
Korea and the Asian Economic Crisis:

Did Korea Change its Economic Model?

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ABSTRACT

The Korean economy has evolved remarkably well for the last 60 years. Its performance has been admired and copied worldwide. But at the end of the 20th century, a crisis that apparently was not related to its economy, devastated the Korean model.

This thesis focuses on the causes and consequences of the happenings during that time. The thesis will deal with the economic and governmental evolution of Korea until the 1990s, the structure of the Asian crisis itself and the fall of Korea that was caused by it.

Keywords: Asian economic crisis, Korean Economy, financial crisis, prudential regulation, chaebol, reforms, resource allocation, moral hazard

Corea y la crisis económica asiática. ¿Cambió Corea su modelo económico?

La economía coreana ha tenido una evolución extraordinaria durante los últimos 60 años. Su rendimiento ha sido admirado y copiado mundialmente. Pero en la última década del siglo XX, una crisis que aparentemente no estaba relacionada con su economía, devastó el modelo económico coreano.

Esta tesis se centra en las causas y consecuencias de este acontecimiento. Para poder realizar el consiguiente análisis, la tesis examina la evolución de la economía coreana durante la segunda mitad del siglo XX, la estructura interna de la crisis asiática, el contagio de Corea y posterior hundimiento del país en ella.

A través del seguimiento del desarrollo del modelo económico, el lector llega a comprender el porqué de la peculiaridad del sistema coreano.

Una vez se llega a la década de los 90, el notorio declive se hace patente incluso antes de la llegada de la crisis al país, debido a la insostenibilidad de la estructura del modelo.

La tesis concluye con un examen de las políticas llevadas a cabo por el gobierno para salir de la crisis y de esa manera adaptarse mejor al mundo globalizado actual.

Palabras clave: Crisis económica asiática, economía coreana, chaebol, crisis financiera, riesgo moral, prudente regulación, reformas, asignación de recursos

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GLOSSARY

\$	US Dollar
¥	Japanese Yen
₩	Korean Won
ASEAN	Association of SouthEast Asian Nations
BBC	Bangkok Bank of Commerce
BIS	Bank's financial Strength
BOK	Bank of Korea
BOT	Bank of Thailand
EPB	Economic Planning Board
FDI	Foreign Direct Investment
FSC	Financial Supervisory Committee
GDP	Gross Domestic Product
HCI	Heavy and Chemical Industries
IMF	International Monetary Fund
KFTU	Federation of Korea trade unions
KPFOC	Korea Public Fund Oversight Committee
MOF	Ministry of Finance
MOFE	Ministry of Finance and Economy
NBFI	Non-Bank Financial Instiutions
NPL	Non Performing Loans
OBS	Office of Bank Supervision
OECD	Organization of Economic Co-operation and Development
SME	Small and Medium Entreprises
SOE	State Owned Enterprise

I. INTRODUCTION

Korea has been considered one of the Asian economic miracles. It is obvious that the remarkable fast development of the country is a source of admiration and study. Plenty of countries have been looking closely to the Korean economic model in order to acquire some of the secrets that makes it so unique.

The effort of the private and public sectors to improve the initial conditions of the Korean economy are impressive. However, not everything is what it seems.

By the last decade of the 21st century, Korea was one of the most promising countries. Its outstanding numbers in GDP growth, productivity and trade balance were considered by everyone as a sign of maturity and good economic performance.

Nevertheless, the opacity of the business practices and the unusual relationship between Korean firms and foreign capital hindered the real facts about its efficiency. Therefore, nobody expected the Korean economy to be affected by market instability and mistrust. When the Asian bubble burst in the Southeast Asian countries, its economy looked sturdy and healthy.

How come Korea was one of the most affected countries? Why did the whole model fall apart so quickly? Can it happen again?

This work is an introduction to the practices implemented by different governments with the same target; the progress of Korea.

The main objective of this thesis is to analyze the evolution of the Korean economy after the Korean civil war and to expose some of the reasons why the admired model was just a veneer. The thesis inquires its evolution until the recovery of Korea from the Asian economic crisis, which has been the most remarkable crisis that affected the Asian economy until today. The signs of an alteration in the course of the system after the crisis are appreciated today, but are they enough? Is there a real change in the established pattern?

Therefore, the intention is to provide the reader with enough information in order to judge the strengths and weaknesses of this singular evolution and to ascertain if the system has significantly changed after the 1090s shock.

The thesis is divided in 5 main parts: an introduction to the Asian Economic Crisis, the evolution of the Korean economy, the effect of the crisis in the Korean model and the conclusions.

In order to acquire all the necessary information to write this thesis, research has to be done on official documents from international institutions like the World Bank, the IMF and the Bank of Korea. In addition, the work from several recognized authors was consulted as well as reports, conferences and books. Therefore the methodology used to carry out this thesis is a mix between a qualitative and a quantitative analysis.

There is a clear consent on what triggered the crisis in Korea but there are some divergences when dealing with the performance of the measures established to tackle the shocks.

The study of the Korean system might be very profitable for developing countries. The Korean governance and its failures are highly valuable for states that are struggling with moral hazard and public-private resource allocation.

Taking the singularity of the model in account, the Korean experience could be a waybill for those specialists trying to solve the puzzle of poverty, stagnation and poor natural resources.

I would also like to point out that in order to deeply analyze the consequences of the political measures taken to heal the economy, it would be necessary to continue the research. Therefore, the conclusions extracted from the work accomplished are the outset of a deeper analysis to be done. Given the restrictions of time and size of the thesis, the work can't be pursued until the end. Hence I would like to clarify that the results obtained might not be completely adjusted to the current reality of the Korean economy.

II. ASIAN ECONOMIC CRISIS: THE ILLNESS OF THE TIGERS

Asia is the world's largest and most populated continent in the world.

The Asian economic crisis that started in 1996 as a real estate problem of Thailand spread over several Asian countries during the late 90's and cost billions of dollars to its economies.

The crisis itself only lasted 3 years, from 1997 until the end of the millennium. The length of it shows the strong healing capacity of these markets and the flexibility to adopt painful policies.

Even though not all the countries were deeply affected by the crisis, the entire region was touched by the shockwave that provoked market instability, negative expectations and fear of a market meltdown¹. Even satellite countries were negatively touched by the shaky situation and the interrelations between countries made the crisis go beyond Asian borders; Australia and New Zealand decreased exports due to the fact that Asia was one of its bigger export markets. Russia and Brazil had a bond crisis (Goldfajn, 2000), sub-Saharan countries suffered from the decline in world commodity prices and a decline of the imports from East Asian countries. Specifically of metals, fuels, and agricultural raw materials, which are important exports from sub-Saharan countries (Calamitsis, 1998).

But like in other international crises that took place before and after this one, the macroeconomic situation looked "fine". No major advisements were made by international regulators, only after the entire financial system collapsed.

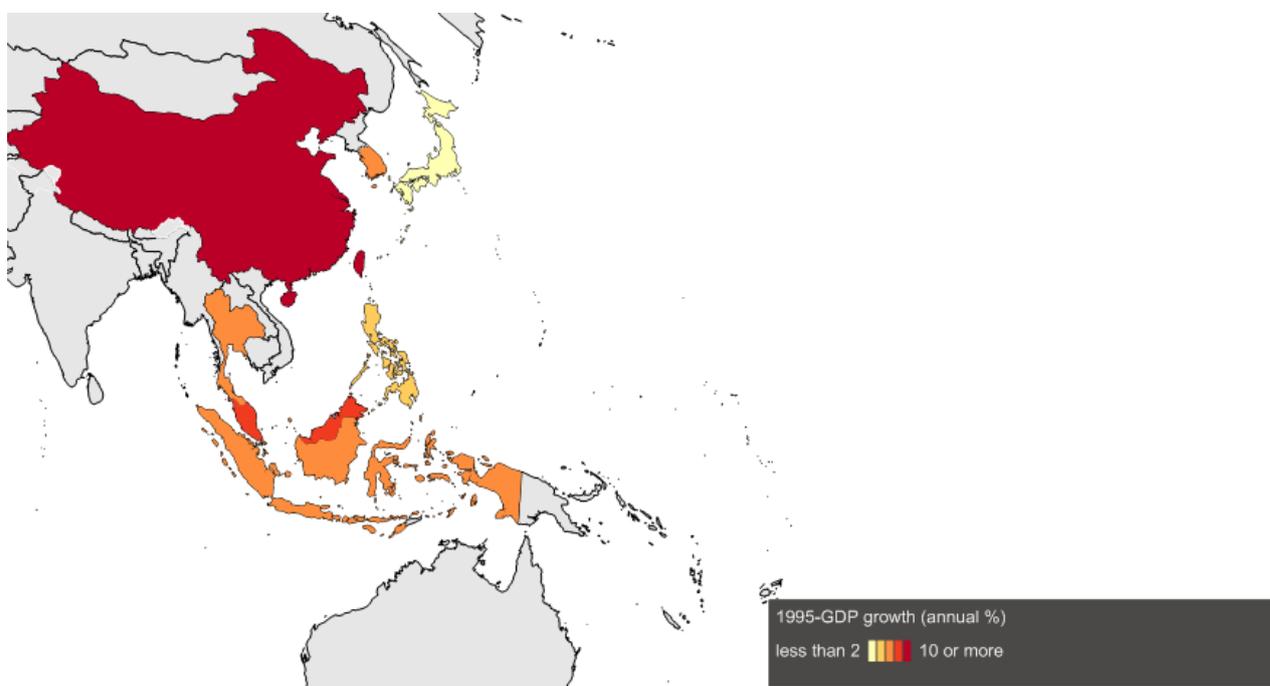


Figure 1. Source: World Bank

¹ See Annex 7.1

2.1 Economic situation

Diverse factors influenced the crisis, some with more intensity than others, but it is clear that it was the sum of various situations that lead to the fluctuation of the Thai baht without control.

East and South East Asia is one of the most populated areas in the world. In the 90's decade they had 25 % of the world output (Veneroso, 2002) , 50% of the world growth and almost two thirds of the world capital spending.

In this context, several things occurred in a matter of years:

China devaluated its currency in 1990 and 1994, the Yuan was the most undervalued major currency in the world. This worsened competitiveness and the exports shrunk.

Due to an agreement with the American government, the Yen depreciated against the dollar, making South East exports even more expensive than the Japanese ones and losing more competitiveness on the way.

Added to these financial readjustments, there was a decline in the semiconductor prices which affected all the technological companies, mostly located in this part of the world.

With the new adversely scenario, Thailand was going to suffer from a major default.

Net capital flows; Indonesia, Philippines and Thailand. 1985- 2006 (US \$ billions)

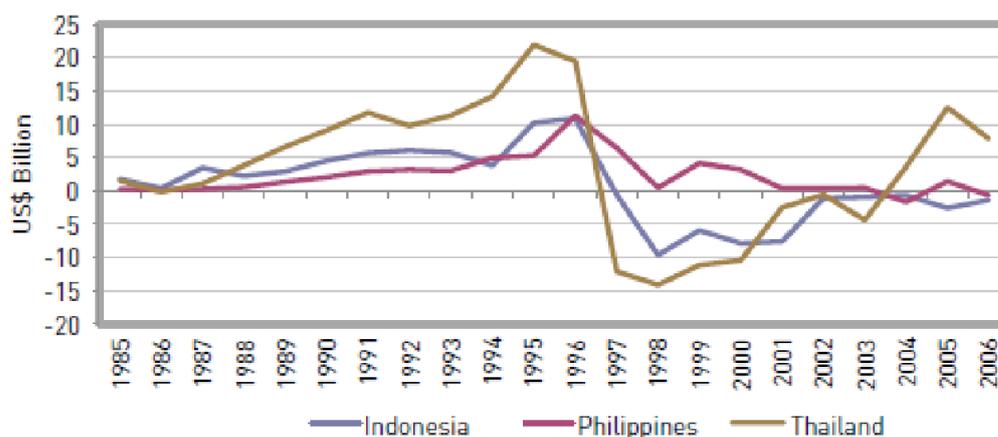


Figure 2. Source: IMF Financial Statistics

The Figure above shows the panic that predominated in the markets. The crisis was continuously fed back by bad expectations of economic performance and because of that no capital channeled into the economies. The most affected countries applied completely different economic policies and in the end, all of them emerged from the catastrophic scenario.

A general sighting of the performance and the consequences of the crisis in the most affected economies is in need. Therefore, the Thai, Indonesian and Malaysian economies are mentioned specifically.

2.2 The Thai fall

Thailand was a very successful country in the region. With a continuous annual growth of 9%, there were high expectations on the Thai economy.

On one hand, foreign investors were highly attracted by healthy internal conditions. The interest rates, policies of financial market deregulation, nominal exchange rate stability between 24.91- 25.59 Baht/Dollar, inflation rate between 3.36% and 5.7% and a trade surplus (Table 1). And on the other hand, the international complicated scenarios (stagflation of the Japanese economy, recession in the European economies). The combination of these macroeconomic conditions produced a pull factor towards foreign capital. Investors from overseas, started to invest massive volumes of capital in the economy.

This fueled a bubble in real estate that affected the cash flow of the Bangkok Bank of Commerce (BBC), especially because of its borrowing from politicians that were not able – or willing – to pay back. Then, the BOT (Bank of Thailand) decided to intervene in order to avoid a major political scandal, and when it finally came out, the reputation of the BOT was severely damaged.

The BOT, foreseeing a major problem with liquidity and cash flow, elevated the reserve requirements in all financial institutions. Stronger banks have higher reserves, which affect its profit and the money supply.

Because of prior complications with the real state bubble, the Thai government decided to suspend the trading during one day of all financial institutions in the country. This policy was directed towards containing possible instability.

The banks and finance companies couldn't pass the test, and due to the biased licenses held by the Thai government there was concern that all the securities and finance companies would go bankrupt (Leightner, 2002).

In this panicking scenario, there was a speculative attack against the Thai currency² that created a severe credit crunch problem. While the government promised to save some of the biggest financial institutions, the BOT spent 28 over 30 billion of its international reserves to defend the value of the Thai Baht in the international market.

After realizing that the situation could not last longer because of the capability of the government to face the amount of foreign liabilities inside the economy, a switch in the policy was made; Thailand went into a flexible exchange rate system. The Thai baht

² See the annex 7.3

devaluated around 20% after the announcement and telephones were ringing all over the region. This was the beginning of the contagion.

Table I. Selected Economic Indicators. Thai economy (1996 -2000)

	1996	1997	1998	1999	2000
	(Percent change)				
Real GDP Growth	5.9	-1.7	-10.2	4.2	4.5 to 5.0
Consumer prices (period average)	5.9	5.6	8.1	0.3	3.0
	(Percent of GDP [minus sign signifies a deficit])				
Central government balance	1.9	-0.9	-2.4	-2.9	-3.0
Current account balance	-6.0	-7.9	-2.0	12.7	9.1
	(In billions of U.S. dollars)				
External debt	90.5	93.4	86.2	76.0	67.8

Sources: Thai authorities and IMF staff estimates.

On July 28th 1997, the Thai government decided to call the IMF. With almost all its foreign reserves drained, the Asian country was in urgent need of capital. It required to renovate the confidence in its currency, therefore it demanded access to the IMF funds. Without the intervention of the reputed international agency, it was a matter of time the whole country might go bankrupt. The tendency of depreciation of the Thai Baht against the Dollar was continuing. The IMF intervened with a combined bailout of \$ 20.9 billion between the institutions and some selected countries of the region. But the flow of capital came with strict economic measures to readjust the economic trend.

Some of the measures were:

- Increase taxes
- Cut public spending
- Privatize state owned businesses
- Raise interest rates
- Close illiquid financial institutions

All of these measures were oriented towards a cooling of the overheated Thai economy.

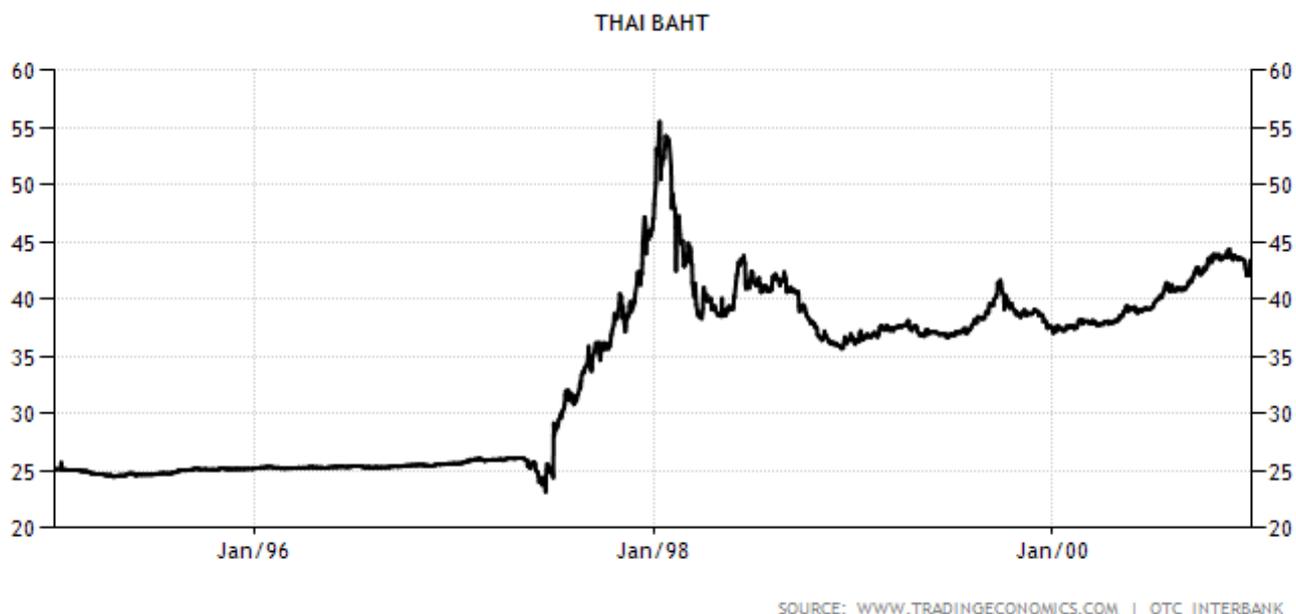


Figure 3. Source: World Bank

2.3 Spreading over: Indonesia

Other Asian countries, which were not pursuing the same policies as Thailand, suffered from massive attacks in their currencies, sinking their exchange rates and forcing them to go to IMF in order to maintain economic solvency.

Indonesia, Malaysia and South Korea were the three most affected countries in the region. Even though they were unwilling to be intervened by the IMF, the institution played a major role in order to safeguard a major default in the region.

Indonesia was not suffering from macroeconomic rigidities. It had low inflation, trade surplus and foreign exchange reserves (Table 2). Although the structural weakness of its financial sector (Staff, 2000) and a large amount of short-term private sector external debt contributed to decrease government's credibility against possible liquidity shocks.

Because of the first speculative attack, the Indonesian government widened the fluctuation range with unsuccessful results. After that, it started floating in Nov 1997 and depreciated by 30%.

The continuing depreciation of the rupiah, worsened the situation drastically. The objectives pursued when the attack on the rupiah was being held were achieved; Indonesian companies rushed to buy dollars, thus putting more downward pressure on the rupiah and exacerbating the companies' debt situation. Indonesian companies were going to have massive loses; therefore, securing themselves with a strong currency was thought to be the best solution back then.

TABLE II. Selected Economic Indicators of the Indonesian economy (1996-2000)

	1996	1997	1998	1999	2000
	(Percent change)				
Real GDP Growth	8.2	1.9	-14.2	1.5 to 2.5	3 to 4
Consumer prices (period average)	5.7	12.9	64.7	-0.6	5.4
	(Percent of GDP [minus sign signifies a deficit])				
Central government balance	1.2	-1.1	-2.2	-3.3	-4.8
Current account balance	-3.4	-0.9	4.4	3.1	1.9
	(In billions of US dollars)				
External debt	127.4	135.0	149.9	147.6	149.1
	(Percent of GDP)				
External debt	54.5	163.1	129.0	91.0	86.9

Sources: Indonesian authorities and IMF staff estimates.

IMF and other Asian countries came to help Indonesia with around \$ 45 billion, which were not enough to content the falling of the Rupiah. By 1998, 16 insolvent banks were closed and the Rupiah had fallen by 65%. Firm money control policies were settled in order to decrease inflation. Meanwhile population had to hoard food (figure 4) fearing deeper devaluations that wouldn't allow them to buy any goods.

The most prompt effect for the population of Indonesia was the accelerating inflation. During the first semester of 1997 Indonesia sustained a fairly low inflation rate (2.6%), but in the 6 following months, the inflation went up to 11%. By February 1998, Indonesia's inflation rate was 20% and the estimated inflation for the upcoming year was ranged from 50 % to 100%.

Indonesia had to face a major political crisis, where a persistent regime was challenged on the streets for a new democratic order. By spring 1998 Jakarta suffered dreadful riots, which ended with one thousand people killed and thousands of buildings destroyed.

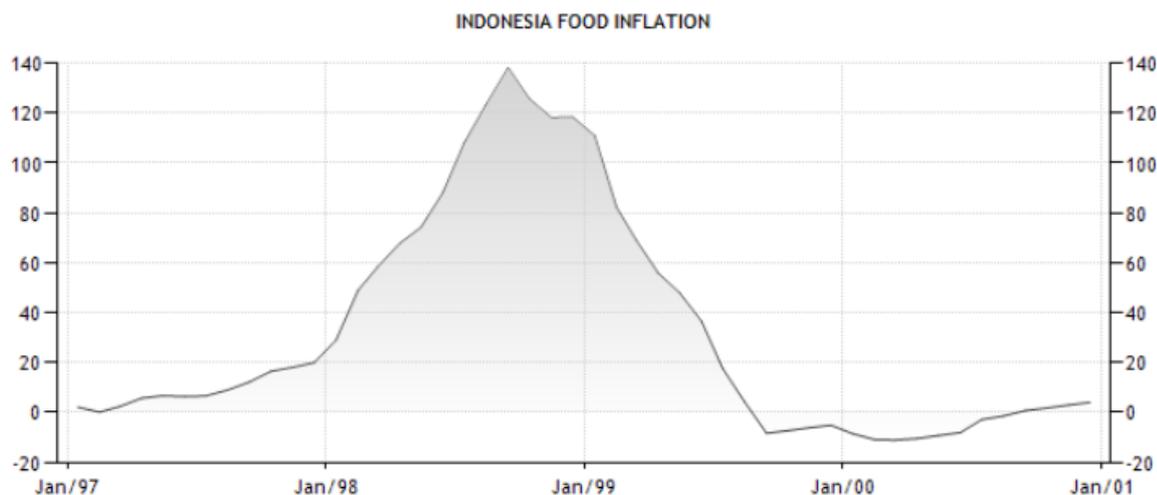


Figure 4. Source: World Bank

2.4 Other affected countries

Malaysia Philippines and Japan were also affected, but their macroeconomic conditions allowed them to dodge the most dramatic phases of it.

A particular case is Malaysia, where there main difference between was the way they addressed the situation. In the case of Philippines and Japan the contagion was repelled quickly by reinforcing the reliance of the investors in the countries.

2.4.1 Special Case: Malaysia

Malaysia had a stronger economy than Thailand and Indonesia (particularly in external debt, inflation and fiscal surplus) and was better off than South Korea in savings and equity/debt ratio. Also its banking system was healthier than the other countries.

Unfortunately, this situation didn't prevent its economy from falling into speculative attacks; the ringgit (national currency) shrunk from RM2.4/\$1 to RM4.9/\$1 and the net portfolio investment fell from RM 22 billion to negative RM 12.9 billion. (Goh)

This provoked a crash of the stock market, massive firm bankrupts, the skyrocketing of the foreign debt and ended up with a banking crisis.

Malaysia, like its neighbors, was at the edge of a massive default, so it decided to follow IMF prescriptions in order to face the crisis. It raised interest rates, the currency started to float, and it reduced public spending by 18%.

After the implementation of these measures, the financial crisis developed to an economic crisis. The real economy contracted 14 %. Going in 1997 from positive GDP of 7.7 % to negative GDP of 6.7% in 1998.

Due to the lack of effectiveness of the policies promoted by the IMF and the deteriorated situation, the government decided to leave aside the recommendations given by the international institution and change the strategy.

Dr. Mahathir, the Prime Minister of Malaysia, created the National Economic Action Council for the purpose of centralizing all the economic decisions. He developed an alternative plan to improve Malaysia's economy. The aim of the plan was to restructure the banking sector, stabilize the Ringgit, restore the market reliability, maintain financial market stability and invigorate the economy.

Given the "trinity restriction", the government decided to sacrifice the free capital mobility for the exchange rate stability and the monetary independence.

First they reduced the interest rates gradually from 11% to 3%.

Malaysia was an export country, with an open economy that based its performance on external trade (200% of GDP). Therefore, a stable currency is vital for a good development. Before the crisis, the national currency was traded offshore, this played a big role in the maintenance of the speculative attacks and the continuous devaluation of the Ringgit.³

Fearing a massive default from the exporting companies due to the continuous fluctuation of the Ringgit and the incapacity of paying back the loans, by September 1998, Mahathir prohibited the offshore market trading of the Ringgit and gave depositors certain timeframe for repatriating their offshore deposits back to Malaysia. And the most important policy; Mahathir decided to fix the exchange rate of the Ringgit to RM 3.8 / \$1 (Figure 5).



Figure 5. Source: World Bank

³ During the crest of the crisis, the ringgit interest rate in Singapore soared from 20% to 40% a year, while onshore it was 11%.

These measures were highly criticized by the IMF, especially the ones concerning the capital control and the one-year moratorium from the purchase date of shares on repatriation of proceeds from the sale of those shares. There were also some restraints to convert the ringgit to other currencies, except for trading. And the resident firms were banned from foreign loans unless their income was also in foreign currency.

This last policy was designed to prevent currency mismatch, the major agent that boosted the Asian financial crisis.

The policies executed by Mahathir were aimed to dissuade speculation with the currency and loans, restrict the power of the international capital markets in the real Malaysian economy and prevent the flight of capital by local residents. Nonetheless taking care of the export performance and facilitating the FDI⁴ were also major concerns for the government.

The last package of measures was addressed to revive the economy and the short-term expectations through expansionary fiscal policy; an RM 2 billion package was released in 1997 that turned into a surplus of 2.5% of GDP in 1997, a deficit of 1.8% in 1998 and a 3.2% in 1999.

The last policy pursued, after having the currency stabilized and the speculators far from Malaysia's capital markets, was to restructure Malaysia's financial system.

As a consequence, it created a debt restructuring agency (Danaharta) to take over non-performing loans from banks and supplied guarantee of banking deposits to not close down troubled financial institutions, fearing a deterioration of the situation.

Later on, these measures deeply criticized, proved as a good medicine against the economic situation of Malaysia. Its current account balance went from a deficit of RM 17 billion in 1997 to a positive RM 37 billion in 1998.

2.4.2 Philippines and Japan

Meanwhile Philippines had started an IMF-supported program aimed to adjust the macroeconomic situation of the country through a series of structural reforms in the late 1980's and early 1990's. This helped the country to overcome the crisis at a lower cost than other countries that were also hit by market panic.

Other economies, like Singapore, Japan and Hong Kong had its currencies devaluated and their stock market deeply weakened. Major financial firms collapsed and the governments had to invest large sums of reserves to fight back;

Hong Kong's stock index falls 10.4% after it raises bank lending rates to 300% to fend off speculative attacks on the Hong Kong dollar.

⁴ Foreign direct investment

Japan; In the beginning, the Japanese authorities were confident about the little impact of the crisis in their economy. However, more than half of the total foreign lending was in Japanese banks (Hill, 2000) . One of Japan's top 10 banks, Hokkaido Takushoku Bank Ltd., collapses under a pile of bad loans. Sanyo Securities Co. Ltd., the 7th largest Japanese stock brokerage firm, goes bankrupt with liabilities of more than \$3 billion, and in the end, Japan announces that its economy is in a recession for the first time in 23 years .Although Japan followed the same path as the other Asian countries, the troubles in Japan did have an effect on its economic situation. It significantly debilitated Japan’s ability to step in and take a lead role in solving the wider Asian catastrophe. Instead of Japan, the IMF, in conjunction with the United States, had to step in and stop the free fall in Asian stock markets and currencies. The credibility of Japan as a main source of stability in the region, and as an economic leader of the Asian economies, has been harshly ruined by its incapacity to take a leadership role in solving the crisis.

All these major shocks in the economies affected to millions of workers that went unemployed⁵ (see Figure 7) created a major political crisis in Indonesia that lead to a change of regime and changed the political situation in South Korea.

This new scenario was the one the lead Asia to the new millennium, waking it up from the dream of fast speed growth rate, uncontrolled financial and banking systems and little government ethic.

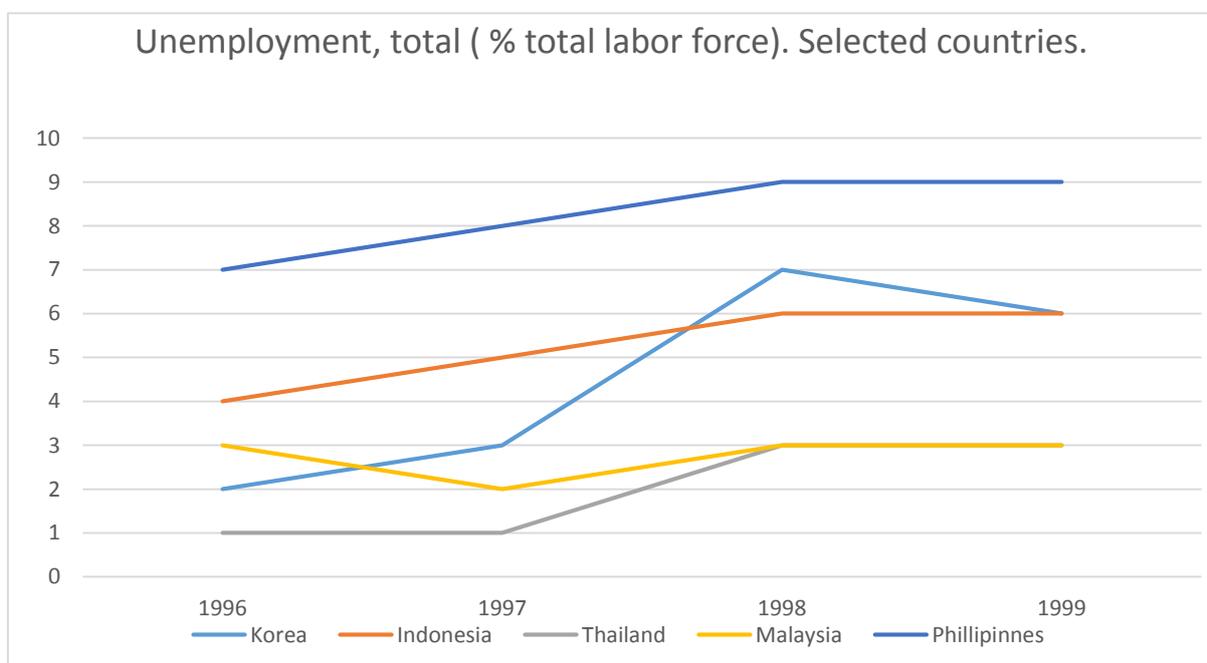


Figure 6. Source: World Bank

⁵ Especially white neck workers in Thailand and industrial workers in SK

III. THE EVOLUTION OF THE KOREAN ECONOMY

The Republic of Korea (Korea, hereafter) has astonished the world with an average growth rate of 9% (Moosa, 1996) over the 30 years previous to the Asian Economic Crisis. Its “economic miracle” hasn’t come alone and without sacrifice. It is well-known how North- and South Korea were devastated after the desolating civil war that harried both of them. In this chapter, the Korean economic system is deeply observed in order to place the reader in the late 90’s with all the necessary information to analyze the impact of the crisis and the measures taken to palliate its effects.

Growth rate of GDP. Selected countries (1970-1996)

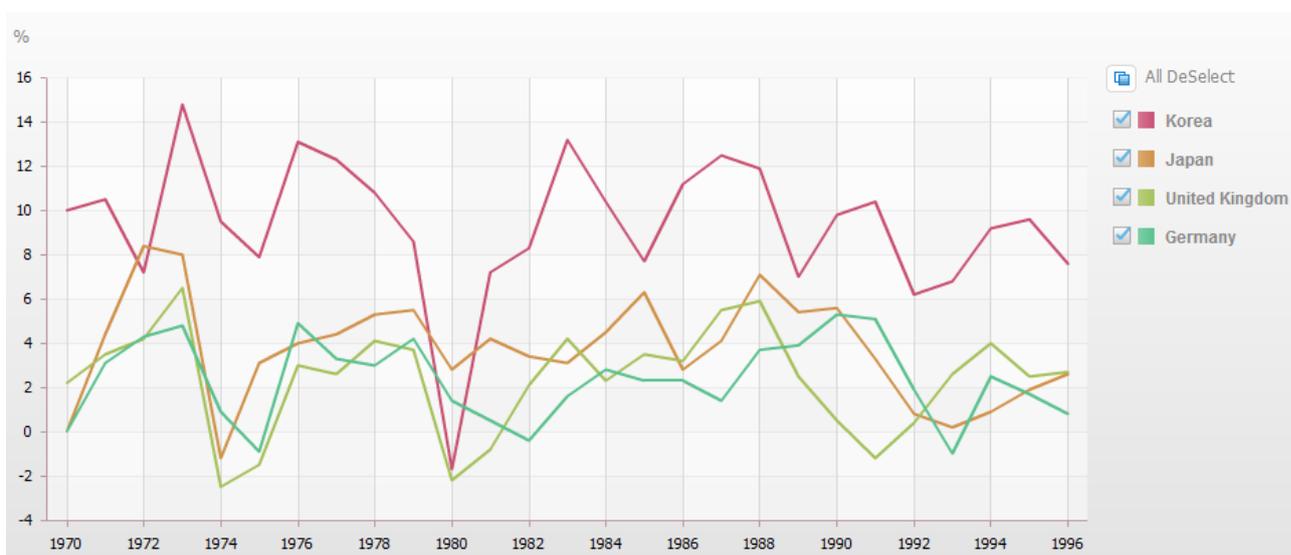


Figure 7. Source: Bank of Korea

The table above is an illustration of how Korea developed in the first 25 years of economic growth. Having a background as mentioned later, it is at least surprising how fast they developed certain areas of the economy. The comparison between Korea and these selected countries shows a fast growing economy that is also very vulnerable to external shocks (see decrease from 1975-1980) and at the same time is surprisingly fast to overcome instability .

3.1 Korea, extraordinary circumstances

Korea is not an ordinary country and its entrance into the second half of the 20th century neither. After suffering from a colonial invasion during 35 years that resulted in a chaotically social situation, stagnation, poverty⁶ and the loss of the main exporting market⁷.

Production in Korea (1910 – 1940)

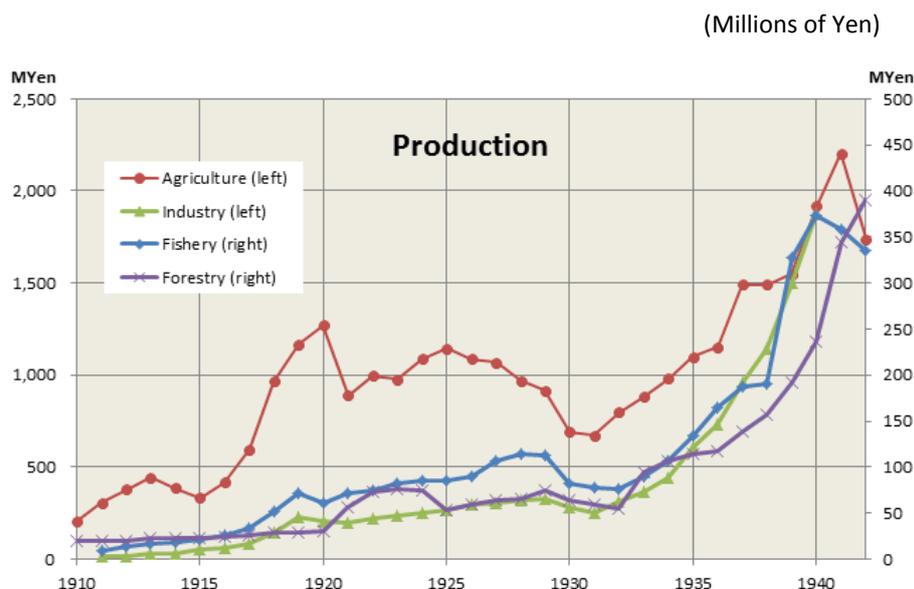


Figure 8. Source: Governor-General of Korea (March 1944)

After the departure of the Japanese rulers, the peninsula of Korea suffered from a bloody civil war during 3 years that ended in the division of both Koreas. In this situation, Korea was left in 1953 with a rent per capita of \$ 67 and a life expectancy at birth of 50 years. After the separation of the Korean peninsula, the Americans backed a moderate group of politicians in order to form a unified government through negotiation.

⁶ Japanese intention was to develop agriculture in Korea in order to satisfy the increasing dependence on rice in Japan. Afterwards Japanese decided to increase the industry in order to prepare the new empire for being self-sufficient and for the foreseeing war. This didn't mean that Korea was benefiting from this development taking place in his own land; Korean capital was just a 1.5% of the total capital spent (unfortunately almost all industrial enterprises were based in the north of the peninsula).

But even if Japan developed a significant number of infrastructure, the political and intellectual power was held by the colonial society, which reduced the access to information and severely limited the positive impact of these improvements.

⁷ More information about the Japanese rule of Korea is presented in the Annex.

3.2 First steps after desolation.

Korea welcomed the 1950s with a desolate civil war for 3 years that ended up with a ceasefire (which is not a peace treaty).⁸

The first president of Korea was Syngman Rhee, a Ph.D. from Princeton that had been exiled in the US for a more than 41 years.

Mr. Rhee lacked a domestic power base and had to cope with the complicated arduous task of re-developing economic institutions, re-assigning property rights and re-establishing the external trade⁹ and foreign exchange regime (Lim., 2000) .

He decided to implement a policy to attract capital and technology, given the fact that Korea had no natural resources (North Korea was richer in resources than the south) and no technology.

Nevertheless his political situation was far from being stabilized, therefore he decided to create a series of alliances to secure his power. He used economic policies to gain supporters, to mobilize funds to finance elections and to improve his relationships with selected private companies.

Through his privatization process, the reader will be able to understand how the mistakes of the Korean economic system were created from the beginning:

The Japanese colonial times left in Korea industrial properties (SOE's)¹⁰ that the government had to take. These firms could have been privatized through a competitive process in order to assure efficiency. Rhee, however, decided to ignore all qualification standards and lowered the qualifications in order to permit the acquisition of these companies from interim plant managers. In return of this favor, generous contributions to Rhee's Liberal party were made.

A similar process was held in the privatization of banks. Rhee's administration put the banks up for sale in 1954 but a series of qualifications were also set up¹¹. Experts were concerned about the possibility of Industrial firms controlling financial institutions and creating a dangerous distortion of resource allocation.

When no bids were able to meet the provisions, the government decided to relax them. Consequently, the fears of the experts became the reality. Industrial capitalists used their

⁸ The fact that both Koreas didn't sign a peace treaty had big consequences for the development of the countries in the XX century. It is explained later how psychosis and fear were used as political weapons to accomplish the desired policies. The enemy right above had a high impact in the society and was used by businessmen too in order to accelerate production to "be more prepared than the enemy".

⁹ During the Colonial time, most of North and South Korea's export were directed to the Japanese Market. From 1910 to 1944, 81.7% of imports came from Japan and 83.8% exports were sold in that market (Lim., 2000).

¹⁰ State-owned enterprises

¹¹ There were a number of provisions set in order to ensure the separation of banking and commerce.

political connections to borrow money from banks in order to bid for them and gain their ownership. By 1957 all major financial institutions were owned by industrial capitalists.

Syngman Rhee was in position to exploit the geostrategic importance of Korea. He was aware that the US considered the country as an important strategic ally. Therefore, he controlled the imported grains¹² and other goods. They were provided as aid by the US and he distributed them directly to government employees and selected manufacturers.

Plunged in a concentrated economic system, government and big enterprises were in control of almost everything in the economy.

Korea's economy was the typical developing country. It was based on big import-substituting industrialization. The economic policy of Korea was the result of crony capitalism with little interest for economic development.

3.3 Changing the course of history

The Korean society couldn't cope with this endless wave of corruption and on May 16th 1961, after a series of riots, General Park Chung Hee made a coup d'état and became former president of the Republic of Korea for 18 years.

General Park was very much concerned about the weakness of South Korea compared to North Korea.¹³ Therefore, he decided to lead the nation to a future of economic development and modernization. His past¹⁴, though, played a big role in the policies he implemented at first.

He created the Economic Planning Board (EPB) substituting in some tasks the Ministry of Finance and the Ministry of International Affairs (Lim., 2000).

The EPB had to develop economic plans for the next five years. This new economic policymaking surprised everyone, especially businessmen who didn't foresee what was coming afterwards. After centralizing the economic planning, the government accused important businessmen to have gained part of their fortune through political favors and corruption.

The military regime confiscated their equity shares in commercial banks alleging tax evasion. This measure facilitated the re-nationalization of banks, after the privatization committed by the predecessor. Following the path of government control over every part of the economic system, General Park transferred the monetary authority from the Bank of Korea (BOK) to the Ministry of Finance (MOF) and therefore the power of designating the monetary policy and the foreign exchange.

¹² Three-white industries: sugar, cotton and wheat flour

¹³ In the 1960s, North Korea's per capita income was estimated to be double that of South Korea.

¹⁴ More information about the past of general Park Chung Hee can be found in the annex.

The government also banned all labor unions and created a national one called Federation of Korea Trade Unions (FKTU).

Korea faced the 1960s with a lack of capital, industry and a much deteriorated foreign image. In this situation decided to set up a plan for accessing foreign capital, boosting the internal demand and re-industrializing the country.

These 3 factors are also complementary, due to the fact that during the 1960s most of the developing countries were in the process of industrializing in order to compete into the yet-to-be globalized world. In order to have internal demand, the population needed to be employed. The Industry was the main source of jobs at that time, and for developing a strong industry network it was necessary to have capital.

The first plan launched by the government (1962-1964) was based on exporting primary products and develop basic industries. This plan sought to help the improvement of the country through helping the industries, and they gave special emphasis to the textile branch.

As a weak and aid-dependent state¹⁵, Korea had no choice but to follow what the US advised. It was more than alarmed when the new government decided to boost economy through “industry deepening”. These industries were the embryos of the companies known today as *Chaebols*¹⁶.

The US insisted in developing infrastructure and human capital as main factors of the economic recovering, as they obviously didn't agree with the main fields of resource allocation.

US Assistance to Korea (1950- 1979)

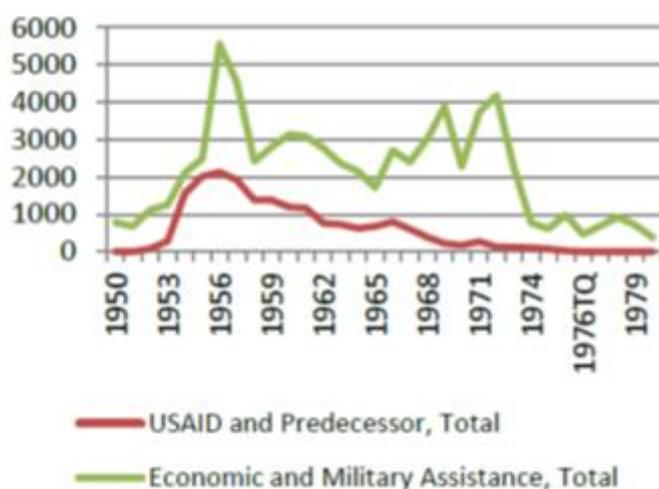


Figure 9. Source: South Korea: From Aid Recipient to Donor. USAID

¹⁵ US aid was 52% of the supplemental budget

¹⁶ See chapter 2.4 Chaebols

This graphic shows the major importance of the US aid-packages in the Korean economy. From 1953 to 1963 it counted for an average of 69% of the total amount of imports. After 1973 the direct aid was cancelled and it remained a symbolic help in the military field and some public loans.

Accepting the reality, Park's government had to carry out a series of measures in order to stabilize the internal economy and to minimize the international criticism over his policies:

- Macroeconomic reforms to stabilize economy (especially increasing inflation)
- Share investment risk with the industries (repayment guarantees for foreign loans)
- Incentives to export based on market results

To promote exporting, the government decided to facilitate the path for the firms and devaluated the currency in 1963-1964. The won went from 180 per dollar to 255 per dollar.

The main problem of South Korea was the lack of natural resources and the nationalism prevailing these days. Korea was waking up after 30 years of colonialism that undermined the moral of the country and afterwards a bloody civil war that ended up with a division of the nation, many families broken and two destroyed countries.

Therefore, there was much more concern about foreign direct investment. Korean firms were not keen on foreign capital having access to all the economic net, therefore they chose to rely on foreign loans; they needed capital in order to develop all these gigantic economic plans that they were creating, but they didn't want multinationals to be part of their project.

This decision had its consequences. Nowadays, it might look very simple to rely on foreign loans in order to get capital, but in the 1960s it was not easy at all.

Korean companies had no international credit and for them it was almost impossible to get loans with viable interest rates, so the government had to intervene.

Through the re-nationalized banks, the government helped to solve the problem of information asymmetry and guaranteed the private-sector foreign borrowing. This was the beginning of the "Korean developing model".

The government, however, had an important position regarding the private sector, simply because it was their path to external capital. Hence, it decided to take some action in the process. All loans had to be authorized by the government in order to pass to the banks, and the government allocated them in priority order depending on the field of investment.

A new hybrid system was created. One were the firms used the government to abide the market restrictions in order to get financial resources, and where the companies were governments employees that carried out the projects decided by Park's administration. This win-win situation was a mix between state intervention and free market that tried to exploit the best of both in a doubtful moral hazard way.

May the reader rethink the situation that the companies were facing, with free access to credit, just restricted with a few constraints that were purely acceptable. This state of affairs put the firms in a very especial position; no risk. While one may think that this is a good situation because of the “possible” amount of innovation that never occurs due to the lack of credit, the fact that a company has no risk-capital free can be very dangerous. Unless there is a tight control over the final destination of the money, there is a big possibility that there are some deviations on the road.

The government, consequently, try to monitor the performance of the firms by checking their export efficiency.¹⁷

The continuous promotion of exports led the government to create the Korea Trade Promotion Corporation in 1962, a partial import liberalization in order to provide the industries with cheaper raw material and tax deductions.

This obsession that Park had over exports was embodied in the monthly export promotion meetings that organized between his officials and the most important businessmen. These reunions became a place to discuss about new policies and solutions for struggles they were facing.

This evolution must be located in that especial time and place. Korea is not an ordinary country. When the average GDP was less than \$100 per capita, Korea decided to rely on human capital.

Coming from a deep tradition of Confucianism that reiterates the importance of education, Korea started an extreme race against illiteracy and poor education. By 1960, 19% of government's budget was spent on education, primary school enrollment increased eight times and secondary school by 10 times (Tudor, 2012).¹⁸ In the job market there were continuous incentives to increase productivity. It was common to see nationalistic appealing posters encouraging them to “Beat Japan”. The country became an army of workers, working extra hours and 6 days per week in order to “help the country”, they had cheap and quality labor.

The export-oriented policy helped the companies enter into the international market. Even if the government was supporting them in the financial field and they were performing well in the internal market, there were no guarantees for their success in the international field.

Once they started exporting, it was noticeable the exports were well performing. Korea solved its structural problems; its cheap labor and facility to access credit compensated the lack of natural resources and previous technology. This resulted in a positive circle for Korea, given that the good image projected internationally enhanced its international credit ranking, more foreign investors were attracted to the Korean market.

¹⁷ They directly monitored and market tested the export yield of the companies.

By 1965, the relations with Japan were normalized and Korea started exporting to one of its relevant markets (country-data, 2014), also some compensations for the damages suffered during the colonial regime were given to Korea and it smooth the relations between the neighboring countries.

3.4 The Chaebols

Before going further into the description of the evolution of the Korean economy, I find indispensable to introduce the reader to the concept of *Chaebol*.

Chaebol is a very Korean way of doing business. They were first created observing the principals of the Japanese *zaibatsu*.¹⁹

Following their main purpose, Chaebols are firms with a very high control-ownership disparity. There is a controlling shareholder (normally the founder) that monitors the company but in reality has a very small portion of the company (forming a controlling minority structure). In 80% of big companies, the largest and controlling shareholder or family members are among the top executives²⁰.

Even when professionals manage the firms, there are highly restricted.

Notwithstanding their small equity ratio, they sustained control due to 2 factors:

- Korean big firms have more disseminated ownership than those in the rest of East Asian countries.²¹ Due to the minimum 5% required to have any decision rights, most of these small shareholders couldn't easily object the main decisions (Baliño, 1999).
- Institutional stockholders did not interfere the Chaebol's activity, although they controlled over 40% of the shares. Banks – that were controlled by the government- usually owned 10% of the shares. Other financial institutions tended to held around 10% also. Nonfinancial institutions had more than 20% of the shares. Using the cross-holding or interlocking ownership, the small groups were able to keep control of the corporation despite owning less than their counterparts in independent Chaebols. The direct cross-holding where A owns B and B owns A is illegal, so the large conglomerates had to design complex, pyramidal interlocking ownership structures.

In summary, Chaebols were the consequence of highly dispersed ownership, insufficient public surveillance, weak environment and a poor governance system.

¹⁹ Later evolving into *keiretsu*.

²⁰ Corporate governance and firm profitability

²¹ More than 95% of all stockholders were small individual shareholders possessing less than 1% of total shares.

3.5 Strengthening in the Path

This risk partnership resulted in a complete success with a high growth rate and a massive industrialization of the country (see table 3). Korea was already focused towards a successful road.

Thereby, the second 5-year plan was executed. This plan, aimed to develop the industrial structure and improve building of import-substitution industries; steel, chemical and machinery.

By the end of the 60's Korea already established the base of its risk partnership, assuring this successful image with continuous increasing of foreign loans.²² Meanwhile the external debt kept amplifying.

TABLE III. Korea's external debt. Millions of US Dollars (1962-1968)

Year	External debt	Percentage in the GNP
1962	89	3.8
1963	157	5.8
1964	177	6.2
1965	206	6.9
1966	392	10.7
1967	645	15.1
1968	1199	22.9

Source: National Bureau of Economic Research

During this period, the third five-year economic plan was delivered (1972 -1976) promoting a fast development in heavy and chemical industries that were export-oriented. The new industries started to be located in the south of the peninsula, far from North Korea and also from Seoul, which proved to be a good economic stimulation for the southern regions and a source of new employment.

Substantial success was achieved during the first and second economic plans, which led to an excessive amount of confidence in the system and a dangerously relaxed institutions.

Domestic savings grew, the exports kept increasing significantly and inflation surpassed 15% annual rate.

This uncontrolled borrowing, lead to a complicated scenario where companies were not able to meet the foreign debt obligations .Therefore the state had to take over 30 firms in 1969.

²² In the first five-year economic plan foreign capital accounted for 52.8% of total investment. And in the second five-year economic plan it counted for 39.4%.

After observing these signs, the IMF decided to intervene in order to prescribe some guidelines. The government objected to it, but when the United States considered the creation of additional loans upon acceptance, Korean government change its criterion.

This reaction steered a monetary cool down in the market. It went from 52% of expansion in 1968 to 11% in 1970. The intense credit control provoked a big change in the financial scenario; banks were not able to relief firms with a high credit burden. The only solution available for the companies was the curb market.

Things got worse for exporting firms; a devaluation of 18% of the ₩ in 1971 and a 7% the year after complicated their already weak financial situation. The global slowdown affected Korea intensely. By 1971 several firms were on the edge of a bankruptcy, Korea had to face a systemic crisis.

Park's government decided to bail out the insolvent firms and created the Presidential Decree for Economic Stability and Growth on August 3, 1972²³. This Package featured a moratorium on the payment of all the firm's debts on the curb market²⁴ and rescheduled the bank loans at a lower interest rate.

The complex situation was also used by firms to convert their short-term high interest into long-term ones.²⁵

At last, this policy was also supported by the Bank of Korea, which accepted liabilities from commercial banks.

The government plan saved the immediate crush of the Korean financial sector and firms, but didn't improve the situation (see table IV) .It just shifted the all the load towards the curb lenders and the regular citizens which had to bear an increasing inflation tax.

Moreover, the owners and managers of the companies remained intact, obliging only curb lenders and citizens to face the consequences of the lack of responsibility held by the managers.

Neither government officials took responsibility for the lack of surveillance that lead to the crisis. In the end, this desperate solution benefited the ones that carried the economy to the edge of a massive collapse. It showed that the government will do the necessary to make the save the economy, despite the terrible consequences that the taxpayers had to suffer.

²³ Commonly referred as "the August 3 Measure"

²⁴ The moratorium was to be endured during 3 years. After the established period, all loans had to be turned into 5-year loans with 1.35% monthly interest rate or 16.2% annual rate.

After the bailout forced curb lenders and debtors to register with the government, it showed that 42% of total bank loans in the formal financial sector were curb loans. It evinced to what degree was the financial sector dependent on the curb market.

²⁵ Approximately 30% of the debts were converted with the concessional terms.

After the economic stabilized and started to recover, Park's administration decided to open the family-owned firms to shareholders, in an attempt to disperse the ownership and set up professional and qualified managers.²⁶

Notwithstanding the efforts made by the state to improve the situation of the companies, it had to face the reluctance of entrepreneurs to share the ownership with people outside of the family.

The tendency was still to rely on loans more than equity sharing.

TABLE IV. Economic trends in Korea before and after the emergency decree of 1972

(Percent per Annum)

YEAR	GROWTH RATE OF INVESTMENT	RATE OF INFLATION	INTEREST RATE ON BANK LOANS	INTEREST RATE ON CURB LOANS
1965	19.3	5.8	18.5	58.92
1966	84.0	14.6	26.0	58.68
1967	25.2	15.9	26.0	56.52
1968	52.3	16.1	25.8	56.04
1969	45.1	15.5	24.5	51.36
1970	11.3	15.5	24.0	50.16
1971	24.9	12.5	23.0	46.44
1972	3.7	16.7	17.7	39.00
1973	40.7	13.6	15.5	33.24
1974	30.2	30.5	15.5	40.56
1975	24.9	25.2	15.5	47.88
1976	77.1	21.3	16.1	40.47
1977	43.1	16.6	15.0	38.07

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

3.6 The peak of the Chaebol

The 2nd five-year plan and the crisis of the 1972 altered the government economic policies towards large firm conglomerates. The ambition of the state to improve the HCI²⁷ led to a consolidation of the government-risk partnership.

It was not infrequent for the firms to acquire new companies coming from the heavy and chemical industries, or even creating a specific department on its own.

²⁶ From the opening of the stock Exchange in 1956, only 66 enterprises went public. From 1973 to 1979, more than 300 firms decided to become public.

²⁷ Heavy and Chemical industries

This shift in the basic structure of the companies was mainly provoked by the extreme financial support held by the government.

TABLE V. Chaebol's value added as a share of GDP (%)

	1973	1974	1975	1976	1977	1978	1979	1980
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	-	-

Source: SaKong (1993)

The aspiring HCI drive conducted the firms to an intense-borrowing situation in order to expand their conglomerates. And at the same time, Park was worried about the lack of public companies.

The contradictory picture created massive companies that became “too big to fail” and provoked a biased situation in favor of a deeper indebtedness.

Other aspects of the economy were performing relatively well, such as the employment rate (3-4%) which was a consequence of the high industrialization and the dynamism of the markets.

Not only Korean Chaebols were working inside Korea, but also they were expanding abroad and exporting their knowledge overseas. This was the case of the “Middle East Construction Boom” during the decade that helped firms to counteract the negative results of their good exports.

3.7 Continuous growth

By 1979, the government decided to call off the HCI program and stabilize the cool down the economy. But there were a series of internal and external factors that complicated the scenario. The external factors were the second oil price shock, the increase in the world interest rates and a slowdown in world's growth. The internal factors included the assassination of president Park Chung Hee, the social and political turmoil that followed and a disastrous harvest.

The GDP started to decrease and a new military regime arrived to the government. The new general in charge, Mr. Chun Doo Hwan prioritized the control of the inflation as one of the main goals; devaluation of the won, the end of the subsidies for the HCI and an austerity package imposed by the IMF.

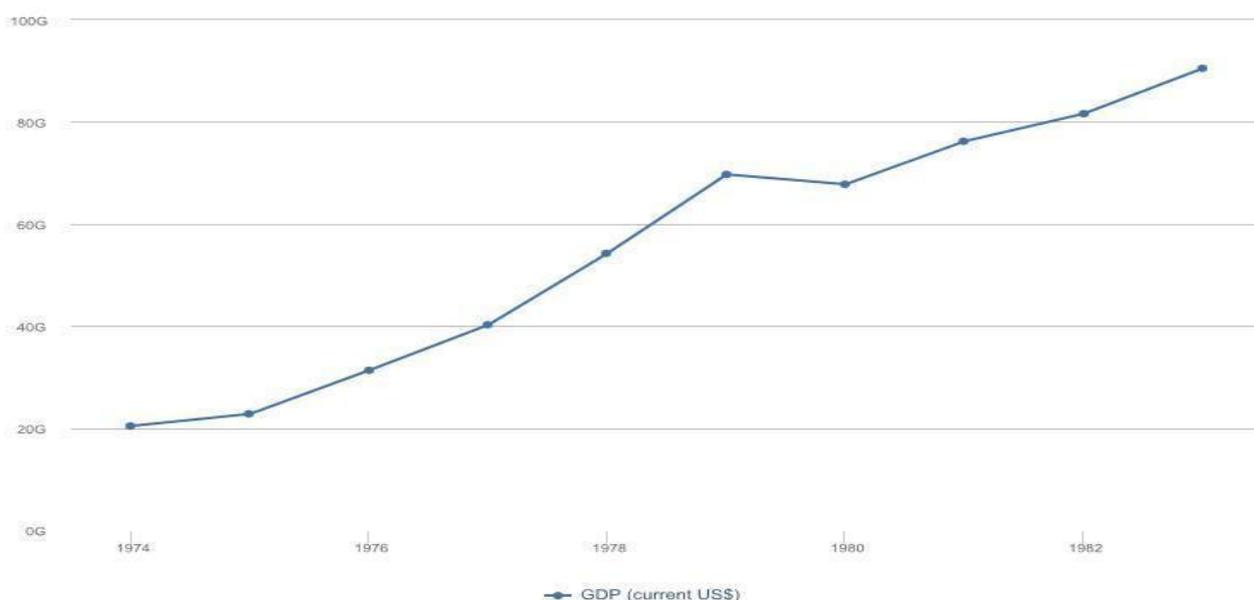
In this context, a group of experts that were advising the new transitional government suggested a change of course towards a more market oriented economy. They feared that no possible solutions were available regarding the risk-partnership model.

The dilemma was well-known by the technocrats; the government was forced to back up Chaebols in case they went bankrupt, since a massive failure would collapse the system. Therefore, the government was obliged to warrant the credibility and stability of the financial system and the Chaebols. At the same time, the knowledge of a government back up stimulated the firms to assume excessive hazard. This vicious circle where the state was trapped in, led to an uneven scenario with companies leading the economic system and a state following their decisions.

The group of independent experts went further on their analysis and advocated a transition towards a market-oriented economy letting the market forces to operate freely in the Korean system and displaying some positive signs of credibility. They thought the managers and owners of the companies should held responsibility for their acts and decisions. The government, as well, should step back and stop intervening in their investment decisions.

GDP of Korea (1974-1982)

Millions of US \$



Country : Korea, Rep.
 Created from: World Development Indicators
 Created on: 01/11/2015

Figure 10. Source: World Bank

Independent institutions should be established. Being them in charge of a restricted control of the operations and transactions happening in the Korean market.

Finally the government would have to re-establish a new paper and focus on the maintenance of a free and non-biased market. Promoting the competence and controlling the concentration of the conglomerates would be a priority while re-defining the new rules.

What the experts highlighted was a complete manipulation of the system towards personal interest in the business sector;

While during the 60's the Korean firms struggled to raise some capital abroad and had to rely on the government in order to have a certain credibility, the machinery itself developed a series of interested economic players that used it for their personal purposes.

By this time, nevertheless, the economy worked out alone without the need for a public intervention. The advantages supplied from the corporations to some politicians and bureaucrats made the coalition of the state-business risk partnership unbreakable. Growing from the very bowels of the system and making it more and more inefficient.

Mr. Chun Doo Hwan initiated a triple reform: financial liberalization, company unionism and industrial rationalization. Nevertheless, the idea of a state-leadership was never put aside and all the reforms were made for strengthening both the economy and the firms. Therefore, the measures never seek a real promotion of competition, but a safer path for the companies to operate.

After the shift in the policy, Chaebols followed with a modification of their financing behavior.

3.8 Liberalization measures

The first step was the re-privatization of the commercial banks. The bad experience of the 50's was taken in account to formulate the procedures and the framework. The separation between banking and commerce was ensured due to the maximum of 5% ownership available for firms or individuals.

Even after the dispersion of banking ownership, the state maintain its indirect control over the operations and resource allocation. The approval of new bank managers depended on the approval of the Ministry of Finance.

The bank credit control was also revised in order to allow SME's to gain more access to the loan system. The government also decided to monitor the share of Chaebols in any bank's loans. These arrangements were settled in order to ameliorate the problem of loan concentration.

Following an increasing demand for income re-distribution, equity and balance growth, the government decided to focus its efforts in sectors that were forgotten during the HCI's period. Sectors such as agriculture, fishing and mining were granted with preference in credit assignment.

The reduction of loans to large firms and the policy promoting to forbear from excessive diversification modified the relationship between large firms and the state.

Their way of promoting the competition was based in the allowance of NBFi (Non-Bank Financial Institutions) to enter the market with no limits. However, since the government

allowed companies to own NBFIs, the system evolved into a new strain of resource allocation.

Although these measures may look as an important change in the system, the fact that there were no institutions to provide private remedy or even a deeper distension of the market forces and the state, provoked a perverse scenario where the government just place behavioral restrictions.

Now only the financial system was still misfit to the international markets, but the foreign trade was suffering from it as well.

The continuous obsession for a surplus trade balance led Korea to a series of restrictions that were not accepted by the US. While the exports in the 1980's counted for more than 30% of its GDP, Korea remained unfavorable of FDI. Significant barriers remained for imports, such as the ones that allowed Korea to not have a trade deficit with Japan.

By 1987, Korea started a democratization process. General elections were held with little control over campaign financial and spending. Big firms financed the campaign for politicians from different parties, and consequently political connections with the Chaebols remained the same.

Economic reforms inquired by the people were implemented by the new democratic governments, but they were mostly income distribution - oriented and only to cover the immediate demand of the general public. Not significant system-reforms were carried out.

By the end of the decade, the Chaebols were even bigger and more dominant in the market than before. There was no room for competition from outside, the NBFIs were controlled by private companies and a new relationship between politicians and private firms was created.

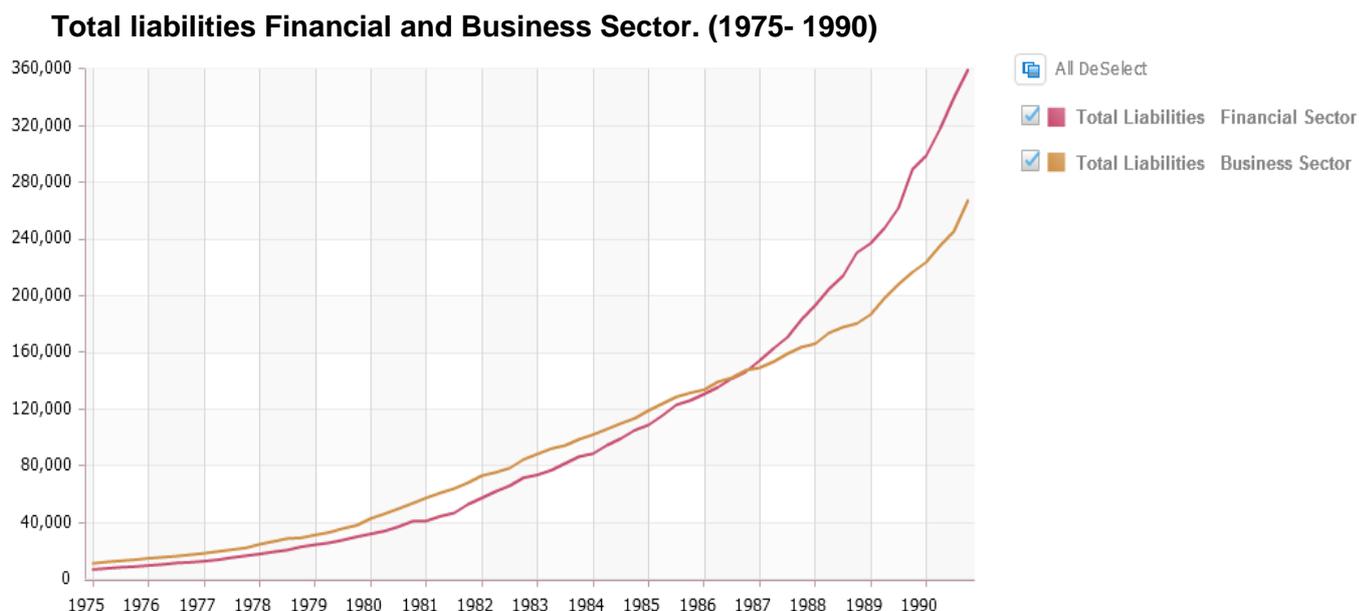


Figure11. Source: Bank of Korea

3.9 The edge of the cliff

By 1990, the evolved risk-partnership relationship turned out to be more colossal and dysfunctional than ever.

In a world with a focus on globalization and seeking for clarity in the markets, Korea remained as a dark spot where resource allocation was still manipulated by the government.

The state continued to control the licensing decisions and supplied implicit warranty on borrowing.

On the other side, conglomerates kept donating to politicians and used the loans for implemented ambitious investment plans without little concern for insolvency.

Although it may look too late, in the beginning of the 1990's capital account liberalization was considered an important asset. Therefore, by 1991, foreign –currency dominated bonds were deregulated. During the winter of 1992, the Korean stock market was exposed to foreign investors for the ²⁸first time and by 1995, commercial loans by domestic firms were allowed.

In contrast of the strict restriction that remained to enter in the Korean market, banks enjoyed comparatively major independency when borrowing from foreign creditors. No quantity regulation existed in short -term nor long-term borrow but the situation within both lends was highly different. The government discouraged long-term borrows by forcing the companies to reveal the purpose of the loan as a condition for its

²⁸ These policies created maturity mismatches and currency mismatches.

admissibility. On the other hand, short-term borrow was seen as trade-regarded financing and required no further information. Therefore, the government policy stimulated the use of short-term borrows to finance long-term projects.

Therefore, the well- announced portfolio liberalization was partial and biased towards the continuation of the systemic rigidities already existing in the country.

The decision of the government was deeply motivated by the fear of a new globalization wave entering to Korea. Koreans had still a nationalistic pride that didn't allow them to look further beyond. The slight idea of Korean firms owned by foreign capital was something inconceivable.

Hence, despite the rigidities that started to come up in the economy²⁹, the alarms of weakness and excessive exposure of the companies, Korea prevailed in the idea conceived during the 60s and 70s. Although the scenario was absolutely different.

Current Account Balance of Korea (1988 – 1996)

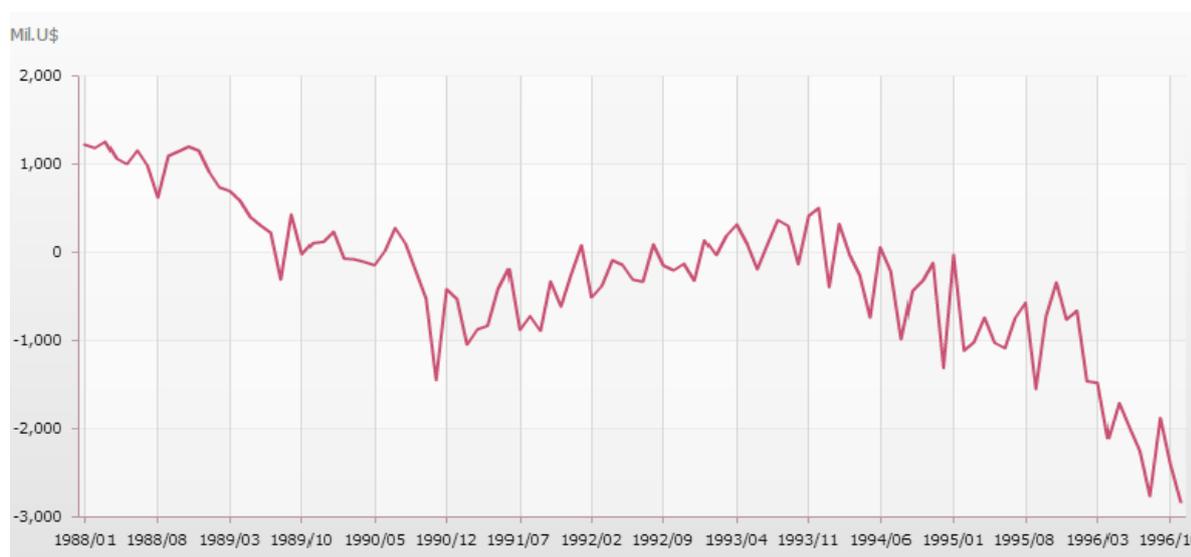


Figure 107. Source: Bank of Korea

The Chaebols, used to rapid growth and with the idea of “too big to fail” continued their expansion and overinvestment (Kim, 2000). External borrowing reached one third of the GDP. Some of the investments made by the Chaebols turned out to be not very profitable.

This situation, combined with a financial crisis that started in South-East Asia and a couple of external shocks that shook the Korean economy, exploded inside the country and provoked the biggest crisis in its history.

²⁹ By 1990, Korea's account balance started to deteriorate, mainly because of the rising inflation, a recession in the world's economy and the appreciation of the Korean Won.

IV. KOREA AND THE AEC

In the beginning of the 90's decade, Korea was seen as a successful country with an impressive economic history of overcoming complicated initial scenario and finally achieving a stable continuous development. The "Korean miracle" was an example for developing countries and their governments.

The Korean economy was relatively stable and positive (see figure 14), except for the current account deficit (see Figure 13). It was one of the fastest growing economies, with a 7-9 % average growth rate, a 5 % inflation rate before the crisis, the ratio of foreign debt to GDP was less than 30%, one of the lowest among developing countries and the government's budget was balanced. Even the IMF predicted that Korea was not going to become a victim of the Asian Economic Crisis (Kihwan, 2006).

South Korea current Account.

(In millions of US \$)

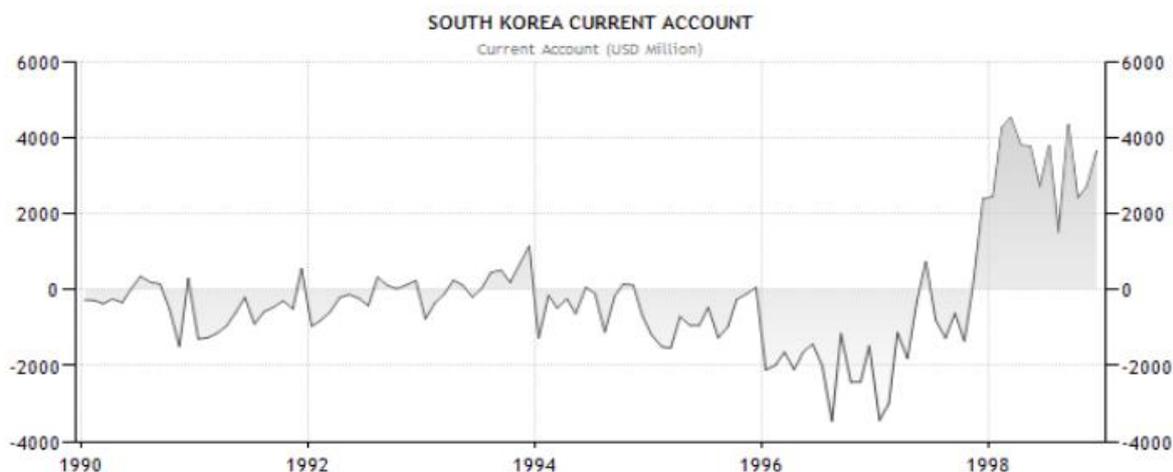


Figure 13. Source: Bank of Korea

There were hidden factors not analyzed or partially covered by the government in order to maintain credibility and stability in the country. The available information was not correctly interpreted, therefore the crisis hit the economy unlike other strong economies of the region like Japan, Taiwan and Hong Kong.

Comparison between the GDP growth rate of Korea and Taiwan. Selected years.

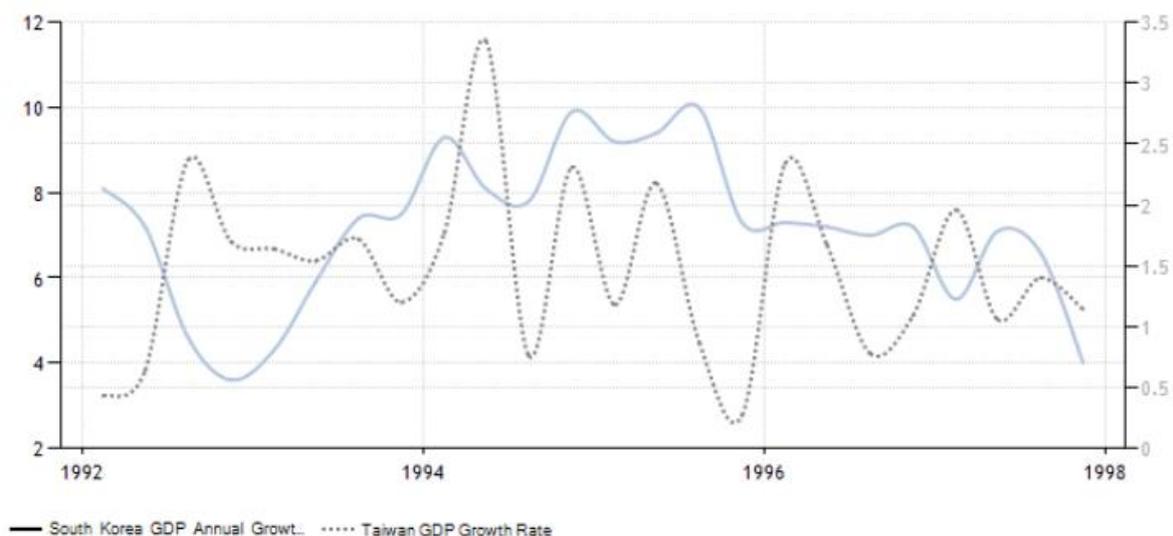


Figure14. Source: Bank of Korea

If almost all the macroeconomic indicators were performing well, what caused the unexpected crisis in Korea?

Even though there was a major currency crisis going on in South-East Asia, Korea could have avoid it, or just have been partially affected. However, the situation was completely different, therefore there were other factors involved in the failure.

There were several causes of the crisis in Korea. The special circumstances that brought Korea to edge of a sovereign default are diverse, but important. In my opinion we can divide them in 2 main blocks: internal factors and external factors.

Internal factors:

- Rapid wage increase
- Asset inflation
- Shift towards non-tradable goods
- Structural problems
- Poor governance

External factors:

- Appreciation of the US Dollar
- Semiconductor decline
- Instability

Most of the variables are related to each other. The existence of one factor can provoke or modify the intensity of another one. This led to a vicious circle that ended up with Korea intervned by the IMF and the fall of the house of cards of its economic model.

In order to better understand the impact of the crisis in the Korean economic model, it is important to deeply study all the different causes.

4.1 Internal Factors

The internal factors are very important to understand why a foreign crisis affected the Korean economy so sharply. The structure of the relationship between financial markets and the real economy made it so easily for external shocks to invade the whole system. The risk-partnership was over.

4.1.1 Rapid wage increase

By the beginning of the 90's, domestic wages increased faster than labor productivity (even higher than Hong Kong, China and Singapore). As a result, the companies started to reduce its competitiveness and the profits.

Nominal wages increased at a rate of 16% per annum from 1987 to 1996, exceeding productivity growth of 11%. The labor market was full of rigidities (Lee, 1999).

By the mid 90's most of the exporting companies started to incur in operation deficits.

TABLE VI. Hourly wage in the manufacturing sector and Per Capita Income

(In US \$)

	HONG KONG	JAPAN	KOREA	SINGAPORE	TAIWAN	US
Hour wage						
1985	1,73	6,34	1,23	2,47	1,50	13,01
1990	3,20	12,80	3,71	3,78	3,93	14,91
1995	4,82	23,66	7,40	7,28	5,82	17,20
Per capita income						
1995	22.990	39.640	9.700	26.730	12.293	26.980

Source: US Bureau of Labor Statistics, 1995.

4.1.2 Asset inflation

The ratio of total land value to GDP was relatively high compared to other countries. This led to an appreciation of the rental costs, rental income and consequently, the cost of living.³⁰

³⁰ This resulted in a big demand from the employees for a wage increase.

TABLE VII. Land Value to GDP ratio. 1994.

COUNTRY	TOTAL LAND VALUE/GDP
FRANCE	0.9
JAPAN	3.5
KOREA	5.4
UNITED KINGDOM	1.6
UNITED STATES	0.7
TAIWAN (CHINA)	3.3

Source: *National Statistics Office*

The rising in real state meant that firm's assets value increased artificially and it permitted them to cover the operational deficits. This modification in the final numbers of the companies allowed them to inquire more capital for investments. And as in every real state bubble, it extended the fast expansion of credit particularly from non-banking institutions.

Hence, in spite of many years of loses and bad performance, conglomerates were still able to raise their debt/equity ratio even more.

4.1.3 *Shift towards non-tradable goods*

The export sector started to decrease, manufacture labor was becoming more expensive, while third sector labor – in some areas- didn't have to be qualified and the labor unions were weak. The non-tradable goods had high profit-earning capacity despite low technology. Thus, firms moves from exporting to domestic-oriented markets and from tradable to non-tradable goods.

The importance of the manufacture sector started to decline. Meantime, the service sector was expanding continuously, especially in wholesale, retail and entertainment sectors.

Manufacture, value added % to GDP. Rep. of Korea (1985- 1996)

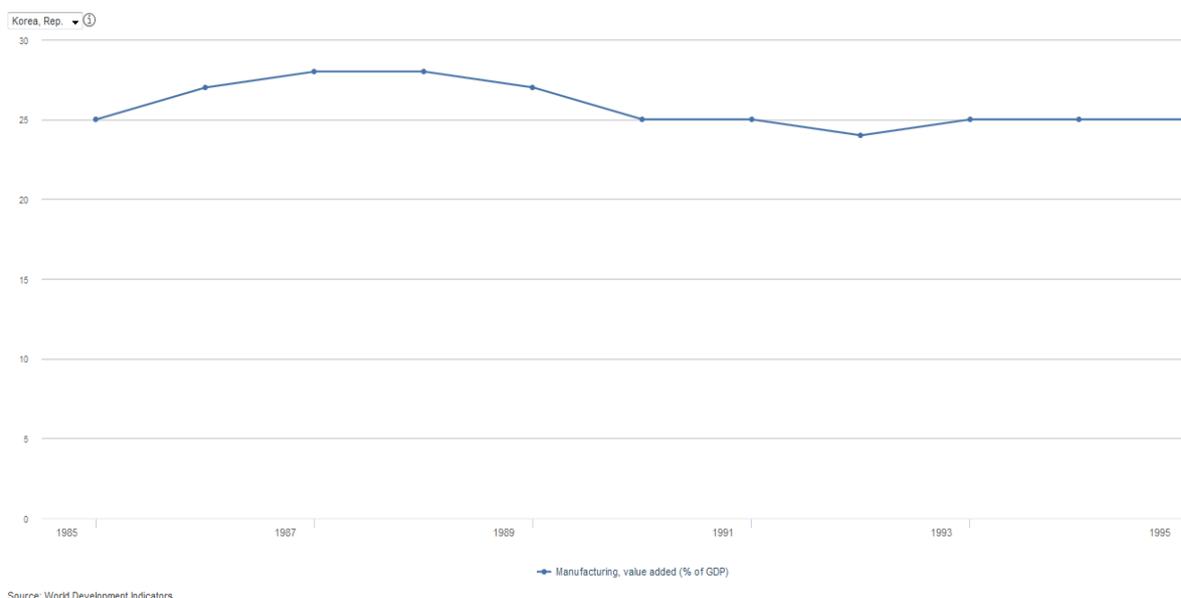


Figure 595. Source: World Bank

The structural problems that Korea's economy had to face were an important cause of the deepness of the crisis. The problem was already in the country, it just needed a small shove to unchain it all.

In the preceding chapter, we study the evolution of the economic system in Korea. It gives us a glimpse of the main causes of Korea's financial structure in the 90's.

The Korean financial system includes 3 types of main financial institutions: Specialized and development banks, commercial banks and non-bank financial institutions. There is also the informal curb market.

Commercial banks are almost half of the financial system. They were public until the banking privatization of the 70's. There were 16 nationwide banks, 10 regional banks and a large amount of foreign banks. They employ both short-term and long-term borrowing, including leasing.

Financial System in Korea, Share in Total Assets, June 1997

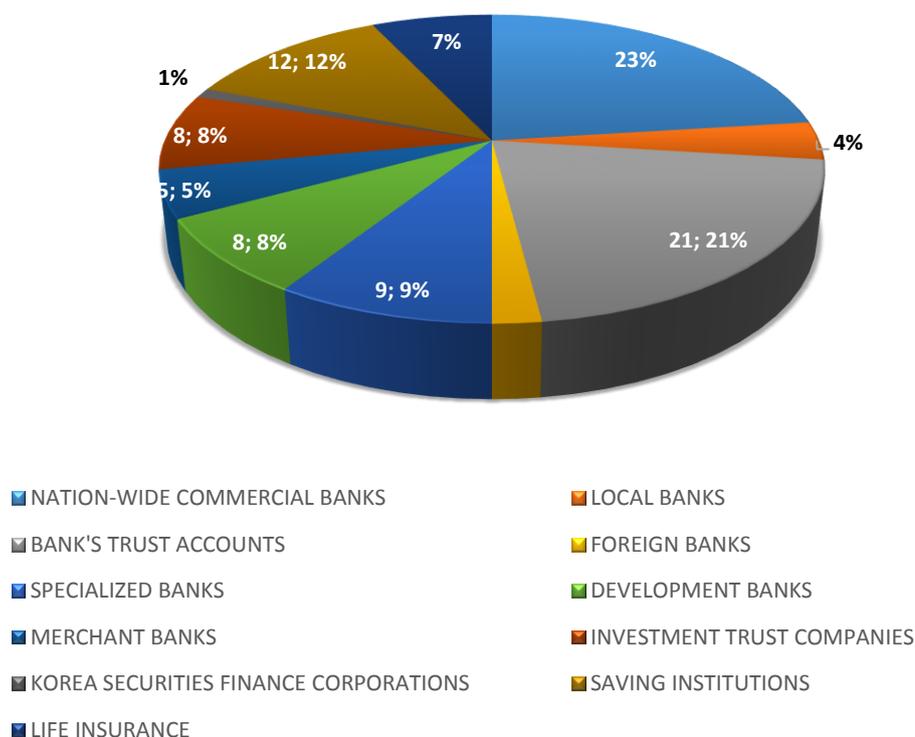


Figure 15. Source: Bank of Korea

Commercial banking is highly concentrated. Regional banks were mainly established to help develop regional economies through small and medium enterprises. Foreign banks have a very small impact in the economy due to a reduced market share.

Commercial banks (until April 1998) were supervised by the OBS³¹ at the BOK.

Development and specialized banks are partially or completely owned by the government. Created during the 50's and 60's in order to sustain big investments in strategic sectors, they are approximately 17% of the financial system institutions. The funding from development banks comes mostly from government-guaranteed bonds. These assets are issued domestically and abroad. They were supervised (until April 1998) by the MOFE.³²

NBFI's are accounted for 30 % of the financial assets. There are 3 types of institutions: saving, investment³³ and insurance companies.

³¹ Office of Bank Supervision.

³² Ministry of Finance and Economy.

³³ Investment institutions comprise: merchant Banks, investment trust companies and securities companies.

NBFI were owned³⁴ by Chaebols³⁵. They became the main source of resource allocation for large conglomerates. Their loose restrictions allowed them to avoid control and supervision³⁶ from the public institutions.

Apart from these institutions, there is the curb market. It was mainly used by SME's with little credit or individuals with limited access to main financial institutions. The curb market started to decrease from the 70's when the first NBFI were launched and they went further down in the 1990s with the deregulation of interest rates.³⁷

By 1993 Korea was preparing itself to the accession in the OECD. Therefore, a series of financial measures were established to open up the market and deregulate the economy.

The first step was to deregulate the interest rates on all loans, time deposits and a big proportion of bonds. Other measures were the introduction of auditors for some government bonds and the simplification of credit control. Moreover, the government lost all control of private financial institutions through the suppression of commercial bank manager's appointments.

But this move couldn't come alone. The deregulation of a system that has been over controlled and protected for decades must be carefully followed by the economic authorities in order to prevent deformities in the market due to its previous composition.

Detailed attention and coordination from the different institutions should be held at all times. Especially when addressing a situation where capital flows and lending opportunities are more accessible.

As mentioned before, there was a lack of a unified institution supervising the process; commercial banks were under the control of the OBS, specialized banks and NBFIs were under the authority of the MOFE.

This absence of a united supervisory body created the appropriate situation for the development of risky practices among private institutions.

Some of the dangerous behaviors carried out by these institutions were;

- Provisions for loan losses in commercial banks always remained under the tax-deductible 2 percent limit.
- Short-term foreign borrowing rates were lower than long-term ones, therefore domestic banks started to employ external short-term funds to domestic long term loans.

³⁴ Directly or indirectly.

³⁵ See part 3.4 Chaebols

³⁶ Even though they were supervised by the MOFE, in reality the supervision was scarce. There was no asset classification, capital or provisioning rules. After 1998, merchant banks were supervised by the Financial Supervisory Commission (FSC).

³⁷ Despite the difficulty to measure the real size of the curb market, the OCDE estimates that the size of the market in the mid 90's was approx. 2- 5 percent. While during the 70's, the curb market accounted for almost 30 % of the total loans of the financial sector.

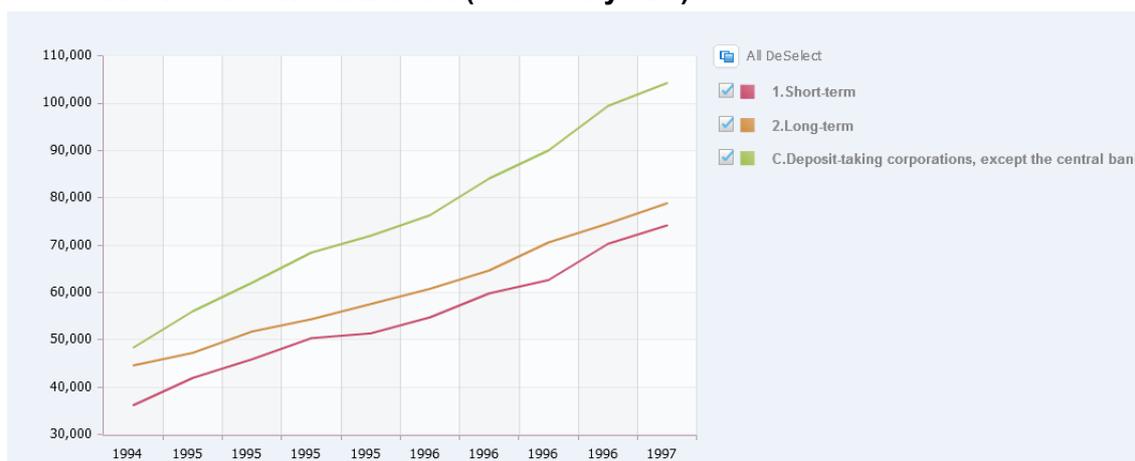
South Korea's external debt. (Selected years)

Figure 16. Source: Bank of Korea

4.1.5 Poor governance

The relationship between private sector and the Korean government has been unhealthy from the beginning. First covered by the need of improvement and development, Korean firms and the state needed each other reciprocally.

There was little control and supervision from the US concerning Korean governance. The main purpose was to check the macroeconomic data and to ascertain the economic development.

Therefore, the toxic relationship necessary for the start, continued and grew over the years until it became the cause of a major failure.

Corruption and relationships of interest between public and private sector were created. The inefficiencies resulted in a poor control over the performance of the business. Risky practices were common among them, and it exponentially increased until developing a complex framework.

The government demanded loans to be made on political rather than economic foundations, and hence much investment was unable to generate cash flows to meet debt repayment requirements.

It kept working even after the change into a democracy. No prudential supervision was carried out and the influence of the private firms was underestimated by foreign actors. Therefore, no major institutions estimated the real situation of the Korean economy.

Indicators of Bank Balance Sheets & Asset quality.

(Year and value, %)

	1992	1993	1994	1995	1996	1997	1998
Capital/total Asset ratio	6.77	6.13	5.68	4.78	4.26	2.99	2.82
BIS Capital ratio	11.18	11.0	10.62	9.33	9.14	7.04	8.23
Non-performing loan ratio	7.1	7.4	5.8	5.2	4.1	6.0	7.4

TABLE VIII. Source: Monthly Financial Statistics Bulletin. Feb 1999. Financial Supervisory Service.**4.2 External Factors***4.2.1 Appreciation of the US Dollar*

During the 90's, most of the investment carried out in the Asia pacific region was based on the expectative of a weak dollar. The dollar was too attractive for investors to hold on.

Nevertheless, from mid- 1995, a new monetary policy was implemented and it changed the course of events; the US \$ started to appreciate.

As the dollar strengthened, Korea's exports started to suffer. The Korean Won was pegged to the American currency, unlike the Japanese Yen. For that reason, the Korean Won couldn't depreciate as much as the yen. Moreover, both countries produced similar goods for exports and competed directly in the international markets. Hence, this depreciation didn't benefit the Korean manufacture sector³⁸ and provoked an increase in its trade deficit.

Some large conglomerates suffered from financial difficulties around this time and non-performing loans (NPLs) at Korean banks bluffly increased, thereby sinking the financial sturdiness of domestic banking institutions.

There were other major consequences ³⁹ that sometimes are underestimated or disregarded. The debilitation of the Japanese currency had another major effect for Korea; it drained the Japanese direct investment into East-Asian countries.

Japan had dollar-denominated loans that increased in yen terms hen the American currency appreciated. As a consequence, the BIS⁴⁰ ratio of banks in Japan fell, which forced them to recall loans from their clients in Japan and overseas (including Korea).

³⁸ It provoked the downfall of the profitability in the export investments.

³⁹ In particular, Korea.

⁴⁰ Bank's financial strength.

This brought 2 consequences to the international markets:

- An increasing commonness of rejection from the Japanese banks to roll over their loans to both domestic and foreign clients
- A rising friction on the foreign exchange reserves of the countries, including Korea, developing eventually into a credit crunch for the whole region.

4.2.2 *Semiconductor decline*

The semiconductor decline was the consequence of a bad industrial policy carried on by the Korean firms for more than 10 years.

From the beginning of the 80s decade, China shifted its exports policy towards a more "open door policy". The successive measures taken in order to unfold the economy were very successful and for more than 15 years China's real GDP grew more than 10 % per annum.

These growth had consequences for the neighboring countries, especially for Korea. By mid 80s Chinese firms were real competitors for Korean companies in textiles, apparel and electronics. Not only Korea was facing competition from China, but also from some ASEAN countries⁴¹ that were developing their industrial net.

Evidently, this severe competition put more pressure on the Korean exports: more competitors that produce cheaper. It was not able to reduce costs like its competitors; it couldn't lower wages or increase productivity. Therefore Korea had to adjust to the new scenario.

Korea decided to modify its industrial structure and become more high-tech oriented (Lee, 1999). Korea invested a large amount of capital in the so-called "strategic industries" such as biochemical, automobiles and electronics. But the market was already been provided by Japanese industries. Korea had to face a dilemma, either to compete against Japan or to sell its products in the same market as China and the ASEAN countries.

In 1996 the price of semiconductors fell by 80 % and it sharply sunk Korea's trade balance. Semiconductors accounted for 20% of Korea's exports by value. The decline in Korea's terms of trade initiated in 1994 and kept on decreasing until the beginning of the crises.

At the same time, there was a cyclical recession in the Asian region (especially Japan) that was associated with an oversupply of manufactured goods in international markets. The little flexibility to adapt to the new international economy scene, produced a declining in the external demand for Korean products.

⁴¹ Particularly Indonesia, Malaysia, Philippines and Thailand.

4.2.3 *Instability*

While the uncertainty was already spreading over foreign investors, the currency crisis in Southeast Asian countries was intensifying. This early expanded over the region.

In October 1997, the contagion spread to Hong Kong in the form of a speculation attack on the currency and a severe fall in the stock market. Even though the currency attack failed, at the time it was not clear whether Hong Kong government authorities had the faculty to avoid the contagion from developing into an entire financial crisis. With Hong Kong in a very delicate situation, foreign creditors denied to roll over their loans to Korean financial institutions.

The lack of credit forced the Korean government to use its limited foreign currency reserves to help Korean financial institutions refund their short-term obligations. As a result, a considerable large amount of the nation's foreign reserves was advanced to the overseas branches of Korean banks. This quickly reduced the nation's usable foreign reserves to a risky low level.

4.3 The crisis in Korea

The danger in Korea started to be foreseen during the summer of 1997. Kia, Korea's third largest car company run out of cash and asked for an emergency bank loan to avoid bankruptcy. These incident was seen as a first symptom of a much bigger issue, and credit agencies started to downgrade the ratings of banks with large exposure to chaebol.

This movement increased the cost of borrowing for banks, and forced them to tighten credit. As a consequence, the heavy indebted chaebols had even more difficulties to get additional funds.

To prevent a major failure from Kia, by october 1997 the government took the company into public ownership. This decision resulted a major impact in the international markets. The nationalization of the car company implied the conversion of private sector debt into public sector debt.

Standard & Poor's promptly downgraded Korea's debt, and the stock market lost 5.5% of its market value.

The grade's deterioration from Standard & Poor's plunged the Korean Won. In order to protect the national currency, the BOK raised the interest rates to 12 %, more than double the inflation rate (Kihwan, 2006). Since the ₩ was pledge to the US\$, the government was forced to sell dollars in order to maintain the exchange rate \$1 = 1₩. Even when the Chinese Yuan and the Japanese Yen were depreciating and the currency crisis was already installed in Southeast Asian countries. The aim behind this measure was to allow chaebols and banks to pay back their loans in their currency, fearing that a depreciation of the Korean Won would lead to heavy indebted institutions to inmediate failure.

After the beginning of the turmoil and the currency crash in Thailand, creditors started to roll over their loans in order to reduce their credit exposure. Due to their increasing problems to face short-term obligations, Korean banks turned towards the BOK for help. During October-November 1997, BOK sent US\$ 20 billion of official reserves to the overseas branches of Korean banks that were in the edge of illiquidity (Baliño, 1999)

The country run out of reserves rapidly. By 1st of November 1997 the BOK had \$30 billion, but two weeks after it only had \$15 billion.

Even after all the effort from the government, they couldn't prevent the bubble from exploding. An outbreak of failures expanded through the chaebols, unable to meet their debt liabilities.

With Korea facing immediate sovereign default, the outlook of an IMF led bailout of the country was being outright contemplated. On November 13th, the Korean government declared that it "did not need help from the IMF", apparently believing that it would be able to settle bilateral loans from the US and Japan. The result of this move was negative, and on November 17th, with the nation's foreign exchange reserves almost drained, the Korean Central bank gave up its defense of the won.

The won immediately fell below \$1=Krw1.000 exchange rate, and it kept dropping. On November 21st the now humiliated Korean government was obliged to reverse course and formally requested \$20 billion in standby loans from the IMF.

4.4 Solutions

The country and the IMF formally signed an aid package of US \$ 58.3 billion, subject to strict conditions including important structural reforms and macroeconomic control.

The first emergency package was a US \$ 21 billion. An extra package of US \$ 14 billion was released by the Asian development Bank and the World Bank.

After these 2 packages, United States Japan and other concerned countries contributed with extra US\$23 billion.

When the helping program was announced the IMF expected it to be enough to balance the macroeconomic numbers and therefore calm restlessness in the markets.

IMF demanded the Korean government to pursue hard measures to retrieve the lost confidence. Some of the measures were a tight monetary policy, to prompt closure of insolvent financial institutions and to raise interests stoutly.

The interest rate was raised from 12.3% in 1st December 1997 to 20.7% on 3rd December, and by 23rd December same year it had already increased until 30.1%.

Consequently, the performance on 3-year corporate bonds ascended from 14 % before the crisis to 30%. And very short-term yields on 91- day went from 13 % to 40.8%.

The M3 was reduced from 16.3 % in November to 14 % at the end of the year 1997.

Troubled financial institutions had to be restructured or closed. By 2nd December, nine insolvent merchant banks were forced to appoint a rehabilitation plan within 30 days.

The banks that were not able to meet the standards were closed. The remaining banks were required to meet 4 % capital adequacy ratio of the Bank for International Settlements (BIS) by March 1998.

Commercial banks were required to meet 8% of BIS ratio by September 1998.

Despite all these measure to reestablish reliance in Korea, the rollover ratio of short – term debt considerably decreased (Lee, 1999) .

Table IX. Rollover ratio of the 7th largest commercial banks in Korea.1997. (%)

	October 1997	November 1997	December 1997
Rollover ratio	86.5	58.8	32.2

The stock market kept falling and the currency continued depreciating against the dollar (1,150 US\$ / ₩ to 2.000 US \$ / ₩ at the end of the same month).

The IMF was disconcerted because all of these measures were not effective towards changing the depressive tendency of the investors.

By 24th December 1997, Korea faced immediate default. The IMF determined that the foreign commercial banks had to roll over their short-term credits. On January 16th the banks and the government agreed on a complete roll over of all short-term debts falling before April 1998. The solution was to convert US \$ 24 billion from short-term debt into maturities between one to three years.

Afterwards, the IMF enabled the Korean government to govern its own the economy. The newly elected President Daejung Kim (hereafter D.J. Kim), after taking office in February 1998 began the labor of leading the country out of the IMF ‘trusteeship’. D.J. Kim’s government decided to apply Keynesian measures in order to reactivate the economy. It shaped a new macroeconomic policy to stimulate domestic demand and prevent a worse economic collapse.

The IMF’s high interest rates and restrictive policies employed to assist the currency collapse had led to a sharp deflation.

The IMF soon agreed on an increase of the budget deficit from an initially 1.7% of GDP to a 4% of GDP.

To finance the deficit the government issued eight trillion won (\$6.12 billion) in bonds. Moreover the BOK was allowed to increase the money supply to lower interest rates, and the IMF-mandated fiscal targets were progressively loosened.

There was also a question whether lowering interest rates would successfully expand the total money supply. The intention of the financial reforms was to consolidate the governance in the financial sector to adequate itself more closely to international norms and to promote private capital to take an effort for bank recapitalization.

Therefore the rehabilitation of banks was the most important element in the strategy for corporate financial restructuring. To facilitate the financial reform, the D.J. Kim government selected to consolidate and enhance the authority of the Financial Supervisory Committee (FSC), which was formally established in April 1998 as an integrated financial supervision body.

Commercial and merchant banks and other financial institutions had been continuously controlled for the accomplishment of the restructuring plans and capital adequacy targets, as recommended at the 8% Bank of International Settlements (BIS).

Korea had to a certain extent succeeded in reducing insolvent institutions or recapitalizing them. It involved a big collateral expenditure; by the end of the third quarter of 1998 the government had spent more than a half of the total budget of 64 trillion won (14% of GDP) that had been allocated to financial sector restructuring.

Chaebols, one of the main reasons of the sinking of the real economy, were the main target. The objective, while reducing debt/equity ratios, excess capacity, and corporate governance at the enterprise level, was to improve the country's industrial efficiency and international competitiveness.

The first movement of the government was to deal separately with the top five Chaebols (Hyundai, Samsung, LG, Daewoo, and SK). Afterwards it continued with the more than sixty others⁴².

The top five were basically the leaders in Korean industry (Kihwan, 2006). They were more globalized in operations and much bigger in size with more access to external financing and an easier cash flow position.

For the rest of the businesses, especially for small and medium-sized suppliers working with the main Chaebols, it was vital for the government to adopt more indulgent measures since, unlike the top five, they would be more harshly influenced by the credit crack.

The top five were required to agree on the forthcoming of the financial and operational restructuring in order to satisfy the government-imposed targets for debt/equity ratios and other international norms. By the end of 2000 their total production units were to be reduced from 271 to 136. They had to reduce their debt-to-equity ratio from their previous 400% to the 200% established by international norm. They were additionally demanded to raise their capital base by selling off assets and subsidiaries and issuing stocks overseas.

⁴² More information about the structural reform taken by the government in the Annex 7.4

By 1999, signs of a recovery started to show up in the Korean economy. The GDP increased by 4.6 % in the first quarter of 1999 and by 9.8 % in the second quarter.

By the end of 2002, the Korean Public Fund Oversight Committee (KPFOC), reported that there has been important restructuring in the financial sector.

The total number of employees has been reduced by 40% (Keun Lee, 2005). The total ratio of non-performing loans (NPL) in total assets has been reduced from 8.3 % in 1999 to 1.9 % in 2001.

The BIS ratio has increased from 7.0 in 1997 to 10.5 in 2002.

4.5 Consequences

Despite the unavoidable consequences of instability in the economy and the successive financial institution's closing, Korea performed well after the crisis.

One of the reasons was the maintenance of the confidence in the banks; foreign investors continued to bet on Korea. Notwithstanding the serious restructuring of the financial sector, lenders maintained their capital.

It is obvious that the Korea's present position has been a consequence of broad structural reforms that were implemented after the previous financial crisis.

The most important measures undertaken were related to:

- Strengthening prudential regulations
- Reducing moral hazard
- Promoting capital account liberalization
- Invigorate corporate governance of financial institutions
- Fortify legal and regulatory infrastructure

These reforms strengthened Korea's flexibility and resilience which are deeply important for a highly open economy in the era of globalization.

Despite the changes in the structure and the measures taken, there is a social downside that sharply hit the country. The unemployment rate went from 2% in 1996 to 6.8 % in 1998. Youth was also affected, the rate of unemployment among young workers (20- 24 years old) raised from 7.4% to 12 % by the end of 1997.the working conditions also worsen and the wage froze.⁴³

Nowadays, we often hear that a crisis represents an opportunity. Korea is an example of a country that was truly able to utilize such an opportunity. A crucial fact is that Korea did not limit itself only to reforms of the affected financial sector. On the contrary, the

⁴³ A survey of 400 enterprises found out that 45 % of the firms imposed a freeze on new recruitment. 17% used early retirement and 14% resorted to a reduced number of working hours. The same survey disclosed that 45% of unions were willing to accept wage freeze if employers guaranteed job security. (Serrat, 2000)

country started to build a knowledge about open market economy and it has been successful to some extent.

V. CONCLUSIONS

Once called the Asian tiger, the Korean economy had a big challenge to face in the 90s due to the result of 30 years of poor governance and a private corruption.

During the first 20 years of development, Korean decided to rely on the government as the main origin of resource allocation. It had control of capital and labor; therefore it was the main actor in the economy.

The Korean economic system was created for a specific purpose: helping develop a backwarded economy.

The procedure of the system was pretty biased, but it always resulted in a success. Even if the main purpose of the investments made was not achieved, or the efficiency was not as expected, the cheap labor compensated the lack of competitiveness of some industries.

The structure of the Korean economy was highly opaque. The interrelation of private and public interests ended up in a huge framework of responsibilities that were not met by anyone. The moral hazard poses a serious challenge in terms of a well-functioning financial system.

Different causes triggered the wellknown outcome , it is obvious that non of these facts would have created the crisis itself, but its accumulation led to a spiral of hassles that almost swallowed the system itself.

The Korean model, in spite of having accomplished great succes in the foregoing decades, has no theoretical base behind. Therefore, it completely failed against the Anglo-Saxon model when the crisis hit.

The domino effect of the asian economic crisis and the internal situation of the Korean economy originated a series of shocks that plunged the real economy and the expectatives of foreign investors.

It is important to underline that the crisis in Korea was a liquidity crisis due to important mismatches in short and long term loans. The weakness and high exposure of financial and corporate sectors were highly damaged when the capital account liberalization was implemented.

The fast and unbalanced liberalization of the financial sector was a big mistake. A complete liberalization was needed in the sector. Instead of that, only short-terms were liberalized. The economic institutions should have realized the volatility of the products and that the partial opening was only creating uncontrolled mismatches in maturity and in currency. It is completely necessary to develop long-term capital markets.

The policies implemented to help the exports were very biased towards a continuous expansion of the Korean industry, without taking in account future economic changes. The managed floating system hid current account and trade imbalances. The control over a currency led to speculative attacks when instability and fear rove the markets.

The modern environment of globalization enhances the need for flexibility.

A reform process tends to involve tension between global standard and local ideas and interests.

Transparency within the business practices and independent institutions is vital in order to maintain investor's confidence in Korea and overseas. The law has to be applied; therefore responsibilities should be taken by managers when deciding strategic investments. The absence of it creates a critical confidence situation for international creditors.

Stability is as well essential to maintain a permanent growth rate. And among the corporate sector, it is fundamental that the firms are given full freedom in their investment decision-making.

Profitability has obtained significant progress since the crisis. The net profit to sales ratio of the average of the top 30 Chaebols increased from -0.8% in 1997 to 3.48%. This guideline entails that conglomerates are redirect their spotlight from sales or market share expansion to profitability or rate of returns.

While the Korean economy should continue to grow with sharp investment, the firms have one of the lowest equity debt –equity ratio in the world (100%) (Keun Lee, 2005).

The main target for the economy should be to pursue long term growth rather than short term profitability. So as to carry out this, the Korean government should focus on:

- Creating jobs
- Developing new markets
- Impulse new firms

Once these 3 factors are achieved, The Korean economy would be one of the most successful actors in the world.

As a matter of fact, the outcome obtained after this work is that the Korean economy did change after the Asian Economic Crisis, but the model didn't disappear completely. The Korean model still remains in the economy, but under tight control and supervision. The Chaebol is still a reality in modern Korea, but the moral hazard is disappearing from the public sector.

Regulation and policies to promote competition are being implemented. The financial sector is thoroughly observed and market liberalization it is one of the main targets of the new Korean governments.

Finally, it is worth bringing out that despite its dramatic impact, the long run effects of the crisis may be somehow beneficial for Korea. To the extent that the crisis gives Asian countries an stimulus to reform their economic systems, and to stablish some much in need restructuring, they may arise from the experience not weaker, but more solid institutions and a greater ability to reach sustainable economic growth.

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VII. ANNEX

7.1 Timeline of the AEC

1997

- Early May - Japan hints that it might raise interest rates to defend the yen. The threat never materializes, but it shifts the perceptions of global investors who begin to sell Southeast Asian currencies and sets off a tumble both in currencies and local stock markets.
- July 2 - After using \$33 billion in foreign exchange, Thailand announces a managed float of the baht. The Philippines intervenes to defend its peso.
- July 18 - IMF approves an extension of credit to the Philippines of \$1.1 billion.
- July 24 - Asian currencies fall dramatically. Malaysian Prime Minister Mahathir attacks "rogue speculators" and later points to financier George Soros.
- Aug. 13-14 - The Indonesian rupiah comes under severe pressure. Indonesia abolishes its system of managing its exchange rate through the use of a band.
- Aug. 20 - IMF announces \$17.2 billion support package for Thailand with \$3.9 billion from the IMF.
- Aug. 28 - Asian stock markets plunge. The Philippines stock market decreases down 9.3%, and in Jakarta 4.5%.
- Sep. 4 - The peso, Malaysian ringgit, and rupiah continue to fall.
- Sep. 20 - Mahathir tells delegates to the IMF/World Bank annual conference in Hong Kong that currency trading is immoral and should be stopped.
- Sep. 21 - George Soros says, "Dr Mahathir is a menace to his own country."
- Oct. 8 - Rupiah hits a low; Indonesia says it will seek IMF assistance.
- Oct. 14 - Thailand announces a package to strengthen its financial sector.
- Oct. 20-23 - The Hong Kong dollar comes under speculative attack; Hong Kong aggressively defends its currency. The Hong Kong stock market drops, while Wall Street and other stock markets also take severe hits.
- Oct. 28+ - The value of the Korean won drops as investors sell Korean stocks.
- Nov. 5 - The IMF announces a stabilization package of about \$40 billion for Indonesia. The United States pledges a standby credit of \$3 billion.
- Nov. 3-24 - Japanese brokerage firm (Sanyo Securities), largest securities firm (Yamaichi Securities), and 10* largest bank (Hokkaido Takushoku) collapse.
- Nov. 21 - South Korea announces that it will seek IMF support.
- Nov 25 - At the APEC Summit, leaders of the 18 Asia Pacific economies endorse a framework to cope with financial crises.
- Dec 5 - Malaysia imposes tough reforms to reduce its balance of payments deficit.
- Dec 3 - Korea and IMF agree on \$57 billion support package.
- Dec 18 - Koreans elect opposition leader Kim, Dae-jung as new President.
- Dec 25 - IMF and others provide \$10 billion in loans to South Korea.

1998

- Jan 6 - Indonesia unveils new budget that does not appear to meet IMF austerity conditions. Value of rupiah drops.
- Jan 8 - IMF and S. Korea agree to a 90-day rollover of short-term debt.
- Jan 12 - Peregrine Investments Holdings of Hong Kong collapses. Japan discloses that its banks carry about \$580 billion in bad or questionable loans.
- Jan 15 - IMF and Indonesia sign an agreement strengthening economic reforms.
- Jan 29 - South Korea and 13 international banks agree to convert \$24 billion in short-term debt, due in March 1998, into government-backed loans.
- Jan 31 - South Korea orders 10 of 14 ailing merchant banks to close.
- Feb 2 - The sense of crisis in Asia ebbs. Stock markets continue their recovery.

Source: CRS Report. The 1997-1998 Asian Economic Crisis

7.2 Chronology of Korea's political situation

1945 - After World War II, Japanese occupation ends with Soviet troops occupying area north of the 38th parallel, and US troops in the south.

1948 - Republic of Korea proclaimed.

The Korean War (1950-1953) killed at least 2.5 million people. It pitted the North - backed by Chinese forces - against the South, supported militarily by the United Nations

1950 - South declares independence, sparking North Korean invasion.

1953 - Armistice ends Korean War, which has cost two million lives.

1950s - South sustained by crucial US military, economic and political support.

1960 - President Syngman Ree steps down after student protests against electoral fraud.

New constitution forms Second Republic, but political freedom remains limited.

1961 - Military coup puts General Park Chung-Hee in power.

1963 - General Park restores some political freedom and proclaims Third Republic. Major program of industrial development begins.

1972 - Martial law. Park increases his powers with constitutional changes.

After secret North-South talks, both sides seek to develop dialogue aimed at unification.

1979 - Park assassinated. General Chun Doo-hwan assumes power.

1980 - Martial law declared after student demonstrations. In the city of Gwangju (Kwangju) at least 200 killed by the army, causing resentment that has yet to fade. Fifth republic and new constitution.

1981 - Chun indirectly elected to a seven year term. Martial law ends, but government continues to have strong powers to prevent dissent.

1986 - Constitution is changed to allow direct election of the president.

Return to democracy

1980s - Increasing shift towards high-tech and computer industry.

1987 - President Chun pushed out of office by student unrest and international pressure in the build-up to the Sixth constitution. Roh Tae-woo succeeds Chun, grants greater degree of political liberalization and launches anti-corruption drive.

1988 - Olympic Games in Seoul. First free parliamentary elections.

1993 - Roh succeeded by Kim Young Sam, a former opponent of the regime and the first civilian president.

1995 - Corruption and treason charges against Roh Tae-woo and Chun Doo-Hwan.

South Korea admitted to the Organization for Economic Cooperation and Development.

1998 - Kim Dae-Jung elected president of the country in the middle of an intense economic crisis

Source: BBC News. South Korea's political chronology

7.3 The speculative attack against the Thai Baht.

There were two ways used in order to carry out the speculative attack against the Thai Baht: the spot market and the forward market.

An attack in the spot market was implemented by selling the Thai currency for US dollars. The main responsible were foreign investors.

The main purpose of this attack was to devalue the currency by pushing the value of the Baht in the spot market or to push up the swap premium. With this initiative they would be able to repay contracts with cheaper currency, therefore they were making huge profits.

There were alternative ways of speculating with the currency: investors would bet against the baht by performing contracts with traders who would give US \$ in return for an agreed amount of baht after some months. If the baht depreciates, the speculators made enormous profits, because they could repay the deals with cheaper baht.

When the baht was heavily attacked, deteriorated further by capital outflow, the Bank of Thailand was forced to intervene directly in the spot market. The BOT had a currency peg: the baht would deviate maximum two satang from the fixed exchange rate.

The Exchange Equalization Fund, is able to buy or sell US dollars without limit. But in almost all the time in 1997, it was draught to sell out the US dollar to support the value

of the Baht at a fixed rate. By doing so, it depleted the country's foreign exchange reserves.

Without the BOT's intervention, the baht would have debilitated considerably and the short-term interest rates would have increased uncontrolled because the speculative attacks would have dry up liquidity in the money market.

By May 14th, 1997 an attack against the Baht was executed. The exchange rate then was Bt25/ US\$ 1. A baht attack for US\$10 billion was accomplished, which implies that approximately Bt260 billion disappeared from the economic system. There was only Bt 400 billion in circulation at that time, hence it could have been the havoc of the payment system.

During the speculative attacks, which straight away bind the liquidity market, the Banking Department "sterilized" the contractionary effect from the speculative attacks by boosting the baht back into the system through the buy-sell swap contracts. Through this policy (buy dollar/sell baht, with an obligation afterward to sell dollar/buy baht), the BOK drove the dollar into its account and sent the baht into the system.

Contractually, the Bank of Thailand was obliged to hand the dollar back to the contractual parties and get the baht returned. The share for such deal is called a swap premium, or risk premium.

7.4 Structural Reform Measures

Initial program: December 1997

➤ Trade Liberalization

A timetable will be set in line with World Trade Organization commitments to eliminate trade-related subsidies, restrictive import licensing, and the import diversification program. Steps will be taken to streamline and improve the transparency of import certification procedures.

➤ Capital Account Liberalization

Foreign financial institutions will be allowed to participate in mergers and acquisitions of domestic financial institutions in a friendly manner and on equal footing. By mid-1998, foreign financial institutions will be allowed to establish bank subsidiaries and broker-age houses. Legislation will be submitted to the first special session of the National Assembly to harmonize the regime on equity purchases with OECD practice. The ceiling on aggregate foreign ownership of listed Korean shares will be increased from 26 to 50 percent by end-1997 and to 55 percent by end-1998. The ceiling on individual foreign ownership will be increased from 7 to 50 percent by end-1997. By end-February 1998, other capital account transactions will be liberalized by easing foreigners' access to domestic money market instruments and the corporate bond market and simplifying the

approval procedure for foreign direct investment. A timetable will be set by end-February 1998 to eliminate restrictions on foreign borrowing by corporations.

➤ Corporate Restructuring

Corporate balance sheet transparency will be improved by enforcing accounting standards in line with generally accepted accounting practices. The commercial orientation of bank lending will be fully respected and the Government will not intervene in bank management and lending decisions. To strengthen market discipline, bankruptcy laws will be allowed to operate without Government interference.

The “real name” system in financial transactions will be maintained, although with possible revisions. By late 1998, the restructuring of corporate finances will be encouraged by, among others, reducing the high debt-to-equity ratio of corporations and changing the system of cross-guarantees within conglomerates.

➤ Financial Sector Restructuring

Legislation will be enacted to set up a strong and independent supervisory agency, (ii) strengthen and consolidate prudential supervision, and increase transparency.

Time-bound action plans will ensure that there will be an orderly exit of nonviable institutions, procedures and policies to deal with weak but viable financial institutions, and measures to improve the commercial orientation and risk management of the financial sector.

The National Assembly should pass the following:

- A revised Bank of Korea Act, providing for central bank independence, with price stability as its main mandate.
- A bill to consolidate supervision of all banks, merchant banks, securities firms, and insurance companies into one agency with operational and financial autonomy.
- A bill requiring that corporate financial statements be prepared on a consolidated basis and certified by external auditors.

Troubled financial institutions will be restructured and recapitalized within a specified time frame. The exit strategy will require troubled institutions to present a viable rehabilitation plan and close insolvent financial institutions and those failing to carry out their rehabilitation plans within specified periods.

Domestic and foreign institutions may engage in mergers and acquisitions. A timetable will be set for all banks to meet or exceed Basle standards.

All forms of assistance to banks, including that coursed through the Korean Asset Management Corporation (KAMCO) and deposit insurance funds, will be provided only

as part of viable rehabilitation plans. Blanket guarantees will be phased out and replaced by a limited deposit insurance scheme.

Merchant Banks

The foreign exchange operations of nine technically insolvent merchant banks will be transferred to other institutions. (The banks were suspended on 2 December 1997, with depositors fully protected.)

The consolidated deposit insurance corporation will issue bonds to raise the funds needed to meet the deposit insurance obligation. The Government will guarantee these bonds and bear the interest costs. The Government announced that it would propose amendments of laws to allow foreign financial institutions to participate in mergers and acquisitions of domestic financial institutions. Foreign participation in merchant banks is allowed up to 100 percent.

The Government did the following:

- It immediately placed the nine suspended merchant banks under the control of the Ministry of Finance and Economy (MOFE) and required each to submit a rehabilitation plan within 30 days.

If MOFE fails to approve such plan, the institution will have its license revoked and will not be eligible to participate in the KAMCO program of bad-asset purchase or receive any financing from the deposit insurance fund.

- It monitored the banks' rehabilitation in close consultation with IMF. If the head of the supervisory authority concludes that rehabilitation has not been successful within three months, the institution will be closed.
- It required the remaining merchant banks to present by 31 December 1997 a program of recapitalization or downsizing that will allow them to meet at least a 4 percent capital requirement ratio by 31 March 1998, 6 percent by 30 June 1998, and 8 percent by June 1999. Failure to obtain supervisory approval of the program or to meet the schedule will lead to suspension of their foreign exchange business and possibly revocation of their license.
- It required the two distressed commercial banks to prepare a plan to meet the Basle capital standard within four months after approval of the plan. It required other commercial banks to make full provisioning for their impaired assets and for their securities losses by end-March 1998. The banks will agree on a timetable with the supervisory authority by June 1998 to achieve current minimum capital standards within a time frame of six months to two years.
- It required that the rehabilitation plans submitted by financial institutions to supervisory authorities should specify the sources and amounts of new capital, a clear schedule to meet Basle capital adequacy standards and provisioning requirements, and confirmation

from the supplier of funds; indicate changes in management and ownership; and present a business plan.

The Government proposes to do the following:

- In consultation with IMF, it will prepare a comprehensive action program to strengthen financial supervision and regulation in accordance with international best-practice standards.
- It will subject specialized banks and development institutions to the same prudential standards that apply to commercial banks and require external audit on their financial statements.
- It will closely monitor Korean banks' overseas branches' borrowing and lending activities to ensure that they are sound. New injections of foreign exchange by BOK to Korean commercial banks or their overseas branches will carry a penalty rate of 400 basis points above the London interbank offered rate. BOK's deposits with nonresident branches and affiliates of domestic financial institutions will not be increased after December 1997, but will be reduced gradually as soon as circumstances permit.
- It will adjust the ceiling on net domestic assets and the indicative limit on reserve money to comply with required reserve ratios.

Source : (Cho)