Bailing Out or Sinking In?  
The IMF and the  
Korean Financial Crisis

A presentation by  
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The question that I am asked to address is how an industrial juggernaut like South Korea – widely touted as the eleventh largest economy in the world – has ended up in the lap of the International Monetary Fund, and what this portends for an economic system that came to be known as Korea, Inc.

Rather than revisit the daily unfolding of the Korean financial debacle in the past few weeks, with which you all are familiar, I would rather like to use this occasion to discuss the political and historical logic of the Korean economic system, so that that we can better discern the parameters of current and future Korean (and American) action. When we do that, I think we may find that the IMF has bitten off a lot more than it may be able to chew, let alone digest.

We do not want for explanations of the Korean crisis. They have commonly ranged between "too little deregulation" and "too much deregulation," along with assurances that the "fundamentals" of the Korean economy are sound, thus to calm jitters in the market. Mainstream economists have argued for years that the Koreans have not deregulated their financial systems enough, and although the current crisis does involve a lack of financial transparency, that has been true for decades in Korea. Others say that deregulation went too far, leading to reckless investment and lending both domestically and in Southeast Asia.

How can the degree of deregulation simultaneously be too much and too little, and how can economic fundamentals be said to be sound amid a massive financial collapse, requiring a $60 billion bailout? What is missing is the history and the international context of the Korean political economy.

The Korean economic system has always been intrinsically unstable, and therefore vulnerable to exactly the sort of financial calamity that has now befallen it. The only interesting question was when the other shoe was going to drop, revealing the instability of an obsolescent and increasingly corrupt system.

To adumbrate my argument, the other shoe dropped when Washington and Tokyo refused to aid Korea bilaterally. One of the great cushions to the Korean economy was the Cold War, such that any serious economic crisis also invoked security concerns, or even transformed economic crises into crises of security. At any time before 1989, Seoul could expect Washington and Tokyo to step in and help it out bilaterally (with the best example being the crisis of the early 1980s). But that was then and this is now; it is far preferable for the United States today to rely on multilateralism to solve problems like this, with organizations like the International Monetary Fund in the lead. To understand this logic better, we need to recover some basic facts regarding Korea’s political economy.

Korea emerged from a half century of colonialism and war utterly destitute, as is well known, but during the Cold War it occupied a central divide and a prominent, exposed position between the superpowers. Parlaying its geopolitical
position into economic advantage, the government amassed huge amounts of foreign aid in the 1950s and then later, foreign loans. The linchpin of the mechanism to promote economic growth, and at the same time to prop up the fledgling South Korean state, was its financial policy.

The state allocated foreign capital (along with domestic savings) to rising industries and firms, who would produce almost entirely for the export market. Economic planners did this by fiat at first, by setting low financial prices (or even negative real rates, as was the case throughout the 1970s) and allocating credit through banks which were owned by the state. Thus, the banks in Korea were policy instruments of what may be called a "late industrialization," emphasizing exports, and in the Korean instance, also the development of heavy industries related to security needs. This may not have been kosher for economists, but it was a strategy indulged by Washington for many years, because it both promoted South Korean security made the ROK a model of export-led development.

In the course of this development, the state created an impressive constellation of mammoth industrial firms, the chaebol, a group of can-do oligopolies with plenty of entrepreneurial spirit, great firms like Hyundai and Samsung that founded one new industry after another. In turn these firms provided political support for the ruling party, in the form of floodtides of cash passing between the industrialists and the politicians.

For the chaebols this was their best insurance against default, since the state was always behind them. Additional insurance came from their sheer size and therefore their importance to the domestic economy; they were so big that they could be in what we political scientists call a "state of permanent receivership." The big firms were always hugely leveraged, with very high debt-equity ratios, and because they usually had lower profit rates than small-sized firms, they always needed periodic infusions of new cash.

Memories can be very short in the media: in the current coverage of the IMF bailout I saw hardly any reference to last year’s Korean news, which involved the cashiering of two previous presidents for truly mind-boggling levels of corruption, owing to the very system I am talking about: politicians and political parties collecting huge amount of money from the chaebol, and offering in return loan guarantees to sustain these cash-strapped firms.

The inquiries into the slush fund scandals proved that one former president, Chun Doo Hwan, got more than $900 million, and the other, Roh Tae Woo, about $600 million. These recent cases were certainly revelatory to the Korean people of the operational method of patronage in Korea, Inc., and now we should not forget them.
Korea, Inc. was far more arbitrary than Japan Inc.: in the 1980s, a racketeering state became the flip side of the benign developmental state (the earlier, more systematic pattern of chaebol support for the ruling groups became in the 1980s a kind of mad extortionism, especially in Chun’s case).

Now it is true that since the early 1980s, Korea has worked hard on financial liberalization, privatizing banks, internationalizing financial markets, deregulating financial prices, and developing equity markets as alternatives to bank loans. But the habits of state interference died hard and in some cases got revived; thus the vulnerability of the financial system persisted.

Remarkably, the chaebols today remain as leveraged as they were in 1969 when Korea experienced its first major debt-crisis, or in the 1970s when they were hungry recipients of the so-called "policy loans" which, given high inflation, were outright subsidies. The problem of non-performing loans has not abated, either, but remained more or less steady for the past thirty years.

My random inquiry shows that in 1983, in the midst of recession and three years of poor export performance, the percentage of non-performing loans in the banking sector was estimated to be 14 percent of total loans – about the same as what it is today. In other words, sixteen years of financial liberalization – slow, steady, tortuous – has brought about much change in the financial sector, but did not eliminate the vulnerability of the Korean financial system.

It is an odd outcome when you think about it: the whole purpose of the financial liberalization had been precisely to prevent a financial collapse, the cost of which would then have to be socialized. But this is not hard to understand as an outcome of the peculiar political system that locks politicians and chaebol in an ungainly embrace.

Today there is no historical task more urgent than to cut this Gordian knot. President Kim Young Sam seemed to understand this clearly, and in fact made financial liberalization was one of his priorities –with one major reform being the real-name system for bank deposits. But a thorough reform of the financial sector would have required extraordinary determination on the part of the state leadership, an exercise of power which could not be mustered by a democratic regime that also happened to be unpopular.

So the regime stalled, unable and unwilling to overhaul the system that has given so much clout to the state, and unwilling to overrule the privileged chaebol. Neither could it overrule an increasingly strong labor movement, one
that spilled out to the streets last January, opposing a new labor law that would have made layoffs easier. Then Kim Young Sam’s administration went catatonic in the face of a string of bankruptcies that also started in January, claiming six of Korea’s top thirty chaebol, but featuring the collapse of the Hanbo conglomerate, which triggered a huge political scandal involving the president’s own sone – and in an election year, no less.

The economic team that stayed in office for the first ten months of the year could do nothing, and therefore did nothing as the stock market dropped 20 percent and as the currency, the Korean won, fell by percent. It was able, however, to suppress with great alacrity a government think-tank report written in March arguing that Korea, with short-term debts over 30 percent of GDP and very low levels of foreign exchange reserves, was headed toward a repeat of the Mexican crisis of 1995. In other words the IMF today is doing for Korea what the government could not do in the preceding year: and the reason for the state’s inaction is precisely the imbrication of politics and finance.

In the halcyon days of the Cold War, the deviant nature of the Korean financial system (deviant from the standpoint of laissez-faire) was ignored or soft-pedaled. The United States always stood ready to help out in the event of trouble, slapping the Korean wrist now and then for maintaining market barriers and not liberalizing enough. During the economic debacle of 1979-1980, for instance, the United States acted swiftly to stabilize Korea, sending signals to the international financial community that Korea, the assassination of Park Chung Hee and the Kwangju rebellion notwithstanding, was a sound investment for more loans.

More importantly, the United States exerted pressure on Japan to "share burdens" in bailing out a Korean regime then grappling with financial and other economic troubles, amid massive popular disaffection. The Reagan-Suzuki agreement stipulated in effect that the maintenance of peace on the Korean peninsula was important for the security of Japan, which meant that Japan would have to ante up. In the midst of economic crisis, then, the Korean government presented Japan with a stunning bill: $10 billion in aid and loans from Japan over a five-year period, to begin in 1982.

When the back-and-forth negotiating was all over, Korea got from Japan $4 billion in government and EXIM loans. This was nearly 13 percent of Korea’s net external debt, more than 5 percent of the GNP, and almost a fifth of total investment in 1983. A comparable figure today (i.e., 5 percent of GNP) would be approximately $25 billion – roughly half the size of the IMF bailout, according to news reports this week. The big difference is that when the Korean government called for bilateral help from the central banks of Japan and the United States two weeks ago, the refusal was swift and decisive.
Although the main reason for this change is the post-Cold War milieu in which the U.S. finds multilateralism more appropriate for the achievement of its goals (or the world’s goals, often said to be the same thing), it is important to note something entirely new in the Northeast Asian security situation, which is the developing bilateral relationship between the U.S. and North Korea. In the middle of the IMF bailout news, Pyongyang agreed to join four party talks to finally bring an end to the Korean War, and representatives of both sides held high-level bilateral meetings in Washington, reportedly toward the goal of exchanging diplomatic envoys.

This new American diplomacy has not gone down well in Seoul, but it is another illustration of the post-Cold War distance that can be seen in Washington’s relationship with Seoul. More broadly, however, Washington has sought to move toward a multilateralism in East Asia and the Pacific that would somehow catch the region up with the historic alphabet-soup multilateralism of Europe – and thus the Clinton administration’s emphasis on the Asia-Pacific Economic Cooperation grouping (APEC) and the ASEAN Regional Forum (ARF), and the use of diplomatic mechanisms to solve old Cold War problems (witness the October 1994 agreement freezing North Korea’s nuclear facility, and the four-power talks).

What will the IMF package do for the Korean political economy? Above all, it will attempt to do what the Kim Young Sam administration did not have the power to do: open up the financial nexus of Korea, Inc., raise taxes, push interest rates higher, and lower the planning estimates for Korea’s GDP growth in the near term of the next couple of years. It may also try to restructure the labor market by making layoffs and wage freezes easier: the one important thing that Kim Young Sam did try to do a year ago, with a new labor law. The result was massive labor unrest in the streets, approaching a general strike at times last January.

Let us now look more deeply at each of these measures, at what amounts to several structural changes that Koreans have not had the will or the power to enact themselves.

The first and most important measure is financial liberalization. The IMF is already reported to have asked for a complete liberalization of the financial sector, making it possible, among other things, for a much higher degree of transparency and for foreign takeovers of Korean banks and other financial intermediaries. Maybe they will be successful, and maybe not; but from the historical perspective I outlined above, I will believe it only when I see it. In any case I believe that true reform here will be harder than anywhere else, because it challenges the very basis of Korean economic success since the 1960s.
The second question concerns the problems of market concentration and chaebol oligopoly. It is likely that the IMF will use the occasion of the current stabilization, placing the Korean government in a weak position, to reduce various forms of trade and investment barriers, running the gamut from tariffs on foreign cars and agricultural products to policies on government procurement and intellectual property rights. Already the government has opened the domestic bond market (there were few foreign takers), and most analysts assume that more market opening will be the price of IMF stabilization.

Given past experience, we can expect much foot-dragging. It is unlikely, for example, that at a time of idle capacity in the automotive sector the domestic market will be flung open to foreign cars. As for reining in the chaebol, the stabilization in the early 1980s is a good guide: administrative measures in search of "industrial rationalization" led to forced mergers for the weaker firms and monetary infusions for those firms deemed competitive in world markets. It is also likely that the IMF will demand that foreign firms be allowed to take over failing firms.

It is not easy to gauge how successful any reorientation of the chaebol would be. On the one hand, these firms for years have wanted freedom from government regulation. On the other, they have not succeeded in breaking the umbilical cord of state financial support. Certainly the top handful of firms-Hyundai, Samsung, Daewoo for example-are world-class organizations, competitive in diverse industries around the world. The problem comes in with weaker firms like KIA and Hanbo, to take the two biggest examples of failure this year, and more generally with an economy that is grossly distorted by a small number of huge corporations.

By far the toughest question for Korean stabilization relates to labor, and this is where the experience of earlier stabilizations is of little help. Wage restraints and layoffs in the 1980s were an artifact of sheer political terror, a wholesale assault on unions that, by contrast, made even the worst years of Park Chung Hee's rule appear like balmy days. In the particularly cantankerous year of 1980 the number of labor disputes recorded by the Ministry of Labor plummeted from 407 incidents to 186 the next year, and then to only 88 in 1982. Workers were massively laid off, more so in large enterprises than in small ones, thus giving the lie to the claim of paternalism in the chaebol companies.

Today Korean labor is highly organized, with a ten-year record of rapid mobilization. The number of strikes and other incidents that occurred after the Chun dictatorship collapsed in 1987 was the highest ever recorded in the world, and today strong unions exist among both blue-collar and white collar workers. This makes the situation quite different than in the early 1980s, compounded by the impending presidential election on December 19.
A combination of strong organization and strong disincentives for layoffs means that the IMF will have to tread very carefully with Korean labor – and perhaps that is why no news has leaked out about what the stabilization package says about labor. If there is a widespread perception that labor is unfairly bearing the brunt of stabilization, we can expect widespread unrest. If on the other hand Korean workers perceive that everyone is tightening their belts, the chaebol groups above all, it is likely that residual patriotism and nationalism will lead labor to support the stabilization package.

Since 1987 Korean labor has become sensitized to the need to ally themselves with the middle class if their demands are to succeed, so a fair and broad sharing of austerity will encourage both middle class professionals and industrial workers to fall in behind genuine reforms.

What I have argued, in short, is that the Korean political economy is another kind of leftover Cold War artifact, good for an era of security threats and close bilateral relations with Washington, but of questionable use in the global "world without borders" of the 1990s. At some point Koreans have to reckon with a highly-leveraged, highly political, manifestly corrupt nexus between the state and big business, one that nonetheless had propelled the Korean economy forward at world-beating rates of growth.

Since it has been unable to reckon with this juggernaut on its own, Korea now rests its fate with the IMF. A multilateral body first formed in 1944, the IMF has always been influenced most by Americans. Washington and the IMF will now have to tread a fine line: one that restores the fundamentals of the Korean economy, does not alienate Korea’s strong labor movement and its increasingly active civil society, gets serious about change in the financial system and the reform of the chaebol, and to do all this at a time when sharp currency devaluations (the won has fallen 20 percent in the past four months) threaten to beggar Korea’s neighbors and raise the specter of competitive devaluations and a massive U.S. trade deficit.

When you stir this pot even more with a highly contested Korean election, just around the corner, you see that the IMF is walking a tightrope. It may succeed, and bail the ROK out of a stew of its own making. But it may also fall into that stew, with unknown consequences for an IMF that prides itself on always eschewing politics, but which also has its own, traditionally highly secret, considerations.

In any case East Asia’s flying geese are now launching into an unknown future with an unexpected head goose: not Japan, the avatar of the Pacific Century, but the goose that Washington first launched at Bretton Woods: the International Monetary Fund.