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Working Paper

The Evolution of Korea's Development Paradigm: Old Legacies and Emerging Trends in the Post-Crisis Era

ADB Research Paper Series, No. 21

Provided in Cooperation with:

Asian Development Bank Institute (ADBI), Tokyo

Suggested Citation: Lim, Phillip Wonhyuk (2001) : The Evolution of Korea's Development Paradigm: Old Legacies and Emerging Trends in the Post-Crisis Era, ADB Research Paper Series, No. 21, Asian Development Bank Institute (ADBI), Tokyo, <https://hdl.handle.net/11540/4126>

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The Evolution of Korea's Development Paradigm: *Old Legacies and Emerging Trends in the Post-Crisis Era*

Phillip Wonhyuk Lim

July 2001

Focusing on corporate governance and financial resource allocation mechanisms, this paper uses path dependence and comparative institutional analyses to trace the evolution of Korea's development paradigm and to assess the extent of changes in the economy since the 1997 crisis. However, the transition from an established government-business risk partnership to a market-oriented paradigm has not proved easy.

Although the government dealt with the nonperforming loans problem, the author contends that it has been less willing to take substantive measures to enable financial institutions to lead corporate restructuring based on market principles. As long as Korea continues to harbor structural problems in corporate governance and the allocation of financial resources, the investment efficiency of the economy is likely to suffer. Instead the reform program should concentrate on improving the autonomy of the financial sector and introducing private remedies to address the persistent problems of corporate governance.



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**The Evolution of Korea's
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Phillip Wonhyuk Lim

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PREFACE

The ADB Institute aims to explore the most appropriate development paradigms for Asia composed of well-balanced combinations of the roles of markets, institutions, and governments in the post-crisis period.

Under this broad research project on development paradigms, the ADB Institute Working Paper Series will contribute to disseminating works-in-progress as a building block of the project and will invite comments and questions.

I trust that this series will provoke constructive discussions among policymakers as well as researchers about where Asian economies should go from the last crisis and current recovery.

Masaru Yoshitomi
Dean
ADB Institute

ABSTRACT

Focusing on corporate governance and financial resource allocation mechanisms under various regimes, this paper uses the concept of path dependence and comparative institutional analysis to trace the evolution of Korea's development paradigm and to assess the extent of changes in the Korean economy since the 1997 economic crisis.

In the early 1960's, Korea addressed the policy challenges of economic development by essentially combining a state-led allocation of financial resources and an export market orientation. The government nationalized banks and restricted inward foreign direct investment while providing repayment guarantees to foreign financial institutions on loans extended to Korean firms, most of which lacked the standing in the international financial markets to raise capital on their own. Scrapping the import-substitution bias of the 1950's, the government removed various market distortions that had made it difficult for firms to exploit profitable investment opportunities. Korea's development paradigm, which centered on the idea of government-business risk partnership, proved an effective choice given the country's resource endowment at the time.

From the outset, the government sought to contain idiosyncratic moral hazard, but systemic risks began to build up as apparently successful firms kept borrowing to expand their business. When an economic slowdown threatened to topple heavily indebted firms in 1972, the government decided to bail out the debt-plagued corporate sector and imposed a debt moratorium on curb loans—without holding the incumbent managers and owners responsible for their previous business decisions. The ensuing heavy and chemical industry drive further weakened investment discipline as the government increasingly directed private firms to carry out targeted projects.

Disturbed by the distortion of the government-business risk partnership, some technocrats began to advocate a transition to a more market-oriented paradigm as early as the end of the 1970's. Although domestic and foreign pressure for liberalization and democratization did lead to the weakening of government control, institutional reforms required to improve corporate governance and financial resource allocation were not implemented. In fact, what might be called “de-control without de-protection” proceeded as family-based business groups known as the *chaebol* took advantage of liberalization and the government's implicit guarantee against their bankruptcy. The 1997 crisis should be understood within this context.

In the post-crisis era, changes in the risk profiles of economic activities, combined with the collapse of the authority hierarchy after the crisis, seem to be the primary drivers behind Korea's evolving development paradigm. The transition from the old government-business risk partnership to a more market-oriented paradigm, however, has been difficult. Although the government has swiftly dealt with the massive nonperforming loans problem, it has been far less willing to take substantive measures designed to put financial institutions in a position to lead corporate restructuring based on market principles. As long as Korea continues to harbor structural problems in the areas of corporate governance and the allocation of financial resources, however, the investment efficiency of the economy is likely to suffer, making it extremely vulnerable to macroeconomic shocks. The reform program should focus on improving the autonomy of the financial sector and introducing private remedies to address the problem of corporate governance.

TABLE OF CONTENTS

<i>About the Author</i>	II
<i>Preface</i>	III
<i>Abstract</i>	IV
<i>Table of Contents</i>	V
1. Introduction	1
2. Basic Analytical Framework	3
(1) Development Paradigms	3
(2) Comparative Institutional Analysis	4
(3) Path Dependence	6
3. The Emergence of Korea's Development Paradigm	6
(1) The Formation of the Government-Business Risk Partnership	6
(2) The Consolidation and Distortion of the Risk Partnership	11
4. The Road to Crisis	15
(1) The Dangers of De-Control without De-Protection	15
(2) The 1997 Crisis in Perspective	18
5. Alternative Scenarios in the Post-Crisis Era	21
(1) Foreigners Take Over: The "Foreign Dominance" Scenario	21
(2) Old Habits Die Hard: The "Government Intransigence" Scenario	21
(3) The Empire Strikes Back: The "Chaebol Resurgence" Scenario	22
(4) The New Economy Takes Off: The "Fundamental Reform" Scenario	22
6. Korea's Post-Crisis Paradigm: Work in Progress	23
(1) Dramatic Changes in Individual Mentality and Behavior	23
(2) Institutional Reform: Accomplishments and Limitations	25
(3) Dashed Hopes and Remaining Challenges	27
Tables and Figures (in body of text)	
Table 1 Economic Trends Before and After the 1972 Emergency Decree	12
Table 2 Value Added of the <i>Chaebol</i> as a share of GDP	14
Table 3 Trends in Corporate Financing in Korea (Based on Flows)	16

Table 4	Market Share of Financial Institutions in Korea	17
Table 5	In-Group Ownership Share of the Top <i>Chaebols</i>	18
Figure 1	Korea's Exports, Imports and Investment as share of GDP	10
Figure 2	Interest Rates and Inflation	13
Figure 3	Profitability and Opportunity Costs of Capital for Korean Manufacturing Firms	20
Figure 4	FDI Flows into Korea (Notification Basis)	25
Figure 5	The Internet Boom in Korea	29
References		31

The Evolution of Korea's Development Paradigm: Old Legacies and Emerging Trends in the Post-Crisis Era

Phillip Wonhyuk Lim

1. Introduction

The economic crisis that swept through Asia in 1997-1998 shattered what had been accepted as the conventional wisdom on Asia's "miracle economies," and led to a serious reappraisal of their economic systems. In no other crisis-stricken country was this trend more pronounced than Korea. Widely regarded as a watershed in the evolution of Korea's development paradigm, and not just as a one-time shock, the crisis cast into doubt the viability of the old system based on government-business alliances and the public management of private risks. The old system might have contributed to rapid capital accumulation and helped catapult Korea from one of the poorest countries in the world to the ranks of OECD countries in a little more than three decades; however, the crisis made it clear that this system, fraught as it was with the risks of moral hazard and outright corruption, could not be sustained in a new economic environment characterized by liberalization and democratization.

Korea is now in search of a new development paradigm. With regard to the future of the Korean economy, a spectrum of views seems to exist, ranging between two extremes. Appalled by the enormous cost that the old system exacted, proponents of the Anglo-Saxon model are calling for a comprehensive program of liberalization in capital, labor, and product markets. In contrast, champions of the old Korean system are trying to preserve the status quo, appealing to nationalist sentiments and inflating public fears about potential job losses. These two extremes, which represent the imperative of the market and the weight of history, respectively, serve as useful reference points in discussing the evolution of Korea's development paradigm. No coherent paradigm has yet to emerge in the post-crisis period, but it is certainly possible to lay out alternative scenarios for the future based on the emerging trends that are changing the Korean economy.

It is the objective of this paper to trace the evolution of Korea's development paradigm and to identify emerging features of the new system, using the concept of path dependence and comparative institutional analysis. The paper is organized as follows.

Chapter 2 presents an overview of the major concepts and methodology used in the paper. A development paradigm is viewed as being shaped by the combination of the roles and functions of markets and non-market institutions as a nation responds to the developmental challenges of investment, conflict management, and engagement with the outside world. This paper employs comparative institutional analysis to highlight the distinguishing features of various development paradigms, and uses the concept of path dependence in a political economy context to demonstrate how "history matters" in their evolution.

Chapters 3 and 4 look at Korea's development paradigm before the economic crisis of 1997. After a brief discussion of the origins of Korea's government-business risk partnership, these chapters examine how the emergence of economic actors with an interest in preserving this system prevented Korea from adopting fundamental reforms. Adopting a structuralist view of the Korean economic crisis of 1997, these two chapters analyze the political economy of moral hazard. In order to provide a historical perspective on post-crisis policy challenges, Chapters 3 and 4 focus on the corporate governance of Korean firms and financial resource allocation mechanisms under different political and economic regimes.

The analyses of the pre-crisis system and the crisis itself help clarify the nature of the challenges that Korea faces in the post-crisis era. These challenges include: How can the state manage the economic crisis and formulate its own "exit strategy" so that risks and rewards will be effectively privatized in the post-crisis era? How can the state credibly signal a regime change and put an end to moral hazard without unduly increasing systemic risks? How should incentive, monitoring, and disciplining schemes be changed so that a coherent system adapted to the new realities may emerge out of the crisis?

Chapter 5 explores the possible directions for the evolution of Korea's development paradigm in the post-crisis era, covering both the influence of legacies inherited from the past and the impact of new trends generated by globalization and the information technology (IT) revolution. In order to facilitate discussion, *four alternative scenarios* are considered: (1) foreigners take over ("Foreign Dominance" Scenario); (2) old habits die hard ("Government Intransigence" Scenario); (3) the empire strikes back ("Chaebol Resurgence" Scenario); and (4) the new economy takes off ("Fundamental Reform" Scenario).

Chapter 6 assesses developments to date. Changes in the risk profiles of economic activities, combined with the collapse of the authority hierarchy after the crisis, are real and seem to be the primary drivers behind Korea's evolving development paradigm in the post-crisis era. The transition from the old state-led paradigm to a more market-oriented one, however, has been marked by a stop-and-go pattern. In the name of "crisis management," the state has tended to provide liquidity to distressed financial institutions, but refrained from substantive measures that were likely to enhance the autonomy of financial institutions and put them in a position to lead corporate restructuring based on market principles. As a result, progress in restructuring tended to get stalled until market forces, whose strength had been significantly enhanced thanks to post-crisis liberalization policies, compelled the state to take proactive measures. It is argued that without fundamental reforms in corporate governance and financial resource allocation, neither liquidity-based crisis management nor a technological fix based on the IT revolution will be likely to lead to sustainable improvements in the Korean economy.

2. Basic Analytical Framework

(1) Development Paradigms

Developing countries typically face three interrelated challenges: investment, conflict management, and engagement with the outside world. In order to escape from the curse of underdevelopment, they must formulate effective strategies to accumulate physical and human capital, manage social conflicts, and maximize the benefits of “openness” while containing risks [Rodrik (1999)]. In responding to these policy challenges, a country can arrive at a particular combination of roles and functions for markets and non-market institutions that provide the background for the interaction of economic players in the government, corporate, financial, and labor sectors. That particular response to developmental challenges defines the country’s development paradigm.¹

Consider developing countries around the world at the beginning of the 1960s. The dearth of private entrepreneurs and lack of domestic capital in these countries seemed to imply that the state would have to take the initiative in economic development and in attracting foreign capital in order to facilitate investment. Many Latin American countries pursued import-substituting industrialization supplemented by foreign direct investment [Bruton (1998)]. Their investment strategy relied heavily on foreign multinationals. Their conflict management strategy was based on a combination of authoritarian rule and populist programs. Their external strategy contained a heavy dose of skepticism about the benefits of free trade, as they had seriously suffered in the wake of the Great Depression.

By contrast, Asia’s development paradigms were rather different. Taipei, China was making a transition from import substitution to export-oriented industrialization, promoting state-owned enterprises in the intermediate goods sector and private enterprises in the labor-intensive sector, and using linkages to overseas Chinese capital [Tien (1989); Haggard (1990)]. Singapore was poised to adopt a state-led model of its own, relying on “government-linked companies” in infrastructure-related industries and foreign multinationals in the manufacturing sector as its twin engines of growth [Low (1991)]. Taipei, China and Singapore were relying on the stick of authoritarian, single-party rule, as well as the carrot of rapid economic growth to manage social conflicts. While their receptivity to foreign multinationals varied, both had a sizable state sector and relied heavily on exports.

In short, in arriving at different development paradigms, the developing countries at the time tried to find a way to access foreign resources to make up for a lack of domestic capital, define the role of the state and market in resource allocation and conflict management, and set their terms of engagement with the outside world.

While much has changed in the world economy since the 1960s, the basic developmental challenges have remained the same. As illustrated by the examples given above, a development paradigm is conceptualized in this paper as being shaped by

¹ In thinking about development paradigms here, it may be useful to visualize a matrix with the three developmental challenges in rows (investment, conflict management, and engagement with the outside world) and the four sectors in columns (government, corporate, financial, and labor sectors), and consider how the norms and rules governing the interaction of the four sectors are structured to respond to the policy challenges.

a combination of the roles and functions of markets and non-market institutions in response to the core policy challenges of investment, conflict management, and engagement with the outside world.

(2) Comparative Institutional Analysis

This paper employs the methodology of comparative institutional analysis to highlight the distinguishing features of various development paradigms, and utilizes the concept of path dependence within a political economy framework to demonstrate the importance of history in the evolution of economic systems.

Comparative institutional analysis looks at how incentives are structured to affect the behavior of economic players with different objectives and information sets, given transactions costs. Using the economic tools of game theory, Aoki and Okuno-Fujiwara (1996) emphasized the following concepts in their comparative analysis of economic systems: (1) diversity of economic systems; (2) strategic complementarity between institutional arrangements and individual behavior; (3) institutional complementarity, or internal consistency (coherence) of institutional arrangements within an economic system; and (4) path dependence. Strategic complementarity and institutional complementarity constitute the reinforcement mechanisms for the system.

The rise of East Asia and the fall of the Communist bloc through the 1980s inspired a great deal of comparative research on economic systems. Using game-theoretic tools, Aoki (1988) demonstrated the rationality and internal consistency of the Japanese economic system.² Kornai (1992) analyzed the distribution of information, incentives, and decision-making power in the socialist economic system and showed the fundamental limitations of such systems. Amsden (1989), Wade (1990), World Bank (1993), and Rodrik (1995) used comparative institutional analysis to try to make sense of the “East Asian miracle.”

The outbreak of the Asian economic crisis in 1997, combined with the stagnation of the Japanese economy since the early 1990s, has also led to a new search for coherent explanations of Asia's development paradigms [Rajan and Zingales (1999)]. The focus of this inquiry has been on the actual workings of financial resource allocation mechanisms in Japan and other Asian countries.³ Although much more research needs

² Since this seminal work, Aoki has attempted to grasp the nature of an institution as “a self-sustaining system of shared beliefs” that contains “a summary representation (compressed information) of an equilibrium of the game” strategically played by economic agents. In this formulation, institutions are regarded as the equilibrium outcomes endogenously created through the strategic interactions of agents rather than as formal and informal constructs exogenously imposed by rule-makers. See Masahiko Aoki, *Toward a Comparative Institutional Analysis* (Cambridge: MIT Press, forthcoming), pp.21-26.

³ It may be interesting to recall that much of comparative research on the Japanese and U.S. economic systems in the 1980s was based on a rather simplistic dichotomy between “relationship-based transactions” and “arm’s-length transactions.” This body of literature tended to regard the U.S. economy as dominated by “arm’s-length transactions” and to overlook the important role played by reputation and other relationship-building mechanisms. Instead of resorting to a simplistic dichotomy, it might have been more useful to focus on the differences in the types of “relationship-based transactions” adopted by the two economic systems. With the benefit of hindsight, it also seems clear that this body of literature tended to rule in Japan’s favor without closely analyzing the potential shortcomings of the Japanese system.

to be done, it would seem useful to divide the information problem involved in financial resource allocations into two components: (1) project evaluation problems and (2) asymmetric information problems between the borrower and the lender. Although game-theoretic literature has tended to focus on the latter problem, of information asymmetry, the former problem of objective evaluation (or lack thereof) may be more relevant for understanding the nature of the Asian crisis.

In order to separate the problem of asymmetric information from that of objective evaluation, let us assume (in accordance with the most basic asymmetric information models of financial resource allocations) that the borrowers know *with certainty* the profitability of their investment projects. In this case, it is efficient to set the price of loan provisions equal to the actual cost and let the borrowers carry out investment projects when the rate of return from the projects exceed the cost of loan provision.⁴ Since the borrowers have all the necessary information on the profitability of their projects, it is inefficient to incur project evaluation costs. The borrowers and lenders should simply bargain over how to split the surplus (i.e., the return from the project minus the cost of loan provision). A debt contract modified to include an equity component may be a solution to this bargaining problem.⁵

In fact, as long as it is fairly easy for *either* the borrowers *or* the lenders to identify profitable investment opportunities, a financial resource allocation system designed to economize on project evaluation costs is not likely to create much trouble. In an economy, for example, with an abundance of unexplored profit opportunities due to market-suppressing regulations and/or insufficient capital, such a financial system may be more than adequate to support “catch-up” growth once these stifling conditions are removed. Also in such a situation, access to credit may be a more important determinant of a firm’s success than its ability to innovate (in the broad sense of the term).

When these unexplored profit opportunities are exhausted and when even the borrowers do not know for certain the profitability of their investment projects, a system designed to economize on project evaluation costs is increasingly likely to lead to investment inefficiency. Because of the limited capacity of single agents to collect and process information (to say nothing of their objectivity), it will be desirable to have a large number of independent project evaluation experts in such a situation. In fact, the microeconomics of the Asian crisis suggests that the lack of autonomous financial institutions capable of carrying out objective credit analyses became a serious problem as the amount of available domestic and foreign capital relative to sure profit opportunities increased in the wake of liberalization in the immediate pre-crisis period [Rajan and Zingales (1999)].

⁴ Unless an extremely forgiving form of limited liability is in operation, the borrowers are not likely to undertake investment projects that they know for certain will *not* cover their debt service obligations. When there is uncertainty about profitability, however, the degree to which the borrowers discount downside risks will depend crucially on the extent of limitations on their liability to lenders.

⁵ In the Japanese main bank system, for instance, the main bank tends to hold major equity stakes in firms with which it has established a long-term relationship. For an analysis of the Japanese main bank system based on the theory of incentive compatibility, see Braguinsky (1999).

(3) Path Dependence

Path dependence, as opposed to state dependence, emphasizes the importance of *initial conditions and subsequent developments* as a system evolves. This notion crucially depends on the presence of increasing returns or network externalities. As the expected network size of such a system depends in part on the size of the installed base or its current market share, “historical accidents” in the early stages of system competition are likely to have a significant effect on the eventual outcome. Consequently, in the presence of increasing returns, a seemingly extraneous event can have a more than transitory effect. Moreover, if the adjustment cost is sufficiently high, a local optimum is the best that can be hoped for, and the global optimum may not be obtained [David (1985); Arthur(1994)].

For competing economic systems, the current “market share” associated with a particular economic system refers to the “influence proportion” of economic players supporting that system. If this kind of adoption game is imagined as being played within policymaking circles, the amount of influence of policymakers representing the interests of economic players may be more relevant. In such a situation, policymakers advocating one economic system or another must take into account its stand-alone qualities as well as its compatibility with the interests of economic players who have already made specific investments. Depending on the level of organization and the payoff structure associated with policy choices, these actors may exert varying degrees of influence on the decision-making process. Under such conditions, the most efficient economic system (or development paradigm) may not be adopted, even if it can be clearly identified.

Furthermore, especially when increasing returns are significant, a system that was once efficient, but is no longer so, may persist. For example, employing the concept of path dependence and using Japan as a reference point, Dertouzos et al. (1989) argued that the earlier success of the U.S. mass production system made it difficult for Americans to adapt to the new world of flexible manufacturing achieved by their later competitors.

3. The Emergence of Korea’s Development Paradigm

(1) The Formation of the Government-Business Risk Partnership

In the early 1960s, the Republic of Korea (South Korea) addressed the policy challenges of economic development by essentially combining a state-led allocation of financial resources and an export market orientation. The government nationalized banks and minimized inward foreign direct investment (FDI), while providing repayment guarantees on foreign loans extended to private firms, most of whom then lacked the standing in the international financial markets to raise capital on their own. The government in effect formed a risk partnership with large private firms to facilitate capital accumulation. Replacing the import substitution bias of the 1950s with this outward-looking export orientation, the government, for the most part, used the performance of firms in competitive export markets as a selection criterion in extending financial and other support. To cope with social conflicts, successive military governments used both the carrot of improving living standards and the stick of ruthless

suppression— until Korea was finally democratized in the late 1980s. Throughout this period, social security was primarily provided by the private safety net of family support.

In the wake of the Student Revolution of April 1960, which put an end to the corruption-prone regime under Syngman Rhee, the “Military Revolution” of May 1961 provided the political background for the adoption of *the Korean model of economic development*.⁶ Upon seizing power through a bloodless coup, General Park Chung Hee and his followers declared that they were determined to “focus all energy into developing the capability to confront communism, in order to realize the people’s long-standing wish for national unification.” In the next few years, the Park government implemented a series of measures that came to define Korea’s development paradigm.

First, in 1961, building on the bureaucratic reforms undertaken by the previous government, Park implemented a number of institutional innovations to centralize economic policymaking. Second, starting in late 1962, and under strong pressure from the United States, the military government instituted a set of macroeconomic reforms designed to “get the prices right” and stabilize the economy. Third, the government adopted drastic measures to share the investment risks of the private sector, providing, in particular, explicit repayment guarantees to foreign financial institutions on loans extended to Korean firms. Fourth, with the determination to reduce economic dependence on the United States, Park Chung Hee himself spearheaded the effort to boost exports, offering various incentives based on market performance. The resulting government-business risk partnership, for which the export market performance of private firms was used as a selection criterion, defined the core of what later came to be seen as “the Korean model of economic development.”

Although Park and his followers had only a rudimentary knowledge of economics, they believed that the state should take a leading role in economic development. In order to centralize economic policymaking, the military government established the Economic Planning Board (EPB) in July 1961, charging it with the task of formulating and implementing five-year economic development plans based on an “indicative planning” approach.

The military government also took several measures to strengthen the role of the state in resource allocation. After the Student Revolution of April 1960, prominent businessmen were accused of having grown rich through political connections with the previous Syngman Rhee regime. Taking on the task of dealing with these “illicit wealth accumulators,” the military government accused them of tax evasion and other illegal business practices, and forced them to turn in their equity shares in commercial banks as “fines.” This drastic measure paved the way for the government to exert direct control over commercial banks, and in effect re-nationalizing those that had been privatized in the late 1950s.

In addition, the government created a number of “quasi-governmental organizations”(QGOs) in order to facilitate communications with business and labor. Various business associations were used as channels for government-business interactions, and were granted special favors such as the right to allocate quotas among

⁶ For a more detailed analysis of the evolution of the Korean economic system from the 1950s to the 1997 crisis, see further Lim (2000).

member firms. Membership in these associations was mandatory. As for labor, all unions were disbanded following the 1961 coup, and the restructured Federation of Korean Trade Unions (FKTU) was forced to take a moderate stance.

In just over one year, thus, the military government established various levers of control. Although the size of the state — as measured by the share of government spending in GNP — remained relatively small, its power was overwhelming. A question remained, however, as to what kind of state-led system Korea would have.

The macroeconomic reforms launched in late 1962, at the insistence of the United States, ensured that Korea's state-led development paradigm would not deviate significantly from a market-based one. Building upon the stabilization policies of 1963-64, the government devalued the Korean won from 130 to 255 to the dollar in May 1964. Also, in order to protect depositors from inflation and to encourage domestic savings, it raised the ceiling on the one-year time deposit rate from 15 percent to 30 percent on September 30, 1965 [C. Kim (1995: 114)].

These orthodox policies, which were designed to reduce distortions in macroeconomic variables, were accompanied by dirigist measures that deliberately introduced distortions into the microeconomic incentives. The Park government knew that Korea lacked the domestic resources to carry out its ambitious economic development program; however, unlike Latin American countries at the time (or Southeast Asian countries in the 1980s), it was not willing to depend on foreign direct investment (FDI). In a bid to tap into foreign capital while limiting the influence of foreign multinationals, the fiercely nationalistic government decided to rely heavily on foreign loans.⁷ However, as domestic firms lacked the standing to go to the international capital markets alone, the government decided to deal with the problem of lack of stature and asymmetric information and to allow state-owned banks to guarantee private-sector foreign borrowing.

In adopting this measure, the Park government signaled that it was willing to form a risk partnership with business leaders. Although Park Chung Hee and his followers had initially condemned most of these businessmen as “illicit wealth accumulators,” they apparently concluded that a combination of state monitoring with private entrepreneurship would be the most effective means of carrying out its economic development plans. The alternative, of using state-owned enterprises to accelerate industrialization, as in the case of Taipei, China was not actively pursued. The government decided to use its credibility to raise capital on the international market and allocate financial resources to private firms, in effect *contracting out* the provision of goods and services to the private sector under a system of government monitoring and guarantees on loans. Through direct monitoring and market testing based on export performance, the government tried to contain the potential costs of moral hazard created by state-backed debt financing. Export performance, in particular, provided the government with a relatively objective criterion for selecting private firms when it made its decision on extending its repayment guarantees.

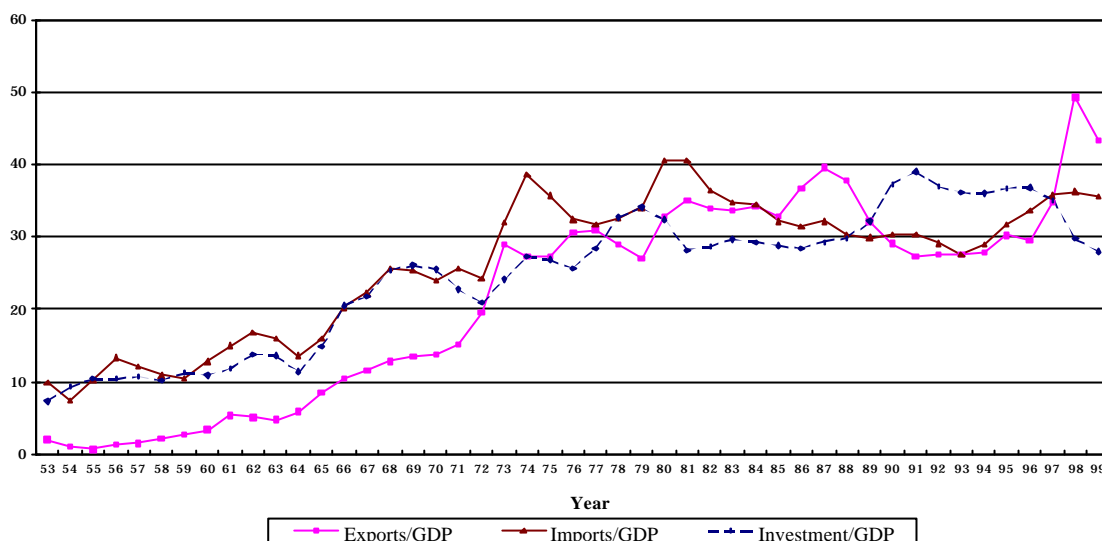
⁷ Cho and Kim (1997: 103) estimate that had investment been financed exclusively by domestic savings, the average economic growth rate during 1962-82 might have been only 4.9 percent per annum, well below the actual growth rate of 8.2 percent which was achieved with the injection of foreign capital.

In order to increase economic independence through export promotion, the government also introduced a number of export incentives. The short-term export credit system was streamlined as early as 1961. The essence of the new system was the automatic approval of loans by commercial banks to companies with an export letter of credit (L/C). In order to provide institutional support in the area of foreign marketing and technology imports, the government established the Korea Trade Promotion Corporation (KOTRA) in 1962, while an elaborate network of exporters' associations provided more industry-specific services. A nearly 50-percent devaluation of the Korean won in 1964 gave a tremendous boost to exports, and a partial import liberalization, which was designed to allow Korean firms to purchase intermediate goods at world prices, gave an additional impetus. The government also gave exporters various tax deductions, generous wastage allowances, tariff exemptions, and concessional credits. In order to monitor export performance in reference to indicative targets set at the beginning of each year, the president himself chaired monthly export promotion meetings. Strong export performers were even given medals and national recognition on Export Day, which was established in 1964 to commemorate the day when Korea's annual exports exceeded 100 million dollars for the first time. With an awareness of Korea's comparative advantage in the 1960s, the government encouraged private firms to concentrate on labor-intensive industries.⁸

Korea's development paradigm proved an efficient choice given Korea's resource endowment at the time. In 1965, primary and secondary school enrollments in Korea were similar to rates in countries with three times its per capita income [World Bank (1993: 45-46)]. Cheap and high-quality labor could be readily employed to produce a high rate of return on investment in physical capital, as long as the country could tap into foreign capital and technology to compensate for the shortage of domestic resources and exploit its comparative advantage. The government's decision to issue selective guarantees on the foreign borrowing of private firms and to promote exports was a solution to this developmental challenge. The government thus compensated for capital market imperfections and removed the constraints that had made it very difficult for firms to exploit profitable investment opportunities in the 1950s.

⁸ In 1962, labor-intensive manufactures accounted for less than 15 percent of Korea's total exports of \$54.8 million. In 1963, exports increased by \$32 million (a 58.4% jump!) to reach \$86.8 million, and labor-intensive manufactures such as textiles and footwear accounted for more than 80 percent of this increase. Overall, exports increased at an average annual rate of 35 percent in real terms from 1963 to 1969 [Yoo (1996: 8-9)].

Figure 1 Korea's Exports, Imports and Investment as Share of GDP



Source: Bank of Korea, *National Accounts*, various issues.
 Note: Investment here refers to gross fixed capital formation.

Thus, what the Korean government did “right” in the take-off stage was of a different nature than is usually pointed out in the existing literature.⁹ The market failure that was effectively addressed by the government in the 1960s was due to the “imperfections in the international capital market” rather than coordination failures in the domestic manufacturing sector. Far more important for Korea’s economic growth, however, was the government’s effort to correct for the *government failures* of the past: policies designed to generate arbitrage opportunities that had made it virtually impossible for firms to exploit Korea’s comparative advantage in the 1950s. With the government addressing financing problems as well as macroeconomic imbalances, private firms could now invest and export to take advantage of unexplored profit opportunities. Rapid capital accumulation, combined with learning by exporting, was the key to Korea’s economic success.

The country’s development paradigm was a popular choice in political economy terms as well. In this regard, it is important to note that if a nation has a comparative advantage in the labor-intensive sector, as Korea did in the 1960s, export orientation can

⁹ Most neoclassical perspectives typically trace Korea’s economic success to a set of market-oriented macroeconomic reforms carried out in 1964 and 1965 [Krueger (1979)]. But these measures by themselves would not have been very effective in correcting for the “imperfections (reluctance) in the international capital market” (i.e. it was basically impossible for little-known Korean firms to tap into foreign resources on their own, without government guarantees). Statist perspectives, by contrast, point to the pervasive distortion of government microeconomic incentives (“getting the prices wrong”), and argue that this corrective intervention promoted rapid economic growth [Amsden (1989)]. It is unclear, however, whether the Korean economy grew thanks to or in spite of government intervention. Although more sophisticated statist studies advance “coordination failure” arguments, they are less than convincing in showing the existence of essential, nontradable intermediate inputs in the “take-off” stage and demonstrating the role of the government in coordinating the production of these goods.

improve the welfare of workers. In addition, politicians, bureaucrats, and business leaders naturally favored the government-business risk partnership because it provided them with a large degree of control over resources. As a product of strong U.S. demands for macroeconomic stabilization, on the one hand, and a nationalistic Korean response designed to enhance economic independence, on the other, Korea's development paradigm could thus secure wide support.

(2) The Consolidation and Distortion of the Risk Partnership

Korea's development paradigm, which centered on the government-business risk partnership, encouraged rapid capital accumulation and produced spectacular economic growth. Reassured by government guarantees and subsequent economic growth, foreign financial institutions expanded loans to Korean firms and provided the lion's share of the necessary capital for investment projects.¹⁰ Korean firms, for their part, dramatically increased their leverage while their profitability actually *declined*: the debt-equity ratio of manufacturing firms, as measured by their total liabilities divided by net worth, rose from 92.7 percent in 1965 to 328.4 percent in 1970.¹¹ While encouraging investment conducive to rapid economic growth, the Korean system thus led to a highly leveraged corporate sector that became extremely vulnerable to shocks.

Although the Korean system was designed to minimize idiosyncratic moral hazard by making government support contingent on market performance, it was not prepared to deal with the increased *systemic* risks manifested by the higher leverage of most private firms. Firms that were apparently successful kept borrowing to expand their business, under government guarantees on foreign debt, and neither the government nor the private sector stopped to think seriously about the potential toll that a major economic downturn would take on the heavily indebted firms.

When, in 1972, a serious economic slowdown following the investment explosion of the late 1960s threatened to topple the debt-plagued corporate sector, President Park decided to bail them out. He issued the Presidential Emergency Decree for Economic Stability and Growth, on August 3, 1972. This Decree placed an immediate moratorium on the payment of all corporate debts to curb lenders, and called for an extensive rescheduling of bank loans at a reduced interest rate. The moratorium was to last three years, after which all curb funds would have to be turned into five-year loans at a monthly interest rate of 1.35 percent, or an annual rate of 16.2 percent — at a time when the prevailing market rate exceeded 40 percent. The August 3 Emergency Decree forced “usurious” curb lenders and disorganized taxpayers to share losses, but left the owners and managers of firms and banks intact. Furthermore, no government officials took responsibility for the macroeconomic mismanagement of the late 1960s, and the

¹⁰ In the First and Second Five-Year Economic Development Plan periods (1962-71), foreign savings accounted for 52.8 percent and 39.4 percent of total investment, respectively. The share of foreign savings in investment remained significant through the 1970s, hovering around 20 percent.

¹¹ During the same period, the net profit-to-net worth ratio of manufacturing firms declined from 15 percent to 11 percent. Normally, a firm with a high debt-equity ratio would be expected to have a high average return in order to compensate for the high risk of default. From 1970 to 1997, the debt-equity ratio of Korean manufacturing firms generally exceeded 300 percent while their profitability barely improved.

overheating of the economy that served as the background for the crisis of 1972. Violating the property rights of the creditors in the informal curb market, the government relieved the debt burden of the private firms it had come to rely on as agents to carry out its ambitious economic development plans.

Table 1 Economic Trends Before and After the 1972 Emergency Decree (1964-1978)

(Percent Per Annum, %)

	Growth Rate of Investment	Rate of Inflation	Interest Rate on Bank Loans	Interest Rate on Curb Loans	Total Liabilities/Net Worth	Net Profit/Net Worth
1964	13.3	30.0	16.5	61.80	100.5	15
1965	19.3	5.8	18.5	58.92	92.7	15
1966	84.0	14.6	26.0	58.68	117.7	17
1967	25.2	15.9	26.0	56.52	151.2	17
1968	52.3	16.1	25.8	56.04	201.3	16
1969	45.1	15.5	24.5	51.36	270.0	14
1970	11.3	15.5	24.0	50.16	328.4	11
1971	24.9	12.5	23.0	46.44	394.2	4
1972	3.7	16.7	17.7	39.00	313.4	17
1973	40.7	13.6	15.5	33.24	272.7	30
1974	30.2	30.5	15.5	40.56	316.0	23
1975	24.9	25.2	15.5	47.88	339.5	17
1976	77.1	21.3	16.1	40.47	364.6	22
1977	43.1	16.6	15.0	38.07	350.7	21
1978	45.1	22.8	17.1	41.70	366.8	23

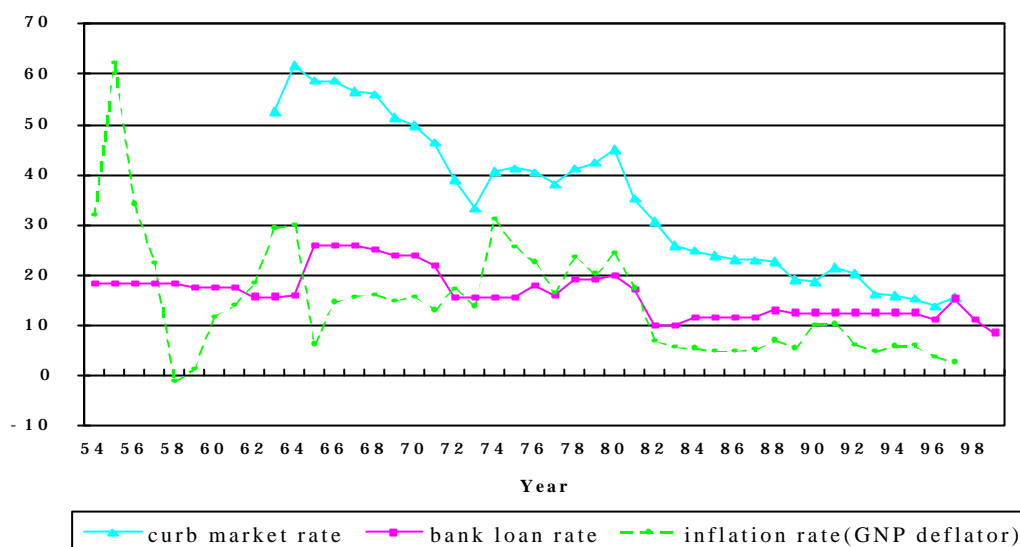
Source: Bank of Korea, *Economic Statistics Yearbook* and *Financial Statements Analysis*, various issues; Cho, Je and Kim (1997).

Note: The last two columns are the average figures for manufacturing firms (weighted by net worth).

In retrospect, the August 3 Emergency Decree of 1972 was a turning point in the evolution of Korea's development paradigm. It established the precedent for the government taking extraordinary measures to relieve financial distress when necessary — *without* holding the management of firms and banks accountable for their previous investment and lending decisions. Moreover, the Decree seemed to imply that an excessive dependence on debt would not only go unpunished but might actually be rewarded by the government — as long as other companies also depended heavily on debt. The Decree thus fundamentally changed the nature of state guarantees, and ushered in a new era characterized by the deepening of the government-business risk partnership.

The ensuing Heavy and Chemical Industry (HCI) drive aggravated moral hazard as the government was increasingly trapped in a vicious cycle of intervention [Stern et al. (1995)]. During the late 1970s, HCIs accounted for almost 80 percent of all fixed investment in the manufacturing sector, though their share in manufacturing sector output was around 40 percent. The banks, as well as the newly established National Investment Fund, supported the HCI drive by providing policy-oriented loans at a *negative* real interest rate. As Figure 2 shows, this was a dramatic departure from the second half of the 1960s. As a result, the interest rate was no longer allowed to serve as a price signal, and serious macroeconomic imbalances ensued.

Figure 2 Interest Rates and Inflation



Source: Bank of Korea, Economic Statistics Yearbook, various issues; KDI internal data.

Note: The curb market rate is the interest rate applied to “Grade A” firms.

For the 1954-1995 period, the bank loan rate is the interest rate at the end of each year on general loans with a maturity of one year or less, for general enterprises. Effective July 1996, the monthly bank loan rate is calculated as the weighted average of the interest rates on new loans incurred in that month. The annual bank loan rate is equal to the December rate.

In order to minimize time and exploit scale economies in establishing the capital-intensive HCI sector, the government relied on a select group of large conglomerates, providing them with extremely generous financial support. Known as *chaebol*, these family-based business groups drastically increased their share of GDP thanks primarily to the generous government support.¹² During the heyday of the HCI drive, from 1974 to 1978, it was not uncommon for *chaebol* to triple their number of affiliates through new acquisitions in the heavy and chemical industries.

¹² The *chaebol*, which literally means “a wealth clique,” could be defined as “a large business group that owes a significant portion of its growth to state support and is disproportionately controlled by a family with partial ownership.” Although the *chaebol* has become notorious for its large size and high degree of diversification into unrelated fields, these characteristics are primarily the *consequences* of the *chaebol*’s competitiveness as well as distortions in capital and product markets (due to state intervention in financial resource allocation and weak domestic competition). The *essence* of the *chaebol* has much more to do with its characteristic corporate governance (i.e. partial ownership but complete control by a family dynasty) and its political power, which influences the state in economic decisions. Given these defining features, the *chaebol* may behave more like a rule-setter than a rule-taker, and may have an objective function that diverges significantly from profit maximization for the firm as a whole.

Table 2 Value Added of the Chaebol as a Share of GDP

	(%)								
	1973	1974	1975	1976	1977	1978	1979	1980	1981
Top 5	3.5	3.8	4.7	5.1	8.2	8.1	-	-	-
Top 10	5.1	5.6	7.1	7.2	10.6	10.9	-	-	-
Top 20	7.1	7.8	9.8	9.4	13.3	14.0	-	-	-
Top 46	9.8	10.3	12.3	12.3	16.3	17.1	16.6	19.5	24.0

Source: SaKong (1993).

The HCI drive in the 1970s transformed the government-business risk partnership decidedly in favor of these family-based business groups. Unlike in the 1960s, international competitiveness (i.e., the “market test”) no longer operated as a selection criterion. The government simply believed in the entrepreneurship of a few *chaebol* founders and directed massive resources into their firms. Although Park Chung Hee might have felt that he could always control the *chaebol* like “quasi-SOEs,” he was in fact creating behemoths that would eventually come to dominate the Korean economy and change the government-business risk partnership in their own favor.

Having channeled massive resources into the *chaebol* to carry out high-priority investment projects — sometimes over the initial objection of their owner-managers, the government had to take responsibility when the projects turned sour. Moreover, the gigantic size and high leverage of the *chaebol* strengthened the case for a “too big to fail” argument when crisis struck.¹³ In addition, a peculiar model of corporate expansion and restructuring seems to have been born in this period: (1) the *chaebol* relies on state-backed debt financing to undertake massive investment projects; (2) the going-concern value of the firm turns out to be greater than its liquidation value but less than its debt — i.e. the firm cannot really service its debt obligations; (3) the state steps in to write off a large portion of the debt and either sells the “clean” company to a different *chaebol* or preserves the ownership interests of the original firm; and (4) taxpayers wind up paying the bill.

These developments in the 1970s had a profound impact on Korea’s development paradigm. In the 1960s, when the government was forging a risk partnership with private firms by guaranteeing the repayment of their foreign borrowing, it certainly did not intend to guarantee the governance rights of the incumbent owner-managers. The Emergency Decree of 1972 and the HCI drive, however, transformed the nature of the government-business risk partnership and exacerbated moral hazard. The installed base of business interests, with its high debt burden, pushed the government to move in this direction. Subsequently, the industrial targeting approach adopted during the HCI drive trapped the government in a vicious cycle of intervention, and the massive financial support extended to the top *chaebol* firms transformed the government-business risk partnership in favor of these family-based business groups.

¹³ The Daewoo experience in the 1970s provides an example. During the HCI drive, the Park government asked Daewoo, a textile and trading company, to take over a machine-tool manufacturer and a shipyard, as well as to enter the automobile industry. In the process of complying with the government’s wishes, Daewoo’s debt-equity ratio climbed to 900 percent. When Daewoo could not meet its debt obligations, the government had to bail it out.

4. The Road to Crisis

(1) The Dangers of De-Control without De-Protection

By the 1980s, it had become possible for successful Korean firms to raise capital internationally on their own. It had also become increasingly difficult for the government to identify profitable investment opportunities and monitor the performance of individual firms. Moreover, increased domestic and foreign pressure for liberalization and democratization was beginning to force the government to relinquish some of the important policy instruments it had used to motivate and discipline private firms. Given the reduced desirability and effectiveness of government intervention in the economy, policymakers should have fundamentally re-defined the role of the government.

In fact, as early as the beginning of the 1980s, many technocrats had started to advocate a transition to a more market-oriented system. They were clearly aware of the dilemma faced by the government. Since the collapse of any large *chaebol* would bury the financial system in nonperforming loans, the government was more or less obliged to guarantee their stability. This implicit guarantee, however, encouraged the *chaebol* to undertake excessive investments. With the expectation that they would be bailed out should a crisis strike, they discounted the downside risks and invested wildly — unless restrained by the government. In order to maintain economic stability, the government thus found itself forced to intervene in the investment decisions of private firms.

The technocrats believed that the only solution to this apparent dilemma would be for the government to let market forces operate and to allow nonviable *chaebol* to go bankrupt while containing the fallout from their collapse. The technocrats also thought that the government would have to hold the incumbent owner-managers accountable for their previous decisions and to refrain from intervening in the investment decisions of private firms in the future. Moreover, autonomous financial institutions, free from the control of the government *and* industrial capitalists, would have to be allowed to make decisions on their own and bear the full consequences of their actions. The government would have to re-define its role and focus on competition policy and prudential regulation rather than on allocating financial resources according to its industrial policy objectives. In other words, the government would have to stop providing direction and insurance to private firms, and limit its role to setting and enforcing “the rules of the game” and providing a social safety net. This series of decisive measures would serve as a credible signal that the regime had indeed changed.

By this time, however, the Korean economic system had produced a coalition of economic players who were more interested in consolidating and maintaining the government-business risk partnership. Politicians and bureaucrats wanted to hold on to the levers of control, especially in the area of financial resource allocation. Business leaders wanted the government to continue providing loan guarantees and other support. Certainly, as evidenced by the experience of Taipei, China and Singapore, among others, the Korean economic system was not the only system that could produce rapid growth.¹⁴ Whenever reform-minded policymakers advocated a transition to a more

¹⁴ Note that Korea’s government-business risk partnership helped to create an economic system that was *structurally* vulnerable to cyclical shocks. Although Taipei, China and Singapore depend heavily on exports and are exposed to external shocks, they tend to deal with these shocks quite well. In contrast,

market-oriented system, however, the installed base of economic players with system-specific interests blocked reforms. In the end, reform-minded policymakers were pushed aside by bureaucrats who were more willing to accommodate the wishes of the vested interests.

In fact, while there were significant changes in Korea's development paradigm from 1980 to 1997, these changes were not necessarily for the better. The country's investment strategy began to rely increasingly more heavily on the private sector, but the institutional reforms required to improve corporate governance and the allocation of financial resources were not implemented. After Korea was democratized in 1987, its conflict management strategy had to be based on democratic processes, but needed measures to address campaign financing problems and corruption were not adopted, and the resolution of conflicts often involved protracted gridlocks (e.g., between labor and management) [Mo and Moon (1999)]. And Korea's external strategy remained heavily geared to export markets and strongly discouraged inward foreign direct investment. Moreover, product and financial market liberalization was rather selective. Korea's development paradigm during the Park era, in which the state provided both direction and insurance, or both control and protection, was becoming increasingly dysfunctional as what may be called *de-control without de-protection* proceeded. The old system of providing incentives and managing risks had broken down, and the problems of moral hazard and outright corruption grew as fundamental reforms were delayed.

Table 3 Trends in Corporate Financing in Korea (Based on Flows)

	1970	1975	1980	1985	1988	1990	1991	1992	1993
Indirect finance	39.7	27.7	36	56.2	27.4	40.9	41.8	36.3	32.8
Borrowing from banks	30.2	19.1	20.8	35.4	19.4	16.8	19.8	15.1	13.7
Borrowing from NBFIs	9.5	8.6	15.2	20.8	8	24.1	22.0	21.1	19.0
Direct finance	15.1	26.1	22.9	30.3	59.5	45.2	37.9	41.4	53.3
Commercial papers	0.0	1.6	5.0	0.4	6.1	4	-3.8	7.6	14.7
Corporate bonds	1.1	1.1	6.1	16.1	7.5	23	24.2	12.5	15.0
Stocks	13.9	22.6	10.9	13	40.6	14.2	15.1	15.9	16.5
Foreign borrowings	29.6	29.8	16.6	0.8	6.4	6.8	4.4	5.0	-2.3
Others	15.6	16.4	24.5	12.7	6.7	7.1	15.9	17.3	16.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Bank of Korea (1994), *Understanding the Flow of Funds in Korea*; re-cited from Hahm (2000)

Note: "Others" include government loans and trade credits among corporate firms

The *chaebol* were no longer strictly controlled by the state, but implicit protection against their bankruptcy remained. The nature of this explosive combination was most evident in Korea's investment strategy. Starting in the 1980s, the *chaebol* expanded their influence in the financial sector through the ownership of non-bank financial

because of the high debt load carried by the Korean firms relative to their profitability, they tended to be much more vulnerable to external shocks.

institutions (NBFIs) such as merchant banks, security companies, investment trusts, and insurance companies. By offering a much higher rate of return than the banks, the NBFIs were able to attract a great deal of financial resources. Investors apparently believed that their investments in the NBFIs were protected by the government — just as safe as bank deposits. Tables 3 and 4 show how the flow of funds changed to strengthen the position of the *chaebol*. Partial financial liberalization, combined with the legacy of implicit government insurance, led to greatly increased overall risks in the financial system.¹⁵

Table 4 Market Share of Financial Institutions in Korea

(End of period, %)

	1980	1985	1990	1995	1998
Deposits					
Commercial Banks	42.8	31.2	25.5	19.9	22.6
Specialized Banks	28.1	22.4	15.5	7.9	5.2
NBFIs	29.1	46.4	59.0	72.2	72.2
Loans & Discounts					
Commercial Banks	38.8	34.2	29.3	23.9	27.9
Specialized Banks	24.5	24.2	19.0	12.6	10.0
NBFIs	36.7	41.6	51.7	63.5	62.1

Source: Hahm (2000)

Problems in the corporate governance of private firms were no less serious than increased risks for inefficient investment due to the excessive supply of credit to the *chaebol*. Many *chaebol*-affiliated firms have gone public since the mid-1970s, and as Table 5 shows, the ownership share of the founder families has drastically fallen over time. As is well known from the corporate governance literature, this increasing separation of ownership and control has tended to aggravate the agency problem.¹⁶ When ownership and control are separated, it is important to devise an incentive and monitoring scheme to ensure that the managers work in the interests of the owners rather than their own.¹⁷ As the gap between ownership and control widened in *chaebol*-

¹⁵ With the benefit of hindsight, Koreans now appreciate (1) the importance of separating banking and commerce, (2) the problem of the implicit deposit insurance extended to NBFIs combined with asymmetric interest-rate deregulation, and (3) the need to develop autonomous financial institutions liberated from the control of the government and the *chaebol*.

¹⁶ In criticizing the *chaebol*, most casual observers, as well as some scholars, decry the *concentration of ownership* and control by the founder families. They typically argue that the separation of ownership and control will transform the *chaebol* into genuinely modern business corporations. Apparently, they have neither looked at the actual ownership data nor studied corporate governance issues. Their perception might have been shaped by the conduct of the *chaebol* groups before the 1980s, when they were closely owned and held.

¹⁷ In combination with Korea's securities laws, that discouraged outsiders from accumulating voting rights, the general lack of transparency in accounting information acted as a barrier against mergers and

affiliated firms, the lack of such incentive and monitoring schemes created increasingly serious problems.

Table 5 In-Group Ownership Share of the Top *Chaebols*

	1983	1987	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Top 30	57.2	56.2	46.2	45.4	46.9	46.1	43.4	42.7	43.3	44.1	43.0	44.5	49.6	43.4
Family	17.2	15.8	14.7	13.7	13.9	12.6	10.3	9.7	10.5	10.3	8.5	7.9	5.4	4.5
Subsidiaries	40.0	40.4	31.5	31.7	33.0	33.5	33.1	33.0	32.8	33.8	34.5	36.6	45.1	38.9
Top 5	n.a	60.3	49.4	49.6	51.6	51.9	49.0	47.5	n.a	n.a	45.2	6.6	53.5	n.a
Family	n.a	15.6	13.7	13.3	13.2	13.3	11.8	12.5	n.a	n.a	8.6	n.a	n.a	n.a
Subsidiaries	n.a	44.7	35.7	36.3	38.4	38.6	37.2	35.0	n.a	n.a	36.6	n.a	n.a	n.a
Hyundai	81.4	79.9	n.a	60.2	67.8	65.7	57.8	61.3	60.4	61.4	56.2	53.7	n.a	n.a
Samsung	59.5	56.5	n.a	51.4	53.2	58.3	52.9	48.9	49.3	49.0	46.7	44.6	n.a	n.a
Daewoo	70.6	56.2	n.a	49.1	50.4	48.8	46.9	42.4	41.4	41.7	38.3	41.0	n.a	n.a
LG	30.2	41.5	n.a	35.2	38.3	39.7	38.8	37.7	39.7	39.9	40.1	41.9	n.a	n.a

Source: Korea Fair Trade Commission; Yoo (1999).

Note: The in-group ownership share for a *chaebol* is calculated by obtaining the weighted average of the combined ownership share of the founder's extended family and subsidiaries for all subsidiaries.

This was the situation in Korea before the economic crisis of 1997. The desirability and effectiveness of the state-led monitoring and incentive system were greatly reduced, but few financial institutions or institutional investors were allowed to step in to perform these functions. This gap in corporate governance and financial resource allocation formed the background of the crisis.

(2) The 1997 Crisis in Perspective

As the mid-1990s approached, most of the problems of the Korean economic system remained unresolved. Although the government no longer pursued a traditional industrial policy, it retained some important levers of control. In particular, it continued to control the banks and market entry through licensing decisions. It also appeared to provide implicit guarantees on loans. The *chaebol*, in turn, exploited the residual influence of the government to extract favors, established a number of NBFIs to attract financial resources, and carried out ambitious investment projects with little concern for

acquisitions. In addition, a system of "shadow voting" required institutional investors to cast their votes proportionately to other votes, reducing their ability to monitor and discipline the management of the companies in which they had invested. Internal monitoring and supervision of management was also impossible due to the fact that all the board members of *chaebol* were company senior executives, whose careers were wholly dependent upon the controlling shareholder's decisions. As Park (2001) points out, the widespread practice of lifetime employment at Korea's large companies resulted in an underdeveloped managerial labor market, and this reality further weakened managers' incentives to increase shareholder value at the expense of the controlling shareholder families.

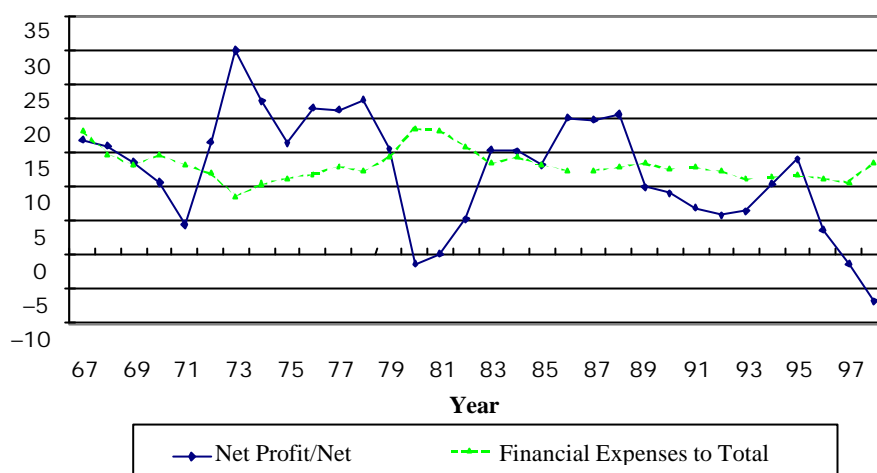
default risks. The government-business risk partnership was becoming increasingly dysfunctional in an era of liberalization and democratization.

In 1995, the average debt-equity ratio of the top 30 *chaebol* was 347.5 percent. The lower-ranking groups (No. 11 to No. 30) had been earning negative average returns on assets since 1993. Halla, Jinro, and Sammi, in particular, had debt-equity ratios of over 2,000 percent, as they piled up losses. Financial institutions, nevertheless, still continued to provide credit to these companies. By 1996, the average debt-equity ratio of the top 30 *chaebol* had climbed to 386.5 percent, but the financial institutions continued to prop up the debt-plagued conglomerates. In April of that year, *Korea's terms of trade began to decline sharply* as the prices of semiconductors collapsed. The decline in the terms of trade reached 20 percent by the end of the year, becoming Korea's biggest terms-of-trade shock since the oil shock [Shin and Hahm (1998)]. In 1997, the average debt-equity ratio of the top 30 *chaebol* reached 519.0 percent.¹⁸ Korea was on the brink of yet another debt crisis.

On the surface, the 1997 crisis had some features of a liquidity crisis, stemming from Korea's low foreign reserves, heavy reliance on short-term foreign debt, and the loss of confidence by foreign investors. It must be recalled, however, that it was the series of *chaebol* bankruptcies that led to the loss of confidence and triggered the international bank run on Korea, and not the other way around. If Korea had secured a sufficient level of reserves, it might have been able to avoid a currency crisis, but it still would have had to face a serious problem with nonperforming loans.

¹⁸ In 1997, the average debt-equity ratio for the Korean manufacturing sector as a whole was 396 percent. Comparable figures for the U.S., Japan, and Taipei,China were 154 percent, 193 percent, and 86 percent, respectively.

Figure 3 Profitability and Opportunity Costs of Capital for Korean Manufacturing Firms



Source: Bank of Korea, *Financial Statements Analysis*, various issues.

Note: Total borrowing does not include non-interest-bearing IOUs.

Figure 3 illustrates the basic nature of the problem with the Korean corporate sector. Korean firms had relied excessively on debt financing, even when carrying out massive investment projects with long gestation periods that might have required more equity or joint venture participation instead. This debt financing might just have been sustainable if they had a sufficiently high profit rate to cover their high interest expenses, but their rate of return on net worth has been below the opportunity cost of capital for much of the past two decades.¹⁹ As a result, they were and are structurally vulnerable to what may simply be cyclical shocks, due to their high leverage. But how could Korean firms operate on such a thin margin of error when they certainly knew that they were extremely vulnerable to shocks? How could they and their lenders be so cavalier in discounting the downside risks?

The answers to these questions can be found in the way the nature of the government-business risk partnership evolved in Korea. In fact, the evolution of the Korean economic system over the past three decades indicates that the crisis of 1997 in Korea was not really a unique event.

¹⁹ In fact, Figure 3 shows that prior to the economic crisis of 1997, there were only two sub-periods during which the profitability of Korean manufacturing firms was substantially above the opportunity cost of capital: (1) 1972-1978, when the corporate sector's debt burden was artificially reduced by the Emergency Decree of 1972 and the low-interest rate policy during the ensuing HCI drive; and (2) 1986-1988, when the Korean economy enjoyed the so-called "three-low" boom triggered by low oil prices, low international interest rates, and a low value of the won relative to the Japanese yen after the Plaza Accord of 1985.

5. Alternative Scenarios in the Post-Crisis Era

The economic crisis of 1997 provided Korea with a rare opportunity to implement long-delayed fundamental reforms. In order to analyze what is feasible in the short run and the long run, it may be useful to consider the following four scenarios, which focus on the interests of various economic players. These scenarios are not mutually exclusive.

(1) Foreigners Take Over: The “Foreign Dominance” Scenario

This was the scenario that was most frequently discussed in the early days of the crisis. With foreign reserves all but depleted, it was feared that Korea would be forced to sell its treasured assets to foreigners at fire-sale prices. There was speculation that what had happened in Latin America in the wake of the debt crisis there was about to unfold in Korea, and that foreign multinationals would come to dominate important sectors of the economy.

In a weaker version of this scenario, which seems far more likely, it is envisaged that the influence of foreign multinationals will increase, but increase in a way that is acceptable and quite beneficial to the Korean economy. In fact, many people think that it is necessary to have *some* foreign presence in the domestic market (especially in the financial sector) if reform measures are to be made to “stick” in the post-crisis era. They feel that foreign firms will serve as an effective antidote against arbitrary government intervention and *chaebol* hegemony. In particular, they believe that Korea needs “banks that can say no” to both the government and the *chaebol*. Some also contend that foreign firms will introduce advanced technology and know-how and management techniques, and possibly enable Korean firms to become partners in their global research and production networks.

Of course, not everyone in Korea is in favor of an increased foreign presence. Labor unions may oppose FDI on the grounds of potential job losses and reduced job security, and the *chaebol* may try to minimize the foreign presence in the domestic market. According to this scenario, however, their attempts to elicit knee-jerk, nationalistic reactions are likely to become increasingly ineffective as Koreans come to understand the true meaning of globalization, and as the prospect of complete foreign dominance fades away.

(2) Old Habits Die Hard: The “Government Intransigence” Scenario

In this scenario, politicians and bureaucrats revert to their old ways and halt the reform process. With the *de facto* nationalization of bankrupt firms and financial institutions in the wake of the crisis, the government has more resources back under its control than it had in the early 1990s. The government may be tempted to delay the re-privatization of these firms and financial institutions, and try to intervene in the process of resource allocation in the name of “crisis management.”

In fact, given the incentives of politicians and bureaucrats, it seems quite likely that the government will delay re-privatization. In addition, popular fears of foreign dominance and *chaebol* hegemony may tend to limit the maneuvering space for the government even if it really wants to privatize. At the same time, politicians and bureaucrats are now under the scrutiny of domestic and international investors, and they

run the risk of massive negative publicity should they openly revert to their old ways in the post-crisis era. Thus, what is more likely to happen is a combination of delayed re-privatization with moderate changes in the behavior of politicians and bureaucrats.

(3) The Empire Strikes Back: The “Chaebol Resurgence” Scenario

This scenario envisages that the *chaebol* will emerge stronger than ever from the crisis, but with their previous structural problems unresolved. In this scenario, the surviving chaebol-affiliated firms will have improved profitability as a result of their restructuring efforts. This, in itself, has to be a welcome phenomenon. This improvement in performance is, however, not accompanied by improvements in corporate governance and mechanisms of financial resource allocation, making it a one-shot event. This scenario also envisages that the *chaebol* will receive special favors in the process of re-privatizing bankrupt firms and financial institutions, making “the *chaebol* problem” even more formidable.

To a large degree, the likelihood of this scenario will depend on whether the government continues with its program of liberalization. Increased competitive pressure due to the continued liberalization of capital and product markets will force the *chaebol* to address their structural problems if they are to survive. Moreover, the introduction of legal measures such as class-action suits should help protect the property rights of minority shareholders and improve the corporate governance of the *chaebol*. In order to remove distortions in financial resource allocations, the true separation of banking and commerce will have to be an essential component of the program as well.

(4) The New Economy Takes Off: The “Fundamental Reform” Scenario

In a broad sense, the term “New Economy” contains the elements of effective deregulation, stable macroeconomic policy, as well as productivity-enhancing technological and organizational changes triggered by the IT revolution. This scenario envisages that Korea will carry out fundamental reforms and take advantage of the IT revolution, and make a successful transition from input-driven to productivity-led growth. As such, it is the most optimistic of the four scenarios.

In this scenario, Korea effectively addresses the fundamental causes of the economic crisis, and corrects the serious problems that exist in corporate governance and the allocation of financial resources. The government carries out legal and institutional reforms to protect the rights of minority shareholders and to improve the transparency of corporate management. These might include, for example, providing effective private and class remedies and raising accounting standards. The government also implements a well-conceived program of liberalization, improving prudential and other forms of regulation and enhancing competition in the product as well as M&A market. Moreover, the government refrains from trying to reverse the macroeconomic cycle. In short, under pressure from both domestic and foreign demands for fundamental changes, politicians and bureaucrats overhaul the old interventionist system.

Concurrently, in this scenario the government also promotes the new venture firms as an alternative to the *chaebol* by implementing significant reforms in the capital market. In order to facilitate the rapid diffusion of information technology, the government also provides and encourages infrastructure for the Internet age.

6. Korea's Post-Crisis Paradigm: Work in Progress

What has actually happened since the outbreak of the 1997 crisis? Has there been a discernible change in Korea's development paradigm? Which of the four alternative scenarios have become more likely to materialize over time?

The collapse of the hierarchy of authority and changes in the risk profile of economic activities have formed the background of the post-crisis era. In addition, the privatization of risks and rewards and a re-definition of the role of the government have been essential policy challenges. Although the transition to a more market-oriented paradigm has not proven to be a completely smooth process, major changes in attitude are affecting the behavior of economic players in fundamental ways. Transparency, accountability, and differentiation according to ability are becoming the guiding principles, triggering important changes in corporate governance, financial resource allocation, and employment practices.

If converted into concrete institutional reforms, it is likely that these changes will *reorient* the evolution of Korea's development paradigm away from the program of de-control without de-protection and proper regulation, which had been underway since the early 1980s. Korea's investment strategy now requires ever more dependence on the private sector, but in comparison with the pre-crisis era, there are much stronger demands for the institutional reforms required to improve corporate governance and the allocation of financial resources. In the post-crisis period, Korea's conflict management strategy must be based on "the parallel pursuit of democracy and a market economy," as Kim Dae-jung emphasized upon being elected president in 1997. Finally, Korea's external strategy must reserve a much greater role for foreign direct investment and market liberalization. Certainly, there is no guarantee that the institutional changes necessary to reshape Korea's development paradigm will be implemented. The collapse of the hierarchy of authority and changes in the risk profile of economic activities, however, do improve their chances in the post-crisis era.

(1) Dramatic Changes in Individual Mentality and Behavior

The economic crisis cast into doubt the competence and integrity of the politicians, bureaucrats, and *chaebol* bosses who once wielded a great deal of influence over the economic system. Although people were willing to make united efforts, under the leadership of the new government, to overcome the economic crisis, their belief in the ruling elite was fundamentally shaken. With the recognition that people were no longer willing to depend on the government to provide paternalistic guidance, non-governmental organizations (NGOs) stepped in to fill the vacuum created by the collapse of the hierarchy of authority. These organizations have led campaigns to demand private remedies and fundamental political reform. NGOs have argued that given the problem of "monitoring the monitor," opening legal channels for interested parties to exercise their rights (i.e., private or group remedies) is the ultimate solution.

The economic crisis, which put into question the desirability and effectiveness of the government-business risk partnership, also greatly weakened the position of the *chaebol* bosses. The principle of holding top managers and majority shareholders accountable for bankruptcies quickly gained popular acceptance as taxpayers became increasingly hostile to the idea of providing public funds for the old-style bailouts that

had preserved the interests of existing shareholders and managers. People began to accept the idea of privatizing risks and rewards.

In addition to eroding the legitimacy of the existing hierarchy of authority, the collapse of the old paradigm based on the public management of private risks dramatically changed the risk profile of economic activities. The series of major bankruptcies seems to have had the desired effect of inducing firms, financial institutions, and investors to behave more cautiously, while the massive semi-forced retirements in the wake of the crisis seems to have led individuals to make efforts to improve their market value.

As it became clear that the state would no longer bear private risks and protect existing shareholders, private firms began to realize the importance of risk management. Since the outbreak of the crisis, most firms have tried to improve their debt-equity ratios and cash flows by issuing new equity and selling assets. According to the Bank of Korea, the average debt-equity ratio for the Korean manufacturing sector declined from 396.3 percent in 1997 to 210.6 percent in 2000. The interest coverage ratio (operating profit / interest expenses) improved from 1.29 to 1.57 during the same period. The end of the “too big to fail” myth, together with intensifying global competition, began to force companies to exercise prudence in investment planning and to concentrate on developing core competencies.

In the financial sector, the unprecedented closure of banks and NBFIs changed the attitudes of investors toward risk. Depositors came to understand that the government would not provide unconditional deposit insurance, and they began to check the soundness of bank balance sheets before making their deposits. The banks, for their part, reassessed the risks involved in lending to highly-leveraged firms and began to shift their business focus toward consumer loans. This shift raised a tantalizing prospect that the *chaebol* would have to improve their corporate governance and transparency in order to obtain more capital through direct financing channels.

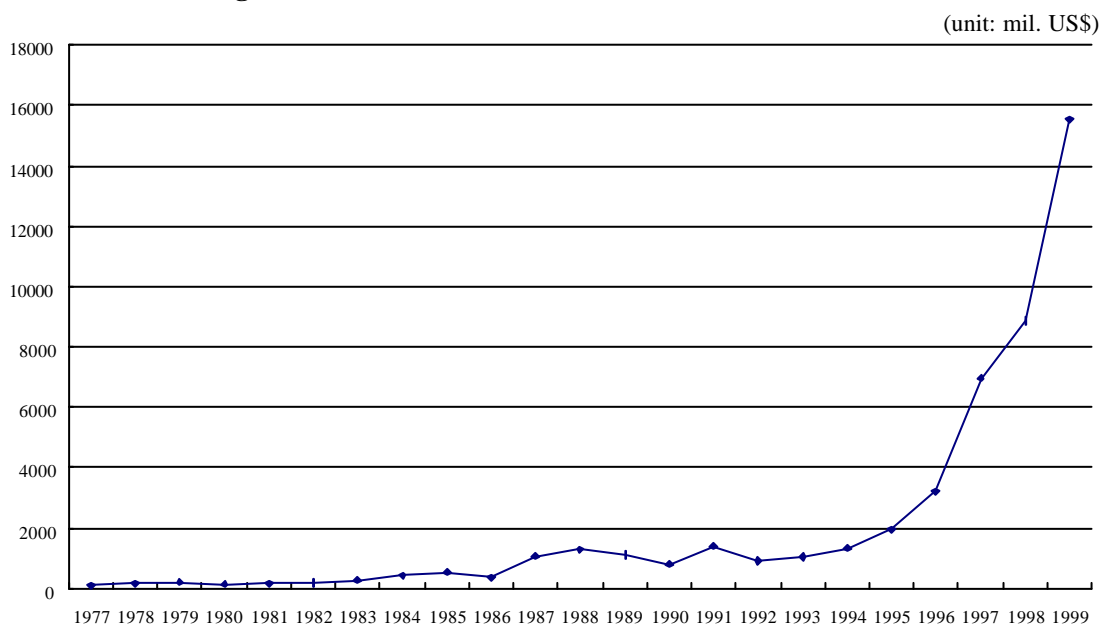
In the labor market, the end of the myth of lifetime employment also drastically changed the risk profile of job alternatives. As “stable” jobs in the public sector and at *chaebol*-affiliated firms turned out to be not so stable, the perceived risk gap between “stable” jobs and “unstable” jobs narrowed. As a result, workers became more willing to move from the “stable” to the “unstable” sector, making personal efforts to enhance their “market value” or mobility. For example, some of the best and the brightest among public servants moved to the private sector in the wake of the economic crisis, and many top-notch college graduates began to consider job choices other than *chaebols*. The IT revolution and the increasing tendency to value ability rather than seniority reinforced this trend. In this regard, it may be useful to note that the economic crisis also damaged the authority of the older generation. Traditional practices such as seniority-based wages no longer seemed tenable in an increasingly competitive environment, and it became increasingly difficult to justify authority based on something other than ability.

(2) Institutional Reform: Accomplishments and Limitations

With the authority of the *chaebol* bosses greatly weakened by the crisis, president-elect Kim Dae-jung announced five principles of corporate restructuring in January 1998. These principles included: (1) enhancing transparency in corporate management; (2) eliminating cross debt guarantees; (3) improving financial structures; (4) improving corporate governance; and (5) streamlining business activities. Principles (1) and (4) were designed to address the problem of “arbitrary imperial rule” by the *chaebol* bosses, most of whom at the time, though not even legally registered as chief executives, exercised complete control over their firms. The intent of principles (2), (3), and (5) appeared to be to break up the “convoy-style” structure of the *chaebol*.

In this early period, a series of policy measures designed to improve corporate governance and protect the property rights of minority shareholders was implemented. From 1998, all publicly listed firms were required to have at least one outside director, in order to promote the effective monitoring of management. Institutional investors were no longer required to follow a system of “shadow voting,” in which they had to cast their votes in proportion to other votes cast instead of exercising their full voting rights. Also, minimum shareholding requirements were significantly reduced for shareholders’ rights, such as the right to file derivative lawsuits against company executives for mismanagement, to request the dismissal of directors and internal auditors, to review accounting books, or to call for a general shareholders’ meeting [Park (2001)]. Non-governmental organizations (NGOs), such as People’s Solidarity for Participatory Democracy, led a campaign to introduce reforms designed to improve corporate governance.

Figure 4 FDI Flows into Korea (Notification Basis)



Source: Ministry of Commerce, Industry and Energy

In addition to institutional reforms designed to improve corporate governance, the government introduced major changes to the FDI regime. The government enacted the Foreign Exchange Transaction Act in April 1999 to liberalize foreign exchange control. It also completely eliminated the ceiling on foreign equity ownership in the stock market as of May 1998. In the same month, the requirement that foreigners needed to obtain board approval for ownership of more than one-third of the outstanding shares of a firm was removed. Moreover, the government fully liberalized foreign land ownership by amending the Foreigner's Land Acquisition Act in 1998.²⁰ In November 1998, the Foreign Investment Promotion Act was enacted to replace the Act on Foreign Direct Investment and Foreign Capital Inducement. The new legislation focused on creating an investor-friendly environment by streamlining foreign investment procedures, strengthening investment incentives, and establishing an institutional framework for investor relationship management, such as the "one-stop service." The government also scrapped its import diversification policy in 1999, which had been used since 1978 to block the inflow of Japanese consumer imports (justified on the ground of Korea's large bilateral trade deficit with Japan). Although this measure was not directly connected with changes in the FDI regime, it reinforced the impression that the government was serious about fundamentally reorienting its external strategy.

Compared with these positive institutional reforms in Korea's FDI regime, which have resulted in a dramatic increase in FDI inflows (see Figure 4), progress in corporate restructuring has been rather slow. Out of concern over charges of revived interventionism as well as possible litigation a few years down the line, the bureaucrats minimized their involvement in corporate restructuring in the immediate post-crisis period. Instead, they opted for "bank-led corporate restructuring"—an oxymoron in view of the fact that the commercial banks in Korea were controlled by the government and were in no position to lead. As they had done before the crisis, the bankers looked to the government for guidance on how to deal with distressed firms. More often than not, "bankruptcy suspension" was the result, as the banks rescheduled just enough debt to keep the firms going and the government, which was the controlling shareholder of these banks, provided little guidance. A number of so-called "workout" firms were allowed to prolong their lives in a state of limbo.²¹

Although the government did introduce policy measures (e.g., a tighter *forward-looking criteria* [FLC] for asset classification and provisioning) to encourage the banks to take decisive actions against financially distressed firms, the speed of implementation left something to be desired. As the controlling shareholder in the nationalized banks, the government should have taken more proactive measures to facilitate corporate restructuring while quickly implementing reforms designed to enhance market discipline. Instead, it has tended to be quite reluctant to intervene to facilitate the orderly exit of nonviable firms, though has been far less hesitant to step in to prop up questionable firms in the name of stabilizing the financial system. Increasingly, it has tended to put off the day of reckoning for distressed companies and nudge creditors to

²⁰ In the words of Pietro Doran, a real estate dealer, Korea went from one of the most closed real estate markets in the world (including PRC) to one of the most liberal.

²¹ To the government's credit, it did allow the Daewoo Group to go bankrupt in 1999 after vainly trying to come up with a solution that would have had a smaller adverse impact on the financial system.

opt for bankruptcy suspension, in the hope that the companies themselves might take care of their problems through self-rescue programs. In many ways, this represents the safest course of action for bureaucrats: intervening just enough to avert an immediate catastrophe but keeping their hands off so as not to invite charges of “killing off valuable firms” or “granting unjustifiable favors to the well-connected.”

The restructuring of the financial sector was compromised by similar problems. Because of past mistakes involving weak prudential regulation and arbitrary intervention, the government was less than strict in applying the principle of accountability to investors who had made their decisions under past regimes. Concerns about systemic risks also played a part. In fact, the resolution of the Daewoo crisis in 1999 was delayed due to these concerns. In the end, the government decided to err on the “safe” side, and used taxpayers’ money to bail out individual investors rather generously, allowing them to redeem up to 95 percent of the face value of Daewoo corporate bonds. Many critics argued that the government carried the “path dependence” logic too far and failed to take advantage of a golden opportunity to address the problem of moral hazard and to establish the principle of accountability.²²

As a result, after the end of the promising start in the early phase of reform, corporate- and financial-sector restructuring in Korea was primarily driven by liquidity injection.²³ In combination with a V-shaped recovery in 1999, the National Assembly elections in April 2000 slowed the momentum for fundamental reform. The government became increasingly reluctant to close nonviable firms and financial institutions. Bank privatization and the separation of banking and commerce were not even seriously considered.

(3) Dashed Hopes and Remaining Challenges

Since the outbreak of the economic crisis, Korea’s development paradigm has been affected by a confluence of changes in institutions as well as changes in people’s expectations. Although it is too early to draw a definitive conclusion on the new development paradigm, it is becoming increasingly clear which of the four alternative scenarios discussed in the previous chapter is more likely to unfold.

The V-shaped recovery in 1999 all but extinguished popular fears about complete foreign dominance. Freed from the fear of having to sell assets to foreigners to pay off debt, some Koreans began to express nationalistic sentiments. During the National

²² Nevertheless, it must be acknowledged that imposing even a 5-percent loss rate on investors represented a dramatic departure from the past. In the pre-crisis period, financial institutions had made easy money by “guaranteeing” more than 90 percent of all outstanding corporate bonds, with an implicit understanding that the government would come to their rescue in time of crisis. Unnerved by the Daewoo fiasco, investors became aware of default risks, and interest rates on corporate bonds began to reflect risk differentials. Prior to the economic crisis of 1997, no meaningful rate spread existed in Korea’s corporate bond market.

²³ In order to clean up nonperforming loans and maintain a functioning financial system, a total of 109.6 trillion won, the equivalent to almost one-fourth of Korea’s GDP, was injected in the first round of financial-sector restructuring. Almost two-thirds of this amount was used to rehabilitate the banking system, with the remainder spent in the non-bank financial sector. The second-stage plan envisages outlays of 50 trillion won, of which 10 trillion won would be recycled money and 40 trillion won additional public money.

Assembly election campaign in the spring of 2000, some even argued that selling assets to foreigners would amount to “a drain of national wealth.” The revival of these old attitudes toward foreign investment has been limited in scope, however. Most Koreans now accept increased foreign presence as a fact of life. For instance, the share of foreign investors in the market capitalization of companies listed on the Korea Stock Exchange increased from 14.6 percent in 1997 to 30.1 percent in 2000, and most Korean investors view this as a positive development. Those foreign companies that have managed to establish a foothold in Korea have also generally received positive publicity. Companies such as Volvo and Clark are using their Korean operations as production bases for the potentially lucrative PRC market, and their management techniques are portrayed in a favorable light. Volvo Korea, in particular, was put in the spotlight when its chief executive was promoted on the grounds of his success in Korea. In the financial sector, the Korea First (Cheil) Bank, which was taken over by the New Bridge Capital, has appointed a foreign CEO, and completely changed its way of doing business, focusing mainly on retail banking. The Korea First Bank has also been at the forefront of rejecting interventionist measures by the government. Through equity participation, a number of foreign financial institutions are also exerting a great deal of influence on the way Korean banks provide credit.²⁴

Although nationalistic sentiments continue to be expressed, Koreans are gradually coming to appreciate the potential benefits of foreign direct investment. In the case of Daewoo Motors, for example, in the second half of 1999 there was a heated debate on the wisdom of selling it to a foreign company, such as Ford or GM. A series of successful FDI cases, including Renault’s takeover of Samsung Motors in early 2000, however, led the public to change their views on foreign companies. People are now clearly less persuaded by arguments in favor of injecting massive resources into financially distressed companies and transforming them into state-owned enterprises for industrial policy reasons. On the whole, the weaker version of the “foreign dominance” scenario — which may be called the “foreign presence” scenario — has become acceptable in Korea.

Against the background of the V-shaped recovery in 1999, the “government intransigence” and “*chaebol* resurgence” scenarios seem to have become very likely possibilities. While institutional reforms in corporate governance and financial resource allocation were certainly less than adequate to address fundamental problems, the government engineered a remarkable turnaround in economic performance with its liquidity-driven restructuring program. With the assistance of favorable external conditions, Korea’s GDP growth rate soared from minus 6.7 percent in 1998 to a positive rate of 10.9 percent in 1999. The surviving *chaebol*-affiliated firms, for their part, could proudly point to greatly increased profits. Critics warning of the remaining problems in the economy were dismissed as Cassandras — as if a little more than a year of reform could have managed to remove all structural problems. The government and the *chaebol* continued to control the lion’s share of financial institutions. Although President Kim Dae-jung mentioned the need for a separation of banking and commerce in his speech of August 15, 1999, no concrete actions were taken. Nor was any program

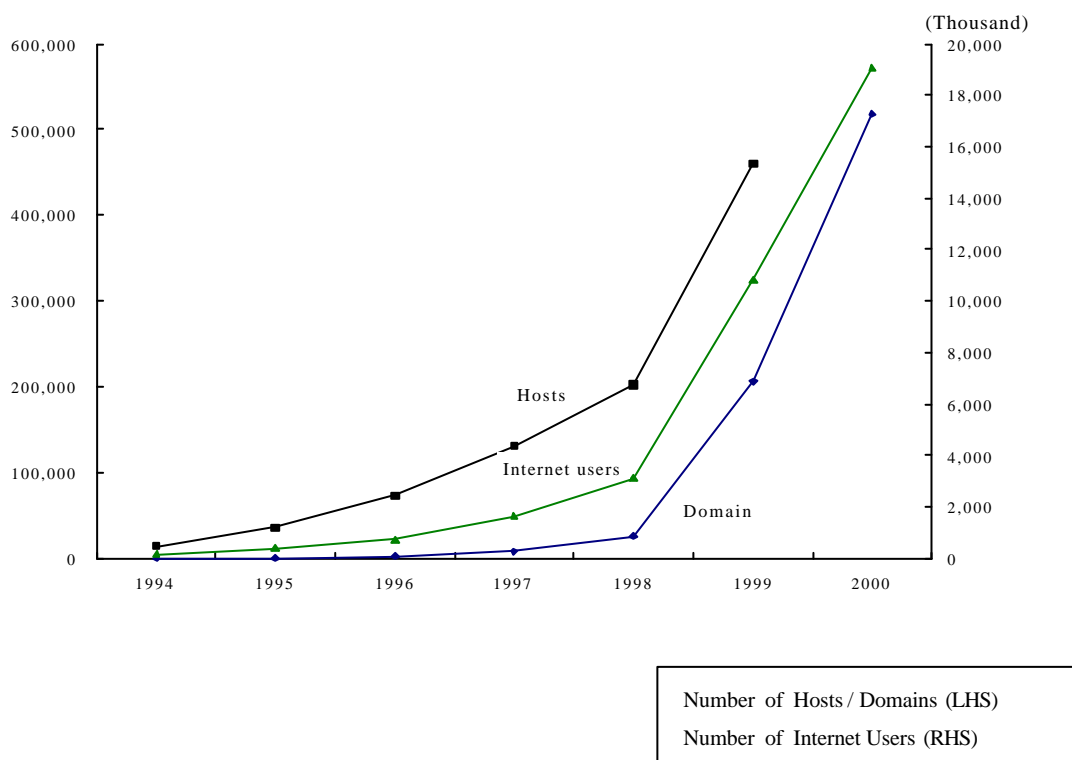
²⁴ For instance, as of end-2000, Goldman Sachs had a 11.1-percent equity stake in Citizens (Kookmin) Bank; the Bank of New York and ING group respectively had 13.1 percent and 10.0 percent of the Housing and Commerce Bank.

formulated to facilitate the privatization of the banks. In the area of corporate governance reform, the mandated increase in the number of outside directors did little to change the established practices of the *chaebol*. The V-shaped recovery reduced the perceived need for fundamental reform.

People increasingly began to talk about a narrower version of the “New Economy” scenario, focusing exclusively on the IT revolution and overlooking the importance of effective deregulation and stable macroeconomic policy. There was a great increase in the number of venture firms and an explosion of Internet-related businesses, thanks in part to government support. The number of venture firms nearly quadrupled from 1,514 in September 1998 to 6,004 in March 2000. As shown by Figure 5, Korea’s internet revolution was truly impressive.

Buoyed by a stock market boom, venture firms even began to attract talented workers away from the *chaebol*. These venture firms seemed to offer an alternative to the *chaebol* as many of them operated on principles closer to the Anglo-Saxon model. From the start, it seemed unlikely that these start-ups would completely replace the industrial giants, but the *chaebol* found themselves having to respond to the important changes introduced by these start-ups. For instance, they increasingly began to offer employee stock option plans and other incentives to retain talented people and induce them to make firm-specific human capital investments. It was hoped that these changes would lead to enhanced transparency in corporate governance and increased differentiation according to ability, thus reducing the structural problems.

Figure 5 The Internet Boom in Korea



Source: Re-cited from Sung (2001), p.126.

These high hopes were, however, all but dashed by the middle of 2000. Under the effect of deteriorating external conditions, the Korean economy began to slow down. In particular, rising crude oil prices and falling semiconductor prices worsened its terms of trade. In addition, the bankruptcy of the huge Daewoo Group in 1999 greatly increased nonperforming loans in the financial system. Due to political considerations in an election year, however, the government was slow to make requests for additional public funds. There was also a sense that the initial batch of public funds, which exceeded 100 trillion won, had been injected according to bureaucratic discretion rather than a well-defined set of rules. Under the burden of nonperforming loans, financial institutions began to reduce their supply of credit.

Moreover, the Saehan Group's abrupt filing for workout proceedings in May revived concerns about the reliability of credit ratings, as the company had been consistently rated investment-grade. It once again highlighted the need to enhance the transparency of corporate management and accounting. In addition, the Saehan case raised uncertainty about the viability of medium-sized *chaebol*, and resulted in a flight to quality in the financial market. The credit crunch was aggravated by the continued existence of nonviable workout firms, which "sucked in" precious resources at the expense of their competitors. Both the bureaucrats and the nationalized banks had incentives to stick to this forbearance policy instead of adopting structural measures such as privatization which would make bank-led corporate restructuring more credible.

On top of these reminders of the incomplete nature of the reform in the financial sector, the feudalistic infighting for corporate control at the Hyundai Group illustrated that Korean firms had changed very little with regard to corporate governance. At times, even the government seemed to disregard the basic principles of corporate governance and encourage the founder families to revert to their old ways, urging profitable companies to come to the rescue of their "brother" companies in distress.²⁵

In short, as long as Korea continues to harbor structural problems in the areas of corporate governance and the allocation of financial resource, the investment efficiency of the economy is likely to suffer, making it extremely vulnerable to external shocks. Unlike in the early stages of economic development, Korea no longer has an abundance of unexplored profit opportunities. It needs to allow a broad base of project evaluation experts to develop. In particular, the reform program should focus on improving the autonomy of the financial sector and introducing private remedies such as class action suits to address the problem of corporate governance. Only then will Korea be able to realistically dream about having a New Economy of its own.

²⁵ For the Hyundai case, there is an interesting anecdote that is quite symbolic of what kind of change is taking place in the corporate governance of Korean firms. In the late autumn of 2000, it was rumored that the government was urging profitable Hyundai affiliates to provide assistance to Hyundai Engineering & Construction and other affiliates in financial distress. People's Solidarity for Participatory Democracy (PSPD), an NGO campaigning for corporate governance reform, sent a letter to Hyundai executives, warning that it would take legal action on behalf of shareholders if unjustifiable resource transfers take place. The Hyundai executives at the profitable affiliates circulated copies of this letter, emphasizing that shareholder pressure prevented them from providing support to the troubled affiliates. Nevertheless, it was alleged that the government was stepping up pressure on these executives, if only to avert a massive bankruptcy and minimize potential taxpayer cost. A few days later, PSPD received a telephone call from a Hyundai executive. He asked the NGO to send a more strongly worded warning letter.

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