthly, and probably most importantly for the purpose of the present paper, a tight capital control existed – on both inflows and outflows.

Unlike Japan or Taiwan, which have had "structural trade surplus" since the 1960s, Korea suffered from a chronic foreign exchange shortage.[4] And when combined with the structural political uncertainty due to the presence of North Korea, a very tight control on capital outflow was seen as absolutely necessary for maintaining economic stability – those who engage in capital flight could be sentenced to death in extreme cases. Central to this regime of control were the so-called Foreign Exchange Concentration System, under which all foreign exchange had to be surrendered to the central bank, and the Foreign Exchange Management Act, which put severe restrictions on the use of foreign exchange (e.g., limits on overseas remittances, on

[4] Between 1945 and 1997, the country recorded trade surplus only for 3 years. It will have posted trade surplus for two years by the end of 1999. However, the two periods of trade surplus are very different from each other because the latter is due to a massive collapse of imports following the 1997 crisis, while the former was achieved amidst the biggest economic boom in the country since the mid-1970s.

overseas real estate acquisition, or even on expenditure on foreign tourism, which was severely restricted until the late 1980s).[5]

At the same time, the Korean government almost fully controlled foreign borrowing and the use of the borrowed capital through the Foreign Exchange Management Act (1961) and the Law for Payment Guarantee of Foreign Borrowing (1962). In 1966, the Law for Payment Guarantee of Foreign Borrowing was merged with the Special Law to Facilitate Capital Equipment Imports (1962) and the Foreign Capital Inducement Law (1960) into the Foreign Capital Inducement Law, in an attempt to improve the effectiveness of the guarantee procedures for foreign borrowing so that what the government considered “unnecessary” or “wasteful” uses of scarce foreign exchange could be prevented.[6] Government control of foreign borrowing meant that the government could control not only capital inflow at the macro level but also the destinations of investment at the micro level, given the critical importance of imported capital

[5] As we shall see later, this system of foreign exchange control began to be relaxed from the late 1980s (see section 3.3).

[6] In the case of foreign *public* borrowing, the borrowing proposal had to be considered first by the relevant ministries, after which the Ministry of Finance had to conduct economic and feasibility studies. The proposal then had to be approved by the Economic Planning Board, which will make it sure that it is consistent with the Five Year Plan and the budgetary plans, and eventually by the Parliament. Only then the borrowing will be approved and government payment guarantee granted. In the case of foreign *commercial* borrowing, the proposal had to satisfy the Guidelines for Commercial Borrowing (issued by the Ministry of Finance) and get passed the Ministry’s Foreign Capital Project Committee in order to get the government approval and guarantee.

goods in investment in late-developing countries.[7]

3. Three Episodes of Foreign Debt Crisis

Since the early 1960s, the Korean economy has experienced three episodes of big surge in foreign borrowing, all of which eventually ended up in a debt crisis. The first episode of debt crisis that happened during 1970-2 was the result of the introduction of a McKinnon-Shaw-style financial reform in 1965. The second episode that occurred during 1980-2 was the outcome of the Heavy and Chemical Industrialisation (HCI) programme launched in 1973, which was financed by the cheap oil money following the First Oil Shock and severely hit by the world recession following the Second Oil Shock. The third crisis that broke out in 1997 was the result of the large-scale financial liberalisation and capital market opening since the mid-1990s that

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[7] The fact that the Korean government provided payment guarantee to all foreign borrowings during this period has been frequently criticised for creating "moral hazard" on the part of the borrowers. However, especially for a developing country, whether or not foreign borrowings had been formally guaranteed by the government or not, a foreign debt crisis compels the government into providing *ex post* payment guarantees to foreign lenders. The best example that illustrates this point in the Korean context is the current financial crisis, where the government was forced to provide such *ex post* guarantee despite the fact that, in the building up of foreign debts during the 1990s, the government did not provide any formal *ex ante* payment guarantee for foreign loans. If the government has to provide *ex post* payment guarantees once a debt crisis breaks out, it may be better for it to provide *ex ante* guarantee while trying to minimise moral hazard in the system by tightening the loan approval and monitoring procedure.

financed excessive and duplicative investments in the industrial sector.

In this section, we discuss in some detail the causes and the resolution (still on-going in case of the 1997 crisis) of these three episodes of foreign debt crises, so that we can understand the current crisis better by putting it in a historical perspective.

3.1. The Unknown Crisis: the late-1960s to the early-1970s

Korea introduced a McKinnon-Shaw-style financial reform in 1965, which, among other things, raised real interest rates to an unprecedented level. Real interest rate on deposits rose from -6.4% on average for the 1960-64 period to the average of astonishing 26.9% during 1965-9 (calculated from Dornbusch & Park, 1987, p. 419, table 14). This naturally created a huge interest rate gap between domestic loans and foreign loans, generating a very strong incentive to contract foreign loans, especially cash loans that enabled the borrower to re-lend the money in the curb market, which paid even higher interest rates. The result was a rapid rise in foreign debts. As we can see from table 1, between 1964 and 1967 Korea's total foreign debt rose 3.7-fold (from $177 million to $645 million) and the debt/GNP ratio rose 2.5-fold (from 6.1% to 15.1%).

In the face of such rapid foreign debt accumulation, the government announced the Rationalization Measure for Foreign Capital Inducement in December 1967. The Measure set ceilings on foreign borrowing, especially cash loans, with a view to contain the debt-service ratio at below 9% (it was already 10.7% in 1966). It also raised the ratio of domestic fund reserve required for the approval of foreign borrowing. However, foreign debt kept on growing. It nearly doubled between 1967 and 1968, and the debt/GNP ratio rose by over 50% (from 15.1% to 22.9%).

As a result, the government introduced even stronger measures (most of them in 1969) in order to “improve the quality of foreign loans”, which meant encouraging public loans and discouraging private loans, especially cash loans. They included the strengthening of the qualifications needed for the grant of government payment guarantee, the imposition of ceilings on commercial loans, the prohibition of cash loans other than borrowing by public corporations or borrowing from international institutions, and the introduction of new guidelines for the management of insolvent firms with foreign debt.

Thanks to these measures, for a few years after 1969, the growth of foreign debt slowed down. During the 3 years between 1969 and 1971, total foreign debt grew by 62.3% (recall that it nearly doubled between 1967 and 1968), and the debt/GNP ratio rose by less than 15% (from 27.2% to 31.2%), whereas it rose by over 50% between 1967 and 1968.

However, domestic financial problems accumulated in the meantime. High economic growth from mid-1960s enhanced the optimism of the Korean firms, leading to an investment boom during the second half of the 1960s. Gross domestic investment ratio, which averaged only 13% between 1960 and 1965, rose to an average of 23.5% between 1966 and 1969. However, the high interest rates that prevailed after the 1965 liberalisation squeezed corporate profitability, thus prompting many firms to borrow even more to meet their interest payments obligations.

Table 1. Korea's Foreign Debt Profile, 1960-97

Year	Total Debt (millions of dollars)	Share of Short-term Debt (%)	Foreign Debt to GNP (%)	Debt Service Ratio (%)
1960	83	1.2	3.9	0.4
1961	83	n.a.	3.9	0.4
1962	89	n.a.	3.8	0.7
1963	157	14.0	5.8	0.9
1964	177	5.6	6.1	2.6
1965	206	1.5	6.9	5.0
1966	392	1.8	10.7	2.9
1967	645	10.2	15.1	5.2
1968	1,199	7.4	22.9	5.2
1969	1,800	10.8	27.2	7.8
1970	2,245	16.6	28.1	18.2
1971	2,922	16.4	31.2	20.4
1972	3,587	17.8	33.9	18.4
1973	4,257	16.5	31.5	14.2
1974	5,933	20.9	32.0	11.2
1975	8,443	28.5	40.5	12.0
1976	10,350	28.9	36.7	10.6
1977	12,649	29.4	33.8	10.2
1978	14,823	21.3	28.5	12.1
1979	20,287	26.9	32.5	13.6
1980	27,170	34.5	44.4	13.3
1981	32,433	31.5	49.0	14.3
1982	37,083	33.5	52.0	16.2
1983	40,378	30.0	50.8	15.7
1984	43,053	26.5	49.5	16.5
1985	46,762	23.0	52.1	18.7
1986	44,510	20.8	42.3	20.8
1987	35,563	26.1	27.6	29.6
1988	31,150	31.4	18.0	13.8
1989	29,368	36.8	13.9	9.7
1990	31,700	45.3	13.3	8.0
1991	39,135	44.0	13.9	4.6
1992	42,819	n.a.	n.a.	n.a.
1993	43,870	43.7	12.7	n.a.
1994	56,850	n.a.	14.2	n.a.
1995	78,439	n.a.	16.1	5.4
1996	104,695	58.3	20.2	5.8
1997	120,800	n.a.	25.5	n.a.

Sources: Economic Planning Board and Bank of Korea

As the current account deficits started swelling from a very small positive balance in 1965 to the equivalent of 10% of GDP in 1966 and 15% of GDP in 1967, and then finally to 27% and 26% of GDP in 1968 and 1969 respectively, the IMF intervened with an orthodox adjustment programme in 1969. The programme demanded, among other things, the devaluation of the local currency (Won), the abolition of export subsidies and import restrictions, ceiling on foreign borrowings, and the tightening of monetary supply. Initially, the Korean government objected the programme, but in 1970 it finally had to accept it (except for the demand for the abolition of export subsidies), because the IMF and the US government made the continuation of US government loans conditional on the acceptance of the programme.

The combination of devalued currency, high interest rates, and tight money supply following the IMF programme naturally resulted in a sharp fall in the profitability of non-financial firms and a rapid piling-up of non-performing assets in the banking sector. Interest payments as a proportion of net sales in the corporate sector rose from the average of 3.9% during 1963-65 to the average of 5.6% during 1966-68, and then to 7.8% in 1969 and 9.2% in 1970, and finally to 9.9% in 1971. Given the tight monetary policy, many firms had to increase their reliance on the informal financial market (the so-called curb market) for their survival, which increased their long-term financial burden even more. By 1972, the consequent increase in corporate bankruptcy pushed the country closer and closer to a full-blown foreign debt crisis, as many of the bankrupt firms had foreign debts, and prompted the Korean government into implementing a series of extraordinary measures.

The most important of these measures was the President's Emergency Decree on Economic Stability and Growth announced on 3 August 1972 (the so-called “August 3 Decree”), which bailed out debt-ridden manufacturing firms by declaring a moratorium on the payments of all corporate debt to the curb market lenders for 3 years – probably the most extreme example of "financial repression" in recent world history.[8] It was declared that, after the end of the moratorium, all curb market loans were to be converted into 5-year loans at the annual interest rate of 16.2% (at the time, the curb market interest rate was more than 40%). An extensive rescheduling of bank loans at a preferential rate was also implemented, with the central bank supporting the rescheduling by accepting the special debentures issued by the commercial banks.

A total of 210,000 cases and 357.1 billion Won of curb market loans were reported by the creditors and 345.6 billion Won by the debtor firms. The amount was equivalent to around 42% of total bank loans. As a result, the interest payments burden of the firms (measured by the ratio of interest payments over net sales) was reduced from 9.9% in 1971 to 7.1% in 1972 and to 4.6% in 1973 and 4.5% in 1974. This ratio stayed constant at 4.9% between 1976 and 1978.

The August 3 Decree, of course, raised the fear among the Korean policy-makers that the rescued firms would become lax in management, believing in continued government support. The trouble that it had to go through in sorting out the financial troubles of a number of major firms with foreign debt in 1969 (through essentially government-mediated takeovers) must have made it realise that there needs to be a more systematic approach to corporate governance.[9]

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[8] However, it should be noted that a substantial proportion of the loans in the curb market was in fact made by large industrial firms, as it made perfect sense for those firms with surplus cash to loan it in the curb market.

[9] The details of the 1969 enterprise restructuring programme, which was managed by a special task force answerable only to the President, has never been made public.

Consequently, the government introduced a series of policy measures intended to improve corporate governance in the aftermath of the August 3 Decree.

The main pillar of these measures was the Presidential Directives on the Inducement of Public Listing and the Sound Management of Private Enterprises (announced on 29 May in 1974). These Directives included the following five major elements. (the details are from Kim, 1997): (i) measures to expedite public listing of corporations; (ii) an information system regarding the credit and tax-paying status of non-listed firms and of their major shareholders; (iii) strengthening of credit restrictions to large firms in order to reduce their dependence on bank credit; (iv) provisions to force highly-leveraged firms to sell part of their businesses when they enter a new business; (v) strengthening of tax collection mechanism and of outside auditing on enterprises and their major shareholders.

The Directives were accompanied by a few more implementational measures to provide the Office of Bank Supervision with the authority to extensively scrutinise the financial state of the business conglomerates (the *chaebols*), which were the main recipients of policy loans and foreign borrowing. According to these measures announced on 30 May and 31 May in 1974, the Office was given the authority to scrutinise, at any time, the state of bank debts, assets, the distribution of share ownership, and foreign debts of the *chaebols*. The Office also had the power to control the amount of new bank credits to the *chaebols*. Also, the Bankers' Association agreed to discriminate against *chaebols* with weak financial status in their lending decisions.

The measures taken to resolve Korea's first debt crisis, while highly unconventional, set the stage for a renewed growth in the following years. The profitability and the financial health of industrial corporations were restored through a brutal confiscation of the financial rentier class as well as through a series of government-mediated corporate restructuring. In addition, the corporate governance system was improved by strengthening the banking system's monitoring and sanction mechanism over the *chaebols*.

3.2. The Notorious Crisis: the late 1970s to the early 1980s

With corporate profitability restored through the August 3 Decree and associated measures, the Korean economy started to accelerate once again. In 1973, the government announced the famous (or notorious, if you are a mainstream economist) Heavy and Chemical Industrialisation (HCI) programme, with an emphasis on six strategic industries – steel, non-ferrous metal, shipbuilding, chemical, electronics, and machinery. The government provided supports to the firms in the strategic industries through preferential bank loans, government investment and loan programmes, tax exemptions, accelerated depreciation allowances, cuts in import tariffs for capital and intermediate goods, the establishment of industrial estates by state expenditure, and so on (for further details, see Chang, 1993).

After experiencing a minor decline in growth rate during 1974 and 1975 in the aftermath of the First Oil Shock – the GDP growth rate slowed down from 12.8% in 1973 to 8.1% and 6.6% in 1974 and 1975 respectively – a major investment and growth spurt started. Gross Fixed Capital Formation grew in real terms by 21% in 1976, 28.7% in 1977, and an astonishing 34.4.% in 1978. And GDP grew at 11.8%, 10.3% and 9.4% in 1976, 1977, and 1978 respectively.

By late 1978, the economy was showing signs of strain. Major investments were made in the HCI industries, but many projects naturally had some way to go before they could turn profitable. Above all, many of them were suffering from very low capacity utilisation ratio, because many plants were (correctly from a long-term point of view) built on scales that needed to export in order to be profitable but major inroads into export markets were yet to be made.

The government made some attempt in 1979 to stop or scale down some of the duplicative investments, but had little success in the face of unstoppable optimism in the private sector (for more details, see Chang, 1987).

The Second Oil Shock in 1979 and the subsequent introduction of monetarist macroeconomic policies in the US and other major industrial economies pushed the Korean economy into an unprecedented crisis. Import bill was skyrocketing with the quadrupling of oil price, the major export markets were in serious recession, and above all, the hike in interest rate resulted in a crushing foreign debt repayment burden. Foreign debt/GNP ratio rose from 25.8% in 1978 to 44.4% in 1980 and 49% in 1981 (see table 1). Financial costs as a proportion of manufacturing value added increased from the average of 16.5% between 1974 and 1978 to 19.2% in 1979, to 28.7% in 1980, and eventually to 32.4% in 1981 (Chang, 1987).

In the face of the macroeconomic instability and corporate distress, the Korean government announced a stabilisation programme with an IMF support in January 1980. However, the tight monetary policy wreaked havoc on the corporate sector, and by June 1980, the Korean government moved away from the monetarist macroeconomic policy stance.[10]

In addition, the 1980 crisis management also included an "industrial restructuring" programme, which imposed forced mergers and market segmentations in 6 industries which were most seriously suffering from over-capacity – power-generating equipments, passenger cars, diesel engine, heavy electrical machinery, electronic switching system, and copper smelting

[10] Similar macroeconomic policy U-turn was observed during the current crisis, but the damage done by high-interest policy in the 1997 was greater as the initial credit squeeze was much more severe (see section 3.3).

(see Chang, 1987, for details).[11] Some financial liberalisation measures were also implemented – bank privatisation, a partial liberalisation of entry by foreign banks, increase in the number of industries that were allowed to borrow from abroad, re-allowance of cash loans in certain “key” industries – but the government maintained a strong grip on the financial sector. Strong capital control that had characterised the Korean financial system was maintained[12] and the government regulations over foreign debts were strengthened (see Amsden & Euh, 1990, for further details).

Subsequently, between 1985 and early 1988, the government once again took up the task of restructuring the overseas construction and the shipping industries, which were the main sources of non-performing assets in the 1980s, and some other “sunset” industries.[13] The Industrial Policy Deliberation Council was set up to select industries as targets for “rationalisation” and approve the merger plans submitted by the main lending banks and the over-taking firm. The Law on Tax Deduction and Exemption was revised in 1985 so that, when

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[11] This is the precursor of the so-called “Big Deal” industrial restructuring programme implemented after the 1997 crisis, but with more coherence and more direct government mediation than the “Big Deal”. See section 3.3.

[12] It was no coincidence that there was virtually no capital flight from Korea around the early 1980s international debt crisis - a major contrast with some Latin American debtor countries during the time (Sachs, 1984).

[13] The popular view is that it was mainly the HCI industries that produced all those non-performing assets in the Korean banking system, but the main sources of non-performing loans were in fact overseas construction and shipping industries, which were not really objects of industrial policy. Amsden (1994) reports that about 60% of non-performing assets of the Korean banks in the mid-1980s were accounted for by construction industry alone.

firms in industries designated for rationalisation merged with other firms in the same industry or sold their assets in order to enter into new (promising) lines of business, they were given tax privileges (e.g., partial exemption of capital gains tax or acquisition tax).

By 1985, the 1980 crisis was largely resolved and the Korean economy entered a new economic boom accompanied by unprecedented trade surpluses between 1986 and 1988. The resolution of the 1980 crisis did not involve direct attacks on financial rentier interests as in the early 1970s crisis, but still bore the hallmark of the pre-1990s Korean economic system. Despite the initial credit squeeze, the pro-investment stance of macroeconomic policy was sustained, and the state control over finance – especially capital control – was largely maintained. The state-mediated corporate governance system was also very much in evidence, as seen in the industrial restructuring exercises (the 1980 industrial restructuring programme and various "rationalisation" exercises during the second half of the 1980s). This recurrent pattern, however, breaks down in the management of the 1997 crisis, which we shall turn to in the following section.

3.3. The Misunderstood Crisis: 1993 to 1997

As we mentioned above, some financial liberalisation measures were taken in the immediate aftermath of the 1980 crisis, but the basic nature of Korea's financial system did not change until the late 1980s. Since then, however, there were a number of structural changes that created pressures for more fundamental changes in the financial system.

First of all, the importance of non-bank financial institutions (NBFIs) started to increase rapidly from the mid-1980s, and by the late-1980s, their importance in the financial system started to outweigh that of the banks.[14] Given that these institutions were subject to much less strict governmental regulation (in the case of the now-infamous merchant banks, it was virtually non-existent), the government's grip on the financial system weakened as never before. The *chaebols* were especially keen to acquire NBFIs, as their ownership of banks was strictly controlled.

Secondly, the large trade surplus generated between 1986 and 1989 made the existing mechanisms of capital account control problematic. Given the Foreign Exchange Concentration System, under which all foreign exchange had to be surrendered to the central bank, the large trade surplus generated excess liquidity in the system, prompting the government to relax restrictions on foreign exchange use. Although trade surplus disappeared subsequently, the surge of capital inflow in the 1990s provided the justification for the continued raising of the ceilings on foreign exchange holdings until the system was finally reduced to near insignificance in 1995.

Thirdly, the increased credit ratings of Korean corporations and banks in the international financial markets meant that the government's grip on the financial sector was diminished even more. By the late 1980s, the private sector seems to have started regarding government involvement in their foreign exchange transactions as a burden rather than a necessity - as we mentioned, previously they simply had not had the creditworthiness to borrow in the international capital market without government guarantees.

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[14] The share of commercial bank assets in total assets of financial institutions fell from 80% in the first half of the 1970s (average for 1971-76) to 73% by the early 1980s (1979-81 average). By 1985, this ratio fell to 59% and then finally below 50% in 1988 (48%). The fall slowed down since then, and the ratio stayed at 42% during the mid-1990 (1993-96 average).

By the early 1990s, the above-mentioned "structural" pressures towards financial liberalisation were becoming very strong. Meanwhile, since the late 1980s, the US government started to put enormous pressure on the Korean government to open up the financial market. The agreement from the March 1992 bilateral talks with the US subsequently formed the basis for the 1993 financial liberalisation programme. The decision of the Kim Young Same government made in 1993 to apply for membership of the OECD also subjected Korea to further external demands for financial market liberalisation.

A series of liberalisation and opening-up measures taken in the early 1990s finally resulted in a fundamental change in the Korean financial system. As we can see from table 2, the changes included, among other things, interest rate deregulation, abolition of “policy loans”, granting of more managerial autonomy to the banks, reduction of entry barriers to financial activities and, most importantly, capital account liberalisation, something that Korea’s previous plans of financial liberalisation had characteristically failed to include.

As it is well known, the result of this financial liberalisation was the accumulation of a huge amount of short-term foreign debts, which led to the 1997 financial crisis. Foreign debt nearly trebled from $44 billion in 1993 to $120 billion in September 1997. This debt build-up was almost twice as fast as that during 1979-85, the period of the country’s second foreign debt crisis following the 1982 Mexican default - Korea's foreign debt grew at 17.8% per annum during 1979-85, while it grew at 33.6% per annum during 1994-96. While Korea’s overall foreign debt was *not* at an obviously unsustainable level[15], the overall debt figures do not tell us the problem

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[15] The World Bank considers countries with debt/GNP ratios under 48% as low-risk cases, but Korea’s debt/GNP ratio was only 22% in 1996, and was still around 25% on the eve of the crisis.

with its maturity structure. As we can see from table 1, the share of short-term debts in total debts rose from an already high 43.7% in 1993 to an astonishing 58.3% by the end of 1996. The magnitude of this problem can be better comprehended if we recall that during the times of the country's two earlier crises, this figure never rose above 20% and 35% respectively (see table 1).

The corresponding figures at the end of 1995 were 70% for Mexico, 57% for Indonesia, 35% for Thailand, 33% for Argentina, and 24% for Brazil (World Bank, 1997). Also, in terms of debt service ratio, Korea on the eve of the 1997 crisis was well below the World Bank 'warning' threshold (18%) at 5.4% in 1995 and 5.8% in 1996. These compare very favourably with those of countries like Mexico (24.2%), Brazil (37.9%), Indonesia (30.9%), Thailand (10.2%) in 1995 (World Bank, 1997).

Table 2. Major Financial Liberalisation Measures in Korea during the 1990s

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1) **Interest rates deregulation** (in four stages: 1991 to July 1997)
- By 1997, all lending and borrowing rates, except demand deposit rates, were liberalised

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2) **More managerial autonomy for the banks and lower entry barriers to financial activities**
- Freedom for banks to increase capital, to establish branches, and to determine dividend payments (1994)
- Enlargement of business scope for financial institutions (1993)
: continuous expansion of the securities business of deposit money banks (1990, 1993, 1994, 1995)
: freedom for banks and life insurance companies to sell government and public bonds over-the-counter (1995)
: permission for securities companies to handle foreign exchange business (1995)
- Abolition of the limits on maximum maturities for loans and deposits of banks (1996)

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3) **Foreign exchange liberalisation**
- Adoption of the Market-Average Foreign Exchange Rate System (1990)
- Easing of the requirement for documentation proving “real” (i.e., non-financial) demand in foreign exchange transactions (1991)
- Setting up of foreign currency call markets
- Revision of the Foreign Exchange Management Act (1991)
: changing the basis for regulation from a positive system to a negative system
- Introduction of 'free Won' accounts for non-residents (1993)
- Allowance of partial Won settlements for the export or import of visible items (1993)
- Foreign Exchange Reform Plan (1994)
: a detailed schedule for the reform of the foreign exchange market structure
- A very significant relaxation of the Foreign Exchange Concentration System (1995)

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4) Capital market opening
- Foreign investors are allowed to invest directly in Korean stock markets with ownership ceilings (1992)
- Foreigners are allowed to purchase government and public bonds issued at international interest rates (1994), equity-linked bonds issued by small and medium-sized firms (1994), non-guaranteed long-term bonds issued by small and medium-sized firms (Jan. 1997), and non-guaranteed convertible bonds issued by large companies (Jan. 1997)
- Residents are allowed to invest in overseas securities via beneficiary certificates (1993)
- Abolition of the ceiling on the domestic institutional investors' overseas portfolio investment (1995)
- Foreign commercial loans are allowed without government approval in so far as they meet the guideline established in May 1995
- Private companies engaged in major infrastructure projects are allowed to borrow overseas to pay for domestic construction cost (Jan. 1997)
- Liberalisation of borrowings related to foreign direct investments related (Jan. 1997)

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5) Policy loans & credit control
- A planned termination of all policy loans by 1997 is announced (1993)
:a step-wise reduction in policy loans to specific sectors (e.g., export industries and small and medium-sized firms)
- Simplifying and slimming down the controls on the share of bank's loans to major conglomerates in its total loans

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Source: Chang et al. (1998)

As the downfall (and the related corruption scandal) of the new major steel company, Hanbo, and the bankruptcy and the subsequent nationaisation of the third largest car manufacturer, Kia, battered international confidence in Korea during the first half of 1997, the financial crisis in Southeast Asia broke out, dragging the country into the whirlpool. Once the international lenders lost confidence in the economy, it did not matter whether their view was justified or not. International lenders stopped rolling over Korean debts from the fall of 1997, and the country finally had to go to the IMF for a rescue package in December 1997 (for a more detailed chronology of the crisis, see Chang, 1998).

Under a most comprehensive and tough IMF programme, with stiff macroeconomic conditions and unprecedented demands for institutional changes (especially regarding corporate governance), the economy contracted to an unprecedented degree. In a country where 5% growth had been considered a “recession”, the economy shrank by 5.8% in 1998, recording the biggest contraction in output since the Korean War (1950-53). Industrial production was especially adversely affected and fell by 7.5%.

The virulence of the 1997 crisis may be put into a clearer perspective by comparing it with the 1980 crisis, which resulted in the biggest fall in output before the 1997 crisis (-2.7%).

According to the figures released by the Bank of Korea, gross fixed capital formation fell by 21.2% in 1998, whereas in 1980 it recorded a 10.7% fall. Particularly hard hit was the machinery and equipment investment, which fell by a staggering 38.5% (a particularly large fall, given that it already fell by 8.7% the previous year). The corresponding fall in 1980 was 24.6% (and at that after a very large positive growth in 1979 – 23.3%). Exports in 1998 fell by 2.8% (in value terms) for the first time since 1958, whereas they grew at 16.3% in 1980.

Unemployment rose from 2.5% just before the crisis (and from the trough of 2% in 1996) to the height of 8.7% in February 1999 (it is reported to have fallen since March 1999), in contrast to the rise from 3.8% in 1979 (or from the trough of 3.2% in 1978) to 5.2% in 1980. Income inequality also worsened markedly following the crisis – the ratio of the income of the top quintile to that of the bottom quintile rose from 4.49 before the crisis to 5.38 by 1999 (*Joongang Daily Newspaper*, 18 June, 1999) and the ratio of the income of the top 10% to that of the bottom 10% rose from 7.1 in the first quarter of 1995 to 9.8 in the first quarter of 1998 and 10.2 in the first quarter of 1999 (*Daehan Maeil Newspaper*, 25 June, 1999). The worsening of income inequality in the aftermath of the 1980 crisis was not very significant, if at all.[16]

It is not simply its virulence but also its management that sets the 1997 crisis apart from the earlier crises. In the management of the 1997 crisis, the traditional anti-finance/pro-industry stance of the Korean government was abandoned. In the management of the 1997 crisis, credit squeeze was much greater than in the two earlier episodes of crisis - loans by deposit money banks *fell* by 0.1% in 1998, whereas they *grew* by about 28% during 1970-1 and by about 36% in 1980. Especially important in creating the credit squeeze during the 1997 crisis was the newly-introduced BIS capital adequacy standard, whose pro-cyclical nature only amplified the crisis (see section 4 for further discussion). Even the fall in exports following the 1997 crisis, which contrasts with the continued rise in exports after the 1980 crisis, owed significantly to the squeeze on export credits, rather than to an over-valued currency or to the depressed world market conditions (the world economy was in a deep recession in the early 1980s, whereas it has

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[16] Of the five estimates of trends in income inequality reviewed in Ahn (1996), two showed a small fall in Gini coefficient between 1980 and 1982 (from 0.389 to 0.357 and from 0.409 to 0.393) and three showed a small rise during the same period (from 0.386 to 0.406, from 0.356 to 0.385, and from 0.337 to 0.376).

remained relatively buoyant since 1997).

As the credit squeeze crushed the economy, the IMF belatedly took a U-turn and allowed the Korean government lower interest rates and (in the face of continued aversion of the Korean government to budget deficits) pushed it to increase budget deficit (the 4th agreement in May 1988 – see table 3). And largely as a result of this U-turn, the speed of contraction of the economy slowed down from the 4th quarter of 1998, and by the end of the first quarter of 1999, the economy started to recover rapidly. Some are now even predicting an 8% growth for 1999.

Table 3. Changes in the Contents of the IMF Programme during the 1997 Crisis

	Macroeconomic Targets for 1998	Monetary policies	Measures for promoting domestic demand
First Memorandum (3 Dec. 1997, revised 24 Dec. 1997)	-Growth rate (GDP): 3% -Inflation: 5% -Trade Surplus: $4.3 billion -Central Government Deficit: Balance or Surplus -Unemployment Rate: 3.9%	-Tight monetary policy -High interest rate policy -Financial sector restructuring -Interest rate over 30% -Elimination of upper limit in interest rate	-Emphasis on tight fiscal policy rather than promotion of domestic demand
7 Jan.1998 Agreement	-Growth rate: 1~2% - Inflation: 9% -Trade surplus: $3 bil. -Usable reserves: $24 bil. (1st Qt.) -Unemployment Rate: 5%	-Establishing foundation for interest rate stabilisation -Monetary base: 14.9% (1st Qt.)	-Inevitable Fiscal deficits allowed
7 Feb.1998 Agreement	- Growth rate: 1% - Inflation: 9% -Trade Surplus: over USD 8 billion -Usable reserves: $20 billion (1st Qt.), $30 billion (2nd Qt.) -Unemployment Rate: 6-7%	-Cautiously Permit lowering inter-bank call rate conditional on the market situation - Increase in money growth rate target monetary base: 13.5% (1st Qt.), 14.1% (2nd Qt.)	-Allow fiscal deficit up to 0.8% of GDP -Reduction in luxury goods tax
2 May 1998 Agreement	- Growth rate: -1% or less - Inflation: less than 10% - Trade Surplus: $21~23 bil. -Usable reserves: $32 bil. (2nd Qt.)	-Pursue a continuous fall in inter-bank call rate	-Fiscal deficit allowed up to 1.7% of GDP -Increase in support for small and medium sized companies
24 Jul. 1998 Agreement	-Growth rate: -4% - Inflation: 9% - Trade Surplus: $33~35 bil.	-Lower interest rate by flexible monetary control	-Fiscal deficit allowed up to 5 % of GDP
29 Oct. 1998 Agreement	- Growth rate: -4% -Inflation: 8% -Trade Surplus: $ 37bil.	-Eliminate the limit on the growth rate of reserve money	
13 Nov. 1998 Agreement	-Growth rate for 1999: positive -Inflation: 5% -Current account surplus: about $20 bil. (7% of GDP) -Usable reserves (targeted to reach $41 bil. at end-1998): already reached $45 bil. at end-October and are expected to rise moderately in 1999	-Maintain the easy monetary stance, consistent with achievement of the inflation target and stability of the exchange rate -BOK intervention in exchange rate: limited to smoothing operations	-Fiscal deficit: around 5% of GDP in 1998 -Direct social safety net outlays: to increase from W5.7tril. in 1998 to W8.2 tril. (about 2% of GDP) in 1999 -Public works programs: W2 tril. - Outlays for job training: W0.8 tril. in 1999
31 Mar. 1999 Agreement	-Growth rate for 1999: over 2% -Inflation: around 3% -Current account surplus to narrow significantly but remain substantial. -Usable reserves, which reached $48.5 bil. at end-1998, to rise further in 1999	-Continuing a flexible Interest rate policy -Broad money (M3) growth expected at 13–14% in 1999. -BOK intervention in exchange rate will be limited to smoothing operations.	-Fiscal deficit allowed up to 5% of GDP for 1999 -Import financing for small- and medium-sized enterprises: at least $1 bil. -BOK rediscount of export bills for small- and medium-sized enterprises: $0.3 bil.

Sources: KIEP(1998), *Adjustment Reforms in Korea since the Financial Crisis (Dec. 1997 - June 1998)*

MOFE(1998), *The Agreement Between Korea and the IMF for Fourth Quarter*

MOFE(1999), *The First Letter of Intent Agreed between Korean Government and IMF in 1999*

Samsung Economic Research Institute (1998), *One Year after the IMF Bailout: A Review of Economic and Social Changes in Korea*

What do we make out of this rapid recovery? Does it prove that the IMF policy was a success, as the IMF and its supporters claim? Our contention is that it does not.

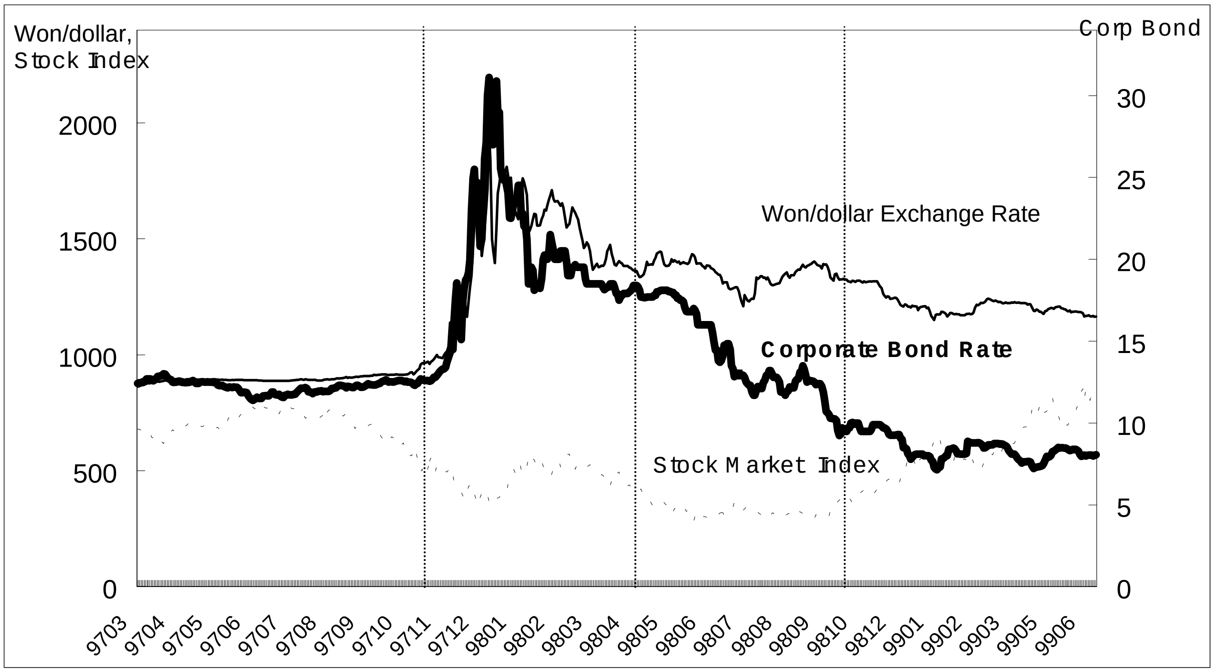
First of all, the recovery is largely a natural reaction to the easing of the initial macroeconomic policy that was excessively tight and unnecessarily shrank the economy. The fact that the financial markets did not stabilise until May 1998, when the IMF abandoned its earlier policy (see Figure 1) suggests that the country could have recovered much more quickly and much more strongly, had the IMF policy not been so restrictive.

Secondly, the quality of the recovery is not as impressive as it looks. Even an 8% growth in 1999 will mean that the economy is only 1.7% larger than what it was in 1997. In contrast, in 1981, the year after the country's worst crisis before the current one, the economy recorded a 6.2% growth following a 2.7% contraction in 1980, which meant that Korea's 1981 GDP was 2.1% higher than that in 1979. The current recovery looks even less impressive when we consider its performance in terms of unemployment and inequality (see above).

More importantly, it is questionable whether the recovery is sustainable in the medium term. The current phase of recovery has been led by consumption rather than investments. What is worrying is that the rise in consumption seems to be largely fuelled by the wealth effect created by an overly-inflated stock market, which in turn was the result of the excess liquidity created by the easing of monetary policy (since the third quarter of 1998) in the face of a dramatic collapse in real investments. Stock market price index, which fell below 300 (297.9, to be precise) in the second quarter of 1998 went up to 562.5 by the fourth quarter of 1998, broke the 1,000 barrier in July 1999, and since then have been moving around 900 (at the time of writing).

In theory, the increase in consumption through wealth effect may eventually lead to an increase in investments, which should make the recovery sustainable, but it is questionable whether the stock market will be buoyant for a long enough period of time, especially given the imminent large-scale correction (or collapse?) in the US stock market.

Figure 1. Trends in Financial Market Variables



Sources: BOK, MOFE, Major Economic Statistics

What is more worrying, however, than the medium-term sustainability of the recovery is that the changes in the country's institutional configuration that were made in the process of crisis management, especially the ones regarding the financial system but also regarding the corporate governance system, are likely to have negative effects on the long-term dynamism of the economy – an issue that we wish to discuss in the following section of the paper.

4. Institutional Changes after the 1997 Crisis – What Future for Korea?

The policy package that was adopted in order to manage the (still-unresolved) 1997 crisis was not entirely in the mould of the standard IMF package and still showed some traditional Korean streaks. For the most important example, the Korean government pushed the *chaebols* into a "voluntary" industrial restructuring programme involving mergers and business swaps in 8 industries (semiconductor, automobile, power-generating equipments, naval diesel engine, aircraft, petrochemical, petroleum refining, and railway carriage) – the so-called "Big Deal". Although this programme is not part of a coherent long-term industrial policy as in the case of previous industrial restructuring programmes, it is similar to its earlier counterparts in its spirit.

However, in general, the crisis management package implemented since 1997 has resulted in institutional changes that are likely to significantly transform the nature of the Korean economy. Are these changes for the better or for the worse? Important changes were made in other areas too (e.g., employment institutions, bureaucratic recruitment and appointments), but, given the nature of the paper, we will confine our discussion to institutional changes that concern the financial system and to a lesser extent the corporate governance system, and discuss what they mean for the future of the Korean economy.

First of all, the "pro-finance" policy stance, which characterised the macroeconomic policy in the early days of the current crisis, was subsequently institutionalised through a series of legal changes in the financial system. To begin with, the role of the central bank was redefined into a fundamentally monetarist (i.e., pro-finance) one. In the old central bank act, the Bank of Korea (BOK) Act, the BOK was supposed to maintain the "soundness of the banking and the financial system" (which can mean a lot of things in practice) as well as price stability. The new Act that took effect from April 1999 specifies that price stability should be the sole aim of the BOK. This change, while appearing minor, has profound implications for the Korean financial system, as it de-legitimises the kind of pro-investment, pro-growth monetary policy that characterised the Korean financial system up to now. Moreover, the banking law and other financial laws were revised in a way that strengthens the shareholder interest in the running of the banks, thus making it possible and, more importantly legitimate, to defend financial interests at the cost of industrial interests (something that was not allowed before).

The second important institutional change in the Korean financial system that followed the current crisis was the introduction of the BIS standard on capital adequacy ratio into the financial system. The BIS standard has certain merits (e.g., simplicity, transparency), but one important problem with it is its pro-cyclical nature as proven by the recent Korean experience – in recession, increased bankruptcy and fall in asset prices shrink the banks' asset bases, which makes them withdraw their loans in order to meet the standard, thereby making the recession even worse.[17] Moreover, the very way in which the BIS standard is defined encourages the holding of liquid assets and therefore a strict enforcement of the standard, to which the Korean government claims to be committed, will make the banks reluctant to lend to industrial projects that involve large sunk costs.

The third important institutional change made after the current crisis was a radical capital market liberalisation and capital account opening, including the full-scale liberalisation of corporate borrowing from abroad (which makes government regulation of foreign debts much

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[17] It should also be noted that the introduction of the BIS standard in Korea was done at the worst time- in the middle the deepest recession in the country's modern history.

more difficult) and the complete opening of the stock and bond markets to foreigners. As shown in Figure 1 above and Table 4 below, these changes have increased the volatility in the financial market, which is not conducive to long-term investments and therefore harmful for the country's investment-growth dynamics. Table 5, which charts the changes in the average holding periods and the turnover ratios for different types of investor in the Korean stock market between 1996 and 1999, shows that what lies behind this worrying trend is the dramatic shortening of the duration of financial asset holding as a result of the radical liberalisation of the financial market.

Table 4. Volatility of Financial Market Variables

	Mean	Standard Deviation	Coefficient of Variation	Volatility*
KOSPI (stock market index)				
Jan. '93 – Nov. '97	830.19	130.06	0.1567	0.00538
Dec. '97 – Sep. '98	538.17	210.71	0.3915	0.01260
Oct. '98 – Sep. '99	676.09	204.61	0.3026	0.01176
Interest Rate**				
Jan. '93 – Nov. '97	12.73	1.10	0.0861	0.00337
Dec. '97 – Sep. '98	12.69	5.23	0.4118	0.01040
Oct. '98 – Sep. '99	8.86	0.94	0.1059	0.00656
Won/Dollar Exchange Rate				
Jan. '93 – Nov. '97	815.47	49.84	0.0611	0.00200
Dec. '97 – Sep. '98	1,319.23	155.28	0.1177	0.00854
Oct. '98 – Sep. '99	1,216.29	50.03	0.0411	0.00202
May '98 – Sep. '99***	1,256.69	80.46	0.0640	0.00280

*The standard deviation of log-differenced values.
**Yield of corporate bond with 3-year maturity.
***This periodisation is used on the ground that exchange rate stabilised markedly from May 1998.

Table 5. Stock Holding Periods (months) and Turnover Ratios (monthly, %) of the Different Groups of Investors

Year		1996	1997	1998	1999 (January-July)
Foreign Investors		22.3 months 54 %	14.4 months 83 %	11.5 months 104 %	9.3 months 129 %
Domestic Investors		12.3 months 97 %	-	-	2.6 months 466 %
	Individuals	5.8 months 207 %	-	-	1.2 months 1,041 %
	Investment Trusts	11.2 months 107 %	-	-	2.4 months 502 %
	Banks	46.8 months 26 %	-	-	6.6 months 183 %

Source: Korea Stock Exchange

Also problematic is the demand made on the *chaebols* that they bring down their debt-equity ratio from above 400% to 200% by the end of 1999, which made them cut down on new investments as well as engage in "distress selling" of their existing assets. The short-run effect of this change was to create a downward investment spiral. But more importantly, in the long run, if they continue to meet this demand, the Korean corporations are unlikely to be able to mobilise the funds necessary for the kind of aggressive investment strategy that they have traditionally pursued. The hope held by the policy-makers who introduced this rule is that the deregulation of the stock market will lead to a greater reliance of the *chaebols* on direct financing. However, given the well-known short-term orientation of the stock market, which is markedly worsening in Korea at the moment (see table 5), it is unlikely that the Korean firms are going to be able to mobilise through the stock market enough "patient" funds needed for the investments in large-scale industries.

5. Concluding Remarks

The present paper has tried to put the 1997 Korean crisis into a historical perspective by comparing the three episodes of foreign debt crisis in the country's postwar history (1970-72, 1980, and 1997).

The 1997 crisis signifies an important watershed in modern Korean economic history. It is not simply that it was the result of the disintegration of the "traditional" economic system, where industrial interests dominated financial rentier interests. What is more important is that the crisis has been managed in the interests of financial rentiers, rather than for the industrial interests as in previous crises - through monetarist macroeconomic policy, full-scale financial liberalisation, and capital account opening, among other things. More importantly, it has brought about institutional changes that is likely to end the dominance of industry over finance that has characterised the Korean economic system.

In contrast, the 1970-72 crisis, although its origins also can be found in a radical financial liberalisation, was resolved through a most dramatic instance of "financial repression" in the interest of industry (the August 3 Decree) and the introduction of more, and not less, financial regulations. In the case of the 1980 crisis, financial libersalisation did not play a role in its making, and its resolution involved only relatively mild and mostly formalistic financial liberalisation measures.

Is this transition to a new economic system desirable? We have shown that it is unlikely to be so. We pointed out that the short-term performance of this new system in resolving the crisis has been much poorer than that of the traditional system. And this was despite the fact that the external economic conditions have been much more favourable than in the two earlier crises

– they were followed, respectively, by the First Oil Shock of 1973-4 and the Monetarist world recession of the early 1980s. From the longer-run perspective, we argued that the institutional changes made in the Korean economic system following the 1997 crisis are likely to dampen the economy's investment dynamism by making the financial system much more volatile and "conservative" than before, thus making long-term, patient capital much more scarce.

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