Carleton University

**The Political Economy of Capital Controls and Chaebols in
South Korea**

**A Thesis submitted to
The Faculty of Graduate Studies and Research
In partial fulfillment of the requirements for the degree of
Master of Arts**

Institute of Political Economy

By Joel Albert M. Barros

Ottawa, Ontario

**JUNE 2007
©Joel Barros**

Library and
Archives Canada

Bibliothèque et
Archives Canada

Published Heritage
Branch

Direction du
Patrimoine de l'édition

395 Wellington Street
Ottawa ON K1A 0N4
Canada

395, rue Wellington
Ottawa ON K1A 0N4
Canada

Your file Votre référence

ISBN: 978-0-494-33737-0

Our file Notre référence

ISBN: 978-0-494-33737-0

NOTICE:

The author has granted a non-exclusive license allowing Library and Archives Canada to reproduce, publish, archive, preserve, conserve, communicate to the public by telecommunication or on the Internet, loan, distribute and sell theses worldwide, for commercial or non-commercial purposes, in microform, paper, electronic and/or any other formats.

The author retains copyright ownership and moral rights in this thesis. Neither the thesis nor substantial extracts from it may be printed or otherwise reproduced without the author's permission.

AVIS:

L'auteur a accordé une licence non exclusive permettant à la Bibliothèque et Archives Canada de reproduire, publier, archiver, sauvegarder, conserver, transmettre au public par télécommunication ou par l'Internet, prêter, distribuer et vendre des thèses partout dans le monde, à des fins commerciales ou autres, sur support microforme, papier, électronique et/ou autres formats.

L'auteur conserve la propriété du droit d'auteur et des droits moraux qui protègent cette thèse. Ni la thèse ni des extraits substantiels de celle-ci ne doivent être imprimés ou autrement reproduits sans son autorisation.

In compliance with the Canadian Privacy Act some supporting forms may have been removed from this thesis.

Conformément à la loi canadienne sur la protection de la vie privée, quelques formulaires secondaires ont été enlevés de cette thèse.

While these forms may be included in the document page count, their removal does not represent any loss of content from the thesis.

Bien que ces formulaires aient inclus dans la pagination, il n'y aura aucun contenu manquant.

Canada

Abstract

In the 1980s and the 1990s, the South Korean government relaxed financial controls, opening the economy to systemic vulnerabilities that resulted in the economic crisis that struck Korea in 1997. This happened because the state lost its autonomy vis-à-vis the Chaebols following the assassination of Park Chung Hee in October 1979. General Chun Doo Hwan assumed power via a coup d'état but the security of the regime was threatened by the unrest that followed by the massacre of dissidents in Kwangju. Facing growing internal dissent and the threat of a North Korean military incursion, Chun Doo Hwan maintained his position and secured the nation by brokering a mutually beneficial economic relationship between the power structures in South Korea. The Chaebol required capital while neoliberal US capitalists were looking for enterprises to loan its petrodollar. The Korean economy became the venue for this partnership which resulted in a progressive overhauling of the economic structures of the developmental state established under Park. Chun moved to dismantle capital controls and installed US trained economists in the bureaucracy to engineer a mutually compatible neoliberal economic platform—a liberalized economy. This set the momentum for dismantling the capital controls in South Korea until it was fully liberalized during the Kim Young Sam administration.

Acknowledgment

This thesis would not have been completed without the research and studies of other experts in the field. I have many fine teachers in person and in print, and I am grateful to each of them for the facts and insights that have enriched this document.

I am very grateful for the direction of Prof. Manfred Bienefeld, Prof. Rianne Mahon and Prof. Jeremy Paltiel who painstakingly guided me through this arduous but enlightening odyssey.

To my sons Eli and Joey who have been a constant source of comic relief, joy and love;

To Mary Ann who has seen me through these very trying times.

But most importantly.....

IXØYE
Ad Majorem Dei Gloriam

Table of Contents

Introduction 1

Chapter 1 The Vision of a Developmental State 3

1.A The Developmental State and its Industrial Strategy

1.B The Developmental State of South Korea

Chapter 2 Finance in the Developmental State of South Korea 43

2.A Finance in the developmental state

2.B The Financial System in Korea

Chapter 3 The Altered State 85

3.A The October 1979 Crisis in Korea

3.B Political Change: Stagflation and shifting state views

3.C The Impact on Chaebols

Chapter 4 Manoeuvres 115

4.A Quelling Corruption, creating vulnerability

4.B Exposing the economy to global finance through short-term instruments

Chapter 5 Conclusion 127

Bibliography

Figures and Tables

TABLE 1A International Cooperative Alliance (ICA) AID (U\$)	22
FIGURE 1B Blue House	27
TABLE 1C Import Coefficient in HCI Development (%)	31
TABLE 1D Percent Share of Heavy Chemical Industry and Light Industry in Manufacturing and Merchandise Exports	36
TABLE 1E Changes in Industrial Structure GDP(%)	36
TABLE 2A Financial Institutions and Market in South Korea	58
TABLE 2B Changes in principal interest rates of banking institutions as of September 30, 1965 (%) per annum	61
TABLE 2C Foreign Loans and Investment, 1959–1983 (in million USD)	62
TABLE 2D Growth effect of Foreign Capital	64
TABLE 2E External Debt and Debt Service	65
TABLE 2F Export Loans by Deposit Money Banks (DMB)	67
TABLE 2G Sources of Current Account Imbalances in Current Market Prices (i.e. 1985), 1963–1982	69
TABLE 2H Selected Financial ratios in the manufacturing industry '63–'78	70
TABLE 2I Basic Macro Indicators, 1962–1984	72
TABLE 2J Foreign Banks With Credit Outstanding in Korea, August 1975, In Millions USD	73
TABLE 3A TOP 10 Combined Sales of Chaebols as % of GDP	90
TABLE 3B Four–Stage Liberalization of Interest Rates	101
TABLE 3C Share of Policy Loans in Commercial and Specialized Banks (%)	105
TABLE 3D Growth of the capital market in Korea (billion Won)	107
TABLE 3E Market Shares of Types of Financial Institutions 1976–1989 (percentage)	109
TABLE 3F NBFIs Owned by Chaebols, 1995	110
FIGURE 3G Debt as % of GDP	112
FIGURE 3H Long Term Debt as a Portion of Total Debt	113

TABLE 4A Growth of Financial Markets	120
FIGURE 4B Number of Financial Institutions	121
TABLE 4C Composition of Foreign Debt	122
FIGURE 4D Short-Term Debt/Assets	123
TABLE 4E International Claims Held By Foreign Banks (billion \$) Distribution by Maturity and Sector	124
FIGURE 5A Financial Flow during the Park Years	129
FIGURE 5B Financial Flow in the 1980s and 1990s	132

Introduction

At first glance, the 1997 Korean financial crisis is puzzling because South Korea had had a very progressive economy, well supported by a coherent system of capital controls in the 1960s and 1970s. Under Park Chung Hee Korea had gained a reputation as a “Tiger Economy”. The South Korean economy under the leadership of Park Chung Hee was organised in such a way as to achieve national development goals collectively and enable the leadership to steer the economy through a debilitating oil crisis—the state was autonomous. With Taiwan and Japan, South Korea embraced a concept and economic logic that came to be the “developmental state”. Fundamental to the success of a developmental state is the ability of governments to contain, control and mobilize capital resources to strategic industries and to maintain stability despite a highly leveraged economy. South Korea was able achieve these goals through stringent capital controls. In the 1980s and 1990s however, South Korea chose to liberalize its financial sector. This laid the basis for the financial crisis in 1997.

The purpose of this thesis is to understand why capital controls were dismantled. A mix of domestic and geopolitical issues initiated South Korea to gradually embrace neoliberalism. Yet to appreciate the change, it is necessary to provide an historical understanding of the developmental state of South Korea. Accordingly, this thesis will first analyze the dynamics of a “developmental state” in Chapter 1. Japan pioneered a form of state that has come to be known as a “developmental state”. Under General Park Chung Hee, Korea created its own developmental state, which bore many similarities to the Japanese. This chapter will discuss the concepts and rationale behind Japan’s economic success taking from experts from the Ministry of International Trade and Industry (MITI) and various sources who have analyzed a developmental state. With this theoretical appreciation of a developmental state, the second half of the chapter will discuss Korea’s own developmental state in action.

Launching an economy to become an export powerhouse entailed the channeling of finance into strategic industries. Some of these industries like steel were capital intensive and only provided returns in the long run. Ordinary investors would have shied away from these kinds of investments and focused their energies on investments that yielded returns at high rates in the shortest amount of time. Chapter 2 discusses the financial policies that enabled the state to successfully channel capital into these firms and secure economic stability. In many respects, the developmental state was working

on Keynesian principles that prioritized economic stability, industrial growth and dynamism. This objective necessitated the control of capital to guarantee that there were enough resources to pursue the industrial strategy, and to prevent the flight of capital that would cause the economy to be unstable.

The third chapter investigates the political maneuvering both by neo-liberal forces of the Reagan administration and the Chaebols to engineer an economy that would suit their mutual objectives—the liberalization of finance. The state framed Park's economic policies as the cause of the 1979 economic crisis in South Korea. Chun overhauled the bureaucracy and appointed US trained economists to create the institutions to facilitate the creation of a financial market system that was compatible with the American financial market, and here began the gradual devolution of Park's institutions that upheld the controls on capital and the controls on the industrial agenda of the state.

The fourth chapter will investigate how short-term capital became the most used and unregulated instrument. Short-term lenders were prone to flee at the hint of a crisis as it was in 1997. Kim Young Sam's effort to quell the corruption in the government was achieved by liberalizing the financial sector—subject the economy to market discipline. The manner in which liberalization was done made short-term loans the most unregulated, and therefore, the most availed financial instrument. Korea's economy fell because the economy was the target of various speculative attacks that were caused by the inability of the state to payoff the short-term debt with foreign exchange. The won devalued immensely and interest rates increased extremely high crippling industries as capital fled the economy. With exit mechanisms created by liberalization, investors left Korea in an attempt to preserve the value of whatever investment they had left.

The fifth chapter concludes the thesis. The conclusion will raise a few themes as this thesis was being written—one of which is the viability of capital controls and a “what if?” scenario—that is, what if Korea's capital controls were in place in 1997? The chapter will feature how countries like Malaysia and China were able to prevent their economies from being destabilized in the crisis through capital controls. It shall also pose a question to the reader as to whether capital is free or not. Is capital flight herd behaviour or shepherded?

Chapter 1 The Vision of A Developmental State

When a nation's survival is at stake, politics, economy, culture, everything should be organized and mobilized for that single purpose.

Park Chung Hee

The policy of an increased national self-sufficiency is to be considered not as an ideal in itself but as directed to an environment in which other ideals can be safely and conveniently pursued.

John Maynard Keynes

This chapter will discuss these structural changes—how an ISI economy evolved into an export powerhouse with the “developmental state” as the mode of South Korea’s political economy. The concept of the developmental state was developed by the Japanese. Although it had many similarities to other schools—Frederick List (1789–1846) of Germany who studied the political economy behind the development of the infant industry and Alexander Hamilton of the US in 1776. It is generally understood to possess the following key features. The developmental state—

- Extracts capital through structures that enable its leaders to mobilize capital
- Creates and executes a national economic strategy
- Influences private access to limited resources
- Directs and synchronizes individual business ventures
- Pursues special industrial undertakings
- Defends the state against political demands of consumers and organized labour
- Protects the economy from foreign capital penetration
- and most especially, carries through a sustained project aimed at constant improvement of productivity, technological sophistication and increased world market shares.¹

The first half of the chapter will provide a discussion of the concept of a developmental state, with particular reference to Asian states that are regarded as its pioneers. Japan

¹ Woo-Cummings, Meredith, (ed). Pempel, TJ., The Developmental Regime in a Changing World Economy in “The Developmental State”. Cornell University Press, Ithaca, 1999. p.139

led the way but under Park, Korea created its own version of the developmental state, one that bore many similarities to the Japanese version. The discussions will therefore refer to the strategies and practices of Japanese officials associated with the Ministry of International Trade and Industry (MITI) and leading students of the Japanese developmental state such as Chalmers Johnson. The second half of the chapter describes the developmental state in South Korea. As early as the 1950s Syngman Rhee had a vision of a state that could stand up on its own. However, the import substitution industrialization (ISI) policies he advocated were fatally flawed.

Under President Park Chung Hee, South Korea modeled many of its plans on Japan's developmental state. Park Chung Hee took control of the industrial class creating the political and economic structures that had the defining characteristics of a developmental state. This half of the chapter will discuss how Park and his officials effectively made South Korea into an export powerhouse in the global economy and how he pragmatically navigated South Korea's political economy through tough crises.

1.A The Developmental State and its Industrial Strategy

The developmental, or plan-rational, state.... has as its dominant feature precisely the setting of such substantive social and economic goals....In the plan-rational state, the government will give greatest precedence to industrial policy, that is, to a concern with the structure of domestic industry and with promoting the structure that enhances the nation's international competitiveness. The very existence of an industrial policy implies a strategic, or goal oriented, approach to the economy.²

Chalmers Johnson

Now if the functions and purposes of the state are to be thus enlarged, the decision as to what, broadly speaking, shall be produced within the nation and what shall be exchanged with abroad, must stand high amongst the objects of policy.³

John Maynard Keynes

² Johnson, Chalmers, *MITI and the Japanese Miracle*. Stanford University Press, Stanford California, 1992. p.19

³ Keynes, John Maynard, "National Self-Sufficiency," *The Yale Review*, Vol. 22, no. 4 (June 1933), pp. 755-769

Governments...tend to be less concerned with the total worth of the world's output than with the value of their own country's share of it. They consider the single state, not the community of states, to be the salient economic unit even as it is the basic unit of international politics. Governments are thus often willing to violate the rule of market, to interfere with economic transactions, to lower the latter's net welfare, if these actions will provide more wealth for their own citizens.⁴

Michael Mandelbaum

A developmental state is a form of state that mobilizes the nation behind the goal of long-term economic enhancement. In many cases, its inception has been motivated by economic nationalism. A developmental state indicates its industrial strategies through a well-publicized plan, created by the government's economic planners. The plan provides the focal point for coordinating complementary activities.⁵ It strives for collective efficiency by enabling major companies and key government departments to coordinate their activities behind the pursuit of the industrialization agenda as a whole. The plan is created by economic planning agencies like the Ministry of International Trade and Industry (MITI) of Japan and the Economic Planning Board (EPB) of Korea. A developmental state's industrial policy tends to be pragmatic and flexible enough to adapt to present and forecasted conditions. At the state's disposal is normally a "complex of those policies concerning protection of domestic industries, development of strategic industries, and adjustment of economic structure in response to or in anticipation of internal and external changes which are formulated and pursued by MITI in the cause of national interest."⁶

Interventions by such agencies were not superficial. These agencies had the power to investigate and intervene into the issues and concerns of a firm even in the operations level. Industrial rationalization in Japan was comprehensive. In Japan's case, the state focused its energies on adopting new techniques of production, investment in new equipment and facilities, quality control, cost reduction, adoption of new management techniques, and the perfection of managerial control among enterprises. More importantly, the best practices were standardized throughout the industries. State agencies discriminately planned and selected the environment of these

⁴ Mandelbaum, Michael, "The Fate of Nations", Cambridge University Press, 1988, p.332

⁵ Chang, Ha-Joon and Grabel, Ilene. "Reclaiming Development", Fernwood Publishing, Nova Scotia, 2004. p.81

⁶ Johnson, Chalmers, MITI and the Japanese Miracle. Stanford University Press, Stanford California, 1992. p.26

enterprises—which include land transportation and industrial location—that would best serve the strategy. As Chalmers Johnson wrote...

Industrial rationalization means state policy at the microlevel, state intrusion into the detailed operations of individual enterprises with measures intended to improve those operations (or, on occasion, to abolish the enterprise.) Nawa Taro says that in its simplest terms industrial rationalization is the attempt by the state to discover what it is individual enterprises are already doing to produce the greatest benefits for the least cost, and then, in the interest of the nation as a whole, to cause all enterprises of an industry to adopt these preferred procedures and techniques.⁷

The Japanese state created a framework for all enterprises in an industry, where each could compete fairly or cooperate in a cartel like arrangement of mutual assistance. More importantly, industrial rationalization also involved the reorganization of the industrial structure itself in order to meet international competitive standards.⁸ It was crucial for Asian developmental states to meet international competitive standards because they focused on exports to increase the national income. In Japan, industrial policy guided the market to deliberately create a competitive advantage in areas where international demand was likely to increase rapidly and would therefore be in Japan's continuing interest. It also had to be achieved as quickly as possible.⁹ The state was faced with the situation where strategic industries were created. The Japanese developmental state was also known as the state that yearned to catch up with European and North American economies—economies that were in the advanced stages of growth with a high per capita income and improved living standards. Fundamental to these advanced states were highly technological societies and structures that encouraged innovation and dynamism. More importantly—these were states that reached their zenith because of their comparative advantage in leading edge technology. For an agricultural economy to leap frog into automobile manufacturing and memory chips in 25 years seemed like an impossible task to international financial institutions. The reasons to be skeptical were many especially in the short-run—the entry barriers were high, these industries are capital intensive and an investor would be hesitant to be financially exposed to an industry that would yield returns in the distant future. The risks of many unforeseen things happening in between were many. In brief, it is only rational that control was absolutely necessary to reduce the risks and make the strategy

⁷ Johnson, Chalmers, MITI and the Japanese Miracle. Stanford University Press, Stanford California, 1992. p.27

⁸ MITI's Industrial Rationalization Whitepaper (1957) in Johnson, Chalmers, MITI and the Japanese Miracle. Stanford University Press, Stanford California, 1992. p.27

⁹ Singh, Ajit., "How Did East Asia Grow So Fast?". UNCTAD no. 97. February 1995. p. 14 also Chang, Ha-Joon and Grabel, Ilene. "Reclaiming Development", Fernwood Publishing, Nova Scotia, 2004. p.75

successful. Vice Minister Ojimi of Japan's MITI eloquently described the rationale for industrial development...

"The MITI decided to establish in Japan industries which require intensive employment of capital and technology, industries that in consideration of comparative cost of production should be the most inappropriate for Japan, industries such as steel, oil refining, petro-chemicals, automobiles, aircraft, industrial machinery of all sorts, and electronics, including electronic computers. From a short run, static viewpoint, encouragement of such industries would seem to conflict with economic rationalism. But from a long-range viewpoint, these are precisely the industries where income elasticity of demand is high, technological progress is rapid, and labour productivity rises fast. It was clear that without these industries it would be difficult to employ a population of 100 million and raise their standard of living to that of Europe and America with light industries; whether right or wrong, Japan had to have these heavy and chemical industries....Fortunately, owing to good luck and wisdom spawned by necessity, Japan has been able to concentrate its scant capital in strategic industries".¹⁰

Selecting the key industries that would determine the economic longevity and success of a developmental state was important. The state economic agencies governed the selection and nurture of specific industries, and all of these were all laid out in a policy known as an industrial structure policy. In this policy the state determined the proportion of manufacturing activities the nation as whole should be doing with considerations such as costs of production, environmental impact, its ability to hire labour, export potential and much more. The policy indicated the optimal level of light industries against knowledge-based industries and other strategic production possibilities. The industrial policy also indicated what sectors needed more support, and more importantly what industrial sectors had to be created. In creating these strategic industries, upstream, downstream, and parallel industries in the supply chain were strategically conceived (*keiretsu*) to support major strategic industries in the economy—all in a collective national effort. The collective national effort was very strong that manufacturers "crossbred" their products with seemingly competitive firms in an attempt to corner the market. As an example, the Isuzu Rodeo was also marketed in the US as the Honda Passport. The Japanese state prioritized building its *competitive advantage* rather than relying on its inherent "factor conditions".¹¹ It engineered its economy to engage in developing *dynamic comparative advantage*—where firms were developed "from the ground" and were later pushed to produce and continually evolve

¹⁰ OECD 1972 found in Wade, Robert., "Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization", Princeton University Press, Princeton 1990. p.25

¹¹ Woo-Cummings, Meredith, (ed). Pempel, T.J., The Developmental Regime in a Changing World Economy in "The Developmental State". Cornell University Press, Ithaca, 1999. p.139

to higher value-added products to compete with the existing market leaders. The Japanese developmental state did not “pick winners”, it was out to “create winners”. The state supported these firms to be in the cutting edge of technology so they would survive in an extremely competitive environment—the global market. Major government investments in research and development—not just firm based R&D—strengthened the capacity of a developmental state to innovate and create export products through the collaboration of a large knowledge-based network.

Industrial structure policy..... is more radical and more controversial. It concerns the proportions of agriculture, mining, manufacturing., and services in the nation's total production; and within manufacturing it concerns the percentages of light and heavy and of labour-intensive and knowledge-intensive industries. The application of the policy comes in the government's attempt to change these proportions in ways it deems advantageous to the nation. Industrial structure policy is based on such standards as income elasticity of demand, comparative costs of production, labour absorptive power, environmental concerns, investment effects on related industries, and export prospects. The heart of the policy is the selection of the strategic industries to be developed or converted to other lines of work.¹²

Creating winners entailed establishing new industries. Understanding the difficulty of establishing an infant industry, Schumpeter¹³ made the observation that firms in developing countries need to be provided with “profits far above what is necessary in order to induce the corresponding investment...which provide the baits that lure capital on to untried trials”(i.e. new industries). He further argued that entrepreneurial profits have to be secured through restraints of trade like cartel arrangements. Schumpeter argued that entry barriers are necessary to provide incentives for creating new industries.¹⁴ Countries such as France and Japan created new industries with the help of tariff protection and other forms of state created rents like subsidies or preferential loans to support new industries.¹⁵ Like Japan, Korea created structures to facilitate these cartel arrangements such as policy loans, capital controls, export credits and subsidies.

The tools of implementation themselves are quite familiar. In Japan during high speed growth they included—on the protective side, discriminatory tariffs, preferential commodity taxes on national products, import restriction based on foreign currency allocations and foreign currency controls. On the developmental

¹² Johnson, Chalmers, MITI and the Japanese Miracle. Stanford University Press, Stanford California, 1992. p.28

¹³ Schumpeter, J., “Capitalism, Socialism, and Democracy” 6th edition, London, Unwin, Paperbacks. 1987. p.87–90 found in Chang H.J., “The Political Economy of Industrial Policy in Korea” Cambridge Journal of Economics 1993, 17. p.144–45

¹⁴ Chang H.J., “The Political Economy of Industrial Policy in Korea” Cambridge Journal of Economics 1993, 17. p.144–45

¹⁵ They are also known as policy loans. These are long-term loans provided to strategic industries at interest rates lower than world market interest rates.

side (or what the Japanese call the “nurturing”) side, the included the supply of low-interest funds to targeted industries through governmental financial organs, subsidies, special amortization benefits, exclusion from import duties of designated critical equipment, licensing of imported foreign technology, providing industrial parks and transportation facilities for private businesses through public investments, and “administrative guidance” by MITI.¹⁶

Gershenkron emphasized the importance of state and capital in development. Gershenkron believed that capitalist development was characterized by a “disjunction between the scale of economic activity required for development and effective scope of private economic networks”¹⁷. He believed that a mastery of production technologies and the capacity to rally capital beyond what local entrepreneurs could raise are fundamental requirements to compete with highly industrialized states. To this end, the state had to be actively involved in organizing financial markets.¹⁸

Hirschman took the argument a step further. Besides capital, entrepreneurship was also important. It is the necessary skill to transform a business opportunities to actual investments. (Hirschman 1958, 35)”. Capitalists and entrepreneurs find it difficult to decide on how to transform their capital into new productive activities. “Maximizing induced decision making” becomes the key to economic progress (44). The state must play this role of decision maker. The state should create “disequilibrating” incentives that induce capital to be entrepreneurial (e.g. low cost loans for key industries).¹⁹ Specific industries and their entrepreneurs have to be selectively stimulated, complemented and reinforced by the state. This necessitates close ties to private economic agents. A state should be “embedded” in society rather than isolated from it.²⁰

The Japanese developmental state had direct responsibility for augmenting the economy’s investible resources and established a mechanism to transfer those resources into productive investment²¹. This involved altering market forces. It is with this reason that the developmental state was sharply criticized by international financial institutions. They argued that moving an underdeveloped economy into innovative technology intensive manufacturing activities (i.e shipping, electronics, computer

¹⁶ Johnson, Chalmers, MITI and the Japanese Miracle. Stanford University Press, Stanford California, 1992. p.29

¹⁷ Evans, Peter. Embedded Autonomy, Princeton University Press, 1995 p. 31

¹⁸ Evans, Peter. p. 32

¹⁹ Evans, Peter. p. 32

²⁰ Evans, Peter. p. 32

²¹ Wade, Robert., “Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization”, Princeton University Press, Princeton 1990. p.9

components) is difficult. There are several risks and costs involved in importing technology, the absence of technical and research support, unskilled labour, being new in the industry, the inability to reach economies of scale, coping with globally competitive products, etc. Like all new things, the results are uncertain. Capitalists often lack the funds and the organizational capacity to launch capital-intensive industries. International financial institutions (IFIs) like the World Bank take the view that developing countries should not risk developing advanced industries because it is an inefficient use of resources and must simply focus manufacturing activities found within their comparative advantage.²²

In “Embedded Autonomy”, Peter Evans elaborates the difference between a state that is a “predator” and a “midwife”. Authoritarian regimes, such as the Marcos regime in the Philippines, are characterized as predatory states—that is, states that do not have the capacity to inhibit officials from pursuing their own interests: “Individual maximization takes precedence over the pursuit of collective goals”²³. A predatory state is characterized by personal relationships with officials rather than relationships between constituents and the state as an institution. This state capitalizes on the weakness of a disorganized civil society. A predatory state can be opportunistic, where rules and decisions are sold to the highest bidder.²⁴ Its officials wield power and use them for the “capricious extraction and wasteful consumption that diminishes private productive capacities rather than enhancing them.”²⁵ This environment is unpredictable, and without a predictable environment for rules and decisions, it is very difficult to engage in enduring investments. What distinguishes “midwife” authoritarianism from the predatorial type is the goals it espouses, and the rationality and methods of getting to these goals. These factors—among many—appear to have led to the political acceptance and legitimacy of an authoritarian’s regime in the interim. Chalmers Johnson, a scholar who has studied and written about the developmental state wrote...

“Authoritarianism can sometimes inadvertently solve the main political problem of economic development using market forces—namely, how to mobilize the overwhelming majority of the population to work and sacrifice for developmental projects....In the true developmental state,....the bureaucratic rulers possess a particular kind of legitimacy that allows them to be experimental and

²² Just before Park Chung Hee came to power, US consultants advised Korea to focus on rice production.

²³ Evans, Peter. *Embedded Autonomy*, Princeton University Press, 1995 p. 12

²⁴ Evans, Peter. p. 246

²⁵ Evans, Peter. p. 247

undoctinaire than in the typical authoritarian regime. This is the legitimacy that comes from devotion to a widely believed-in revolutionary project".²⁶

"Takashima Setsuo, writing as deputy director of MITI's Enterprises Bureau, the old control center of industrial policy, argues that there are three basic ways to implement industrial policy: bureaucratic control, (*kanryo-tosei*), civilian self-coordination (*jishu chosei*), and administration through inducement (*yudo gyosei*)."²⁷

In this sense authoritarianism is needed to mobilize the national economy in solving collective action problems. The developmental state was practically placed on "overdrive" such that the national economy was basically structured to catch-up with the innovation and technology of advanced nations. This form of authoritarianism enabled a state to push the industrial agenda with great efficiency similar to the discipline and directness of a military style "chain of command".

For Evans, a midwife state acts as coherent entity that delivers collective goods. Its institutions and bureaucratic powers prevent powerful politicians from farming out favours. It preserves the state by "protecting the state from piecemeal capture which would destroy the cohesiveness of the state itself and eventually undermine the coherence of its social interlocutors."²⁸ The developmental state as formed in Japan and South Korea are good examples of a midwife state.

The Japanese developmental state created a web (embedded) of industrialists, capitalists, entrepreneurs, and other economic elements. In an Asian developmental state, a strategic alliance between the industrial class and the government was essential to building its economy because the industrial class had the entrepreneurial talent, basic facilities, network of subsidiaries and the capital resources necessary to drive the industries. In this web, relationships and information flow between the state and its collaborators—and vice-versa—as they share their vision and devise plans for implementation. Robert Wade succinctly describes it as a "synergistic connection between a public system and a mostly market system, the outputs of each becoming

²⁶ Johnson, Chalmers., *Political Institutions and Economic Performance: The Government Business Relationship in Japan South Korea, and Taiwan* in Frederic C. Deyo ed., *The Political Economy of the New Asian Industrialism*. Cornell University Press, 1987). Also cited in Woo-Cummings, Meredith, (ed). Kohli, Atul., *High-Growth Political Economies in "The Developmental State"*, Cornell University Press, Ithaca, 1999. p.20

²⁷ Johnson, Chalmers, *MITI and the Japanese Miracle*. Stanford University Press, Stanford California, 1992. p.29

²⁸ Evans, Peter. *Embedded Autonomy*, Princeton University Press, 1995 p. 248 Social interlocutor i.e. social partners.

inputs for the other.”²⁹ A developmental state is different from a predatory state because it creates institutionalized venues for the frequent negotiation and re-negotiation of goals and policies. Though the state provided the needs and created inducements for the private sector, it was autonomous rather than manipulated by private sector interests.³⁰

A state cannot be called developmental if both the components—autonomy and embeddedness do not exist simultaneously. Autonomy alone will deprive the state of economic intelligence from its network and the ability to rely on decentralized private implementation. More importantly, networks necessitate a core structure that is capable of coordinating government economic agencies behind private business to pursue a strategy in a coherent and focused manner. The execution of a governing industrial strategy is crucial to a developmental state’s ability to catch up with advanced states and survive as a nation. It is not like the typical state that maintains an economy that enables firms and networks to pursue random disparate profit-centered goals and objectives—where national economic welfare is an after-effect of their activities rather than the main objective. A core structure focuses the priorities of the nation’s economic elements to strategic priorities—even at the expense of businesses in the network (e.g. forcing firms that create excess competition to close down). A core structure enables the nation to rally economic elements to solve collective action problems even if it had to transcend the individual interests of the private sector.³¹

In a developmental state, initiatives are focused and well planned by a state agency that business networks have to work with a government in a disciplined manner. It is in the network’s interest to do so because the industrial plan is vast and requires the careful sequenced establishment of key economic elements that support a wide array of interconnecting industries that are precisely synchronized by the core structure to achieve an optimal state of national economic development. Government support mechanisms and policies are timed and carefully executed accordingly. A firm pursuing its own interest will only suffocate because survival in the national economy necessitates being connected to a state-business lifeline. Moreover, a core structure is necessary to resolve collective action problems. In the same manner that the core structure pushes

²⁹ Wade, Robert., “Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization”, Princeton University Press, Princeton 1990. p.5

³⁰ Chang, Ha-Joon. East Asian Development Experience. “Rethinking Development Economics”, Anthem Press, London, 2003. p.116 (italics mine)

³¹ Evans, Peter. Embedded Autonomy, Princeton University Press, 1995 p. 12–13

the nation to its economic optimum, government agencies adapt and improvise the economy to execute an industrial strategy with different forecasted scenarios and prepare the nation to cope with unforeseen global economic upheavals with focused efficiency.

A developmental state is autonomous enough to immediately engage the issues of the national economy without the trappings of politicking. As a state engineers its incentives to diminish the adverse effects of market forces, the success of an industrial plan based on these incentives depends on the ability of the government to discipline firms that receive these privileges.³² If not, such conditions lead to coddling or permanent featherbedding and not produce improvements in efficiency. Preferential loans are one of the major instruments for disciplining firms. Preferential loans were only accessible to strategic firms under strict conditions—that firms meet the objective requirements for export performance. Monthly export promotion meetings and deliberation councils are held to review the performance of firms and discuss policy options for industries. Firms that met their targets are handsomely rewarded with low interest loans and other incentives. It is not unusual however for the government to immediately withdraw its loans from firms that are not able to reach their export targets. In many cases, firms that fail to reach minimum efficient scales were merged with other firms with complementary capacities or closed down.

With the state entering new industry sectors, policy makers made mistakes. However, they acknowledged their mistakes and were flexible enough to immediately redirect their policies if they did not initially work (Luedde-Neurath, 1988, Michell, 1981)³³. In this sense, the developmental state was very pragmatic.

State intervention tended not to follow ready-made textbook prescriptions. When the market promised to produce the desired results, it was generally left to operate unhindered. When it did not function in the desired way, Koreans displayed few inhibitions in assisting or directing it as necessary.³⁴

The level of control and coordination in a developmental state enables it to act on problems well. With an economic agency like the MITI of Japan acting as the central control unit of the economy, all the resources of the nation and policies are mobilized and implemented immediately to act on an issue with focused efficiency.

³² Chang, Ha-Joon. *East Asian Development Experience*. "Rethinking Development Economics", Anthem Press, London, 2003. p.116

³³ White, Gordon ed. *State Intervention in South Korea*, "Developmental States in East Asia", St. Martin's Press, NY. 1988. p.99

³⁴ White, Gordon ed. *State Intervention in South Korea*, "Developmental States in East Asia", St. Martin's Press, NY. 1988. p.99

The developmental state of South Korea was a state that had both embeddedness and autonomy. It created a centralized authority with a clear set of objectives and a strategy; authority structures were depersonalized, so that public and private interests are first disentangled and only then reintegrated on a different plane with the public agenda as the goal³⁵. Park Chung Hee created a delivery mechanism composed of an efficient bureaucracy—mostly composed of his military officials—that upheld the chain of command. These structural changes allowed the new guards to create specific public agendas and to implement them in the far reaches of the society with great military efficiency. This structure was engineered to work closely with the entrepreneurial talent of Chaebols, as it drove the key industries in the state's strategy.

1.B The Developmental State of South Korea

General Park set South Korea on course to become a successful industrial economy by implementing policies that would respect the defining characteristics of a developmental state. It was patterned after Japan's developmental state model. This section will discuss its evolution and effectiveness. The objective is to appreciate Park's analysis of the previous economic configuration that motivated the administration to industrialize. More importantly, this section aims to understand how Park and his administration overhauled structures to pursue their vision of the developmental state. This vision was supported by a financial sector that heavily relied on capital controls to expedite industrialization and enforce stability.

It was the desperate plight of the Korean post-war economy (1950s) that fuelled a nationalistic desire to build the foundations of a more prosperous and independent state. A sizeable amount of government aid from the United States fuelled the reconstruction efforts of the Korean economy under the leadership of Syngman Rhee—Park's predecessor. Arguably, these reconstruction efforts were essential in reviving the post-war economy but in the late 1950s, aid from the US started to dwindle as the US government focused its efforts to Vietnam.

³⁵ Woo-Cummings, Meredith, (ed). Kohli, Atul., High-Growth Political Economies in "The Developmental State". Cornell University Press, Ithaca, 1999. p.133

As such, the government is the ultimate guarantor of property and other rights, de jure and/or de facto and is also usually the main actor in setting and executing the public agenda for changes in rights. (Chang and Rowthorn p.41)

To Rhee, America's influence over Korea's affairs was especially disturbing because the United States clearly envisioned South Korea as primarily an agricultural economy that would remain heavily reliant on imports for its other non-agricultural consumer needs. In fact, in 1952, a US study of the Korean economy had recommended that Korea should focus on agricultural development. Consultants reinforced this view arguing that "Any future economy for South Korea should be built on a sound, expanding, agricultural base" (McCune, Lautensach, Zanzi).³⁶ To Rhee, such conclusions appeared complacent.

US consultants doubted the wisdom of rapid industrialization. In fact, "American advisers adhered to the dogma of agricultural development where an economy was first expected to attain agricultural sufficiency, which would then, and only then, lead to industrialization".³⁷ According to Nathan and Associates: "The process of industrialization requires time. A predominantly agricultural economy cannot hope to emerge as a highly developed manufacturing economy within a few years"³⁸. Based on such thinking, those same consultants had identified "rice production" as "the largest bolster to exports" in a subsequent report (1954, p.96). From Rhee's perspective, this cautious or pessimistic diagnosis of the Korean economy only helped to bolster Korea's chronic dependence on imports to meet its consumer needs. A "Coordination Agreement" was made with the US which committed Korea to continue its heavy imports of consumer products in 1952.

Korea had some means to engage in small-scale industrialization by utilizing many Japanese manufacturing facilities that remained there. Yet these facilities could not be utilized fully because American forces kept these established Japanese factories and facilities as vested properties after the liberation.³⁹

³⁶ Lie, John., "Han Unbound", Stanford University Press, California., 1998, p. 23 with references to McCune, Shannon., "Korea's Heritage: A Regional and Social Geography", Vt, 1956 Charles E. Tuttle p.114, ALSO Lautensach., "Korea: Land, Volk, Schicksal", Stuttgart, Germany, 1950 K.F. Koehler Verlag. P.116-117. AND Zanzi., "Economic Reconstruction Problems in South Korea: NY: Institute of Pacific Relations, 1954 p.43-44.

³⁷ Lie, John., "Han Unbound", p. 24, with references to Johnston and Kilby., "Agriculture and Structural Transformation: Economic Strategies in Late Developing Countries" NY, Oxford University Press. 1975, Chap.2. And Lewis, " "The Theory of Economic Growth". London: George Allen and Unwin, 1955. p.75

³⁸ Nathan Associates. "Preliminary Report on Economic Reconstruction of Korea" Washington, D.C. 1952, p. 132

³⁹ Michell, Tony., "Control of the Economy During the Korean War: The 1952 Coordination Agreement and Its Consequences." In James Cotton and Ian Neary, eds., The Korean War in History, p. 151-62. Atlantic Highlands, NJ: Humanities Press International. 1989

In line with wider geo-political considerations, the US government concluded that Korea's interests would be best served by remaining a dependent economy—a largely agricultural economy. Korea had been ascribed this status as part of the postwar global order that had been devised by Acheson, Kennan and Dulles. They saw the Asian region mainly as a set of forward defenses to ensure the containment of the communist threat. Containment could only succeed if the nations of the region became integral components of continental regimes with the “potentiality both for political cohesion and economic growth.”⁴⁰ Keenan and Acheson saw Japan as the engine of the region's economic growth in part because of its history as a regional economic power: “The logic of regional recovery placed Japan at the core of trade and as the centerpiece of American East Asian policy, which meant that Korea had to be a market for Japanese goods, with open trade and export promotion (and not ISI), as Korea's overall economic policy; in this scenario, Korea was to be a dependent state.”⁴¹

The United States was effectively trying to resurrect the earlier patterns of unequal trade between Japan and its Asian neighbors, as envisaged in Kaname Akamatsu's “Flying Geese Theory” or the Japan East Asian Co-Prosperity Sphere. The US sought to ensure the containment of Chinese and Soviet power in the region by reviving those earlier historical economic structures.⁴² This strategy recreated relationships that had an uncanny similarity to Asia's colonial past and was quick to jolt then president Syngman Rhee. Syngman Rhee was vehemently opposed to bringing back the asymmetrical trading relationship with Japan where Korea was left to export resources like seaweed and rice in order to import finished products such as radios, machinery, and automobiles. To Rhee, Korea's comparative advantage in agriculture should not be the basis of the vision for its future.

⁴⁰ Woo, Jung-en (Meredith Woo Cummings). “Race to the Swift”. Columbia University Press., New York., 1991. p.54

⁴¹ Woo, Jung-en (Meredith Woo Cummings). “Race to the Swift”., Columbia University Press., New York., 1991. p.45

⁴² American design for Japanese economic supremacy in the region was later crystallized in NSC5506, which called for the reduction of the US financial burden by increasing Japan's “trading capabilities with other free nations of Asia,” to which end, the US ought to use its good offices. NSC5516 which spelled out US policy toward Japan, noted that Taiwan was enthusiastic about such trade but that the Japanese, looking nervously over their shoulders at China, did not welcome it: South Asian nations were uninterested in Japan's economic problem. Thus, the US had to work on Korea to open up. (Woo p.55–56)

His concern was expressed very clearly in a letter written to Eisenhower in 1954:

What (aid coordination) means is that Korean recovery is slowed as we are expected to buy more from Japan, and accordingly to use less to build up our own productive facilities. This has an immediate effect of once more placing our economy at the mercy of the Japanese.⁴³

Rhee reacted by launching a massive industrialization drive to enable Korea to develop industries and firms capable of producing the finished products it would have imported from Japan. Korean Import substitution industrialization (ISI) was a defensive maneuver designed to prevent Korea from remaining an appendage to Japan—as envisaged in the US coordinated regional post war reconstruction of Asia.

Import substitution industrialization. Rhee's import substitution strategy was fatally flawed, and was therefore unlikely to achieve the increased economic independence it sought. The basic aim of ISI strategy is to promote the manufacture of goods for domestic consumption within the country, which would then reduce its dependence on imports. To this end, Korean ISI encouraged industry to improve production methods and to move on to manufacture higher value added goods, both for consumption and production inputs. This presumably laid the foundations of a more self-reliant economy. Accordingly, selected firms and industries were supported and subsidized in return for their agreement to manufacture specific goods in accordance to the government's industrial plan. Firms were given guaranteed access to the domestic market by measures (tariffs, quotas) to protect them from imports. The government maintained an overvalued exchange rate enabling them to purchase capital goods and raw materials at relatively low "domestic currency" prices. Though Import substitution industrialization was well intended, it was ill fated. This early version of Korea's nationalist, interventionist development strategy was soon strangled by foreign exchange constraints. The causes were proverbial: increasing imports of capital goods; exports stifled by overvalued exchange rates that reflected both the high inflows of foreign aid and the government's efforts to lower the cost of importing capital goods; and the rampant inefficiency of firms. ISI rested on the belief that it could promote the growth of national manufacturing capabilities that are able to compete with foreign producers at home—substituting domestically produced goods for imports. These hopes could not be realized without heavy and sustained investment in domestic industry. While such investments can never guarantee success, their absence can certainly guarantee failure.

⁴³ Woo, Jung-en. p.57

This “standard” version of ISI gives firms considerable market power that is often misused. A small market and the predominance of oligopolies in the market only enabled the bigger firms to dominate in the economy. Smaller firms essentially were not able to match the resources of bigger firms that had the first move advantage and had already cornered a very small market. Vivek Chibber wrote—

As well known, the immediate effect of import-substitution industrialization is to protect domestic markets from competition from imported foreign products. But the exclusion of imports meant that in many manufacturing lines local markets came to be dominated by a small number of producers. This was partly because of the small size of the local market, but it was also because the scale requirements of modern manufacture called for larger outlays of fixed capital, and hence firms with considerable market power. There was thus an enormous advantage to being the first entrant in any new line, as it was relatively easy to hold off the threat of potential competitors.⁴⁴

Moreover, the IS industrialists—who had monopolistic or oligopolistic control over local markets—were not pressed to innovate and invest in equipment to increase efficiency. Without intense competition there was no threat of losing their market share. Under these circumstances, the conditions for subsidies—that intended to launch firms to aim for higher value added products and upgrades—were complacently adhered to. “While state policy agencies granted subsidies to firms on the basis of a development plan with particular priorities, business houses made their own investment plans based on their prognoses and their priorities, which often did not coincide with those of planners”⁴⁵ In short, these subsidies were essentially wasted from a strategic industrialization perspective.

The ISI strategy is prone to generate chronic trade deficits in its early stages even if it is ultimately intended to ease the foreign exchange constraint. This occurs when the stepping-up of domestic production requires heavy imports of capital goods, intermediate goods and raw materials. These always threaten to exceed the foreign exchange available from the export of primary products.⁴⁶

In foreign trade, which depends mostly on primary and secondary industries, exports do not measure up to imports. In 1959, exports totaled only \$19,160,000, against imports which totaled \$78,520,000, the latter surpassing exports by \$59,360,000. This unfavorable balance of payments of \$50 million on the average per annum persisted after 1955 right up to the May 16 Revolution.⁴⁷

⁴⁴ Chibber, Vivek., “Reviving the Developmental State? The Myth of the National Bourgeoisie.” <http://repositories.cdlib.org/uclasoc/trcsa/20/>., p.7

⁴⁵ Chibber, Vivek. p.8

⁴⁶ Chibber, Vivek., p.13

⁴⁷ Park Chung Hee., “The Country, The Revolution, and I” Hollym Corporation, Korea., 1970. p.40

With this foreign exchange crisis looming, it slowly became apparent that this form of ISI could not be sustained. Ironically these developments were making the economy more dependent on foreign aid and foreign direct investment—the exact opposite of what the policy was intended to achieve.

Moreover, this chronic shortage of foreign exchange was not only due to the massive increase in imports associated with the early stages of ISI. It was further aggravated by the associated overvaluation of the local currency that made local exports more expensive and reduced the domestic incentives for producing them.⁴⁸ It encouraged firms to cater to the needs of the highly profitable, but limited local market while discouraging them from attempting to penetrate difficult and highly competitive export market.⁴⁹

Domestic industrial development showed no signs of achieving the rapid improvements in productivity that might have allowed it to meet the challenge of international competition in the foreseeable future. Under these circumstances, Korea had two choices. Korea could have dumped ISI and gone back to the old export led strategy based on its existing patterns of comparative advantage, while relying on market forces to gradually diversify its economy and shape its future patterns of comparative advantage (like most developing countries). The second choice was to “make ISI work”. This could be achieved by mobilising capital—especially domestic capital—more effectively; investing in strategic national industries; and accelerating technology transfer and productivity enhancement up to a point where some of these national industries could become exporters at a relatively early stage—which would then break the foreign exchange constraint. The second choice meant turning the Korean state into what would later come to be known as the developmental state (DS).

The need for a dramatic and far-reaching national development strategy was already recognized by Syngman Rhee. Yet he lacked the capacity to transform this dream into a realistic strategy. In the words of Cole and Lyman:

Indeed, perhaps earlier than many, Rhee saw the new attitudes of economic and military power that South Korea would need to survive in the post Korean War period. But in common with many of his goals, he saw these attributes in grand terms, in broad strokes. He never faced the technical and administrative

⁴⁸ Cho, L.J. & Kim, Y.H.eds. Kwang, SK, “Economic Development in the Republic of Korea: The East West Center, Hawaii., 1991 p.117

⁴⁹ Hong, Wontack., “Catch-up and Crisis in Korea” Edward Elgar Publishing, UK 2002. abridged version p.3

complexity that they demanded for the society. Part of the problem was Rhee's age and his preoccupation with the past and with reunification. His goal was a very different Korea from the one he had inherited. In addition, his jealousy of his associates as potential rivals and his reliance on personal charismatic authority made it impossible for him to build the political, bureaucratic and private institutions that could absorb and channel the new energies and resources in the country for purposes of modernization.⁵⁰

Park Chung Hee came to power in 1961 and did not share Rhee's failings. Indeed Jones and Sakong describe him as a man "whose orientation could not be more different, with economic growth having priority second only to national and personal political survival. Since only the higher goals are seen as being furthered by growth, economic affairs have been enshrined as the dominant operational system objective."⁵¹

Decreasing Aid. US aid decreased alarmingly between 1955 and 1959. The decreasing trend in aid began with a foreign policy that appears to have left South Korea to fend for itself. As it was with previous administrations, the Kennedy administration was committed to stave-off the domino effect of communism in Asia that foreign policy and resources were soon focused on Vietnam even before the Gulf of Tonkin incident (1964). The looming conflict in Vietnam pressed President Kennedy to send a team to study the conflict in South Vietnam and to evaluate future American aid requirements. The report, known as the "December 1961 White Paper," stressed the importance of increasing military, technical, and economic aid, and the introduction of large-scale American advisers to help stabilize Diem's government and crush the National Liberation Front (NLF)⁵². The conflict in Vietnam was a challenge in resource allocation for the US. The US reduced its commitments to South Korea that it pushed for foreign policies that would enable Korea to pursue crash economic development to sustain itself.

Congressional appropriations committees concluded that the US government was spending more than it should for military build up in South Korea. There was a notion that the threat to South Korea could be contained by an optimal number of troops. More importantly, US foreign policy was rather myopic where it emphasized military

⁵⁰ Cole and Lyman, cited in Jones and Sakong., "Government, Business and Entrepreneurship in Economic Development: The Korean Case", Harvard University Press., Mass. 1980 p.42

⁵¹ Jones and Sakong. p.291

⁵² <http://vietnam.vassar.edu/overview.html>

operations over economic development as Robert Komer writes:⁵³ “in my opinion, one of the basic reasons why we have accomplished so little in Korea since 1953 has been our predominantly military focus. We have spent more money on MAP 1953–1960 than on the domestic economy.”⁵⁴ It was with this reason that Robert Komer wrote then Deputy Special Assistant to the President for National Security Affairs Walt Whitman Rostow and the Director of Central Intelligence a memo entitled “Action Korea” which prioritized economic development over military operations.

The ROK is saddled with the staggering task of supporting a far larger military establishment that it is really able to support, or is needed....Underlying ills and needs are economic...the major thrust of US effort over the next decade must be:

1. Substantial cutback in ROK military establishment, with the diversion of US funds thus released to crash economic development.
2. Build of ROK economy, stressing public sector, creation of light labour-intensive industry, and full utilization of main ROK resource—people.
3. Much more vigorous, imaginative US action in directing and supervising ROK economic development...Closer and more active instruction and supervision of ROK government, but also more attribution to ROK government of their benefits.

Granting of SOFA⁵⁵ agreement to ROK so that we can buy public acceptance that our greater involvement in ROK economic development will acquire...Sharply reduce political role in ROK of the US military and its spokesmen; make US ambassador indisputable spokesman of US policy in Korea.⁵⁶

Park took the reins through a coup d’etat in 1961. When he took power, Park was well aware that dwindling aid to the Korean economy would be ruinous—especially with an

⁵³ Robert Komer: Former member of Directorate Intelligence and Office of National Estimates at the CIA (1947–1960), at this time he was the senior staff member of the National Security Council.

⁵⁴ Woo, Jung-en (Meredith Woo Cummings). “Race to the Swift”, Columbia University Press., New York., 1991. p.76

⁵⁵ Status of Forces Agreement (SOFA) is an agreement between a country and a foreign nation stationing military forces in that country. The SOFA is intended to clarify the terms under which the foreign military is allowed to operate. Typically, purely military issues such as the locations of bases and access to facilities are covered by separate agreements. The SOFA is more concerned with the legal issues associated with military individuals and property. This may include issues like entry and exit into the country, tax liabilities, postal services, or employment terms for host-country nationals, but the most contentious issues are civil and criminal jurisdiction over the bases. For civil matters, SOFAs provide for how civil damages caused by the forces will be determined and paid. Criminal issues vary, but the typical provision in U.S. SOFAs is that U.S. courts will have jurisdiction over crimes committed either by a servicemember against another servicemember or by a servicemember as part of his or her military duty, but the host nation retains jurisdiction over other crimes.

⁵⁶ Woo, Jung-en (Meredith Woo Cummings). “Race to the Swift”, Columbia University Press., New York., 1991. p.77

economy always in a deficit. More importantly, it was undermining the industrial drive that had already started. As Park Chung Hee wrote...

The fact remains, that industrialization to expand productivity, the nucleus of an independent economy, could not achieve its purposes because of the policies of the US Aid administering authorities. This can be readily deduced if we analyse the respective percentages of ICA aid earmarked for capital goods and for raw materials, Herein, there is no need to reiterate the necessity to establish and expand industrial facilities to accomplish industrial development in order to increase productivity.

TABLE 1A
International Co-operative Alliance (ICA) Aid (U\$)

	Capital Goods	%	Raw Materials	%
1955	97,460,000	47.4	108,350,000	52.6
1956	85,390,000	31.4	185,650,000	68.6
1957	92,720,000	28.7	230,530,000	71.3
1958	63,890,000	24.1	201,730,000	75.9
1959	43,610,000	22	164,680,000	78

As we can see, from these figures, American aid during this period was extremely tight-fisted towards the productive facilities which we desired, and generous with regard to consumer goods which we did not require.⁵⁷

The foreign exchange constraint was the Achilles heel of that old strategy. The massive imports of capital goods associated with Rhee's ISI⁵⁸ had depleted the country's foreign exchange reserves. As Park Chung Hee wrote in his analysis of the economy...

The few factories constructed have to rely on imported raw materials, semi-finished goods and processed commodities. Even though Korea is an agricultural country, there is a food shortage every year. Despite large amounts of foreign aid, *our dollar shortage is almost chronic*. The Korean economy has been able to survive, even in this miserable state, thanks to two billion dollars of foreign aid and 1.5 billion of military assistance for the 600,000-man strong Armed Forces. Had it not been for these, what would have been our present reality?⁵⁹ (italics mine)

The country's excessive dependence on aid from the United States was a hindrance to self-determination. This sapped the Korean initiative for independence. The United States dominated the Korean economy because its aid covered more than half of the public sector expenditures in 1961. With a budget of 608,800 million Won, the United

⁵⁷ Park Chung Hee., "The Country, The Revolution, and I" Hollym Corporation, Korea., 1970. p.31

⁵⁸ also spending for imported consumer goods

⁵⁹ Park Chung Hee. p.172

States supplied 316,000 million Won, or 52% of the Korea's total budget.⁶⁰ To Park this was both unhealthy and unsustainable.

In his words..

....Just imagine one person depending on another for half or more, of his living expenses for ten years or twenty years; having no other reason for so doing than that the other person once helped him or is still helping him, or that he has no ability to help himself. The outcome is evident.⁶¹

At the national level, the outcome was a chronic dependence that left little room for policy independence. After all, as Park wrote:

...the US had a 52% majority vote with regard to Korea, and we were dependent to that extent. At the same time, this sum represented the extent of the vested interest on the part of the US in the Republic of Korea. It showed, dramatically, that our government would have to instantly close down if the US aid were withheld or withdrawn.⁶²

To Park and his advisors, the decreasing trend in aid was a foretaste of things to come. Korea urgently needed an alternative strategy. The US-Korea relationship was unsustainable with the United States Congress feeling the drain on its resources. Korea had to accept the reality that the US lessened its commitments. Park wrote..

From 1956 to 1962, we have received, on the average, some 280 million dollars of economic aid each year and some 220 million in military aid. Altogether, these amounted to some 500 million dollars annually. In other words, 330 million dollars should be earned annually to keep the Korean economy on a self-sufficient footing, excluding our military spending. A status quo is all we can expect with this amount. Then, there is the additional problem of feeding the population, increasing at an annual rate of 720,000.

Our present situation is that it would be impossible, once aid is cut, to subsist without incurring trade deficits; it would be day-dreaming to think of rebuilding our economy.

We cannot afford to think of the future. We are pre-occupied with the present with the problem of coping with the present economic situation. Solution of the economic crisis, to cope with food shortages and to create more jobs, is one of the most urgent problems of the present. We cannot afford to retreat even if progress seems impossible. We are forced to struggle just to maintain the status quo.⁶³

⁶⁰ Park Chung Hee. "The Country, The Revolution, and I" Hollym Corporation, Korea., 1970 p.27

⁶¹ Park Chung Hee. p.29

⁶² Park Chung Hee., "The Country, The Revolution, and I" p.27

⁶³ Park Chung Hee., "The Country, The Revolution, and I" Hollym Corporation, Korea., 1970. p.172-173

Park only saw a gradual downward spiral if current economic structures remain unchanged. The ISI strategy that Rhee adopted suffered inherent flaws that only plunged Korea into an even more dependent situation despite his attempts to achieve greater prosperity and independence.

Export Led Industrialization. The economy was now caught in a dilemma—having to choose between the preservation of foreign exchange or pursue industrialization. This gave Park's economic planners the impetus to make a plan that would release the country from this impasse. They took an approach that emphasized a more rapid rate of accumulation with a focus on dynamically evolving industries. They implemented an industrial drive that was coordinated and supported by government agencies, and expanded to exports to ease the foreign exchange constraint. This strategy has come to be known as Export Led Industrialization ELI⁶⁴. Potentially, this new focus on manufactured exports could allow the country to solve its foreign exchange constraints when it would have access to an almost unlimited world market. Korean firms would be motivated to become efficient because they would compete in the ever-evolving arena of global firm rivalry.

Essentially, the key goals of Park's industrialization strategy were: 1) Improvement of the balance of payments situation principally by expanding exports; 2) Promotion of technology; 3) Expansion of key industries and formation of indirect social capital⁶⁵.

Experts were skeptical. They believed that the bureaucracy involved in a state directed strategy undermined the flexibility and agility required to succeed in the global market place. Park was aware of these risks and created a decision-making structure that was pragmatic, flexible and quick to respond to changing circumstances. It also enabled these pragmatic responses to be embedded within a sustained national development strategy. Park's government created winners and did not just pick them. He focused national resources to support and coordinate a network of private and public actors in pursuit of a broadly successful national development strategy. This required a complex, well-trained and coordinated bureaucracy that worked closely with a group of powerful conglomerates—the Chaebol—in support of a national industrial strategy. For this

⁶⁴ The ELI label is apt to be misleading, since Korea did not abandon ISI. In many respects, ISI was intensified but was now complemented by policies to promote export growth.

⁶⁵ Park Chung Hee., "The Country, The Revolution, and I" Hollym Corporation, Korea., 1970. p.65-66

complex system to work systematically, Park needed the power to control these economic elements.

To Park Chung Hee, the country's desperate situation required urgent immediate action led by a state capable of exercising control over key elements of the economy. It had to solve all its problems collectively. After taking power in 1961 through a coup d'etat, he immediately sought to consolidate the powers of the state by establishing institutions and policies designed to formulate and implement a strategic national development plan. It was also clear to Park that freedom from democratic accountability in the short run did not free him from the responsibility of winning the people's support and trust in the longer run. He believed that their support could be won if the policies succeeded in transforming their lives and their world in a positive way. This was very risky. Dictators usually assume a mantle of benevolence, but people are quick to be skeptical. Hence, Park needed a long transition before he could feel confident that Korea's policies could be entrusted fully to the democratic process. Even after a decade in power, he deemed it necessary to create a legal structure to consolidate his power into the indefinite future by adopting the Yushin (Revitalization) Constitution. This legal structure removed all restrictions on Park's future re-election while seriously undermining the power and independence of the legislature. The powers of the legislature were very limited. A third of the body's members were appointed by the executive, and its powers to scrutinize and influence the budget were curtailed. The President was also given expanded rights to invoke emergencies that could circumvent the powers of the legislature completely.⁶⁶ 83% of all the legislation was initiated by the executive branch as opposed to the legislature.⁶⁷

The reins of power were firmly placed in the hands of the Executive Branch—The Blue House. This is Korea's equivalent of the White House in the US. The Blue House was staffed by four presidential secretariats—where two presidential secretariats specialized in politics and the other two in economics. They deliberated with the president to create resolute policy decisions by providing daily information briefings and policy advice.

⁶⁶ Luedde-Neurath, Richard. 1988. "State Intervention and Export Oriented Development in South Korea," in Machi, Miki. "The Role of the State in the Development of Chaebols in South Korea" Research Essay, Norman Patterson School of International Affairs, Carleton University, Ottawa. P.77

⁶⁷ Jones and Sakong., "Government, Business and Entrepreneurship in Economic Development: The Korean Case". p.58

Park never strayed from the central task of pursuing a national development strategy designed to build a stronger, more independent, more prosperous and more socio-politically integrated Korea—despite the occasional misuse of power and political risks involved. It was in the Blue House where the President—assisted by his presidential secretaries—monitored and directed the strategy's evolution. It was in the Blue House that issues were finally ruled on or revised based on information and advice generated by a complex bureaucracy and many non-state actors.

FIGURE 1B Blue House

KDI-Korea Development Institute

From: Economic Governance and Poverty Reduction in Asia⁶⁸

⁶⁸ Henderson, J., Hulme, D., Philips, R., Kim, M.K., Economic Governance and Poverty Reduction in Asia. Globalisation and Poverty, 2002. p.9 downloadable from <http://www.gapresearch.org/governance/ecogovpovelim.html>

It is widely believed that the strategic coordination of the various elements of this complex state structure was greatly facilitated by the widespread influence of a strict Confucian ethic that upheld the virtues of hard work, loyalty and respect for family and authority. In this context, the Park government could function along military lines with marching orders being sent and obeyed through the chain of command relatively unhindered. This was critically important since the state was actively involved in business decisions to seize opportunities in world markets. Speed, coordination, rallying resources and timing in execution were essential. In addition, Park's real powerbase was not democratically constituted—he seized power through a coup. His true powerbase was the military, and a broader mix of the military and executive agencies.

Economic Planning Board. In 1961, the Economic Planning Board was created as the key agency for Korea's ambitious long-term industrial strategy. It was given the task of formulating a national economic development plan; overseeing its implementation; and monitoring its progress in coordination with a number of other agencies such as the Ministry of Finance and the Ministry of Commerce and Industry. Korea's strategic industrialization strategy was realized in a comprehensive five-year economic plan. The EPB was like the chief executive officer of "Korea, Inc." The EPB created directions, identified key industries and was influential in providing them with the necessary support mechanisms. Economic management resembled the notion of corporate management within "Korea, Inc." where banks acted as the treasury unit, the industrial sector and the Ministry of Commerce and Industry as the production and marketing unit respectively, and the government—personified by the EPB with directives from the Blue House—as the central planning and control unit.⁶⁹

The EPB was regarded as one of the highest offices. The minister in-charge received the title of deputy prime minister. He was also known as the senior minister for economic planning.

The key distinguishing feature of EPB's industrial policy—or all developmental state models—was its central and sustained focus on dynamic comparative advantage.⁷⁰ Korean firms were given incentives and resources to continuously move domestic firms

⁶⁹ Cho, Y.J., Kim, J.K. "Credit Policies And the Industrialization of Korea" World Bank Discussion Papers 286, The World Bank, Washington, D.C., 1995 p.25

⁷⁰ Chenery, H. B. 1961. "Comparative Advantage and Development Policy." *American Economic Review* 51(1):18-51

to produce higher value-added products through advanced technologies and constant productivity improvements instead of focusing on the existing patterns of comparative advantage. Dynamic comparative advantage was achieved by innovating new industrial sectors and research capabilities designed to accelerate the absorption, creation & diffusion of technology. It also expedited the transformation process—that is, the process of transforming research to prototyping and tooling of manufacturing plants for production. The EPB was also involved in expanding product lines in traditional industries. Central to this entire effort was the creation of a national innovation system based on extensive collaboration between universities, research groups and laboratories, government agencies, and business firms⁷¹—especially Korea’s Chaebol.

The EPB limited the role of foreign involvement⁷² Foreign firms were conduits of technology more than subsidiaries of multi-nationals. “Genuine” technology transfer—that is, tech transfer to national agents not to multinationals operating within the country’s borders—was of utmost importance. The state prioritized the ownership of firms by nationals with financial assistance from the state and limited the participation of foreign principals to assure the state’s control over the directions of firms. Targeted foreign firms were encouraged to teach and establish their technologies in Korea so that the state could create local firms throughout the supply chain to support the technology they brought in. In turn, local firms received the technological spillovers and the know-how. More importantly, this arrangement provided knowledge to creatively evolve the technology to other value-added products that could be rightfully called Korean made. The EPB coordinated with other academic organizations and state sponsored research institutions to extract and reverse-engineer key technologies.

The EPB created firms that were interconnected and interdependent—where the outputs of each became inputs for the other. It was a rather difficult strategy to implement because the plan called for the simultaneous investment in capital intensive upstream, downstream and parallel industries. It was especially difficult because the state was applying pressure to catch-up with the technology of competing advanced industrial states. The shipping industry in Korea went through this experience and became the subject of many criticisms among IFIs.

⁷¹ Wolfe, David and Holbrook, JA. The Innovation Systems Research Network (ISRN): A Canadian Experiment in Knowledge Management. March 18, 2005, www.sfu.ca/cprost/docs/ISRN%20SPP%20paper%20v4.1.pdf . P1–4

⁷² Amsden, A (1989). *Asia’s next giant: South Korea and Late Industrialization*. New York: Oxford University Press. 1989p.83

The market for ships has long been dominated by the Japanese in Asia and in this period, the market for these ships was dwindling. The World Bank deemed that the Korean shipbuilding plan was a useless endeavor.

“Koreans, taking into account the probable decline through the late 1970s of shipbuilding in Japan, Sweden, and Germany, anticipated capturing nearly 80% of the growth in world shipping trade between 1972–1980 and over 100% between 1972–85. “Even in Japan which now accounts for over half the production of ships” went the WB protest “the growth of shipbuilding industries was not historically as rapid as the planned rate of expansion in Korea.””⁷³

The state pouring investments into these projects seemed like an exercise in futility. To the consternation of IFI’s, the Park administration pushed on with these investments regardless of a major depletion of reserves brought about by the oil price hike in the early 70s.

Other objectives were at hand. The development of the integrated steel industry through the manufacturing of ships was one of the primary objectives. “Shipbuilding was a means to bring the steel industry up to scale. Massive development in shipbuilding was carefully and simultaneously calibrated with steel to take advantage of external economies.”⁷⁴ Other organic and peripheral industries to steel such as machining, are a step forward to the state’s industrial objective of being able to produce more technologically advanced products such as automobiles, transportation, military armaments, machines and electronics. Meredith Woo observed that this massive growth in the steel industry was a boon to over 200 types of metal, machineries, chemicals and electronic goods.⁷⁵

It can be assumed that debt for starting companies is risky because they have not yet yielded any appreciable returns—especially capital intensive firms like steel mills. Yet the state made large investments in key upstream and downstream industries to support steel. It would seem foolhardy for the government to irrationally “splurge” on capital

⁷³ Quoted from The World Bank, Current Economic Position and Prospects of the Republic of Korea, Report 332-ko p.64 Cited in Woo, Jung-en (Meredith Woo Cummings)., “Race to the Swift”., p.132

⁷⁴ Woo, Jung-en (Meredith Woo Cummings)., “Race to the Swift”., p.135. External economies – Those gains, benefits or other advantages of a company’s action which necessarily go to a firm that does not participate in the action. Such advantageous results are often neglected in the economic calculations which determine whether or not an action is or will be considered profitable (defined by the Ludwig von Mises Institute, <http://www.mises.org/easier/E.asp>)

⁷⁵ Woo, Jung-en (Meredith Woo Cummings). p.136

intensive firms aimlessly—as IFIs would criticize. Nevertheless, the EPB was guided by a central plan that coordinated and matched the outputs of each firm to the other. It approached problems collectively. The EPB invested and managed a system of interconnected and interdependent industries. It also saw a wider-scale social investment in technological progress and export earnings rather than the free market view of seizing opportunities and increasing the rates of return in the short-term. Indeed, the government heavily supported the Hyundai Group in shipping despite the threat of the dominance of Japan in the production of ships and rising oil prices. The government gave Hyundai monopoly over steel structures; it ordered all oil transports be carried by Hyundai groups' newly created merchant marine as a way to create demand for Hyundai ships; the government raised overseas credit, provided subsidies, and more importantly became the financial guarantor to help Hyundai win its first order.⁷⁶

The EPB also raised entry barriers to prevent international firms from competing in the local market. The state encouraged local firms—i.e. infant industries—to reach economies of scale and be able to match and surpass the standards of international competition as early as possible. Tariffs and quotas were raised against key products to prevent excessive competition during the starting phases of industry development.

These firms were geared to saturate the market with their own products. In the long-run, ELI geared firms to create competitive products for the local market—where it substituted its imports. The measure for this is known as the import coefficient (Total import/total supply of goods to the market) X 100.

TABLE 1C

Import Coefficient in HCI Development %					
	1970	1975	1980	1985	1988
Light Industry	9.2	10.6	7.3	7	8.5
HCI's	36.9	29.5	23.7	21.3	22.5
>Petrochemicals	23.5	19.7	14.9	17	19.1
>Basic Metals	35.1	27.6	18.9	17.6	20.4
>Metal/Machinery	50.5	41.7	35.8	26.9	25.1

Source: Bank of Korea, "Input-Output Tables," various issues. Cited in Cho and Kim, World Bank Discussion Papers 286, p.86

⁷⁶ Amsden, A (1989). *Asia's next giant: South Korea and Late Industrialization*. New York: Oxford University Press. p.275

The Park administration was able to live up to its word in curbing the amount of heavy industry and chemical imports entering the market. In 1970 the coefficient of HCI was 36.9%. Imports entering the market slowly dwindled to as low as 23.7% in 1980.

Under the Park regime, the roles of government and Chaebol were reversed. Initially, having a “super-agency” to create and implement a strategic plan involving the Chaebol seemed like a very intimidating task. Chaebols after all had been powerbrokers during the previous regime. However, most of their earlier political connections were severed by Park. The authoritarian state of Park Chung Hee gave them no option but to abide by the EPB’s industrial plan because Park placed the state and the Chaebols in a relationship where the state had almost absolute control in all the support mechanisms to create key industries—and could have been easily withheld it if the Chaebols did not comply. Foremost in this support mechanism was the access to low cost credit from state controlled financial institutions.

Increasing exports became one of the overarching objectives of the plan. The EPB modified the ISI model to fix its sights on the global market. With meager resources, the first two five year plans (FYPs) attempted to boost textile exports. This soon became one of the main sources of foreign exchange for Korea. Indeed, by the late 60s, textiles constituted 38% of total exports and employed 32% of the manufacturing population. It was projected to double over the next four years.⁷⁷ This momentum in the growth of Korea’s textile exports was suddenly interrupted however. The Nixon administration, yielding to the lobbying efforts of the US cotton growers and textile producers, unilaterally imposed textile quotas that limited the annual increase in synthetic textile imports to 7.5% over the next five-year period, with additional restrictions imposed on twelve items with high US market shares. As 15% of Korea’s textile exports went to the US, this had a significant impact on Korea’s trade balance.⁷⁸ The move infuriated Park and convinced him that the process of diversifying into other products and industries had to be intensified.

While some consider this incident to have taken Korea in a new direction, it is more of an extension, or an intensification of the strategy on which Park had embarked from the beginning. The difference was that he now came to the conclusion that the push had to

⁷⁷ Woo, Jung-en (Meredith Woo Cummings). “Race to the Swift”., Columbia University Press., New York., 1991. p.126

⁷⁸ Woo, Jung-en. p.126

be expanded more rapidly beyond textiles. This would require Korea to build a stronger, more independent industrial base. There was a change implied, but it was a difference in degree, not a difference in kind. This laid the groundwork for the far more radical third FYP which launched Korea on its controversial Heavy Chemical Industry Strategy. The difference in degree essentially was taking industrialization to a higher level. It invested in heavy industry and people. Park saw to it that capital would be invested in know-how, skills and technology that would enable a firm to revolutionize and innovate. Capital deepening entailed heavy investments in managerial and entrepreneurial talent, technology transfer, skills enrichment programs, foreign technical assistance, and engineering capabilities. This was expressed as an increase in the ratio of capital over labour. This change was technically a progression from a labour-intensive industry—such as textiles⁷⁹—to a capital and skill-intensive industry. It relied heavily on salaried managers who were adept in project management, marketing, engineering, and different production processes. More importantly, these managers were trained to absorb new technology, and were thus, predisposed to improvise and evolve. It was these very characteristics that enabled Chaebol firms to diversify into industries that were almost alien to its traditional industry.⁸⁰

The third FYP (1972–1980) did envisage a more significant and dramatic change in Korea's industrial structure. With investments in heavy and chemical industries (HCI) as its main focus, this phase targeted the expansion of intermediate goods exports with the aggressive substitution of heavy chemical goods imports. The key sectors to be rapidly developed were steel and iron, shipbuilding, and petrochemicals. The fourth FYP (1977–1981) promoted a further diversification of the country's industrial sector, this time promoting the rapid development of more technology-intensive industries in an effort to achieve the high-level industrialization characteristic of an industrially advanced nation.⁸¹ It intensified its development of industrial machinery, electronics, and specialty chemicals as well as getting setting out to expand the export of

⁷⁹ Capital widening entails a multiplication of production units with the same ratio of capital to labour. Essentially this entailed investments in the expansion of traditional technology and skills as in textiles. Cited in Amsden, A (1989). *Asia's next giant: South Korea and Late Industrialization*. New York: Oxford University Press.p.268

⁸⁰ Hyundai diversified from Cement to Shipbuilding. Amsden, A (1989). *Asia's next giant: South Korea and Late Industrialization*. New York: Oxford University Press.p.246–247 and 266–268

⁸¹ Chamarik, S., Goonatilake S., "Technological Independence – The Asian Experience", The United Nations University Press, 1994.
<http://www.unu.edu/unupress/unupbooks/uu04te/uu04te0e.htm#3.%20the%20republic%20of%20korea>

production materials and capital goods.

Korea's adoption of a more fundamental and independent national industrialization plan from the early seventies not surprisingly met vehement opposition from the US and the IFIs. Just as they had criticized South Korea's efforts to shift emphasis away from agriculture in the past, the World Bank now opposed its efforts at industrial deepening and diversification—telling the leadership to focus its attention and resources into developing the textile industry which clearly had an established comparative advantage (that is, textiles already comprised 39% of total exports). Accordingly it recommended a \$2.7 billion loan to further develop that sector.⁸² The objections to Korea's now Heavy and Chemical Industry (HCI) strategy were based on the same arguments that had been raised against Korea's earlier ISI strategy. The World Bank warned that the resulting purchases of capital equipment, and the need to purchase imported raw materials and intermediate goods would adversely affect the impact on the country's already depleted foreign exchange. They were right to a degree since the strategy did carry such risks. Park had concluded that the country could afford to take those risks so long as it could expand its exports rapidly enough and increase its foreign exchange. However, events in the global economy made the situation more difficult to sustain the momentum for HCI. The new phase in Korea's development was soon hit by a global economic storm—the oil crisis (1973)—which reduced global growth and demand while escalating Korea's energy costs, since Korea depended on oil for 60% of its energy requirements⁸³. Hydro-electricity was still in its infancy accounting only 1.4% of total capacity. As a result, the quadrupling of petroleum prices rapidly depleted the country's foreign exchange reserves soon after it had assumed the risks associated with the HCI strategy. That strategy could easily have failed as a result but for the government's swift and effective response. As Duck Woo Nam, Deputy Prime Minister and Minister of Economic Planning during the Park Chung Hee regime noted...

...fortuitous factors, notably the two oil crises, nearly derailed the program. Yet the tenacious leadership of President Park played an offsetting role, leading the government to pursue the program in the face of all sorts of difficulty. I recall what he told me, when I expressed my concern over the uncertain financial outlook for the heavy industry program: "Japan has risen again from the ashes of the lost war for which its leaders risked the entire nation, but what I am now risking is only part of our economy, so let us try." In retrospect, one thing is very clear: Without his determination and leadership, Korea would not now have its success in heavy

⁸² The World Bank, "Current Economic Position and Prospects of the Republic of Korea", Report 768-ko and 1490-ko cited in Woo p.131

⁸³ Woo, Jung-en (Meredith Woo Cummings). "Race to the Swift", p.127

industry, agriculture, and exports.⁸⁴

Park stayed the course with the new HCI strategy inspite of fierce criticism from those who argued that such a heavy industrialization strategy was bound to fail. The global oil crisis was bound to strangle foreign exchange and such fears were not unjustified since the crisis was certainly severe. The oil crisis alone accounted for 62% in the rise in Korea's import bill in 1974. This was to be financed by the remaining foreign reserve holdings and more importantly by borrowing heavily abroad. The resulting explosions in the Korean economy's current account deficit from \$.5 billion in 1972-73 to \$2.2 billion in 1974-75 had to be largely financed by borrowing. Korea's foreign debt rose by 42% and total external debt as a percentage of GNP rose sharply from 32% in 1974 to 40% in 1975.⁸⁵

These development goals were so ambitious that it riled some of Park's economic advisers. Some resisted this big push for HCI as foolhardy—feeling that it was bound to end up as a costly mistake. However, Park was determined to press on to fully develop HCI—its means to accumulate much-needed foreign exchange. To speed up the process, he established a special Heavy and Chemical Industry Committee in the Blue House which was given enormous powers over the government bureaucracy—allowing it to bypass even the EPB and to give orders directly to the Ministry of Finance, the Banks, and the Ministry of Commerce and Industry.⁸⁶ Ultimately, the HCI succeeded in shifting Korea's export profile and probably its pattern of comparative advantage. The share of heavy industries in manufacturing output had risen from 39.7% in 1972 to 54.9% in 1979. Heavy manufacturing exports, which had accounted 13.7% percent of total exports in 1971, had risen to 37.7% by 1979. At the same time, the share of manufacturing output had declined from 60.3 in 1972, to 45.1% in 1979; while light-industrial commodity exports fell from 86.3% to 62.3% over the same period.⁸⁷

⁸⁴ Kwack, Sung Y. ed., "Korea's Economic Takeoff in Retrospect," in *The Korean Economy at a Crossroad*. New York: Greenwood Press, 1993

⁸⁵ Amsden, A., *Asia's next giant: South Korea and Late Industrialization*. New York: Oxford University Press, 1989.p.98-99

⁸⁶ Clifford, M. "Troubled Tiger", ME Sharpe, Inc. 1998, NY. p.105

⁸⁷ Economic Planning Board, cited by Amsden, "Asia's Next Giant". Oxford University Press, 1989. p. 58

TABLE 1D

Percent Share of Heavy and Chemical Industry and of Light Industry in Manufacturing and Merchandise Exports											
Industry	Share	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Heavy and chemical industry	a	40.5	39.7	42.6	49.9	47.5	49.5	50.7	53.0	54.9	56.3
	b	13.7	21.1	23.6	33.2	25.9	28.8	31.6	33.2	37.7	39.9
Chemical	c	56.2	52.2	44.8	46.9	54.3	48.1	43.8	39.6	41.0	49.3
	d	14.2	14.7	10.2	12.9	13.2	11.1	10.2	8.5	9.8	11.6
Basic Metal (iron, steel, non-ferrous metals)	c	14.5	15.4	19.7	18.1	13.3	14.5	15.2	14.7	16.0	16.6
	d	26.5	34.2	33.4	38.8	28.1	27.4	31.3	27.1	31.8	36.6
Machines and Transport Equipment	c	29.4	32.4	35.5	34.9	32.4	37.4	41.1	45.7	43.0	34.1
	d	59.4	51.1	56.4	48.3	58.8	61.5	58.4	64.3	58.4	51.8
Light Industry	a	59.5	60.3	57.4	50.1	52.5	50.5	49.3	47.0	45.1	43.7
	b	86.3	78.9	76.4	66.8	74.1	71.2	68.4	66.8	62.3	60.1

a. In total manufacturing output

b. In total merchandise export

c. Of output in heavy and chemical industry

d. of export in heavy and chemical industry. Heavy includes consumer electronics

Source EPB cited in Amsden p. 58

GNP per capita increased as Korea ventured into manufacturing. Korea was able to expand its heavy industry exports only by subsidizing them to a degree that their production and export left no "net gains" for the Korean economy—at least in the short run. Rates of growth were expected not to be very abrupt since this was the "start-up" phase of the industrial plan. Agriculture, Forestry and Fisheries remained the largest contributors to GDP in the 1960s. Park Chung Hee's industrial policies started gaining economic dividends as the economy shifted to manufacturing—especially at the time when HCI "kicked-in". Per capita GNP increased as the economy changed its focus to manufacturing.

TABLE 1E

Changes in Industrial structure by GDP(%)					
	Agriculture Forestry and Fisheries	Mining	Manufacturing	Others	Per capita GNP (USD)
1960	36.9	2.1	13.6	47.4	79
1965	38.7	1.8	17.7	41.8	105
1970	25.8	1.3	21	51.9	252
1975	25	1.4	26.1	47.5	594
1980	14.9	1.3	29.7	54.1	1592
1985	12.8	1	30.3	55.9	2194
1990	9	0.5	28.9	61.6	5659
1991	8.1	0.4	27.5	64	6498

Source: National Statistics Office, "Major Statistics of the Korean Economy"

Cited in Cho and Kim, World Bank Discussion Papers 286, p.23

Park Chung Hee set a goal of \$10 billion in exports and a per capita GNP of \$1,000 by 1980.⁸⁸ Whereas total exports had only been \$1.62 billion and per capital GNP of \$318 in 1972, Park was able to reach the target he made for Korea with the institutional structure he created. In fact, he exceeded his goals—per capita GNP increased to \$1592 in 1980.

Despite the enormity of the challenges, Korea managed to weather the storm created by the oil crisis. Indeed, one could say that it was at this moment that Park's DS model demonstrated its strength and flexibility. Ultimately there were three reasons why the model was able to survive under the desperately unfavourable circumstances. The first was that the state had sufficient control over the country's financial markets to allow investment to continue to increase at relatively moderate interest rates even under these conditions. Moreover, capital flows were regulated to contain the loans from the United States and Japan as they were used to wipe out the burgeoning deficits borne by the oil price hike. The second was that the system was flexible enough to allow resources to be shifted quickly in response to altered circumstances. Third, and most important, was the simple fact that Korea's new "IS plus Export Promotion" strategy was breaking the looming foreign exchange bottleneck simply because it was so successful in transforming IS industries into large-scale exporters almost immediately, with the help of export subsidies where necessary.

Chaebols. General Park Chung Hee and his administration ultimately had to make a strategic alliance with the country's business elite—the heads of Chaebols—in order to implement this ambitious national development strategy. The Chaebol were patterned after the Japanese Zaibatsu. Chaebols were conglomerates that exploited economies of scale and other synergies and externalities in management, technology and marketing by investing in sets of related activities that range from manufacturing, production, to trade and services. The heads of these Chaebols wielded enormous power and influence. These conglomerates were owned and tightly controlled by individual families—the organization had a patriarchal orientation. The centralization of power carried the risk that these organizations would over-extend themselves until diseconomies of scale and an absence of focus became the dominant outcomes of their complex structures. There would be a danger that these conglomerates would wield power to force the country to

⁸⁸ Clifford, M. "Troubled Tiger", ME Sharpe, Inc. 1998, NY. p.105

live with their mistakes by getting the government to underwrite and protect them in perpetuity as it was in the earlier version of ISI.

Yet while such fears were voiced and recognised, they were not justified in these early stages when the Chaebol were still small and relatively focused in their activities. They were still very weak in relation to potential foreign competitors. Indeed, it was this weakness together with Park's strength and determination that allowed his government to enlist the Chaebol in Korea's struggle for national development as subordinate partners. Subordinate partners who would inevitably gain in strength, if and when national development was achieved.

The initial relationship between the Park government and business approximated the hierarchical relations within his government and within the Chaebol themselves. The government played the role of senior partner, selectively using its power to direct, persuade, protect and punish to influence the strategic directions of private firms.⁸⁹ It did this both directly and indirectly often through market-based incentives that altered prices and interest rates, but also by imposing quantitative restrictions on production or imports or by rationing and channeling available financial resources to certain strategically important firms or industries.⁹⁰

The Chaebol were mere fledgling firms that existed within the framework of the earlier substitution regime that had been totally dependent on the protection and privileges fed to them by the government long before they became high-performing internationally competitive export engines. This relationship was not bereft of graft as favors that were granted by the Rhee administration to the Chaebols were largely in the form of protection from external competition, import licenses, giving them access to lucrative import quotas, financial aid, and cheap bank loans.⁹¹ Although the Chaebol were criticized for these illicit practices, they were tolerated because they were thought to possess the organizational capacity and the entrepreneurial spirit to realize the country's industrialization objectives. Park promised to clean up these corrupt practices when he came to power. He attacked Rhee and the leaders of the Chaebol on the grounds that they had been selling out the country's future in return for short-term

⁸⁹ Cho, L.J. & Kim, Y.H.eds. Kim, P.J., "Korea's Political Economy, An Institutional Perspective" Westview Press Inc., Colorado, Oxford., 1994 p.283

⁹⁰ Mason, Edward S., et al 1980. "The Economic and Social Modernization of the Republic of Korea." Cambridge: Council on East Asian Studies, Harvard University. p. 263-272

⁹¹ Jones, L., Sakong, I., Government, Business, and Entrepreneurship in Economic Development: The Korean Case." p. 271-272

personal gain. In 1961 Park enacted a Law for the Illicit Accumulation of Wealth, and this led to the arrest and imprisonment of the “captains of industry” and their friends in the bureaucracy.

Initially Park thought that he could do away without the Chaebol, but Park was faced with the ensuing vacuum in the business community and rising tensions in the political sphere. Park proceeded to reach a compromise—though one whose terms were largely dictated by him. Park essentially realized that the economic plan that he and his advisers had devised would be difficult to implement without the active support of the existing managers and captains of industry. They were a viable economic force that had to be harnessed since they had entrepreneurial talents and had the advantage of organization, personnel, facilities and capital resources.⁹² They were of no use economically in jail facing charges for illegitimately acquiring wealth under the previous regime. They were also a growing political liability.

Samsung founder Rhee Byung-Chul also was one of those arrested for first grade criminal activity under the 1961 Act. He outlined their position very eloquently in a conversation with Park Chung Hee⁹³

The duty of businessmen is to provide many people jobs and guarantee their living as well as to support administration of the nation-state, such as national defence, government administration, national education, and construction of infrastructures through the payment of taxes. The punishment of the Illicit Wealth Accumulators will hurt the administration of the nation-state by shrinking economies and decreasing the government's tax incomes. Instead what is really beneficial for the state is to make the private business assume part of the task of the economic establishment.⁹⁴ (translated from Japanese by Machi)

Significant in this statement is the clear acceptance of the potential benefits of a close collaboration between the government and the Chaebol group. However, the terms of this relationship were dictated by the state.

⁹² Cited in Kang, David., “Transaction Costs and Crony Capitalism in Asia”, this article was presented at Stanford University; the University of Notre Dame; and the conference “Asian political-economy in an era of globalization,” Tuck School of Business, Dartmouth College, May 10–11, 2002 quoted from Pak Pyongyun, *Chaebol kwa ch'ŏnch'i* (*Chaebol and Politics*) (Seoul: Hanguk Yongusa, 1982); and Stephan Haggard, Byung-kook Kim, and Chung-in Moon, “The Transition to Export-led Growth in South Korea: 1954–1966,” *The Journal of Asian Studies* 50, no. 4 (November 1991): 850–73.

⁹³ Machi, Miki., *The Role of the State in the Development of Chaebols in South Korea*. Research Essay, Norman Patterson School of International Affairs, Carleton University, Ottawa.p. 72

⁹⁴ Song, Byung-Nak. “The Rise of the Korean Economy”. Hong Kong, Oxford, and New York: Oxford University press.1990. p.153

The state wanted to pursue an ambitious national development agenda of ISI plus export promotion, while the Chaebol clearly wanted to protect their property rights—and with the government’s help—have an opportunity to invest and run their enterprises.⁹⁵ This eventually emerged into a mutually beneficial collaboration. The terms of this agreement were largely dictated by the government—which was clearly in a stronger position given the weakness and dependence of the Chaebol at the time. The willingness of the Chaebol to accept the deal offered by the government was clearly enhanced by the fact that this deal envisaged a significant and sustained increase in the funding and assistance that was going to be made available to them by the state. State sponsored finance was the lifeblood of Chaebols—unlike Japanese Zaibatsus who depend on banks within their network⁹⁶. The Chaebols had to agree to give the government a strong, and often leading role in determining the strategic direction of major investment decisions, and the terms of their collaboration with foreign capital in return.

The state made it abundantly clear that the Chaebol would have to work within strategic parameters established by the state; that their access to foreign capital would have to be channeled through the state, which would try to ensure that the terms of these relationships were favourable to Korea’s development objectives. They would have to meet ambitious export targets as a condition of receiving continued assistance from a state controlled financial system. These constraints were never popular with the Chaebol but they were initially accepted because the Chaebol soon found that they could grow and thrive under this new regime. As time went on however, their growing strength and confidence would lead them gradually to take a different view of the balance of costs and benefits implied by this relationship.

⁹⁵ Jones, L., Sakong, I., *Government, Business, and Entrepreneurship in Economic Development: The Korean Case.* p. 282

⁹⁶ Jones, L., Sakong, I., p. 260

Conclusion

Learning from the shortcomings of the ISI policy in the 1950s, the institutional changes made by the Park Regime in the 1960s embodied a more nationalistic, pro-industry (vs. Pro-finance), pro-producer (vs. pro-consumer) outlook.⁹⁷ The focus was on the early development of key industries aimed at building-up foreign exchange reserves in the short run, and the production of technologically competitive goods by national firms for export and home consumption in the long run.

The Park government embarked on a more interventionist, more strategic development strategy because it understood that the previous strategy of ISI—although supposedly “nationalist and interventionist”—was too dependent on foreign capital and did not aggressively emphasize the need to develop industrial exports as an early and central part of such strategy.

This state-directed industrial strategy needed an intricate network of mechanisms and institutions ranging from finance to science and innovation, all working in a coordinated manner. Although the required structural changes could be relatively easily introduced by this authoritarian government acting with military precision and resolution, it could not have been implemented successfully if the government had not been able to forge a strategic alliance with the country's industrial class. They were led by the heads of the Chaebol. Chaebols were rallied by the state to play a leadership role in its national development strategy despite the fact that they were family owned conglomerates, heavily dependent on protection and do not have the capacity to survive in an intensely competitive global marketplace. Growth and development were essential and so capital was directed their way, often on subdivided loans, on condition that they become high performing exporters to the world with the active assistance of the state.

Export targets were systematically linked to various forms of state industrial support, including in particular—low interest credit to guarantee that the industrial agenda would not be stifled by a shortage of foreign exchange along the way. This system of export

⁹⁷ Chang, Ha-Joon, Evans, Peter. “The Role of Institutions in Economic Change”. Paper prepared for the meeting of the “Other Canon” group, Venice, Italy, January 13 – 14, 2000. <http://www.othercanon.org/papers/>, p.24

targeting ultimately proved to be highly beneficial in curbing the tendency for imports to outstrip the embryonic industrial system's capacity to export.⁹⁸

Key to this industrialization strategy was a financial structure that mobilized credit and savings in support of this effort—making available to selected strategic industries loans at subsidized interest rates while using extensive capital controls to prevent the capital outflow that would otherwise have undermined such a strategy. Moreover, the state persisted with these financial policies despite strong opposition from financial institutions including the World Bank and the IMF who argued that this would lead to the misallocation of resources, growing consumption and eventual stagnation. The Park government pushed on with these policies, determined to prevent its industrial agenda so central to its broader development objectives from being derailed. The financial policy of Korea's developmental state is the subject of the next chapter.

⁹⁸ Bienefeld, Manfred. (2005)

Chapter 2 Finance in the Developmental State of South Korea

MITI is convinced that market forces alone will never produce the desired shifts, and despite its undoubted commitment in the postwar era to free enterprise, private ownership of property, and the market, it has never been reticent about saying so publicly.¹

Chalmers Johnson

This chapter will investigate the financial rationale and structures of a developmental state. Any attempt to develop a strategic long term vision aimed at shifting patterns of comparative advantage will necessarily have to mobilize large amounts of capital. Market-altering economic policies are needed to overcome problems associated with the need to gain investor confidence and enhance economic stability. Such a strategy should be able to socialise risks associated with high barriers to entry in production, and overcome information problems that are endemic in early development situations. To these ends, the state needs a high degree of national control.² These are the necessary financial conditions for a developmental state to thrive.

The first section of this chapter will investigate and discuss these conditions in greater detail. It presents a rationale and a framework that will provide insight to the Park administration's conduct as it controlled the financial system. The second half of the chapter will investigate the administration's financial and economic policy. Park nationalized banks to have more control over lending and capital allocation to strategic industries; artificially lowered interest rates to stimulate investment; fixed the exchange rate to stabilize the economy, all in an attempt to undergird the ambitious industrialization strategy of South Korea.

2.A Finance in the developmental state

Initially, strategic infant industries in a developmental state will not be profitable—they need to be nursed with capital supplies until they mature. It is therefore necessary for the state to retain sufficient control of the financial system to direct capital their way, that is, it should have the ability to subsidize and provide low-cost loans to them rather

¹ Johnson, Chalmers, *MITI and the Japanese Miracle*. Stanford University Press, Stanford California, 1992. p.28

² Bienefeld, Manfred, 2005

than relying on investors. The state should also engineer a system to accumulate capital resources and make the capital readily available to invest in selected capital-intensive and high-risk projects that would yield returns in the long-run. Leakages should be controlled as well—investible capital should be kept within the boundaries of the domestic economy because uncontrolled outflows of capital can deplete the capital resources that fund strategic projects. It is also for this reason that the state should regulate capital flows to curb flight and instability that may lead to a liquidity crisis³.

These policies however are an anathema to a free market. A developmental state is often faced with a dilemma in dealing with them. Alice Amsden in her book *Asia's Next Giant* suggests South Korea faced these dilemmas as it pursued its industrialization strategy⁴. Initially a developing economy that has low productivity rates needs low interest rates to stimulate investment. At the same time it also needs high interest rates to encourage people to save to be able to have more investible resources. They need to depreciate exchange rates to stimulate exports. At the same time it also needs to overvalue exchange rates to lower the costs of their foreign debt obligations and their imports of raw materials, intermediate and capital goods. A state needs to shield its infant industries from foreign competition, yet it also needs free trade to meet their import requirements (i.e. capital goods). The economy needs to be stable to grow—where capital is kept in the local economy and directed to long-term investments. Yet it must thrive in a global economy that subscribes to the school that macroeconomic stability requires financial markets to be liberalized.

A developmental state uses a judicious mix of intervention and market forces to sustain its developmental project. This is most evident in the developmental state's approach to finance. The state intervenes in the economy to satisfy the needs of investors and savers, and both exporters and importers by creating multiple prices. Interest rates for loans earmarked for strategic industries are lower than global market rate loans. Importers and exporters have different exchange rates. Under these circumstances market forces are allowed to work with the state in specific areas. The state purposefully places particular segments of the economy in a state of "dis-equilibrium" to accumulate capital and allocate them into strategic firms and projects that will provide the social optimum in the long-run. In a neo-classical sense, a developmental state gets the prices

³ In an event of a crisis, more capital outflows can stifle the capital feeding its main means to uplift the national economy from underdevelopment and a crisis—that is, its strategic export industries

⁴ Amsden, A (1989). *Asia's next giant: South Korea and Late Industrialization*. New York: Oxford University Press.p 14–15

wrong⁵ and it is with this reason that the developmental state has to intervene to prevent and allay the fears of market failures in the economy.

“Let finance be primarily national”. John Maynard Keynes was a staunch advocate of economic development and saw the necessity of establishing a monetary order that pursued this objective. For Keynes, the state had to intervene. It was essential for him that a state must have a stable economy that would enable firms to develop to their fullest potential—that is, a state should have an economic environment that was not prone to volatile market swings borne by speculation and capital flight. A state should also provide low-cost capital to fuel investment and growth, and most importantly the means to control and manage the economic environment. To this end, Keynes believed that it was imperative to control capital, as he wrote...

Control of capital movements, both inward and outward, should be a permanent feature of the post-war system.⁶

Advisable domestic policies might be often easier to compass, if, for example, the phenomenon known as ‘capital flight’ could be ruled out.⁷

It was important for investment to be organized by a state. In July 1944, Keynes and Harry Dexter White negotiated the design of a monetary order that created structures that would privilege a state pursuing economic development. The Bretton Woods System (BWS) enabled the state to govern and mold the behavior of their financial sectors in ways that would suit the state’s economic development goals.⁸ They saw the necessity of a financial system that both coordinated investment and finance...

I believe that some coordinated act of intelligent judgment is required as to the scale on which it is desirable that the community as a whole should save, the scale on which these savings should go abroad in the form of foreign investments, and whether the present organization of the investment market distributes savings along the most nationally productive channels.⁹

⁵ Amsden, A (1989). *Asia's next giant: South Korea and Late Industrialization*. New York: Oxford University Press. p 13–14

⁶ Keynes quoted by Helleiner, Eric. *States and the Reemergence of Global Finance*, Cornell University Press., Ithaca and London, 1994. p.33

⁷ Keynes, John Maynard, "National Self-Sufficiency," *The Yale Review*, Vol. 22, no. 4 (June 1933), pp. 755–769

⁸ Gowan, Peter. p.9

⁹ Keynes, John Maynard., *Essays in Persuasion*, “The End of Laissez Faire” NY: Norton, 1963, p.318

In his work "The General Theory of Employment, Interest and Money", Keynes proposed ... "a somewhat comprehensive socialization of investment...."¹⁰ where the state should have the overarching goal of "taking an ever greater responsibility for directly organizing investment".....¹¹ This development relies heavily on semi-autonomous organizations within the state... "bodies which in the ordinary course of affairs are mainly autonomous within their prescribed limitations but are subject in the last resort to the sovereignty of the democracy expressed through Parliament"¹²

Keynes and White worked towards keeping exchange & interest rates stable and conducive for investment. The architects of the Bretton Woods System (BWS) drew from the experiences of capital flight that caused the great depression of 1931. As Eric Helleiner quotes Keynes and White in their discussions about a new financial order:

He (Keynes) was worried that "movement of funds out of debtor countries which lack the means to finance them" would impose an undue balance of payments constraint on domestic macro objectives....a country with a current account deficit that attempted to maintain interest rates lower than the existing international norm would be subject to substantial disequilibrating capital outflows. If interest rates were to be determined by considerations of external balance, he argued that such capital movements would have to be controlled to avoid external constraints on policy.¹³

Moreover,

The second reason that Keynes and White advocated capital controls was their belief that a liberal international financial order was not compatible with a stable exchange rate system and a more liberal international trading system....With respect to exchange rates, White noted that speculative capital movements were "one of the chief causes of foreign exchange disturbances" and would have to be controlled if a stable exchange rate system were to be maintained.¹⁴

A major feature of the monetary order was to prevent destabilizing capital flows from moving around the world freely. The new order enabled private finance to be transferred for the purposes of financing trade and productive investment. However, other movements of private finance—those presumed to be speculative capital flows—under

¹⁰ Keynes, John Maynard., *The General Theory of Employment, Interest and Money*. NY: Harcourt, Brace and World, 1964 p.378. Cited in Crotty, James. "On Keynes and Capital Flight", *Journal of Economic Literature* Vol.XXI (March 1983) p.65

¹¹ Keynes, John Maynard. Cited in Crotty, James. "p.65

¹² Keynes, John Maynard., *Essays in Persuasion, "The End of Laissez Faire"* NY: Norton, 1963, p.313–314 Cited in Crotty, James. "On Keynes and Capital Flight", *Journal of Economic Literature* Vol.XXI (March 1983) p.61

¹³ Helleiner, Eric. *States and the Reemergence of Global Finance*, Cornell University Press., Ithaca and London, 1994. p.34

¹⁴ Helleiner, Eric. *States and the Reemergence of Global Finance*, Cornell University Press., Ithaca and London, 1994. p.35

this system were banned. Many political economists call it ‘financial repression’ on an international scale.¹⁵

The financial system and industrialization thrust of a developmental state in many respects were Keynesian. The Ministry of Finance, Central Bank and the Economic Planning Board of Korea, The Ministry of International Trade and Industry of Japan appear to be the “bodies” that Keynes referred to as organizing and socializing investment in accordance with a “long-term programme” for development.

In summary, as capital controls are a key policy instrument, it was imperative to keep capital resources from flowing out of the economy to be able to mobilize national resources behind the national development strategy. The Korean state also regulated the composition of capital flowing into the economy—making sure that ownership, and directions are steered by the state. With an industrial strategy heavily dependent on timing, precision, stability and the ability to swiftly react to unforeseen circumstances—a developmental state had to necessarily rally capital resources to fulfill its economic mission. Capital controls were essential for:

- *Allocate Credit.* A state utilizes policy loans to provide prioritized industries with low interest rates.

Credit allocation is also an instrument to influence industries to pursue the directions that the government set. This is achieved by limiting firms to borrow from state sources (or state endorsed sources), and allowing them to be highly leveraged. This effectively creates a *nexum* relationship between the state and the firms.

- *Generate Revenue.* Economies generates revenue by controlling the outflows of capital. With outflow restrictions, investors are limited from the purchase of foreign assets or loans abroad as it was in the two World Wars. This effectively keeps most of the capital in the domestic economy which became accessible to a state. It also enabled the local economy to run high inflation rates which generates more revenue. Moreover, the control of outflows also reduces interest

¹⁵ Gowan, Peter, “The Globalization Gamble: The Dollar-Wall Street Regime and its Consequences”. <http://www.gre.ac.uk/~fa03/iwqvt/files/9-gowan.rtf>, p.9

rates that consequently lowers the government's borrowing costs on its own debt.

- *Prevent the foreign ownership of domestic assets.* Foreign ownership of certain domestic assets can put other entities in control of firms and may potentially conflict with the interests of the government by steering the firm to other directions.
- *Prevent Potentially Volatile Flows.* Capital controls can prevent or alter the composition of international capital flows that can aggravate distorted incentives in the domestic financial system—like portfolio investment.
- *Keep savings for domestic use.* Bank savings and deposits are mobilized for urgent local needs like policy loans rather than investment in other ventures abroad.
- *Prevent Destabilization.* Capital can easily flow out for havens yielding higher rates of returns. Unregulated economies—with free convertibility and liberalized exchange rates—are prone to launch a cycle of investor exit in times of depreciation. Similarly an inflow of foreign capital can easily alter exchange rates. Policies are needed to prevent disequilibrating international capital flows from destabilizing the economy.
- *Correct a Balance of Payment Deficit.* Restrictions on the outflow of capital lower the demand for foreign assets and keep foreign exchange within the domestic economy.

The Irreconcilable Trinity. A developmental state needs to have the autonomy to create macroeconomic policies—say by lowering interest rates—for investment and growth. This condition works alongside fixed exchange rates to prevent instabilities. It also needs capital from the international market to fuel its economy, but most importantly have the means to prevent capital from fleeing. However, a state can only ever have two of the goals of fixed exchange rates, national independence in making macroeconomic

policy, and inward capital flows in a deregulated financial regime.¹⁶ A state needs to abandon the third, allowing it to adjust in accordance with market forces. This economic phenomenon is known as the “trilemma” or the “irreconcilable trinity”—a theory posited by Robert Mundell and Robert Flemming, but more importantly, it was John Maynard Keynes who had insight about the trilemma in his inquiry to the great depression of 1931.

States like South Korea, Taiwan and Japan aimed at industrialization and expansion. Cheap capital was necessary to fund this expansion by lowering interest rates. However, international capital will be hesitant to invest in the local economy since low interest rates on lent capital will yield low returns. Moreover, domestic savers will search for other havens worldwide with higher interest rates to increase returns on their capital. Though the interest rates are lowered to accommodate borrowing firms, investible capital however becomes scarce because foreign and local investors will be hesitant to keep capital within the local economy.

It would also be difficult to keep currencies fixed in this situation. Investors changing their local currencies to foreign exchange—to preserve the value of their capital as they invest abroad—can deplete the foreign exchange reserves and devalue the local currency. This in turn would encourage another cycle of capital flight. In this situation it would be more difficult for a firm to grow, say by purchasing more equipment abroad, since the firm will be hard-pressed to raise more local currency to purchase equipment at inflated dollar prices (hence the preference for fixed rates).

A state with a very permeable borders aiming for expansion policies lowers interest rates to induce growth counter-productive because it is a disincentive for capital to reside locally for investment. As Eric Helleiner noted...

“Macroeconomic management could be easily disrupted by speculative capital movements or by the flight of capital from artificially low interest rates. Similarly, government attempts to ration capital would be undermined if borrowers and investors had access to foreign capital markets. Capital controls thus became an integral part of the new domestic economic interventionism.”¹⁷

¹⁶ Helleiner, Eric. States and the Reemergence of Global Finance, Cornell University Press., Ithaca and London, 1994. p.34–35

¹⁷ Helleiner, Eric. States and the Reemergence of Global Finance, Cornell University Press., Ithaca and London, 1994. p.28

Ellen Frank discusses this issue in a different context. Engineering an economy to be attractive to financial investors is the goal of liberalization programs that are backed by the US and the IMF. Governments must insure investors against private financial loss if they want to be attractive. Adjustment policies compel governments to allow the free convertibility of local currencies into foreign exchange—to enable investors to repatriate their capital as insurance. More importantly, governments are encouraged to keep the value of their local currencies stable against the dollar to prevent further losses when investors have their capital exchanged. However, keeping the exchange rate stable will be difficult to achieve. The exchange rate is influenced by trading in the international currency markets and it is often subject to speculation. In essence, the inflow of capital is “privatized” (not government managed) since the inflow and outflow of foreign exchange is market-driven that foreign investors affect the exchange rates in the country.¹⁸

Keynes had already recognised the trilemma when he concluded that free capital flows were incompatible with macro-economic control, or exchange rate stability. It was he who had the insight and asserted that capital controls were desirable to enable a nation to enjoy stability and have the power to pursue nationally defined monetary policies.¹⁹

The trinity—stimulating capital inflows, fixed exchange rates and control for growth and investment (i.e. low stable interest rates)—cannot mutually exist without one being given over to market forces in an deregulated financial market. Any attempt to develop a strategic long-term vision aimed at shifting patterns of comparative advantage will have to move vast amounts of capital. A state could do this by mustering all the possible savings it could in the local economy. The state would need to have the control to direct the capital to strategic uses like infant industries. It should also be able to prevent the leakages in the financial system (such as local investors purchasing assets abroad) so that instabilities due to exchange rate fluctuations and capital flight are curbed. All three cannot mutually exist without one adversely affecting the policy objectives of the others with a liberalized financial sector. It is with this reason that capital controls are necessary for a developmental state to pursue its economic mission.

¹⁸ Frank, Ellen., Capital Flows and Exchange Rate Policy, in Foreign Policy in Focus, Vol. 4, No. 17, June 1999, Albuquerque, New Mexico.
http://www.fpif.org/briefs/vol4/v4n17cap_body.html

¹⁹ Helleiner, Eric. States and the Reemergence of Global Finance, Cornell University Press., Ithaca and London, 1994. p.29

Regulating the flows of capital is necessary to engineer development, but this school of thought often conflicted with liberal thinkers and IFIs since their economics are oriented towards the free market. As Keynes wrote...

There may be some financial calculation which shows it to be advantageous that my savings should be invested in whatever quarter of the habitable globe shows the greatest marginal efficiency of capital or the highest rate of interest. But experience is accumulating that remoteness between ownership and operation is an evil in relations between men, likely or certain in the long-run to set up strains and enmities which will bring to nought the financial calculation.²⁰....

....The same rule of self-destructive financial calculation governs every walk of life. We destroy the beauty of the countryside because the unappropriated splendours of nature that have no economic value. We are capable of shutting off the sun and the stars because they do not pay a dividend.²¹

John Maynard Keynes

The economic policies advocated by a developmental state are controversial especially among neoclassical economists and/or neoliberals. Placing the economy in a state of disequilibrium or “getting the prices wrong” riles advocates of financial deregulation. A developmental state purposefully lowers interest rates and channels capital into selected industries even if they were not yet yielding any substantial profit in the short-run. The developmental state in Korea was often criticized by neoliberals for misallocating capital—that is, capital is channeled to investments that are inefficient and not based on immediate rates of return. The World Bank was quite frank about its views of directing credit:

“Governments should attack the conditions that made directed credit appear desirable—imperfections in markets or extreme inequalities in income—instead of using directed credit programs and interest rate subsidies. With regard to interest rates, the aim should be to eliminate the difference between the subsidized rate and the market rate.”²²

Developing economies advocating these policies are often branded as corrupt because only a small group of selected industries have access to low interest loans. Those who are not allegedly “politically connected” have to resort to borrowing from curb market lenders who generally have higher rates of interest. Neoliberals argue that low interest

²⁰ Keynes, John Maynard, “National Self-Sufficiency,” *The Yale Review*, Vol. 22, no. 4 (June 1933), pp. 755–769

²¹ Keynes, John Maynard, “National Self-Sufficiency,” *The Yale Review*, Vol. 22, no. 4 (June 1933), pp. 755–769

²² World Bank (1989), *World Development Report 1989: Financial Systems and Development*, NY, Oxford University Press., p.129

rates would tend to encourage savers to keep their capital where rates are much higher. This situation would lower the investible resources (pool of savings) available to firms in a domestic economy.²³

Neoliberals believe that a higher rate of interest and deregulated financial markets would allow the influx of all kinds of savings and investment funds into the local economy, making investible resources plentiful.²⁴ Deregulation allocates capital efficiently because of market discipline—that is, capital will be invested in firms solely on the basis of rate-of-return, objective efficiency, performance not political favoritism. Under these guidelines, it is argued that managers are under the constant watchful eye of investors making sure that firms perform well and get a healthy return on their investments.

However, this financial arrangement does not prioritize the long-term investment required for a developmental state because the basis for investments is the *rate-of-return in the short-run*. “The divergence between private and developmental returns means that alternatives to the market based allocation of capital are necessary to promote investment that is socially necessary, but not necessarily privately profitable”²⁵ in the short-run at the least. Investors direct their capital into projects that yield the highest returns. These investments are more prone to go into quick yielding activities or speculative investments like real estate and the stock market rather than long-term enduring investments like steel mills or petrochemicals.²⁶ It is with this reason that the state must take control of the mechanisms to direct capital to key industries.

Financial deregulation can also make an economy unstable. Fund managers can extract capital whenever they want to. Fund managers are free to flee to other investment havens if there are low returns on their investment. Perhaps this is tolerable in small isolated cases but if a crisis does occur—or even just rumors of it—herd behavior can take place (as it did in the 1997 Asian Financial Crisis). Fund managers can easily “pull-out” their investments *en masse* at a time when the national economy needs it the most.

²³ World Bank (1989). p.128–9

²⁴ World Bank (1989), World Development Report 1989: Financial Systems and Development, NY, Oxford University Press, p.130

²⁵ Chang, Ha-Joon and Grabel, Ilene. “Reclaiming Development”, Fernwood Publishing, Nova Scotia, 2004. p.155

²⁶ Chang, Ha-Joon and Grabel, Ilene. p.154

In this case, business activities are disciplined by investors more than a state in a financially deregulated economy. The threat of capital “pull-out” or higher capital costs pushes firms to perform well within the investors’ directions and expectations—where the rate of return is the highest. In these circumstances, activities and product lines are influenced more by investors rather than the economic development agenda of the state.

As previously mentioned, the economic policies of a developmental state need to overcome problems associated with the need for institutions to gain investor confidence. A developmental state has to be able to rally investible capital and efficiently allocate them to key firms in its industrialization strategy. It also has to enhance economic stability by keeping exchange and interest rates at stable and predictable levels and prevent the flight of capital to other investment havens. To this end a state should have a high degree of national control, but this economic condition is difficult to achieve with a liberalized economy.

2.B The Financial System in Korea

Private financial institutions allowed to follow their own interest would make it difficult to finance Park’s industrial strategy. Banks tend to be risk-averse. It is difficult for banks to lend to firms that have not established themselves and have not experienced positive rates of growth. Nevertheless, almost all the firms in Park’s industrial agenda had not exhibited positive rates of growth since most of them were just starting in fields they had little or no experience in. Budding industries in Korea would experience many difficulties in capitalizing novel business ventures. Companies needed loans in big amounts, often beyond their equity since the HCI program pushed firms to purchase capital-intensive equipment.²⁷ Banks behaving in their own interest needed a form of guarantee or should be compelled to lend beyond equity in fulfillment of the state-pushed industrial directive.

Most firms that required capital were in novel projects and did not have sufficient income streams to show profitable returns. Banks behaving in their own interest would be wary of lending because they would be providing loans to firms that had little or no

²⁷ Amsden, A., *Asia’s next giant: South Korea and Late Industrialization*. 1989. p.85–88

income. Most of these firms were still learning to work with new technology. The state created policies that placed interest rates below global market rates to support the growth of the firm. Commercial banks will not profit as much as their foreign counterparts who set their interest rates around the higher world market rate. These are some major issues that the banks are constrained to deal with in pursuing the developmental agenda. To enable the development plan to move, the financial system had to be altered to behave not on its own interest.

Nationalizing Banks. The mobilization, regulation and allocation of the capital to finance this ambitious industrial plan were of utmost importance that the Ministry of Finance was a key ministry in Park's economic revolution. It was tasked to regulate domestic financial institutions, to ensure a steady flow of capital at relatively stable and low interest rates, to control foreign exchange inflows and outflows, and to oversee the collection of taxes and tariffs in ways that would support the country's national development objectives. The policies of the Ministry of Finance were based on the traditional state-guided, bank based financial system insulated from international markets through tight capital controls.²⁸ Park Chung Hee nationalized banks in 1961. On the grounds that bank shares were illegally hoarded properties, the government repossessed the stocks of commercial banks that were held by large shareholders in October 1961. Under the Temporary Act on Bank Administration, the voting interest of a stockholder was limited to no more than 10% of the total shares despite the shareholders real holdings. In effect, the state became the dominant stockholder and had absolute control over banks. The state appointed its senior officers and issued directives on banking operations²⁹ and budgets of these banks were prepared with the consent and approval of the finance minister.³⁰

Legal structures were necessary to rationalize and justify its control. The economic and legal advisers of the Park administration created a legal framework governing the behaviours of banks which were then required to act in coordination with a "dynamic" industrial strategy. The banking system was streamlined to cut down time-consuming bureaucratic deliberations in formulating policy. In May 1962, the Bank of Korea Act was

²⁸ Crotty, J., Lee, K. "Is Financial Liberalization Good For Developing Nations? The case of South Korea in the 1990s". *Review of Radical Political Economics* 34(2002) 327-334. Economics Department, University of Massachusetts, Amherst, MA 01003, USA. www.elsevier.com/locate/revra.

²⁹ Cho, L.J. & Kim, Y.H.eds. Park, Yung Chul "Economic Development in the Republic of Korea", p.46

³⁰ Cho, L.J. & Kim, Y.H.eds. Kim, P.J., p.280

amended to confine or downgrade the powers of the monetary board from its function from policy deliberation to policy management discussion.

The monetary board's membership was expanded to 9 with two more appointed members. The powers of the finance minister has been augmented where he could request the board to reconsider a resolution previously passed. If it was overruled by the board with a 2/3 majority, the final decision would be made at a cabinet meeting, at which the minister's view would be ensured a hearing. But the process of appointing the governor of the Bank of Korea and the seven non-ex-officio members was such that the strengthening of the position of the minister in the board was unnecessary. The board was divested of the function of formulating exchange policy; this task was transferred to the finance minister.³¹

These measures were taken by the Park administration to bypass the elaborate and often cumbersome policy debates.

In sum, the role of banks, whether commercial or special, was to be that of credit-rationing outlets (or "windows") at the behest of the government. The stance of banks was a passive one; they simply responded to the directives of the government to extend or withdraw credit to designated firms.³²

With the economy on export overdrive, the current staff and facilities of the Bank of Korea were not enough to cope with the demands of foreign exchange transactions. It was necessary to expand the capabilities of the bank to coordinate the monitor multiple foreign exchange requests of various institutions and customers that had foreign exchange transactions. For this reason, the Korea Exchange Bank (KEB) was established in 1967 to support firms with their foreign exchange transactions. The KEB's stock was wholly owned by the Bank of Korea.³³ and it also operated (and had shares) in the EXIM bank. With this tight relationship with the BOK and to a higher level the EBP, the BOK could comprehensively monitor the inflows and outflows of foreign exchange transactions. More importantly, it gave direct control over Korea's foreign exchange assets as it played the role of regulating flows to maintain fixed exchange rates, stable interest rates, and essentially stabilizing the economy.

³¹ Cho, L.J. & Kim, Y.H.eds. Kim, P.J., Financial Institutions in "Korea's Political Economy, An Institutional Perspective", p.279

³² Cho, L.J. & Kim, Y.H.eds. Kim, P.J., "Korea's Political Economy, An Institutional Perspective" p.280

³³ Cho, L.J. & Kim, Y.H.eds. Park, YC., The Development of Financial Institutions in "Economic Development in the Republic of Korea" p.49

With the EPB as the main control hub for all the economic activities in South Korea, the Korea Exchange Bank and the Bank of Korea were key in maintaining the foreign exchange position for EPB activities. Plans and priorities of the planning board were only as good as the resources that were channeled to it, and it is in this situation where these banks consolidated all their efforts to assure that there was enough foreign exchange to fuel the EPB's activities. This relationship had proven to be very effective especially in 1972 and 1973 where large ticket purchases were made by firms in support of the HCI and the succeeding deficits brought about by the oil crisis in 1973. They maintained the economy's stability. These closely coordinated agencies were the unsung heroes during the HCI during these tumultuous times.

The Export-Import Bank of Korea was created to provide support and promote the exports of HCI products.³⁴ The bank provided credit for medium and long term export import transactions; investment overseas such as natural resource development products abroad (as raw materials); the underwriting of export insurance for domestic corporations and foreign institutions; and extend credit to foreign buyers for importing capital goods and technical services from Korea.³⁵ Established in 1969, the EXIM bank was funded by the Bank of Korea, NIF and the Korea Exchange Bank. The operations of the EXIM bank were handled by Korean Exchange Bank for 7 years.

In the earlier phases of the industrialization drive, the Korean Development Bank (KDB) was the main provider of capital. The KDB was founded in 1954 to provide long-term credit to key industries. In 1962 the bank was reoriented to finance the first FYP. In 1967, KDB increased its capital base with the government directing commercial banks to finance long-term policy loans, deposit their funds into the KDB, purchase long-term bonds issued by the KDB, and to extend credit to firms with loan guarantees from the KDB.³⁶

³⁴ Cho, L.J. & Kim, Y.H.eds. Park, YC., The Development of Financial Institutions in "Economic Development in the Republic of Korea" p.51

³⁵ Cho, L.J. & Kim, Y.H.eds. Kim, P.J., Financial Institutions in "Korea's Political Economy, An Institutional Perspective", p.281

³⁶ Cho, Y.J., Kim, J.K. "Credit Policies And the Industrialization of Korea", p.31

With the KDB and EXIM bank acting as intermediaries, the National Investment Fund (NIF) was created to channel capital to the HCI drive during the third FYP. The NIF sourced its funds from³⁷–

1. Proceeds from the sales of NIF funds
2. Contributions in the form of deposits made by the deposit money banks (exclusive of foreign bank branches and fisheries cooperatives), members of the National Savings Association, money in trust, insurance premiums of nonlife insurance companies, and various public funds managed by the central and local governments and other public entities; and
3. Transfers (or deposits) from various government budgetary accounts.

As for the contributions, the deposit money banks were required to deposit 15 percent of the increase in their savings deposit at the NIF and the nonlife insurance companies had to deposit 50% of their insurance premiums and other revenues.

The NIF was a facility that made it profitable for depositors and borrowers to bank with them even if the fund was losing at the state's expense. A regular bank operates on the premise that depositors provide capital to banks at an interest rate much lower than rate it is loaned out where banks profit from the difference of the higher loan rate and the deposit rate. It was the reverse for NIF loans—banks paid the difference. NIF loans were provided to exporters at subsidized rates of 6% up to 16% for loans to HCI firms having three to eight year maturities (1978). While interest rates on deposits were 6% for three-month deposits and 18.6% for one year and over. The losses incurred by the difference (2.6%) between the loan rate and the deposit rate were compensated for by the government.

³⁷ Cho, L.J. & Kim, Y.H.eds. Park, YC., The Development of Financial Institutions in "Economic Development in the Republic of Korea" p.52–53

TABLE 2A Financial Institutions and Market in South Korea

FINANCIAL INSTITUTIONS	
*Central Bank	Bank of Korea
Deposit Money Bank (DMB)	*Commercial Banks (1961)
	<ul style="list-style-type: none"> • City Banks • Local Banks • Foreign Commercial Banks
	*Specialized Banks
	<ul style="list-style-type: none"> • Korea Exchange Bank (1967)
	<ul style="list-style-type: none"> • Medium Industry Bank (1961)
	<ul style="list-style-type: none"> • Korean Housing Bank (1967)
	<ul style="list-style-type: none"> • Credit and Banking Section of the National Agricultural Cooperatives Foundation (1961)
	<ul style="list-style-type: none"> • Credit and Banking Section of the National Federation of Fisheries Cooperatives (1962)
Non-Bank Institutions	Development Institutions
	<ul style="list-style-type: none"> • *Korea Development Bank (1954)
	<ul style="list-style-type: none"> • *Korea Export Import Bank (1964)
	<ul style="list-style-type: none"> • Korea Long Term Credit Bank (1980)
	Savings Institutions
	<ul style="list-style-type: none"> • Trust Business
	<ul style="list-style-type: none"> • Mutual Savings Companies
	<ul style="list-style-type: none"> • Credit Unions
	Insurance Sector
FINANCIAL MARKET	Investment Companies
	<ul style="list-style-type: none"> • Investment and Finance Companies
	<ul style="list-style-type: none"> • Merchant Banks
	<ul style="list-style-type: none"> • Investment Trusts
	<ul style="list-style-type: none"> • Korean Security Finance Corporation
	<ul style="list-style-type: none"> • Kye Market
	<ul style="list-style-type: none"> • Curb Market

* – Controlled by the Park Government

Watanabe, Toshio. Kankoku Keizai (The Korean Economy. (In Japanese) Tokyo, 1990. Cited in Machi p. 85a

Fixed exchange rates. Park was faced with the daunting task of replenishing foreign exchange. The policy of an overvalued currency was a “spillover” from Rhee’s previous ISI strategy. The previous regime was not resolute in enforcing trade restrictions—other non-essential items were imported as well. Park had to curb this problem because it increased foreign exchange outflows. This policy was working against preserving foreign exchange despite its good intentions of encouraging firms to import capital goods. At this period, a policy arrangement was made by the state to increase foreign exchange by creating a link between foreign exchange and its export—that is, firms were only entitled to use foreign exchange corresponding to the amount of foreign exchange they earned through exports to a particular country.³⁸

This particular policy also created multiple exchange rates because the foreign exchange earned from exports could only be used to purchase items from countries the foreign exchange came from. As an example, foreign exchange export proceeds from Japan were more expensive in comparison to the free-market foreign exchange rate because Japan traded a lot with Korea. Moreover, US dollars received from assistance were allocated by a system of foreign exchange bidding, or other methods that increased the exchange rate higher than the official level.³⁹ Foreign exchange was difficult to preserve despite measures to control outflows because imports of essential capital goods and commodities have risen to fuel Park’s export agenda.

A bigger issue was at hand as previously noted—foreign assistance started to dwindle at this time. The steady outflow of foreign exchange had to be controlled, especially when the taps of foreign assistance were slowing down to a trickle. The system of multiple exchange rates was becoming more complex and “esoteric” that the differential rates were creating unnecessary inflated costs for firms as they acquired foreign exchange. Between 1964 to 1965, the Park administration put forth an exchange rate reform that devalued the currency from 130 won to a US dollar to 256 won. This effort recalibrated and re-focused firms to export their products. The system of multiple exchange rates was also gradually phased out. The government also announced more tariffs and indirect taxes on non-essential imports to resolve the indiscriminate import of

³⁸ Cho, L.J. & Kim, Y.H.eds. Kim, Kwang Suk, The 1964–65 Exchange Rate Reform, Export Promotion Measures, and Import Liberalization Program, “Economic Development in the Republic of Korea”. p.103

³⁹ Cho, L.J. & Kim, Y.H.eds. Kim, Kwang Suk. p.103

unnecessary items. These reforms increased the exports of Korea while imports declined.

The government announced an exchange rate system that enabled the Ministry of Finance and the central bank to contain the amount of foreign exchange in the domestic market. Kwang Suk Kim documents the policies⁴⁰ of exchange rate reforms–

- “All foreign exchange earned by exporting and by sales to United Nations forces in Korea were supposed to be converted into foreign exchange certificates to be issued by foreign exchange banks (except in cases of amounts less than US 50 dollars). The foreign exchange certificates were to be effective for 45 days after the date of issuance, and could be freely transacted on exchange markets during the period. When the certificates expired, they were to be surrendered to the exchange bank for conversion into domestic currency.”
- “All those who required foreign exchange for imports, including imports financed by USAID (but excluding PL 480 funds⁴¹), were to submit exchange certificates at the time of issuance of import licenses by the exchange banks.”
- “The Bank of Korea was to announce the daily foreign exchange buying and selling rates of both the central bank and the foreign exchange banks on the basis of free-market prices on certificates during the previous day.”
- “The foreign exchange department of each commercial bank was to play an exchange bank role by buying and selling the exchange certificates.”
- “The Bank of Korea was given the right to intervene in the exchange market for prevention of any large fluctuations in exchange certificate prices that could result from seasonal and speculative factors.”

The Ministry of Finance and the Bank of Korea were effectively able to contain the amount of foreign exchange by controlling the amount of foreign exchange certificates in circulation in the local economy. More importantly the system of issuing certificates of foreign exchange enabled the government to monitor and control the amount of foreign exchange on reserve, and in effect, fixed the exchange rate.

⁴⁰ Cho, L.J. & Kim, Y.H.eds. Kim, Kwang Suk, The 1964–65 Exchange Rate Reform, Export Promotion Measures, and Import Liberalization Program, “Economic Development in the Republic of Korea”. p.107

⁴¹ U.S. assistance programs also known as “Food for Peace” uses appropriated funds to provide U.S. agricultural assistance to countries at different levels of economic development.

Interest rates. Capital was scarce. Fuelling an industrial agenda with the magnitude of Park's strategy necessitated large sums of capital. The state had to acquire capital both from the local economy and heavily borrow from abroad. The situation was becoming desperate because foreign assistance for industrialization was dwindling. The Park administration was pushed to take proactive measures to muster capital to push export driven industrialization and to do this before reserves ran dry. To beef up savings the government raised the nominal interest rate on (one-year) time deposits from 15% to 30%, and the general loan rate from 16% to 26% in 1965. This "negative margin" between the deposit and loan rates was an incentive for financial saving, without raising the cost of loans to industrial firms.⁴² Loan rate increases were selective⁴³, leaving out export, agricultural and many other categories of investment loans. Loans to exporters hovered at around 6.5%⁴⁴ which eventually re-focused firms to go into exports.

TABLE 2B

Changes in principal interest rates of banking institutions as of September 30, 1965 (%) per annum		
	Old rate	New rate*
DEPOSITS		
Time Deposits		
> 3 month maturity	9	18
> 6 month maturity	12	24
> 12 month maturity	15	26.4
> 18 month maturity		30
Notice Deposits	3.65	5
Savings Deposits	3.6	7.2
Installment savings deposits	10	30
Passbook deposits	1.8	1.8
Demand deposits	0	0
LOANS		
Discount on commercial bills	14	24
Loans on other bills (unspecified)	15	26
Overdraft	18.5	26
Overdue loans	20	36.5
Call loans	12	22
Credits for exports and supply of goods to US armed forces**	6.5	6.5

Source: BOK, Economic Statistics Yearbook (1967) Cited in Cho and Kim (eds.) Economic Development in the Republic of Korea. P. 141

*indicates the rates agreed by the Korean bankers association

** In the case of unperformed export or supply of US offshore procurement, the rate on other bills is applied.

From 1966 to 1969, deposits and loans rapidly increased at annual rates of 72.5% and 26.5% respectively. Real GNP increased at the average annual rate of 12% during the same period. The stock of M2 relative to GNP increased from 8.9% in 1964 to 31.8% in

⁴² Cho, Y.J., Kim, J.K. "Credit Policies And the Industrialization of Korea", p.33

⁴³ Amsden, A (1989). Asia's next giant: South Korea and Late Industrialization.p.74

⁴⁴ Cho, Y.J., Kim, J.K. p.33

1971. The annual growth rate of bank loans rose from 10.9% during 1963–64 to 61.5% during 1965–69 signifying an increase in investment. Meanwhile inflation was running at the average annual rate of 3.5%, in comparison to 17.5% in the preceding 5 years.⁴⁵

The policy was designed to reduce inflation and channeled financial resources from curb markets to commercial banks, which in turn augmented the financial resources the government could allocate as strategic loans. More importantly, the reform helped shift funds from the unregulated informal sector to the state controlled banking sector. Essentially, the 1965 interest rate reform increased the scope of government control over investible savings.

The Korean government preferred to have capital inflow in the form of loans rather than equity shares to minimize ownership and control of businesses.⁴⁶

TABLE 2C

Foreign Loans and Investment, 1959-1983 (in million USD)				
	Loans (I)		Direct Foreign Investment (II)	Total III=I+II
	Public	Commercial		
1959-1961	4.4	-	-	4.4
1962-1966	115.6	175.6	16.7	307.9
% of total	37.5	57	5.4	
1967-1971	81.8	1354.7	96.4	2261.8
% of total	35.8	59.9	4.3	
1972-1976	2388.9	3043.9	556	5988.8
% of total	39.9	50.8	9.3	
1977-1979	2529.5	4793.7	328.8	7652
% of total	33.1	62.6	4.3	
1980-1983	6246.5	4434.1	404.1	11084.7
% of total	56.4	40	3.6	

Source: Economic Planning Board, Handbook of the Korean Economy, 1983, as quoted by Y.C. Park (1985)

Cited in Amsden, p.92

⁴⁵ Cho, L.J. & Kim, Y.H.eds. Kim, P.J., "Korea's Political Economy, An Institutional Perspective"p.281

⁴⁶ Cho, L.J. & Kim, Y.H.eds. Park, Yung Chul "Economic Development in the Republic of Korea", p.47

Acting as gatekeeper, the state institutionalized a stringent bureaucratic process to obtain a foreign loan. Loans first had to receive the endorsement of the Economic Planning Board, which in turn required the authorization of the National Assembly for the provision of a guarantee covering repayment of foreign borrowings. Once the guarantee had been authorized, The Bank of Korea issued the guarantee to the foreign lender while the commercial banks issued the guarantee to the bank of Korea. Creditors had very favourable lending guarantees and conditions because the loan was backed by the Bank of Korea, and the commercial bank.⁴⁷ Moreover, the Park Administration created the Foreign Capital Inducement Law in 1962—that is, a law that had provisions and guarantees to eliminate the risks of default and exchange rate depreciation to lessen the risk on foreign creditors.

The interest rate increases in Korea attracted funds from abroad. Interest rates during this period were generally much higher than the world interest rate that the difference ranged from 4.4% to 18% during 1965–70. Foreign capital poured into the economy that investment as a share of GNP rose from 15% in 1965 to 30% in 1969.⁴⁸ The state chose to fill any gap between domestic savings and investment through foreign borrowings rather than encouraging competition and liberalization of the domestic financial system.⁴⁹ The investment requirements for the industrialization program in the 70s hovered at an average of 30% of GNP. Savings that were generated in the bank only amounted an average of 20% of GNP. The shortfall was of 10% was funded by foreign debt with government guarantees.⁵⁰ Foreign capital—in the form of loans mostly from Japan and the United States—played a very important part in the development of industry in Korea. A study conducted by the World Bank concluded that the GNP would have grown only by 4.9% from 1962 to 1982 without foreign capital instead of the actual 8.2%.

⁴⁷ Cho, L.J. & Kim, Y.H.eds. Park, Yung Chul “Economic Development in the Republic of Korea p.47–48 (also Haggard, Lee, Maxfield)

⁴⁸ Amsden, A., *Asia’s next giant: South Korea and Late Industrialization*. 1989 p.94

⁴⁹ Kwon, Jene (ed)., Yoon Je Cho., *Financial Policy in Korea and Taiwan.*, in “Korean Economic Development” Greenwood Press., NY. 1990., P.227

⁵⁰ Woo, Jung-en (Meredith Woo Cummings)., “Race to the Swift”., p.151

TABLE 2D

Growth effect of Foreign Capital					
	1962-66	1967-71	1972-76	1977-82	Average 1962-1982
GNP growth rate (A)	7.9	9.7	10.2	5.6	8.2
Incremental Capital Output Ratio*	2.3	3.1	3.4	5	3.4
GNP growth rate without foreign savings (B)	3.8	4.9	6.9	4.1	4.9
Growth effect of Foreign Capital (A-B)	4.1	4.8	3.3	1.5	3.3

Source: Economic Planning Board, "White Book on External Debts" Cited in Cho and Kim, World Bank Discussion Papers 286, p.76

GNP is calculated at 1975 constant prices

*Incremental Capital Output Ratio measures the additional capital required to generate an additional unit of output. Total capital includes domestic gross fixed formation, increases in inventories, and statistical discrepancy.

The Park administration needed the assurance of a steady supply of capital for extended periods of time since the industrialization project spanned several years. With this in mind, the Ministry of Finance was very circumspect in selecting the type of loans for the needs of the economy. Long-term loans were the favored instrument, that throughout the entire duration of Park's administration, the average amount of **long-term debt** as a portion of Korea's total external debt was **85%**.

TABLE 2E

External Debt and Debt Service					
Year	Total Foreign Debt (million USD)	Long-Term Debt as % of Total	Total Debt as % of GNP	Debt Service as % of GNP	Debt Service as % of Exports ^a
1963-1971					
1963	157	85.99	4.06	0.05	2.3
1964	177	94.35	5.29	0.15	4.17
1965	206	98.54	6.81	0.46	8
1966	392	98.21	10.26	0.34	5.2
1967	645	89.77	13.62	0.72	10.15
1968	1199	92.58	20.07	0.77	9.47
1969	1800	89.22	24.07	1.2	13.68
1970	2245	83.39	25.48	2.84	28.34
1971	2922	83.61	30.06	3.28	28.16
1972-1978					
1972	3589	82.17	33.95	3.87	24.4
1973	4260	83.54	31.55	4.35	17.87
1974	5937	79.13	32.01	3.25	13.33
1975	8456	71.51	40.55	3.38	14.01
1976	10533	71.09	36.73	3.5	12.85
1977	12648	70.63	33.79	3.58	13.33
1978	14871	74.08	29.71	4.16	16.38
1979-1982					
1979	20500	67.8	31.75	4.03	17.68
1980	27365	61.22	44.68	4.81	17.13
1981	32490	63.8	48.34	5.53	17.98
1982	37295	61.94	52.65	6.23	21.15
1983	40094	70.58	53.23	6.18	20.07
1984	43100	73.55	53.16	6.74	20.75

GNP Gross national product

^aMerchandise exports

Sources: Bank of Korea and Economic Planning Board

Cited in Amsden p.95

Competition for Loans. The dynamics of loan allocation to specific industries are competitive. The Korean government conducted a stringent performance-based appraisal of companies to qualify for loans at preferential rates. "Exports, and especially manufactured, nontraditional exports, were the yardstick against which the success of other allocation decisions—for example, credit allocation, domestic content requirements, and industrial licensing—were judged".⁵¹ The state assessed their performance, and demanded success from the companies. When targets were not met, funding was withdrawn forcing them to close-shop or open themselves for a buy-out to other industries who were plying a similar trade.

⁵¹ World Bank., *The East Asian Miracle Economic Growth and Public Policy*. Oxford University Press., 1993 N.Y. p.97

State directed mergers were regular fare in Korea. Besides absorbing firms that did not perform up to par, state directed mergers were also meant to curb excessive competition. Excessive competition can lead to a duplication of investments and hence an abundance of similar products in the market that create price wars. As a result, economies of scale are not immediately reached due to too many firms participating in each industry.⁵² To illustrate, among the eight companies in the heavy electrical machinery industry, three companies (Hyosung, Ssangyong, Kolon) were merged into one (Hyosung) and were allowed to produce specialized products in the late 60s and early 70s. Two Korean copper smelting companies were merged by forcing one to buy the other's equity through the equity participation of the state owned Korean Development Bank. They were also given a moratorium on bank loans repayment. In some cases companies were merged into one and nationalized by the government primarily because it was very difficult for any single firm to make it profitable. This was the case of four power-generating companies that were merged to form the Korea Heavy Industries and Construction Co. (KHIC). KHIC's debts were rolled over by the government and boosted its activities by giving monopoly rights to produce power-generation components and heavy construction equipment.⁵³ Kia, one of three car manufacturers in Korea was asked to exit the car industry to focus its resources on creating a line of buses and trucks with the assurance that it would come back to the car manufacturing business when the car market demand was much higher.⁵⁴ These are a few examples that illustrate the fact that the state was very much in control of industry behavior that it had autonomy and flexibility to maneuver various elements in the economy. These measures executed by the state would have invited anti-trust lawsuits and corruption charges against the government if they were done in the West.

Korean firms that conformed to the government's development priorities were privileged to borrow from a commercial bank in amounts in excess of the firm's net worth—this practice is not traditional in western banks (see Selected financial ratios in the manufacturing industry: 1963–78). Generally, banks do not lend more than the entire firm's worth. Loans—especially to targeted firms—however were guaranteed by the

⁵² Lal, D, "The Poverty of Development Economics", London, Institute of Economic Affairs. P.222 found in Chang H.J., "The Political Economy of Industrial Policy in Korea " Cambridge Journal of Economics 1993, 17. p.140

⁵³ Far Eastern Economic Review, June 2 1983, p.67–8 found in Chang H.J., "The Political Economy of Industrial Policy in Korea " Cambridge Journal of Economics 1993, 17. p.148

⁵⁴ Chang H.J., "The Political Economy of Industrial Policy in Korea " Cambridge Journal of Economics 1993, 17. p.148

central bank since the financial system was controlled by the state. The Bank of Korea was the ultimate guarantor of the financing system where the minister of finance served as chairman of the Monetary Board. Risks were significantly lower even if they were highly leveraged.

Entry barriers into heavy industries like steel were high because it was capital intensive. Directed credit was one of the state's incentive and instruments to engage local business to establish key capital industries that were essential to the industrial plan. Preferential loans for exports became an important instrument of export promotion in 1963. The interest on export credit was incrementally reduced from 14% in 1961 to 8% for key firms in 1963 while other loan rates remained at the 14% level.⁵⁵ Korea used directed credit during its economic takeoff in the 1960s and 70s mostly used to make investments in equipment.⁵⁶

TABLE 2F

Export loans by deposit money banks (DMB)					
	1961-65	1966-72	1973-81	1982-86	1987-91
Export loans by DMB/ total loans DMB	4.5	7.6	13.3	10.2	3.1
Export loans by DMB/ total policy loans DMB	NA	NA	20.4	16.5	4.5
Export loans by BOK/export loans by DMB	NA	66.3	73	64.5	45.3
Export loan interest rate (A)	9.3	6.1	9.7	10	10.0-11.0
General loan interest rate (B)	18.2	23.2	17.3	10-11.5	10-11.5
B-A	8.9	17.1	7.6	0-1.5	0-5

Source: Bank of Korea, "Economics and Statistics Yearbook". Cited in Cho and Kim, World Bank Discussion Papers 286, p.32

Lowering interest rates was not only a means to nurture firms but a means for control. The state effectively intervened in the strategy of these industries now that Chaebol industries were highly leveraged. The state had an influence in their directions since Chaebols received capital mostly from the state. Key industries that sourced policy loans from the government placed themselves in a bind.

⁵⁵ Cho, L.J. & Kim, Y.H.eds. Kwang, SK, "Economic Development in the Republic of Korea p.101

⁵⁶ World Bank., The East Asian Miracle Economic Growth and Public Policy. Oxford University Press., 1993 N.Y p.289

Minimizing information asymmetry. The Korean state was deeply involved in the affairs of the firm where it constantly tried to close the information feedback loop between industries, the market and policy makers. Market failures due to information deficiencies were a primary concern of the economic planners, so effective strategies and monitoring systems were put in place to minimize imperfect information. Institutional arrangements such as monthly export promotion meetings and monthly briefings on economic trends, were venues for close consultation. This meeting was the key to pre-empt and coordinate the operations of government agencies, leaders, and managers of firms. CEOs and captains of industry expressed their views about markets, regulations, and potential plans. Park Chung Hee himself presided over these meetings and instructed specific ministers to attend to each important issue and provided progress reports of their assigned tasks in subsequent meetings.⁵⁷ Key firms were carefully studied by the government and made pragmatic adjustments based on the current issues in international trade and finance. These meetings were supplemented by government-initiated discussion groups involving company managers, middle-level government officials, experts or scholars. Information necessary for loan allocation was obtained in this venue. They monitored performance closely, and relied on a competitive business environment to provide an objective measure of performance. Enforcement of government goals—primarily the imperative to export—was achieved by rewarding successful firms with continued credit support while reducing credit to less successful firms.⁵⁸

Maintaining stability. The progressive mounting of debt became a cause of concern for the WB and IMF. It was observed that the state investment in the operation of public-sector enterprises have tended to outstrip savings. The government spent far more than it collected that it borrowed its way out of balance-of-payments difficulties to sustain its fast growth.⁵⁹

⁵⁷ World Bank. p.183

⁵⁸ World Bank. p.286–287

⁵⁹ Amsden, A., *Asia's next giant: South Korea and Late Industrialization*. 1989. p.90

TABLE 2G

Sources of Current Account Imbalances in Current Market Prices, 1963-1982 (in billion won)						
Year	Private Sector (A) ^a	Government (B) ^a	Public Sector Government Invested Corporations (C) ^a	Subtotal (D=B+C)	A/GNP (%)	D/GNP (%)
1963-1971						
1963	-11.67	14.34	-16.06	-2.02	-2.4	-0.4
1964	-3.39	23.26	-13.79	9.47	-0.5	1.3
1965	-27.88	36.49	-16.15	20.34	-3.5	2.5
1966	-65.2	38.82	-15.14	23.68	-6.3	2.3
1967	-70.89	51.26	-54.39	-3.13	-5.5	-0.2
1968	-136.63	57.03	-36.19	20.84	-8.3	1.3
1969	-110.8	29.98	-63.73	-33.75	-5.1	-1.6
1970	-195.55	60.91	-63.12	-2.21	-7.3	-0.1
1971	-179.19	42.81	-130.13	-87.5	-5.4	-2.7
1972-1978						
1972	35.8	-9.16	-200.51	-209.67	0.9	-5.2
1973	51.31	24.86	-107.94	-83.08	1	-1.6
1974	-422.54	-36.09	-223.5	-259.59	-5.8	-3.5
1975	-337.19	-129.29	-482.24	-611.53	-3.4	-6.2
1976	-20.73	329.49	-455.95	-126.46	0.2	-1
1977	472.45	18.08	-749.27	-731.19	2.8	-4.3
1978	-281.57	448.27	-1031.84	-583.57	-1.2	-2.5
1979-1982						
1979	-1675.45	493.31	-1170.45	-677.14	-5.8	-2.3
1980	-2381.04	20.81	-1344.91	-1324.1	-6.9	-3.9
1981	-1513.67	5.89	-1869.06	-1863.17	-3.6	-4.4
1982	489.47	-124.05	-2260.19	-2384.24	1	-5

^a A,B and C refer to balance after investment from savings is subtracted from each sector.

Source: Bank of Korea, Economic and Statistics Yearbook, various years, as cited by Y.C. Park, 1985.

Figures for savings and investment of government-invested corporations, which include nonfinancial operations of Federations of Agricultural and Fisheries Cooperatives, obtained from BANK of Korea's flow of funds tables.

Cited in Amsden p.91

Massive expenditures on infrastructure, capital equipment and raw materials blew up its external debt from US \$1199 Million in 1968 to \$ 2922 million in 1971.⁶⁰

The IMF was quick to react. In a standby agreement, the IMF required the Korean government to issue a letter of intent to limit foreign capital movements to one to three year loans.⁶¹ This starved the firms of much needed capital. Investments fell and exports slowed down with an average growth rate of 36% from 1968-1969 to 27% from 1971-1972. Moreover, the growth rate of GNP fell from 13.8% in 1969 to 7.6% in 1970. The policy recommendation of the IMF agreement slowed the economy down.⁶²

⁶⁰ Amsden, A.. p.90-96

⁶¹ Amsden, p.96

⁶² Amsden, A., Asia's next giant: South Korea and Late Industrialization. 1989.p.96

The Park administration took urgent measures to avert the effects of the IMF policy. To push exports, the Park administration again devalued its currency lower from an average of 228.22 from 1961 to 1970 to a peg of 400 Won to a US dollar. The devaluation of the currency adversely impacted on the foreign denominated debts of firms. Interest costs on foreign loans became more expensive and was bound to make heavily indebted firms struggle and even go bankrupt. Their debt rose to as almost 400% of their equity in 1971. Profit slowly began to lag and dropped at an increasing rate between 1968 and 1972. Similarly interest expenses also have increased at an increasing rate since 1968 that firms relied on other financial instruments and securities.

TABLE 2H

Selected financial ratios in the manufacturing industry: '63-'78				
Year	Debt/Equity Ratio	Interest Expenses/net sales Ratio	Net Profit/Net Sales Ratio	Securities in corporate investment financing (%)
1963	92.2	3	9.1	14.8
1964	100.5	4.9	8.6	11.7
1965	83.7	3.9	7.9	9.3
1966	117.7	5.7	7.7	8.1
1967	151.2	5.2	6.7	3.5
1968	201.3	5.9	6	6.4
1969	270	7.8	4.3	11.5
1970	328.4	9.2	3.3	14.9
1971	394.2	9.9	1.2	15.1
1972	313.4	7.1	3.9	19.5
1973	272.7	4.6	7.5	21.5
1974	316	4.5	4.8	8.2
1975	339.5	4.9	3.4	12.2
1976	364.6	4.9	3.9	16
1977	350.7	4.9	3.5	17.7
1978	366.8	4.9	4	30.8

Sources: Bank of Korea, Financial Statements Analysis (1981); BOK Flow of Funds Accounts (1980) Found in Cho, L.J. & Kim, Y.H.eds. Park, Yung Chul "Economic Development in the Republic of Korea", East West Center., Hawaii., 1991 p.164

Influential business associations reacted. The Federation of Korean Industries called for a meeting with President Park to impart their ideas on how to deal with bankrupt firms in the latter part of 1971.⁶³ In August 3, 1972 an executive order known as the Emergency Decree Concerning Economic Stability was issued freezing the payment of debts and the reversal to a low interest rate policy. Interest rates were lowered to stimulate investment and to relieve firms from their debt burdens. The time deposit

⁶³ Lee, C.H., Lee, Keun, Lee, Kangkoo. "Chaebol, Financial Liberalization, and Economic Crisis". Institute of Economic Research, Seoul National University in its series Working Paper Series no 31. March, 2000, p.5

rate was reduced from 17.4% to 12.6%, and one-year loans fell from 19% to 15.5%.⁶⁴ The state also placed a moratorium on curb-market loans, stretched (re-structured) commercial bank loans, and provided rationalization funds (and/or bail outs) to assist key industries in improving productivity.⁶⁵ The path taken by the state after this economic downturn was the resurgence of exports and rapidly resumed expansion.

The policy worked and the impact on firms was significant. Interest expenses to net sales ratios that increased to as much as 9.9 in 1971 went down to 4.6 in 1973. Profit ratios as low as 1.2 in 1971 increased to 7.5 in 1973. By 1973 the Korean economy had regained its momentum GNP increased up to 14.1% and more importantly, exports surged to as much as 73% (see basic macro indicators).⁶⁶

In late 1973, Korea faced another economic obstacle just when the economy was fighting its way out of the hole. The onset of the HCI plan was hit by the oil crisis. This was certain to increase foreign borrowing again because 60% of the country's energy requirements were dependent on imported oil. Importing oil meant a rapid depletion of the hard-earned capital the economy reaped from the previous year. A policy decision was made in January 1974 to move on with the industrialization agenda and absorb the costs of the oil price increase—after long deliberations on dealing with this imminent issue. The administration encouraged exports, devalued its currency, continued the campaign for foreign loans and borrowed its way out of a deficit.⁶⁷ With this decision, the state's import bill rose by 62% (EPB 1984)⁶⁸. Such measures slowly depleted whatever foreign exchange was left. The current account deficit jumped by a factor of 5 to 11% of GNP despite a 16% growth in exports in 1974. More importantly, the state funded its import bill and other expenditures with foreign debt. Between 1973 and 1974, Korea's foreign debt increased. The total debt as percent of GNP rose from 32% in 1974 to 40% in 1975 (see External debt and debt service table). Korea needed to borrow more capital. The state dispatched a mission of finance executives to banks in New York, London and Tokyo to convince foreign bankers of the growth potential and credit-worthiness of the Korean economy.⁶⁹

⁶⁴ Amsden, A., *Asia's next giant: South Korea and Late Industrialization*. 1989.p.96

⁶⁵ Cho, L.J. & Kim, Y.H.eds. Park, Yung Chul "Economic Development in the Republic of Korea", p.165

⁶⁶ Amsden, A., *Asia's next giant: South Korea and Late Industrialization*. 1989. p.96

⁶⁷ Woo, Jung-en (Meredith Woo Cummings). "Race to the Swift", p.181

⁶⁸ Amsden, A., *Asia's next giant: South Korea and Late Industrialization*. 1989.p.98

⁶⁹ Cho, L.J. & Kim, Y.H.eds. Yoon Hung Kim, "Economic Development in the Republic of Korea", p.186

The state's persistence in pursuing the industrial agenda proved to be very beneficial despite the dangers of running down its foreign exchange and borrowing heavily. The devaluation of the won in the 1970s made exports extremely competitive in the global market. The economy pushed on with a positive growth of 7.7% of GNP in 1974 and 6.9% in 1975—at a time when most other non-oil-producing countries were plunged into depression. By 1976 fast growth had resumed, and GNP grew by 14.1%. Exports grew by 49.2% despite a decline in investment.⁷⁰ (see basic macro indicators)

TABLE 21

Basic Macro Indicators, 1962-1984						
Year	GNP Growth Rate (%)	Change in GNP Deflator	Export Growth Rate ^a	Export Growth Rate ^b	Real Effective Exchange Rate ^c	Ratio, Current Account/GNP
1962	2.2	13.5	31.7	31	112	-2
1963	9.1	28.3	61.1	61.6	134.4	-3.7
1964	9.6	30	37.9	37.6	106.3	-0.8
1965	5.8	6.3	45.8	43	91.6	0.3
1966	12.7	14.2	42.9	38.3	96.1	-2.7
1967	6.6	15.8	34	33.7	107.9	-4.1
1968	11.3	15.9	45.1	41.5	115.2	-7.4
1969	13.8	14.6	35.4	30.3	120.1	-7.3
1970	7.6	15.7	34	29.3	124.2	-7.1
1971	8.8	13.4	28.5	24.3	120.7	-8.7
1972	5.7	16.4	47.9	41.7	109.4	-3.5
1973	14.1	13.4	95.9	73.2	92.4	-2.3
1974	7.7	29.5	37.5	15.7	93.6	-10.9
1975	6.9	25.8	10.8	1.4	93.5	-9
1976	14.1	20.5	56.2	49.2	103.4	-1.1
1977	12.7	15.8	28.6	21.1	103.9	0
1978	9.7	21.9	26.5	17.4	101	-2.2
1979	6.5	21.1	15.7	2.8	110.7	-6.4
1980	-5.2	25.6	17.1	2.6	100	-8.7
1981	6.2	15.9	20.1	10	103.1	-6.9
1982	5.6	7.1	1	-1	106.9	-3.7
1983	9.5	3	11.1	9.8	100.2	-2.1
1984	7.6	4	13.5	10.9	97.8	-1.7

a-GNP, Gross national product; NA, not available. In nominal US dollars

b-Export Value deflated by US wholesale price index

c-1980=100

Sources: Bank of Korea and IMF

Cited in Amsden, p. 56

Park borrowed its way out of the deficit in 1975. There are many opinions as to why the US and Japan lent large sums to South Korea. The security of the Asian region went hand in hand with economic lending to favored states. South Korea was strategic to secure US hegemony over the Asian region. With the threat of the North Korean politik, the United States was obligated to sustain the economic capacities of South Korea to resist this ideological and military incursion. It was also in Japan's interest to keep the Korean

⁷⁰ Amsden, A. p.99

economy afloat. Besides trade, South Korea was Japan's point man in establishing regional security. Unlike Japan, South Korea was the launch pad for US tactical nuclear warheads. A large portion of the US armed forces was also deployed in South Korea to stave off any threats Asiawide.

It was with this reason—with the expressed support of the US government—that US and Japanese banks liberally lent capital to South Korea despite US estimates that South Korea was bound to falter during the oil price increases. It was considered by those in the banking circles as the most likely nation to default (Wall Street Journal February 14, 1975). Even the Morgan Guaranty Bank of New York reported that it had “absolutely no confidence in Korea's balance of payment position”. However, the rhetoric did not stop the bank from being the syndicate leader for loans to Korea.⁷¹ In 1975, 80% of total outstanding loans to South Korea were from American Banks. Likewise, the Bank of Tokyo lent 53.7 million dollars.

TABLE 2J
Foreign Banks With Credit Outstanding in Korea,
August 1975, In Millions USD

Chase Manhattan	298.4
First National City of New York	272.8
Manhattan Trust	257.4
Bankers Trust	226.6
Chemical Bank	126.0
Fidelity of Philadelphia	61.1
Irving Trust	36.4
Girard Bank of Philadelphia	30.0

Source: The New York Times, November 21, 1975, Cited in Woo p.157

Top US banks were highly (and most) exposed in South Korea, that any threat to their debt exposures would create economic disorder in the US economy. Arguably, bankers were lending to South Korea for increased returns—bigger stakes meant bigger gains. Banks continued to pour loans into its economy though firms that were highly leveraged. It was the popular perception that it was in the interest of the United States to secure its loan exposures by buoying Korea's developmental state so that US banks

⁷¹ Woo, Jung-en (Meredith Woo Cummings). “Race to the Swift”, p.156–157

with large exposures would not be subject to risks that would adversely impact the US economy.⁷²

Park's Industrial Push. It appears that Park's leadership was a major factor that made Korea bankable despite the rhetoric and negative press he was receiving in the global markets. The developmental state was bankable that many other bankers wanted to be a part of the action. As Jung En-Woo wrote...

In 1976 Japanese and European banks had been a mere 12% percent in 1976, but grew to 33% in 1978, then leaped to 70% of total funds provided in 1979. They had entered Korea with ruthless determination, fighting off American competitors through price-cutting and trading profit for a larger market share.⁷³

More importantly,

The country was out of trouble by 1976, having balanced its current account (after inducing a severe recession) several years ahead of the World Bank prediction. In an incredible turnaround that was complete by 1978, Korea even "threatened" to repay (much to the consternation of the bankers about loss of income) the out standing \$114 million from the particularly usurious \$200 million debt negotiated in 1975.⁷⁴

The progress his economic policies created since 1961 was undeniable. His goal was clear—complete the medium of accumulation and all its systemic support mechanisms despite the overwhelming odds against him. Stopping midstream, in Park's view, was not an option—the momentum would be lost. He pushed on with the HCI drive despite an oil crisis, and overwhelming debts. These policies depleted reserves, skyrocketed the national debt, and invited criticisms from the international financial institutions in the beginning. The powers of the executive as provided by the Yushin Constitution created a legal foundation that buttressed his leadership and gave him more powers to make executive decisions.

A robust political and economic system was essential to move this big industrial plan forward and make it survive global economic storms. It was of utmost importance for a system to be pragmatic, to forecast, react swiftly to sudden changes, and optimally back decisions and strategies with resources—essentially, have a firm control of the economy. It was crucial for the state to predict and channel resources with precision and timing. Capital controls were one of the fundamental economic policies that made this possible. Capital had to be kept in a "closed" system to avoid the various drains and imbalances

⁷² Woo, Jung-en (Meredith Woo Cummings). "Race to the Swift", p.155

⁷³ Woo, Jung-en (Meredith Woo Cummings). "Race to the Swift", p.158 citing Euromoney, July 1979, p.90

⁷⁴ Woo, Jung-en (Meredith Woo Cummings). "Race to the Swift", p.157

borne by capital flight; to enable planners to formulate realistic strategies based on capital resources available; and to optimally focus capital resources into key elements of the strategy in the form of policy loans and privileges. Moreover, inflows had to be sustained and guarded in coordination with other ministries. Capital inflows in the form of revenue from exports and foreign debt had to be sustained at substantial levels to make sure that the economy had enough resources to fulfill its objectives.

Managing Risks. The state was highly leveraged. Pushing an economy to acquire capital-intensive assets was certain to drain the reserves of the Bank of Korea. As it was previously noted, the capital required to kick-start HCI required 30% of the GNP. 20% was raised by national savings and the remaining 10% was covered by foreign loans. In 1972 almost 3.6 billion USD was borrowed from foreign banks to capitalize this big project.

Initially, the Korean economy did not have any paying capacity. Park, more than a president, was acting as the “state’s entrepreneur” starting a new business—the Korean economy. Like any business, there are little or no returns during the start-up phases. This is a time when fixed assets such as land and capital goods are purchased that expenses are at its highest—capital intensive. More importantly, it is a time when the firm cannot start paying any obligations yet because there is no substantial income. It took a few years to get large-scale industries to be operational and fully functioning.

By regular standards, firms were highly leveraged as well. Even if firms sold all their assets, they still wouldn’t be able to pay their entire debt at this stage of development. Firms had debt to equity ratios beyond unity—even ranging to as much as 400%. Despite these unusual ratios, many international banks have continued to lend the state capital for its industrialization program. Each time the state needed to borrow its way out of a balance of payments deficit—especially during the oil crises—capital was made available to them.

As we have seen, a system of pragmatic policies and guarantees engineered an economic environment that was stable and enabled the state to push onwards with its industrialization strategy despite several hurdles along the way. Capital controls were essential in engineering this environment.

The Park administration was careful to use committed capital because they did not want the industrialization strategy to be derailed. It appears that Park made it a point to use financial instruments that were appropriate to the term of the project—capital that was meant for the long-term. Portfolio capital and other short-term instruments were not prioritized by his government because there is a risk for state planners to lose control and derail strategic projects. Many industries were dependent on many upstream and downstream industries so it was essential that projects moved in a synchronized manner. Paul Krugman writes “almost all market participants took a short-term view, and they were attempting to forecast future prices without reference to future fundamentals.”⁷⁵ A short-term financial instrument enables lenders to cease their commitments to firms which in turn would leave firms to scuttle about for other lenders to fund their operations. This process can take long and can potentially hold back a whole sector of related industries in the project.

It is for this reason that Park was very strict to borrow long-term loans and restricted the outflows of foreign exchange. Long-term loans had the bigger part of his debts. In fact, during the HCI phase (1972–1978), the Ministry of Finance maintained long-term debt at an average of 76% of its total debt portfolio. However, when the leadership changed, this percentage went down to as low as 64%.

Park minimized the entry of foreign direct investment (see foreign loans and investment table from 1959–1983). It is commonly known that FDI are investments that are more likely to stay within the economy for the long haul. They come in the form of subsidiaries of international firms or trans-national corporations (TNCs) and venture capital. Neo-liberal economists believe that this is very favourable because FDI brings in new innovations and new technology to the local economy. Moreover, the presence of TNCs in local soil enables the local economy to secure a foothold in the global supply chain. FDI is seen as more stable. The foreign exchange, and capital goods they bring remain in the local economy for extended periods. This is not like portfolio investment which is liquid & reversible that it can easily be transformed to foreign exchange within shorter times. FDI is also seen as creating jobs. Some TNCs and subsidiaries are conveniently situated in coastal areas and rural townships where unemployment is high. Export processing zones train and provide jobs to the most impoverished areas of the economy.

⁷⁵ Krugman, Paul., *The Case for Stabilizing Exchange Rates*. Oxford Review of Economic Policy, Vol.5, No.3, Oxford University Press. p.67

In Park's point of view, this could potentially harm the infant industries he was trying to nurture. Selected imported items were prevented from entering the local market, and FDI more so because it competes with local firms. Foreign owned companies have innovative technologies and a lot of experience marketing products in the international market. Foreign owned companies have the advantage of diversified products and having reached economies of scale. Budding local firms in developing economies do not have these advantages that it can be difficult for them to compete.⁷⁶

The Park administration had control over the directions of companies in South Korea and this was achieved by pushing firms to manufacture strategic products, and to reach acceptable levels of performance as a condition to receive low-cost financing. Company directions of FDI are guided by boards of directors and management in firms that are majority owned by foreigners. The foreign company still gets its directives from its head office, not the state, even if the state has programs that encourage innovation and research towards a certain direction. In Canada, there is a concern raised by the Conference Board of Canada that even among foreign invested firms in the nation, research and development decisions and directions are made outside the country.⁷⁷

In addition, foreign exchange outflows from foreign firms can be a bane to the host economy especially if the economy is deregulated. Some developing countries have little or no limitations for foreign investors to repatriate profits. If done in large quantities, this upsets the foreign exchange balance of the host economy and would have direct bearing on exchange rates and interest rates.⁷⁸

The government played a key role in bringing the technology FDI otherwise would have brought in. The Park administration provided an environment that is conducive for creativity and innovation, and the immediate conveyance of the products of research to the shop floor for manufacturing. Absorption capacities and skills were developed so that many firms as possible could profit from the new technological breaks. With the

⁷⁶ Sitglitz, Joseph. *Globalization And Its Discontents* W.W. Norton & Company, London, NY, 2002. p.16–17, 68

⁷⁷ The Conference Board of Canada. *Exploring Canada's Innovation Character, Benchmarking Against Global Best*. Ottawa, On, 2004. p.iii

⁷⁸ Singh, Ajit., *Capital Account Liberalization, Free Long-Term Capital Flows, Financial Crises and Economic Development*, Queens College, University of Cambridge. P.19 www.networkideas.org/feathm/dec2002/Ajit_Singh_Paper.pdf

market research made by the Korean Trade Investment Promotion Agency—an arm of the Ministry of Industry and Commerce—firms are constantly updated about the market trends and technological breakthroughs since “the core of export-led industrialization was a compelling obligation for firms to compete in the global markets”⁷⁹. Doing so required expertise, research and development in a sustained effort. An environment was created to raise scientists and engineers who can develop new technologies or unpack technologies from abroad and make it better. State involvement in the synchronization of ministries ranging from education⁸⁰ to social welfare was essential in developing the workforce.

However, FDI can be beneficial to an economy if properly managed and informed by a coherent state development goal—that is, having a defined technological direction, the means to control that direction through local ownership and state involvement, a technology transfer scheme that specifically targets technologies that are relevant to the development strategy of the state⁸¹, and the ability to fund these activities.

The Park administration created policies to keep capital within to prevent instabilities borne by flight. The Ministry of Finance tried to muster all the capital resources to put the industrial strategy in motion that regulating the conversion of capital to foreign exchange (through exchange certificates) was one of the key policies that prevented capital from leaving. It essentially fixed the exchange rate. This policy was very controversial to liberally inclined financial institutions.

⁷⁹ Chibber, Vivek., “Reviving the Developmental State? The Myth of the National Bourgeoisie.” p.9

⁸⁰ In 1968, the government established the Korean Institute for Science and Technology (KIST) whose objective was to import advanced science and technology and to introduce and disseminate advanced industrial technology. KIST was created as a venue for research and applied science (operating in part under contracts from industrial conglomerates) to provide innovations in manufactured commodities, especially in the field of electronics and machinery.

⁸¹ “For a developing country to attain sustainable growth, the government must adopt measures aiming “directly” at promoting investment, these measures should be part of an explicit industrial strategy to promote the leading industries of the future. Decisions about ownership arrangements, including privatization, should relate to actual economic, political and social conditions in the country concerned, not to the universal desirability of privatizing enterprises. For example there may be legitimate national sentiments about the desirability of foreign ownership.” Wade, Robert, “Japan, The World Bank and the Art of Paradigm Maintenance: The East Asian Miracle in Political Perspective”. New Left Review, no. 217, p.3–37

Neo-liberal economists believe that little or no limits to currency convertibility are essential because investors will not commit funds if they cannot freely repatriate their capital. One of the keys in protecting the value of capital exposures in a foreign economy is the investor's ease of exit. No limitations on currency convertibility enable a foreign investor to be able to extract and liquidate his assets into foreign denominated currencies without any bureaucratic hindrances.

Park placed limits on currency convertibility. He made it very difficult for wealthy nationals to flee and invest in other havens—they were forced to keep their investments in the local economy and prevented the inflow of destabilizing flows such as portfolio capital. Consequently, this freed-up more foreign exchange to be allocated into strategic firms who imported essential equipment. In a deregulated economy—where currency is easily convertible—sudden exits of large capital can cause the local currency to depreciate. This in turn can trigger another round of depreciation because investments denominated in the local currency suddenly lose value that investors will be pressed to convert to US dollars (or other major currencies) to cut their losses.

Park used financial instruments that were committed for the extended gestation period of strategic industries—he used long-term loans. Short-term instruments re-rolled for a long gestation period are potentially hazardous because banks would be forced to find other funders at the end of each short-term. It becomes hazardous if banks are not able to find any—where firms will be left hanging until another source of capital comes along. This situation can potentially stifle key projects in the strategy. In a deregulated economy, short-term loans were prone to flight. The withdrawal of short-term loans can affect economic stability especially if the biggest composition of foreign debt is short-term. Lenders are well within their rights not to extend or re-roll their loans at the end of the term when rates of return start to dwindle. In a deregulated economy, lenders can repatriate their capital and would put pressure on the local currency to depreciate. This in turn, can inaugurate another round of capital flight and alter exchange and interest rates as it did in 1997.

The state minimized the risk of price uncertainties by keeping exchange rates fixed despite clamors from IFIs. Neoliberals argue that floating exchange rates are more beneficial for a developing economy. It is better to devalue its currency than to deflate

the economy⁸² or to have capital controls when a state encounters a balance of payments disequilibrium. The value of a currency should be flexible enough to move so other more important values or “real” variables such as wages and employment do not have to change in the event of a change in relative prices.⁸³

Neoliberals also argue that floating exchange rates impose market discipline in a deregulated economy. “Countries are “forced” to have good economic policies, lest capital flow out of the country.”⁸⁴ Governments are obligated to create policies to stimulate the inflow of foreign exchange through investments in high interest bearing local assets with short-term returns, and it is with this reason that more investible resources can become more available for local development.

IFIs advocate floating exchange rates because they also prevent savvy investors from speculating on the market. The exchange rates are reflected immediately in the market that it leaves no room for investors to speculate.⁸⁵ The cycle of purchasing foreign exchange further depletes the reserves of the central bank and inadvertently fulfills the depreciation of the local currency—especially if forex reserves are very low. It is when reserves are low that currency markets are very vulnerable to speculative attack in a deregulated economy.

However, it appears that the Park administration did not see the merits of a floating exchange rate especially for a developing economy that had ELI as a strategy. He prevented this by limiting convertibility and in effect fixed the exchange rate and prevented capital outflows. Local firms with foreign denominated loans will get hurt by the rise in interest payments if and when the local currency depreciates unpredictably. Firms will be forced to purchase foreign exchange at a “higher price” since expanding firms needed foreign exchange to purchase equipment and materials abroad. This can hamper the operations of local firms. Indeed, during the 1997 liquidity crisis, firms with

⁸² A situation where supply exceeds demand, high unemployment and a generally sluggish or slow economy.

⁸³ Gilpin, Robert, *The Challenge of Global Capitalism*. Princeton University Press, 2000, p.127

⁸⁴ Stiglitz, Joseph, *Capital Market Liberalization, Economic Growth and Instability*. “World Development” Vol. 28, No. 6., Elsevier Science Ltd. 2000., pp. 1080

⁸⁵ Speculation, in this case, is a bet on the depreciation of a local currency in a fixed exchange rate regime. As the central bank tries to defend the exchange rate levels by tapping on its foreign exchange reserves, investors purchase more foreign exchange in anticipation of its appreciation against the local currency.

foreign denominated loans were forced to do massive lay-offs or declare bankruptcy because they could not cope with their debt payments.

The sudden inflow and outflow of foreign exchange will also make exchange rates volatile in a deregulated economy. As Paul Krugman wrote..

“there is convincing evidence that floating exchange rates lead to much more volatile real exchange rates than occur under fixed rates...that substantial excess volatility in real exchange rates results from the speculative character of markets under floating exchange rates.”⁸⁶

This in turn will affect the exports and imports of the host economy. A sudden large inflow of foreign exchange will appreciate the local currency and increase the prices of exports. This, in turn, dampens international demand—a condition that is bound to cripple Park’s ELI strategy. Inversely, prices of imported raw materials and capital goods essential for the industrialization strategy will increase if a devaluation of local currency happens due to a sudden outflow of foreign exchange. When prices of exports and imports fluctuate erratically in big ranges, it becomes difficult for firms to adjust their costs and predict their operations for the long-term and it may even delay investments because of a “wait and see” response⁸⁷. It is important that foreign exchange levels and prices remain relatively stable to become predictable for the long term, and this could be achieved by keeping rates fixed.

The administration needed to overcome risks associated with the need for the economy to gain investor confidence and to socialise risks associated with high barriers to entry in production. The HCI strategy was capital intensive. Steel mills, ship manufacturing and machines were very difficult industries to start because of the immense capital requirements to establish these kinds of industries even for local chaebols. Though the barriers to enter these industries were high, they were fundamental and strategic to the industrialization strategy of South Korea. It was in these cases that the state relied on the capabilities of the Ministry of Finance to rally capital for these industries, and the EPB to create externalities (i.e. downstream industries such as automobiles) that would enable these industries to thrive.

The administration eased the entry to these industries because they controlled the banks. Banks are embedded in the political economy of the developmental state. The

⁸⁶ Krugman, Paul., The Case for Stabilizing Exchange Rates. Oxford Review of Economic Policy, Vol.5, No.3, Oxford University Press. p.67

⁸⁷ Krugman, Paul., The Case for Stabilizing Exchange Rates. p.68

central bank was one of the main institutions that Park Chung Hee controlled when he came to power because he envisioned the bank's role to be similar to Japan's. In Japan, conglomerates called Zaibatsu had banks embedded within their network that—in effect—allocated finance to its subsidiary companies. Park Chung Hee had the similar idea but evolved the concept in the government level. The central bank and its affiliates provided low interest rate loans to key industries deemed essential to the state's long-term development strategy. Policy loans or selective credit have been one of the essential policy tools to develop strategic industries such as steel, electronics and the chemical industry in the 1970s. Park took control of the financial system to allocate capital because these industries were not attractive to investors—that is, they did not have the incentives to be investible projects because they did not have a high rate of return in the short-term and entailed huge sums of capital.

Besides controlling the financial system, the government also guaranteed all the loans that were made internationally to minimize the lender's risks. This however, contradicts the way neoliberal economists reduce risks.

Neoliberal economists believe that the economy should be attractive for investors. It should have high rates of return and minimized risks. This is achieved by keeping inflation at low levels through increased interest rates.⁸⁸ Banks are willing to lend long-term loans to firms only if conditions are stable because inflation increases the operating costs of firms and will weaken their capacity to repay their loans while high interest rates also make it profitable for lenders. International financial institutions make it a condition—in their structural adjustment policies—to pursue contractionary monetary policies to control inflation.⁸⁹

The planners in the Park administration however saw that this policy was not appropriate for an economy that is engineered for high growth. High interest rates make it difficult for firms to borrow money that huge capital costs are a disincentive to

⁸⁸ Sitglitz, Joseph. *Globalization And Its Discontents* W.W. Norton & Company, London, NY, 2002. p.12–13

⁸⁹ "...the IMF has changed markedly.... Founded on the belief that markets often worked badly, it now champions market supremacy with ideological fervor. Founded on the belief that there is a need for international pressure on countries to have more expansionary policies—such as increasing expenditures, reducing taxes, or lowering interest rates to stimulate the economy—today the IMF typically provides funds only if countries engage in policies like cutting deficits, raising taxes, or raising interest rates that lead to a contraction of the economy." From Sitglitz, Joseph. *Globalization And Its Discontents*. p.12–13

industrial expansion. High interest rates can also affect exchange rates that it can be a disincentive for investors to proceed with their expansion plans because it dampens international demand for their exports due to price increases brought about by an appreciation of their local currency. This in turn can further de-industrialize an economy in extreme cases. Indeed, the US economy experienced this economic phenomenon in the 80s. The US attempted to lessen government spending and raised interest rates to encourage the influx of US dollars as savings during the Reagan administration. These savings were intended to cover deficits caused by the large military spending during his term. Increased interest rates drew in the savings they needed from global investors, but this made the US dollar appreciate against other currencies. As a result, US exports became more expensive. Other currencies such as the Yen and DM became cheaper—and so were their imports. Japanese goods became more affordable to the US market that demand for their imports rose. Cheap imported goods affected US businesses adversely because Americans were buying less locally made products. It became a disincentive for US entrepreneurs to invest in local businesses because of high interest rates and affordable imports. This in turn forced massive lay-offs and shelved projects in the American auto and high-technology industry.⁹⁰

Lowered interest rates are necessary for development and expansion, but by how much? When does it become disadvantageous? Though lowering interest rates increased inflation levels in Korea to about 16% in 1977⁹¹, it is important to know the ideal level where the economy's expansion and long-term dividends outweigh the costs of inflation. The norm for US is usually below ten percent. However, neoliberal economist and inflation hawk Robert Barro in 1996 concluded that inflation rates ranging from 10 to 20 percent have low costs to economic growth, while rates under 10 have no negative effects on growth.⁹² Another World Bank study (Bruno 1995) concluded that inflation rates below 20 per cent have no empirical significance for long-run growth when they tried to determine the link between inflation and economic growth in 127 countries from 1960 to 1992. It was observed that growth rates only fall when inflation rates go beyond the 25 per cent level. The World Bank study also concluded that the country reaps economic growth dividends when they move from inflation rates in the three-digit range to inflation rates of 20 per cent per annum. In 1996, Bruno and Easterly observed

⁹⁰ Gilpin, Robert, *The Challenge of Global Capitalism*. Princeton University Press, 2000, p.229.

⁹¹ Amsden, A (1989). *Asia's next giant: South Korea and Late Industrialization*. New York: Oxford University Press. 1989p. 100–101

⁹² Chang, Ha-Joon and Grabel, Ilene. "Reclaiming Development", Fernwood Publishing, Nova Scotia, 2004. p.185

that inflation in the 15 to 30 percent level can be sustained for long periods without major economic costs.⁹³ At 16 percent, it appears that South Korea was well within the tolerable limits where growth and inflation are not disadvantageous.

In addition, the IMF advocates having high interest rates because they have a way of weeding out firms that are not performing well. Firms that are not able to cope with the cost of capital are deemed inefficient and uncompetitive and unable to deal with the realities of the market.

The EPB pushed South Korean firms to become more competitive and efficient in a different way. Rivalry in the international market is very intense so firms in the developmental state are pressed to evolve and add more value to the products they export. The state adds more pressure by pushing firms to reach performance objectives (increased exports and quality) as a condition of receiving additional interest rate subsidies and policy loans. If they underperformed, they ran the risk of closure or the suspension of support.

Though this system of capital controls has proven itself to be powerful and beneficial to Korea, it soon became a bane to one of the major players in the developmental state – the Chaebol. Their frequent contact with the global market expanded their horizon of opportunities, and deliberately went into new lines of production that were not kosher with the industrial plan of the state. Chaebols persistently attempted to politically alter the economic landscape to their advantage. These conglomerates tried to make changes in economic policy to enable them to access other sources of capital and this entailed opening-up the financial sector the Park regime fought very hard to control. This is the subject of the next chapter.

⁹³ Chang, Ha-Joon and Grabel, Ilene. p.186

Chapter 3 The Altered State

"Capitalists simply would not countenance the installation of policy instruments that would have enabled planners to hold firms accountable to plan priorities".¹

Vivek Chibber

This chapter will investigate how the Korean developmental state lost the autonomy required to pursue its mission. It examines the combination of external and internal forces that produced this result, following the assassination of Park Chung Hee. The United States was quick to react to Park's assassination because it left South Korea vulnerable to a military and ideological incursion from the North. The US could ill-afford the fall of another US sponsored regime as had recently happened in Iran. The domestic power vacuum had to be filled immediately with a leader that espoused American values and upheld its interests, Gen. Chun Doo Hwan.

Chun Doo Hwan, however, faced a legitimacy crisis arising out of the massacre of more than 200 pro-democracy activists at Kwangju. Union and student protests spread across various cities and towns. Chun also inherited an economy that was in the depths of an economic crisis, adding fuel to the flames of dissent. Though Chun had the military under his control, the threat of an ouster seemed imminent. Moreover, North Korean troops were ready to launch a military incursion if the instability worsened. It was for these reasons that Chun Doo Hwan turned to those forces that could help stabilize the situation and secure his position as its leader.² Chun Doo Hwan brokered an economic relationship between the two strongest power structures in South Korea—the United States and the Chaebols. One of the consequences was that petrodollars from US banks were now available to satiate the Chaebol's appetite for finance. US geopolitical and

¹ Chibber, Vivek, *Reviving the Developmental State? The Myth of the National Bourgeoisie*, Conclusion.

² Cummings, Bruce., "The Asian Crisis, Democracy and the end of Late Development" in Pemepel T.J. (ed)., *The Politics of the Asian Economic Crisis*, Cornell University Press, Ithaca, NY. 1999 p. 30-33

financial interests in South Korea came with a renewed assurance that their stakes in the Korean economy were safeguarded by the most powerful military in the world.³

The match of US financial interests with the Chaebols was serendipitous for conglomerates striving to be autonomous from the state but not for the future of South Korea's developmental state. The first part of the chapter will feature how the various events and forces evolved and placed Chun Doo Hwan in power. With insights from theories of political change, the second half of the chapter discusses how Chun Doo Hwan altered the political economy of South Korea to accommodate the Chaebol and US interests.

3.A The October 1979 Crisis in Korea

Park Chung Hee was assassinated in October 26. Though Park Chung Hee had a legacy of industrializing Korea to become a Tiger Economy, social groups expressed their displeasure towards the regime. As it was previously noted, one can only remain skeptical about an authoritarian regime even in Park's case, where the work Park had accomplished brought considerable economic changes. In a number of ways, the economic drive that prioritized industrial growth overlooked the concerns of labour despite increasing wages. Labour and students called his administration authoritarian in its contemptuous sense.⁴ Voices of disapproval against Park's administration only intensified where in 1979, young women workers at the YH Company—a wig manufacturing company—formed a union and took action demanding basic rights. The women began a sit-in at the factory and were later approached by law enforcement officers. They then moved their demonstration to the New Democratic Party headquarters where a dispute ensued between law enforcers and NDP members and supporters.⁵ It was also at this time that then NDP leader Kim Young Sam bitterly attacked Park. On one occasion, the police prevented opposition members from entering the National Assembly. Pro-government members voted to strip Kim Young Sam of his

³ Cummings, Bruce., "The Asian Crisis, Democracy and the end of Late Development" in Pemepel T.J. (ed)., *The Politics of the Asian Economic Crisis*, Cornell University Press, Ithaca, NY. 1999 p. 32

⁴ It was in this political milieu when dissident Kim Dae Jung (1973) was kidnapped. With US and Japanese objecting to this, he was later released. The Park administration was allegedly thought to have caused the mysterious death of dissident leader Jang Jun-ha (1975), and the execution of the members of the "alleged" People's Revolutionary Party (1974). Key agents of the Korean Central Intelligence Agency (KCIA) stifled social groups and movements.

⁵ NDP members and supporters were injured and one worker's life was taken.

powers as a member of the assembly in October 4, 1979. In a concerted move, opposition members resigned their seats in disapproval. This sparked disturbances that intensified in the cities of Busan and Masan⁶ and triggered the assassination of Park Chung Hee on the October 26, 1979.⁷

Upon the announcement of Park's death, Choi Kyu Hah took over as acting president and imposed martial law where 39,000 troops stationed in South Korea were placed on high alert. US forces were placed on defense condition 3 in preparation for an incursion attempt of North Korean troops mobilized on the northern edge of the 151 mile demilitarized zone—with the southern edge 30 miles north of Seoul.⁸

Korea's economy was not performing well during this period. The Korean economy was in a state of relative stagflation, with slow growth of GNP—that is, 7% in 1979 and -4.8% in 1980. The economy had had strong growth performance in the previous three years. This had been also accompanied by rapidly increasing prices—18.8 and 38.9 percent per year in 1979 and 1980.⁹ These were adverse effects brought about by cost-push inflation created by the second global oil crisis. Accordingly, the import bill increased dramatically. The import price index rose by 25.7 and 27.5 percent in 1979 and 1980,

⁶ www.kdemocracy.or.kr/english/3b.pdf, Kie-Chiang Oh, John Korean Politics Cornell, 1999 p. 72.

⁷ The November 5, 1979 edition of Time magazine reported that Kim Jae Kyu acted on intelligence provided by a faction in the KCIA confirming that Park could not effectively manage the affairs of the country anymore. There were personal issues involved as well. It was believed that Park Chung Hee was beginning to lose his confidence in Kim Jae Kyu as head of KCIA because he was not able to predict the swelling opposition against his regime. In a dinner party, Kim argued that Park was too harsh with dissidents and pleaded with him to ease-off in his treatment of detractors. Intelligence chief Cha Chi Chul and Kim had an explosive argument with Cha expressing his disapproval and chided that Kim was getting "soft". Kim took offense and conspired with two men to assassinate Park and Cha. Henry CK Liu of The Asia Times (Oct. 5, 2006) <http://www.atimes.com/atimes/Korea/HJ25Dg01.html> however provides another view – "It was common knowledge that the KCIA could not have made any move without the approval of the US CIA, which suspected Park of being a communist. It was also a time when US foreign policy was strong—arming its autocratic Cold War allies all over Asia, in South Korea, Taiwan, Singapore, the Philippines, Indonesia and other countries, into token political reform toward "democracy". The assassination of Park excised the cancer of communist sympathy at the top in South Korea."

⁸ The November 5, 1979 edition of Time magazine

⁹ Cho, L.J. & Kim, Y.H.eds. Kim, P.J., "Korea's Political Economy, An Institutional Perspective", p.293

as compared with 5.1 percent in 1978. The primary sector also experienced a big drop in harvest—output decreased severely by 19.9%.¹⁰

Associated with the poor economic performance was the worsening state of Korea's international balance of payments. The current account deficit had increased from US\$ 1.1 billion in 1978 to \$4.1, \$5.3, and \$4.6 billion in 1979, 1980 and 1981 respectively.

The Korean economy was already in debt, and needed to borrow more to survive. The Chun Doo Hwan administration needed to access more capital to be able to compensate for the economic losses generated by the oil crisis. The nation's foreign debt had increased from \$14.8 billion in 1978, to \$32.4 billion in 1981 and finally to \$46.8 billion by the end of 1985.¹¹ Korea's external debt grew by more than 59% from 1979–1981. The debt increase was also compounded by the fact that interest rates were increased. Loan interest rates were hiked by the Fed on October 6, 1979 by Paul Volcker which also caused a global economic slump that dampened demand for Korea's exports.

Capital Needed. The economic environment had to be altered to meet the demands of a nation in crisis. The assassination of Park Chung Hee by his KCIA chief Kim Jae Kyu on October 26, 1979 marked the end of the autocrat behind the developmental state's financial regime, and commenced the evolution of another economic order. After Chang Myon took the leadership, Chun Doo Hwan seized power¹² in a coup d'etat in May 17, 1980, and this was meted out in a rather bloody manner—the massacre in Kwangju.¹³

¹⁰ Cho, L.J. & Kim, Y.H.eds. Kim, P.J., "Korea's Political Economy, An Institutional Perspective", p.293

¹¹ Cho, L.J. & Kim, Y.H.eds. Kim, P.J. p.293

¹² From Park's successor Chang Myon

¹³ Chun Doo Hwan had already established ties with high-level officials in the US government even before he took control of Korea. Little was known about his connection to Washington until the 1990s. Declassified documents obtained through the Freedom of Information Act were disclosed to the public, implicating the United States in a series of events in support of Chun Doo Hwan's actions in Kwangju. They were known as the Cherokee files. The files were a series of communications between South Korea and a secret policy making group in Washington, which involved the US ambassador to South Korea William Gleysteen; Secretary of State Cyrus Vance; Deputy Secretary of State Christopher Warren; Assistant Secretary of State for East Asia Richard Holbrooke; and top intelligence officials at the National Security Council. Other advisers involved in these discussions were Secretary of State Edmund Muskie; National Security Adviser Zbigniew Brzezinski; CIA Director Admiral Stansfield; NSC top intelligence official and CIA station chief Donald Gregg and US Defense Secretary Harold Brown—all in the Carter administration. In these secret communications between Chun Doo Hwan and the US, senior officials in Washington approved South Korean plans to deploy military troops against pro-democracy demonstrations ten days before Chun Doo Hwan controlled the

The legitimacy of Chun Doo Hwan's accession to power was challenged. The violent reprisal at Kwangju was hailed as one of the greatest tragedies in Korea's history—which in many respects, overshadowed the oppression of the previous regime. Though Chun Doo Hwan had a firm control of the military, it became important to secure his hold in power by securing a very good relationship with other power structures—the Chaebol.

The Chaebol also needed Chun Doo Hwan. Chaebols needed a leader that could access capital to satiate their need for finance. Reduced global aggregate demand and increasing oil costs were forcing Chaebols out of business that it needed a fresh infusion of capital just to keep the economy alive. Chun sought the help of the government of the United States and Japan. And the latter was forthcoming.

At this time, US banks were awash with petro-dollars from OPEC surpluses and were seeking to put their capital to work in developing economies. American capitalists saw the investment potentials of the Korean economy but were not sold to the idea of infusing more capital because Korea did not exactly have a free market. Convincing the US to open the taps to capital wider required fulfilling the prescriptions of its lenders. More importantly, it necessitated an economic system that was similar with the way the Americans ran their lending business. Chun Doo Hwan aimed for this compatibility.

Unlike Park, Chun did not put the same emphasis on strategic foresight or bureaucratic discipline. He sought to change the immediate situation confronting his country at that time. With the economy in a slump, it was necessary for him to push the nation out of its misery by creating the structures that made it necessary for the Chaebols to access capital. The Chaebols played an active role in engineering the economic environment. Indeed, with the regime change, new ideas and personalities permeated the bureaucracy, altering the path of the economy, gradually liberalizing access to financing and accelerated the neo-liberal dilution of the developmental state model.

The Chaebols beat the war drums as the Korean model faced the challenges of the crises of the 1980s. They easily became a strong internal power structure—along with the

country through a military coup in May 17, 1980. These high level discussions in Washington were an attempt to “prevent another Iran”. Top officials in Washington were cautious not to have another regime undermined that US officials endorsed the use of excessive force to control the situation. From Shorrock, Tim., *The US Role in Korea in 1979 and 1980*, 1999 <http://www.kimsoft.com/korea/kwangju3.htm>.

US—since the state's hold was slowly weakening. The success of the Chaebols in the global market gave them considerable economic might that the three largest Chaebols in 1984 accounted for a staggering 36% of national product in Korea.¹⁴ The top ten Chaebol accounted for 67.4%

TABLE 3A
TOP 10 Combined Sales of Chaebols as % of GDP*

1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
15.1	17.1	19.8	26.0	30.1	32.8	48.1	55.7	57.6	62.4	67.4

*(Aggregate net sales of the largest ten business groups/GNP) x 100 for each year.
Source: Seok Ki Kim (1987), cited in Amsden p.116

The Federation of Korean Industrialists and technocrats became critical of the state's intervention. The Chaebols deemed that the state was no longer providing them an environment for high-speed growth. The state was accused of providing insufficient finance while frequently demanding costly corporate restructuring; of triggering industrial downturns due to its mismanagement of finance; of creating instability and corporate default by its arbitrary and whimsical decrees; and of refusing their demands to privatize banks¹⁵. Indeed, Chong Chu-yong, Hyundai's patriarch made a public plea *to end state interventionism and to grant full autonomy to the financial markets*.¹⁶ Within this context, the Chaebols seized every opportunity to commence their own internal structural overhaul to enable them to access new sources of finance where and when they could. In the 1970s however, it was clear to Duck Woo Nam—Park Chung Hee's deputy minister and head of the Economic Planning Board that a liberal introduction of foreign capital without government intervention was problematic. He writes "...it was clear from the beginning that the financial resources forthcoming from the banking institutions in the absence of government intervention would fall far short of the requirements for heavy industry even if a liberal introduction of foreign capital was taken into account¹⁷. It was with this reason that liberalization placed Korea's stability into question.

Chun tried to find many ways to access capital from countries other than the United States—he set his sights on Japan. Korea was acting as the "point-man" in securing the

¹⁴ Amsden, A (1989). *Asia's next giant: South Korea and Late Industrialization*. New York: Oxford University Press. 1989 p. 119

¹⁵ Chosun Ilbo, November 12, 1988 (cited in Woo p. 200)

¹⁶ Maeil kyongje shinmun, April 15, 1985 (cited in Woo p.200)

¹⁷ Sung Y. Kwack, ed., *The Korean Economy at a Crossroad.*, D. W. Nam, "Korea's Economic Takeoff in Retrospect". New York: Greenwood Press, 1993

Asian region by allowing US troops and tactical nuclear weapons on its soil. However, this was supposedly Japan's role—based on an agreement between Sato and Nixon—but was necessarily carried out by the Koreans instead. The Koreans were not being properly compensated for these “regional security services” that it was this “hand” that Chun used to coax capital from the Japanese.

Coaxing Capital From the Japanese. Chun administration coaxed assistance by playing the geopolitics card against the Japanese. The United States wanted to keep Asia secure against the communist threat from the USSR and North Korea. South Korea was strategic. As it was before, the United States sought to contain Soviet and North Korean influence in the region by securing the region by encouraging Asian states to have strong economic relations with each other and with the United States. By 1978, the United States was able to normalize relations with China that the scope of this economic region became bigger. America's security burden suddenly became larger. In 1969, Nixon and Sato agreed to share the burden of securing the region between the US and Japan where the territory of South Korea was Japan's security burden. Securing the region also entailed fortifying countries with nuclear capabilities to be able to deter a nuclear attack from the Soviets. Instead of Japan, South Korea became the regions “point man” to deter threats from the Soviets and the North. Given the experience at the end of WW2, the Japanese were averse to the presence of nuclear weapons on their soil. Richard Walker—Reagan's ambassador to Korea wrote..

The presence of American conventional and even tactical nuclear forces in Korea helps to confirm strategic guarantees for Tokyo and to discourage any Japanese thoughts about a French solution: a force de frappe of their own. This is a fact well understood by leaders of many political persuasions in Tokyo and also appreciated in Peking.¹⁸

South Korea was bearing most of the security burden not Japan. In balance though, sea and air were patrolled by the Japanese armed forces as well. The relationship between Japan and South Korea was strained by this arrangement since the Nixon-Sato agreement stipulated that Japan would bear the burden of security. Korean leaders felt that the Japanese should share in the costs for securing the region. Defense Secretary Harold Brown asked the directors of Japan's Self-Defense Agency for a loan for Korea's military modernization efforts to salve strained relations with South Korea.¹⁹ The Reagan administration affirmed its commitment to secure the region by providing sophisticated

¹⁸ Walker, Richard. *The Future of Trans-Pacific Alliances.* Orbis 1975, p. 917 (cited in Woo p.185)

¹⁹ Woo, Jung-en (Meredith Woo Cummings), *Race to the Swift*, Columbia University Press., New York., 1991p.185

military equipment and extended economic concessions to South Korea to fulfill its security responsibility.

South Korea needed an injection of capital—in the form of loans or aid—to assist Korea's "stagflating" economy induced by the oil crisis in 1980. Bolstered by Reagan, South Korea presented a bill to Japan of 10 billion dollars in aid and loans commencing in 1982 for a period of five years. In the end Korea received 4 billion dollars, consisting of 1.85 billion dollars in governmental loans and 2.15 billion in loans from Japan's EXIM bank. This was nearly 13% of Korea's net external debt, more than 5% of GNP and almost a fifth of total investment in 1983.²⁰

Later in 80s however, South Korean credit woes became a godsend to Japan. Japan lent to South Korea to mitigate the upward pressure of dollar surpluses. The Japanese were experiencing record breaking surpluses with the United States, their major market. Japanese exports to the US as a percentage of total exports increased from 26.4% to 38.9%. The current account surplus increased from .4% GDP in 1981 to 4.2% GDP in 1986²¹. Rising Japanese trade surpluses—the other side of rising US trade deficits—were putting pressure on the Yen to increase upward. It was for this reason that exports dropped by 15.5% in 1984 and 4.0% in 1985. The Japanese economy let off steam by lowering interest rates from 5% to 3% to as low as 2.5% in the late 80s.²² With an ailing economy in need of debt, South Korea availed itself of this manna. In 1985 the accumulative debt of South Korea was USD 45 billion with much of it from Japan.²³

3.B Political Change: Stagflation and shifting state views

It was the view of the Chaebols and the like-minded bureaucrats in the Chun Doo Hwan regime that the developmental state was largely responsible for the sudden inflationary pressures, debt problems and bankruptcies as Korea faced the global turmoil of the early 1980s²⁴. However, the stagflation was mostly caused by a cost-pushed inflation

²⁰ Woo, Jung-en, p.187

²¹ Brenner, Robert., *The Boom and the Bubble*, Verso Books, London and NY. 2002. p. 106-107

²² Ibid.

²³ Kim, C. I. Eugene South Korea in 1985: An Eventful Year Amidst Uncertainty, in *Asian Survey*, Vol. 26, No. 1, A Survey of Asia in 1985: Part I. (Jan., 1986), pp. 74.

²⁴ Haggard, S. and Moon, C., *Institutions and Economic Policy: Theory and a Korean Case Study in World Politics* Vol. 42, No.2 (January 1990). P. 217

brought about by the oil price increases that afflicted the world and the sudden rise of global interest rates.

The government was hard pressed to sustain growth and stability in a stagflationary economy and to maintain good relationships with the power structures at this time. Chun Doo Hwan affirmed his dedication to tame runaway inflation, lower corporate indebtedness, and to restore balance in the current account to maintain stability. This was to be achieved by putting to work a bureaucracy geared towards the free market. In his 1980 inaugural address, Chun Doo Hwan announced that *economic liberalization was the goal of the new republic*.²⁵ The stagflationary problem was seen as confined to Korea alone. This campaign for economic liberalization was believed to be a cure for poor economic performance that came with Park Chung Hee's legacy of economic policies. However poor economic performance was not just a Korean problem, it was a global turmoil then engulfing most of the developed and the developing world—a global recession. Ironically, despite his intention to liberalize the economy, Chun implemented the same policies that Park implemented when he pushed HCI in the middle of an oil crisis in the 1970s. His administration encouraged exports, devalued its currency, continued the campaign for foreign loans and borrowed its way out of a deficit.²⁶

The perceptions of Korea's economic situation was however "spun" by an economic logic that was different from the previous regime's. This diagnosis was created in a very political environment where stakeholders like Chaebols and US foreign policy were directly involved.

Wolfgang Streeck and Kathy Thelen in their work "Institutional Change in Advanced Political Economies" (p.27–31), bring theoretical insight into the changes that transpired in South Korea.

Displacement happens as new models emerge and diffuse which call into question existing, previously taken-for-granted organizational forms and practices. In the political science literature, the emphasis is typically more on political than on cognitive or normative factors, with change emanating mostly from shifts in the societal balance of power....While some institutional arrangements may impose a dominant logic of action, these typically coexist with other arrangements, created at different points in time and under different historical circumstances, that embody conflicting and even contradictory logics. Beyond this, and equally important, even within dominant frameworks there will normally remain possibilities of action that institutions neither prescribe nor

²⁵ Woo, Jung-en Woo, Jung-en (Meredith Woo Cummings), *Race to the Swift*, Columbia University Press., New York., 1991 p.191

²⁶ Woo, Jung-en. p.181

eliminate. Where either of these is the case, institutional configurations are vulnerable to change through displacement as traditional arrangements are discredited or pushed to the side in favor of new institutions and associated behavioral logics. Such change often occurs through the rediscovery or activation – and, always, the cultivation – of alternative institutional forms. As growing numbers of actors defect to a new system, previously deviant, aberrant, anachronistic, or “foreign” practices gain salience at the expense of traditional institutional forms and behaviors...²⁷

In other words, although Chun’s government appeared to follow the same path as Park’s, “displacement” was occurring. The economic slump in the early 1980s called into question the existence of the current state of affairs. Park’s developmental state policies had undoubtedly raised South Korea to become an economic and industrial powerhouse but by the 1980s, the popular perception was Park’s economic policies had become the bane of the administration. Arguably, it was repressive to labour; there were indigenous problems inherent to heavy industry plants exhibiting surplus capacity owing to insufficient demand in Korea and in the export markets; many large investment projects had long lead times and required additional capital for loan repayment and operational purposes, and there were duplicative investments made by Chaebol.²⁸ Park had announced an economic stabilization drive to address the inefficiencies and quell the acceleration of inflation in April 17, 1979²⁹ but these policies lost their momentum under a new leadership,

Economic stagflation was now understood to have been caused by the Park administration. Park’s economic policies were in many respects Keynesian and Keynesianism had been discredited especially in the US. The US was a staunch advocate against Keynesian economics. The new US neoliberal economic remedies were believed to be universal and could apply to the Korean economy as well. With the logic of the free-market, the cure to Korea’s situation was liberalization—an idea endorsed and committed to by Chun Doo Hwan. The combination of pent-up dissatisfaction with the high-handed methods of the previous government contributed to Park’s further

²⁷ Streech, Wolfgang and Thelen, Kathy. Institutional Change in Advanced Political Economies. www.graduateschool.unimi.it/allegati/Streeck%20and%20Thelen%20chapter%20PDF_8.pdf, p.27–30

²⁸ Haggard, Stephan et. al (eds) Choi, Byung Sun., Financial Policy and Big Business in Korea in the Politics of Finance in Developing Countries. Cornell University Press, Ithaca, London, 1993. p.40

²⁹ Haggard, S. and Moon, C., Institutions and Economic Policy: Theory and a Korean Case Study in World Politics Vol. 42, No.2 (January 1990). P. 219

unpopularity³⁰. This condition gave impetus to “rediscover” and activate alternative institutional forms. The discovery of new institutional forms was prodded by the senate, the treasury and banks in the US and these institutional forms required actors or internal stakeholders for the change, As Thelen and Streeck suggest:

... change requires active cultivation by enterprising actors. Such actors either see their interests at odds with prevailing institutions and practices, or they test new behaviors inside old institutions, perhaps in a tentative response to emerging new external conditions. Change is most likely to be effective if actors are willing to pay a price for their “incongruent” behavior (this is the core of what is meant by the “cultivation” of a new “path”). This is because promoting new institutions typically requires the exercise of power or the expenditure of resources, for example to underwrite new forms of coordination. At some point,... innovating actors may also be able to get rule makers to make changes to the formal institutions, or rule takers to demand such changes. In the process, deviant behavior becomes less deviant, and indeed traditional behavior may increasingly run into formal and informal sanctions.³¹

The Chaebols were the most powerful stakeholders that became the internal proponents (or the “enterprising actors”) of these institutional changes. Chaebols and US bankers mutually benefited from a liberalized financial market. Ending a financially controlled regime and the gradual opening of alternative sources of finance were beneficial to Chaebols. Under these circumstances, the US bankers became the willing lenders and Chaebols its borrowers. This effectively opened the opportunity for bankers to have a hand in Korea’s financial system.

The Chun Doo Hwan administration employed the services of like-minded experts and laypersons for economic government. The technocrats were led by Kim Jae Ik, a Stanford University Graduate who earned his doctorate degree in economics. He played a very important role in prompting the Economic Planning Board to move towards financial liberalization and fully supported the introduction of the neo-liberal idea.³² He became the senior advisor to the President. Other important economic advisors were Park Young Chul and Sakong Il, and EPB bureaucrats Kang Kong Shik, Kim Ki Hwan, and Kim Man Jay all had PhD.s in Economics from US Universities, more specifically in monetary

³⁰Asiainfo.,

http://www.asianinfo.org/asianinfo/korea/history/military_revolution_and_the_thir.htm

³¹ Streeck, Wolfgang and Thelen, Kathy. Institutional Change in Advanced Political Economies p.30

³² Kwon, Eundak., “Financial Liberalization of South Korea”., Journal of Contemporary Asia. 3/1/2004.

economics.³³ As early as the 80s, Ha Joon Chang notes that 15% of the PhD economics graduates in American universities were Korean.

The employment of neo-liberal advisors and officials was reassuring for US banks—it contributed to opening the taps to a capital starved economy. US banks then could rest assured that the leadership was committed to a free market—unlike the Park regime when capital outflows were more controlled. Employing US educated economists gave confidence to US lenders that the Korean economy was being structured to become a platform where both US banks and Korean firms can do better business. The Ministry of Finance however mostly consisted of conservative minded personnel loyal to the Park group. The Chun administration reshuffled top-level ministerial personnel filling key posts with free market inclined bureaucrats from the EPB.³⁴ In addition, a Financial Development Council comprised of liberal minded economists was formed as an advisory group to the finance minister in 1982.

The rationale for the liberalization of finance crept-in displacing the logic of the developmental state, and soon became the dominant operating economic logic with powerful stakeholders such as the Chaebol and the US banks. As Robert Gilpin wrote...

Rather than the extensive policy coordination and reduction of its budget deficit advocated by its allies and by most American economists, the principal Reagan administration solution to world economic problems was that of the convergence of domestic policies. This meant the alignment of national economic policies to lower inflation, the use of the IMF to monitor the accomplishment of this task, and the adoption by other countries of expansionary economic policies in order to reduce the American trade deficit. According to this formulation, the American economy had been restructured to enable it again to pursue non-inflationary growth policies. Moves towards the elimination of government regulation and the privatization of the public sector, the reduction of economic interventionism, and the dismantling of the welfare state under the banner of supply side economics, the Reagan administration argued, had weakened the sources of domestic

³³ Kim, Yun Tae., "Neoliberalism and the Decline of the Developmental State", *Journal of Contemporary Asia*. 10/1/1999.

³⁴ Cho, L.J. & Kim, Y.H. eds. Kim, P.J., *Financial Institutions in "Korea's Political Economy, An Institutional Perspective"*, p.297 A similar incident also happened in Japan as "internationalistic bureaucrats" tried to influence the MITI to shift to free trade. The shift in Japan during the late 1960s and throughout the 1970s from protectionism to liberalization was most clearly signaled by factional infighting within MITI between the "domestic faction" and the "international faction". The surest sign that the Japanese government was moving in a more open, free-trade direction was precisely the fact that the key ministry in this sector came to be dominated by internationalistic bureaucrats. Chalmers Johnson. P. 23

inflation. If other economies carried out similar policies, they would also be able to overcome their problems of high unemployment and slow growth.³⁵

Policy Change in the 1980s: paving the way for liberalization. US banks applied pressure to open up the financial sector of Korea in the early 1980s. Initially, US Banks were instrumental in providing loans to the industrial push of Korea but these loans were utilized in a very limited way. US banks underwent numerous bureaucratic scrutiny before their loans reached firms. Stringent measures were made by the state to make sure that the inflows (and outflows) of capital into the system do not upset the stability of the Korean economy during the Park Chung Hee regime. However, these were all going to change. Foreign loans were finding a home in South Korea. The chairman of the US EXIM bank went to South Korea in the middle of this economic crisis. Korea was US EXIM's largest market for loans—3.1 billion in loans outstanding. This highly visible visit signaled to other US and European banks that Korea was a sound investment. Major players in high finance such as David Rockefeller, William Spenser and Nobusuke Kishi visited South Korea as well.³⁶ These highly publicized visits essentially made Korea look good despite the incident at Kwangju—all in an effort to align Korea's economic policies with the US.

In the 1980s, American policy aimed to reduce controls. Anxious to participate in and profit from Korea's development, US banks lobbied for deregulation, equal treatments and lowering barriers for their operations.³⁷ The pressure was strong and the results paid-off. American Banks received hefty returns on their lending business that the Bank of America, Citibank, Chase Manhattan, Manufacturers' Hanover and Lloyd Bank received high returns on capital amounting to 359% in Korea in 1980³⁸. In 1984, their net profit increased by 26.6% from the previous year's level that more banks were encouraged to seize these opportunities.³⁹

³⁵ Gilpin, Robert., *The Political Economy of International Relations*. Princeton University Press, NJ. 1987. p.151

³⁶ Woo, Jung-en. p.187

³⁷ Kwon, Eundak., "Financial Liberalization of South Korea", *Journal of Contemporary Asia*. 3/1/2004.

³⁸ *New York Times*, 14 April 1980. Cited in Woo-Cumings, "Slouching toward the Market: The Politics of Financial Liberalization in South Korea," in *Capital Ungoverned: Liberalizing Finance in Interventionist States*, eds. Michael Loriaux, Meredith Woo-Cumings, Kent E. Calder, and Sofia A. Perez (Ithaca, New York: Cornell University Press, 1997), p. 81

³⁹ *New York Times*, 14 April 1980. Cited in Woo-Cumings, p. 81

The Reagan administration placed significant pressure on Korea to accept a financial open door policy.⁴⁰ Politicians such as Senator E. J. Garn and Donald Regan were among the main proponents of change in the financial sector of Korea. Garn was the author of a Senate bill giving permission for foreign banks to have the same privileges as local banks in Korea. He visited Korea in the fall of 1983, demanding the easing of restrictions for American banks operating in Seoul.⁴¹

Donald T. Regan⁴²—the secretary of the US treasury—had recently been elected Chairman of the Depository Institutions Deregulation Committee at this time. This committee was created by Congress to phase out interest rate ceilings on deposits in commercial banks, mutual savings banks, savings and loan associations, and credit unions. Regan's fervor for neoliberal reform were not confined to the US and so this former Merrill-Lynch CEO was reported by Business Korea (June 1984) to demand equal treatment for American Financial institutions doing domestic business in Korea. By 1985, the banks got what they demanded in Korea—permission to expand their working capital, to venture into trust banking, to join the National Bank Association and Clearing House, and the Bank of Korea rediscount on export loans.⁴³

The American banks were very specific in the kind of banking business they preferred—especially banking operations with low risks. Despite providing loans to Chaebols, US banks were interested in receiving the Bank of Korea rediscount on active export loans because these were loans with guaranteed payments. Rediscounting is a method where a standing facility is provided by a central bank to help banks meet their

⁴⁰ Maeil Kyongje Shinmun, 15 March 1985, cited by Kwon Eundak

⁴¹ Woo, Jung-en (Meredith Woo Cummings), *Race to the Swift*, Columbia University Press., New York., 1991. p.193

⁴² President Reagan nominated Donald Regan on December 11, 1980, when he was Chairman and Chief Executive Officer of Merrill Lynch & Company, Inc., the holding company formed by Merrill Lynch, Pierce, Fenner & Smith, Inc., Secretary Regan served as Chairman pro tempore of the Cabinet Council on Economic Affairs and as the Administration's chief economic spokesman. The Cabinet Council on Economic Affairs had primary responsibility for advising the President on developing and implementing domestic and international economic policies. Secretary Regan also worked closely with the President's Economic Policy Advisory Board, a group of distinguished nongovernmental economists that met periodically with the President and his senior economic advisors to discuss major economic developments.(From the United States Department of The Treasury Website)

⁴³ Woo, Jung-en (Meredith Woo Cummings), *Race to the Swift*, Columbia University Press., New York., 1991p.194

temporary liquidity needs for export. This loan facility practically had very low risk since these loans were earmarked for established export activities (with immediate expected returns), and had the guarantees of the Bank of Korea. In 1985, commercial banks charged 10% interest on export financing. 70% of these loans were rediscounted at the Bank of Korea at 5% interest, and the remaining 5% margin on export loans was the spread that these American banks received.⁴⁴

United States tried to open the Korean life insurance market which provided highly profitable long-term deposits and, as a result, was highly protected by Koreans. It was a very lucrative business and needed a politically loaded “crowbar” to pry it open. The United States initiated an investigation into Korea’s violation of Section 301 of the U.S. Trade Act⁴⁵. There was sufficient evidence to make a case for unfair trade practices based on their findings. The United States threatened to retaliate by hitting where it hurts—Korea’s exports. The US was ready to increase barriers to prevent Korean commodity exports to their shores.⁴⁶ These sanctions left the leadership in a rather precarious position that the government complied to open the insurance market in 1987.

Import liberalization was also one of the Reagan administration’s objectives. Korea had a large export market in the United States. US protectionism was the tool that the US used to bully South Korea into submission. The Bentsen–Rostenkowski bill and the Gephardt Amendment were the pieces of legislation the Americans used to push countries to open their markets.⁴⁷ The bill essentially taxed the imports of countries with large surpluses. These pressures opened up the Korean market to imports. In 1980 only 68.6 percent of the items that were imported were in the automatic approval list. This percentage has grown progressively from 74.5% in 1981, 87.7% in 1985 and 100% by 1990.⁴⁸

⁴⁴ Woo, Jung-en. p.194

⁴⁵ Congress enacted Section 301 as part of the Trade Act of 1974, and it is the principal law authorizing the U.S. government to address unfair trade practices. Section 301 directs the President to identify countries that are engaging in unfair trade practices, and to take trade actions against those countries, including sanctions if necessary, to remedy the problem. (cited in Woo)

⁴⁶ Woo, Jung-en. p.194

⁴⁷ (Woo, Jung-en (Meredith Woo Cummings), *Race to the Swift*, Columbia University Press., New York., 1991. p.188

⁴⁸ Woo, Jung-en. p.198

The U.S Congress tabled a bill insisting "reciprocal national treatment" of US banks and financial intermediaries in other countries. This bill would force foreign governments to give equal treatment of US financial institutions in other countries. President George Bush went to Korea and pressed then President Roh Tae Woo to remain faithful to the principles of this bill in January 1992.⁴⁹

Roh Tae Woo instructed the Ministry of Finance (MOF) to realize liberalization promptly. The MOF drew-up a reform plan to liberalize the economy which was the subject of discussion in the Financial Policy Talks in March 1992.⁵⁰ In May of 1993, the MOF announced the comprehensive four-stage financial market restructuring. The plan worked towards speeding-up interest rate deregulation, assure the structural integrity of the financial system, remove the policy loan scheme, eliminating the credit control system and the reduction of non-performing bank loans. Moreover, foreign Investment ceilings of domestic financial institutions were increased and several regulations about the long-term and short-term capital flows were relaxed. With the stepping up of the financial market reform, domestic financial institutions were left with no option but to compete with other foreign financial institutions.

The pressure from the United States was unrelenting despite MOF efforts. Deputy U.S. Trade Representative Charlene Barshefsky told the Korean government that Washington strongly wanted Korea to accelerate its deregulation and liberalization plans at the June 1993 U.S.-Korea economic consultation meeting in Seoul.⁵¹

⁴⁹ Kwon, Eundak., "Financial Liberalization of South Korea"., *Journal of Contemporary Asia*. 3/1/2004.

⁵⁰ Haggard and Maxfield, "The Political Economy of Financial Internationalization," 59. Cited in an the article by Kwon, Eundak., "Financial Liberalization of South Korea"., *Journal of Contemporary Asia*. 3/1/2004.

⁵¹ *Business Korea*, July 1993, Cited in an the article by Kwon, Eundak., "Financial Liberalization of South Korea"., *Journal of Contemporary Asia*. 3/1/2004.

TABLE 3B
Four-Stage Liberalization of Interest Rates

		Measures
First Stage	Deposits	<Implemented in November 1991> *Bank: CD, large denomination RPs, commercial bills and trade bills, time deposits with maturity of three years (new) *Non-Bank: large denomination CPs, time deposits with maturity of at least three years, time deposits of mutual savings & finance companies with maturity of at least two years, etc.
	Loans	*Bank: overdrafts, discounts on commercial papers apart from loans assisted by BOK rediscounts, overdue loans *Non-bank: discounts on commercial bills of trust, mutual savings & finance companies, insurance, discounts on CPs and trade bills of investment finance corporation, etc.
	Bonds	Corporate bonds with maturity of at least two years
Second Stage	Deposits	<Implemented in November 1993> *Bank: time deposits with maturity of at least two years, installment type deposits with maturity of at least three years such as installment savings, mutual installments, etc. *NBFIs: time deposits with maturity of at least two years, installment type deposits with maturity of at least three years such as installment savings, mutual installments, etc. C.F.) mutual savings & finance companies: time deposits with maturity of at least one Year and installment savings with maturity of at least two years, etc.
	Loans Bonds	*All loans of banks and non-bank financial institutions except policy loans Corporate bonds with maturity of less than two years, financial debentures, Government and public bonds. Minimum maturity of CPs were reduced to two months.
Third Stage		<Partially implemented in July 1994> *Shortened the minimum maturity of CP (91days → 60 days) and allowed the issue of banks' cover bills
	Deposits	<Partially implemented in December 1994> *Time deposits with maturity of less than two years and installment savings with maturity of two year or less than 3 years
	Loans	*Liberalized the interest rate of loans with an aggregate credit ceiling system of BOK to the extent of prime rate
	Deposits	<Partially implemented in July 1995> *Time deposits with maturity of six months or less than one year and installment savings with maturity of one years or less than 2years Expanded short-term marketable products liberalization (shortened the minimum maturity and lowered the minimum issue denomination)
	Loans	*The interest rate of loans with an aggregate credit ceiling system of BOK
	Deposits	<Full implementation in November 1995> *Time deposits with maturity of less than 6 months and installment savings with maturity of less than one year, etc Preferential savings & company savings with maturity of at least three month Expanded short-term marketable products liberalization (lowered the minimum issue pars)
Fourth Stage	Banks	<Implemented in July 1997> Savings deposit, preferential savings with maturity of less than three months and MMDA, Company savings with maturity of less than three months and MMDA
	Merchant Banks	Bills issued with maturity of less than one month,
	Investment Trust	Trust-type securities savings
	Mutual savings	Passbooks
	Mutual credits & Credit unions.	Preferential time & savings deposits with maturity of less than 3 months
	Community credit cooperatives	*Deregulated the maturity of short-term marketable products (CD,RP,CP, etc), the minimum denomination, repurchasing fee of trust companies, interest rate of time deposits with maturity, etc

Source: Cho, Yoon Je., "The Political Economy of Liberalization and Crisis in Korea"

Policy Change in the Neo-liberal 1990s

"Our task is to knock down barriers to trade and foreign investment and the free movement of capital,"

Ronald Reagan (1985)

This time, the American economic agenda arrived with big fangs; first, structural monetarism, pullulating out of Stanford and applied earlier in the Southern Cone of Latin America, and second, ceaseless pressure to pry open Korea's market to American imports and service industries.⁵²

The telos of Korean political economy, however, was usually painted in broad strokes in either New York or Washington, in the epicenters of world capitalism and politics. Korea was allowed the luxury of deviation, a state-led and late development, as long as it remained in the interstices of global capitalism and on the forefront of the cold war. The story of the 1980s, then, is not the story of Korea "reforming," rehabilitating from the bad habits of the past, but adjusting to the new reality in Washington and plunging into the whirlwind of world capitalism....⁵³

Meredith Woo Cummings

Ronald Reagan had championed the cause of neo-liberalism, and his platform was much welcomed by Wall Street and by financial institutions awash with petro-dollars seeking to find refuge in developing economies. His presidency had ushered in an era that progressively tried to break down economic barriers between countries, and Korea was one of the countries that was targeted by this administration. Chun Doo Hwan had very strong relationships with Washington. His liberalization campaign complemented with Reagan's economic platform—in fact, Chun Doo Hwan was the first head of state that was welcomed to the White House by the Reagan administration.⁵⁴

The political pressure applied by the US government was not without teeth because a large share of South Korean exports go to the US market—the South Korean economy was threatened by a monopoly buyer.⁵⁵ The threat of protectionism was real and the Bentsen-Rostenkowski bill, the Gephardt Amendment and Section 301 of the US Trade

⁵² Woo, Jung-en (Meredith Woo Cummings), *Race to the Swift*, Columbia University Press., New York., 1991. p.185

⁵³ Woo, Jung-en (Meredith Woo Cummings), *Race to the Swift*, Columbia University Press., New York., 1991 p.202

⁵⁴ Woo, Jung-en. p.185

⁵⁵ China does not serve one big customer that its economy becomes dependent on this single market. China only exports 25% of its products to the United States.⁵⁵

Act were pieces of legislation that were threatening this trade relationship. The pressure applied by foreign banks pried the economy open throughout the Roh Tae, Woo and Kim Young Sam presidency in a very slow but progressive way where the structural change of Korea's political economy was mostly consummated during Kim Young Sam's administration (1993–1998).

Major Financial Liberalization Measures in Korea During the 1990s⁵⁶

- 1) Interest rate deregulation (in four stages: 1991 to July 1997)
 - a. By 1997, all lending and borrowing rates, except demand deposit rates were liberalized.
- 2) More managerial autonomy for the banks and lower entry barriers to financial activities
 - a. Freedom for banks to increase capital, to establish branches and to determine dividend payments (1994)
 - b. Enlargement of business scope of financial institutions (1993):
 - i. Continuous expansion of the securities business deposit of money banks (1990, 1993, 1994, 1995)
 - ii. Freedom for banks and life insurance companies to sell government and public bonds over-the-counter (1995)
 - iii. Permission for securities companies to handle foreign exchange business (1995)
 - c. Abolition of the limits on maximum maturities for loans and deposits of banks (1996)
- 3) Foreign exchange liberalization
 - a. Adoption of the Market Average Foreign Exchange Rate System (1990)
 - b. Easing of the requirement of documentation proving "real" (i.e. non-financial) demand in foreign exchange transactions (1991)
 - c. Setting up of foreign currency call markets
 - d. Revision of the Foreign Exchange Management Act (1991): changing the basis for regulation from a positive system to a negative system
 - e. Introduction of "free Won" accounts for non-residents (1993)
 - f. Foreign exchange reform plan (1994): a detailed schedule for the reform of the foreign exchange market structure

⁵⁶ Chang, HJ .et al., *Interpreting the Korean Crisis—found in Financial Liberalization and the Asian Crisis*. Palgrave, NY. P. 141–142

- g. A very significant relaxation of the Foreign Exchange Concentration System (1995)

4) Capital Market Opening

- a. Foreign investors are allowed to invest directly in Korean Stock markets with ownership ceilings (1992)
- b. Foreigners are allowed to purchase government and public bonds issued at international interest rates (1994), non guaranteed long-term bonds issued and medium sized firms (Jan. 1997) and non-guaranteed convertible bonds issued by large companies (Jan. 1997)
- c. Residents are allowed to invest in overseas securities via beneficiary certificates (1993)
- d. Abolition of the ceiling on the domestic institutional investors' overseas portfolio investment (1995)
- e. Foreign commercial loans are allowed without government approval in so far as they meet the guideline established in May 1995
- f. Private companies engaged in major infrastructure projects are allowed to borrow overseas to pay for domestic construction cost (Jan. 1997)
- g. Liberalization of borrowings related to Foreign Direct Investments (Jan. 1997)

5) Policy loans and credit control

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

3.C The Impact on Chaebols

Access to capital and favours had been political. The previous Park regime directed capital the Chaebol's way despite the fact that they were highly leveraged, and in some cases almost insolvent. In 1972 the Park administration rescued strategic industries from bankruptcy by restructuring debts and providing subsidies obtained from foreign loans. For a Chaebol, this was a very hard habit to break. Liberalization during the Chun and Roh regimes was gradual so components of preferential allocation were still in place, and this facility was used in a rather dishonorable way. The means to direct capital and favors to the Chaebol's way was through close political affiliations—unlike the Park regime where privileges were rewarded according to a performance-based

consultative process. "Donations and contributions" to presidential foundations were regular fare. Those who did not "donate" to the "foundations" usually met an early demise—such was the fate of the Kukje Group.

The Korean economy was caught in the push and pull of local and international forces. However, the legacy of capital controls in South Korea remained still in place even after proclamations of liberalization—the financial reform of the early 1980s was not a full-scale financial liberalization.⁵⁷

TABLE 3C
Share of Policy Loans in Commercial and Specialized Banks (%)

	1973-81	1982-86	1987-91	Average 73-91
Policy loans by commercial banks (A)				
Government funds	7.5	7.4	8.0	7.6
NIF (national investment funds)	4.2	5.1	3.0	4.2
Foreign currency loans	21.1	19.7	19.4	20.3
Export credits	21.3	16.9	5.2	16.2
Commercial paper discounted	8.0	13.9	16.5	11.6
Special funds for the SMEs	5.9	5.6	6.5	6.0
Loans for Agriculture and Fisheries	6.1	5.3	7.4	6.2
Housing loans	8.0	13.1	14.1	10.8
Others	17.7	13.1	20.0	17.1
Total (A)	100	100	100	100
Loans by specialized banks (B)				
Korea Development Bank	91.9	71.7	83.7	84.8
(NIF)	-25.7	-18.5	-7.5	-19.5
Export & Import Banks	8.1	28.3	16.3	15.2
(NIF)	-2.5	-4.7	-2.3	-3.0
Total (B)	100	100	100	100
(A) / Total loans by commercial banks	63	59.4	59.5	61.2
(B) / Total loans by NBFIs	48	32.3	15.3	35.9
(A) + (B) / domestic credit	48.9	40.8	30.9	42.4

Note : The share of NIF is annual average during 1974-81. Others include loans for imports of key raw materials, machinery and equipment, loans to the export industry, special equipment funds, and special long-term loans.

Source : National Statistics Office, Korean Economic Indicators, various issues; Bank of Korea, Monthly Bulletin, various issues; Cho and Kim(1997)

A large share of policy loans in this table was an indication that the government was still reluctant to liberalize controls. Policy loans made up 60% share of commercial bank loans. The loans Chaebols obtained in the Park years had very low interest rates that

⁵⁷ Lee, C.H., Lee, Keun, Lee, Kangkoo. "Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea", p.6

they were bound to increase dramatically once global interest rates were introduced during liberalization and may perhaps make them insolvent⁵⁸. Chaebols proceeded very cautiously with liberalization. With the new liberties under the new regime, Chaebols began to access other sources of finance to prepare themselves for a full-scale liberalization of the economy. Chaebols utilized the stock and bond market. The capital base increased in the early 1980s. This inflow of capital initially gave the economy a significant boost. However, its stability is questionable—capital that quickly flowed in can quickly flow out as well. The beginnings of the liberalization project was fortuitous since many investors were interested in South Korea's prospects. But waning interest has manifested itself in deleterious ways—as we shall see later. Park Chung Hee struggled to contain and control capital by strictly confining the inflow of capital through long-term loans *not through short-term instruments nor portfolio capital*. Moreover, Park limited control of these firms by preventing shares of investors whose main concern was the immediate rate of return.

In January 1980, bond transactions on Repurchase Agreements⁵⁹ were institutionalized to expand the base of the bond-issuing market. Securities authorities announced the Measures for Reinforcement of Capital Market Formation in July 1983. This policy motivated firms to sell stocks of their companies at market price. The Ministry of Finance further liberalized the securities market by allowing foreigners to invest in Korean firms. In November 1981, open-ended Investment trusts were created. Korean International Trust (KIT) and the Korea Trust (KT) were created and sold for USD 15 million. As the amount of KIT and KT funds increased by 10 million dollars each, two years later. The instruments became very popular among foreign investors, other investment trusts were created amounting to 30 million dollars in March and April 1985. These were the Korea Growth Trust (KGT), Seoul International Trust (SIT), and Seoul Trust (ST). In May 1984, a 60 million dollar close-ended⁶⁰ company-type investment known as the Korea Fund became well supported by the investing public that it was later

⁵⁸ Lee, C.H., Lee, Keun, Lee, Kangkoo. p.6

⁵⁹ Repurchase agreement – A holder of securities (or in this case bonds) sells these securities to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security “buyer” in effect lends the “seller” money for the period of the agreement, and the terms of the agreement are structured to compensate him for this. Dealers use RP extensively to finance their positions.

⁶⁰ Investment trusts raise money for investing by issuing shares. Generally, this happens once – when the trust is created. This makes investment trusts closed-ended: the number of shares the trust issues, and therefore the amount of money it raises to invest, is fixed at the start. Knowing this amount of money is fixed enables fund managers to plan ahead.

listed in the New York Stock Exchange.⁶¹

The Korean Bond and Stock Market grew. Equity that was generated through stocks suddenly rose from a market value/GNP ratio of 6.9% in 1980 to 67.7% in 1989⁶²

TABLE 3D
Growth of the capital market in Korea (billion Won)

	1980	1985	1987	1989	1990	1991	1992
Stock Market							
Companies listed	352	342	389	626	669	686	688
Book Value of the stock	2421	4665	7591	21212	23982	25510	27065
Market value (A)	2526	6570	26172	95447	79020	73118	84712
A/GNP (%)	6.9	8.4	24.7	67.7	46.1	34.1	35.5
Trading volume	1134	3620	20494	81200	53455	62565	90624
Stock price index	106.9	163.4	525.1	909.7	696.1	610.9	678.4
Corporate bonds							
No. of issuers	434	1213	1457	1504	1603	1862	2070
Book value	1649	7623	9973	15396	22068	29241	32696
Trading volume	246	660	5327	4378	2455	1394	453

Source : Korea Securities Dealers Association

Chaebols had their opportunity to access finance through other financial pipelines⁶³. Non-Banking Financial Institutions (NBFIs) became the agents or point of sale for their financial instruments. In many cases, NBFIs were aggressively acquired by Chaebols that collusive lending has been the modus operandi of most Chaebol acquired banks. This "arrangement" became very beneficial to Chaebols—as Duck Woo Nam reminded us..

Even after government intervention was reduced to almost nothing in the early 1990s, there has been little change in the close connection between banks and business conglomerates for the following reasons, among others: the conglomerates comprise not only industrial companies but also financial institutions such as insurance, securities, and merchant banks; therefore it is relatively easy for each conglomerate member to borrow funds from financial member institutions on the basis of cross guarantees among members. Under this situation, for lending decisions the banks simply relied on the financial maneuvers of the Chaebol, rather than on a well-founded risk analysis of the business group as a whole. After all, it is important for the banks to maintain

⁶¹ Cho, L.J. & Kim, Y.H.eds. Kim, P.J., "Korea's Political Economy, An Institutional Perspective", p.299

⁶² Lee, C.H., Lee, Keun, Lee, Kangkoo. "Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea", p. 7

⁶³ Haggard, S. and Moon, C., Institutions and Economic Policy: Theory and a Korean Case Study in World Politics Vol. 42, No.2 (January 1990). P. 228

good relations with big companies in expanding their business volume and ensuring access to large fees.

Duck Woo Nam⁶⁴
Deputy Prime Minister and Minister of Economic Planning
during the Park Chung Hee regime.

NBFIs are multi-functional institutions that offer services such as various types of contractual savings and institutional investors such as pension funds, insurance companies, and mutual funds. They generally mobilize savings and facilitate the financing of different activities. They complement the role of commercial banks by filling gaps in their range of services. NBFIs are actively involved in the securities markets and in the mobilization and allocation of financial resources.

1980s, the Association of National Investment and Finance Companies (ANIFC)⁶⁵ pushed for financial deregulation. With the commercial banks significantly encroaching into its market share, the NBFIs needed some leeway to compete with banking institutions. The Association successfully persuaded the government to eliminate the discriminatory tax rate on the interest earned through short-term financing companies in 1980⁶⁶. As a result, the number of NBFIs such as investment and finance companies and mutual savings and finance companies increased noticeably.

⁶⁴ Prepared for a presentation at the 11th Conference of the Korea U.S. Business Council at the Maui Prince Hotel, Maui, Hawaii, on January 19, 1998.

⁶⁵ Established in 1979

⁶⁶ Haggard, Lee, Maxfield eds. Byung, Sun-Choi, Financial Policy and Big Business in Korea found in, "The Politics of Finance in Developing Countries". Cornell University Press., Ithaca and London. 1993., p.46

TABLE 3E
Market Shares of Types of Financial Institutions
1976–1989 (percentage)

	Loans					Deposits				
	1976	1980	1985	1989	Average Rate of Increase	1976	1980	1985	1989	Average Rate of Increase
Deposit Money										
Banks	68.2	62.2	53.6	49.9	24.7	74.7	66.3	48.5	36.6	23.1
NBFIs	31.8	37.8	46.4	50.1	32.2	25.3	33.7	51.5	63.4	39.6
Development Institutions	16.6	19.2	17.1	9.0	21.9	0.8	0.9	0.5	0.6	26.5
Savings Institutions	7.3	8.8	14.0	22.1	39.1	12.4	15.7	20.5	28.9	38.8
Investment Companies	7.1	6.7	8.8	9.0	30.1	8.2	10.9	17.0	18.7	38.6
Life Insurance Companies	0.8	3.1	6.5	10.0	54.6	3.9	6.2	13.5	15.2	44.3

Source: BOK, *Financial System in Korea* (Seoul, 1990). Cited in *Financial Policy and Big Business in Korea* by Byung, Sun-Choi. In "The Politics of Finance in Developing Countries", Haggard, Lee, Maxfield eds., p.47

Slowly, the growth of NBFIs were displacing the commercial banks as the primary source of funds⁶⁷

Ownership of finance-based enterprises by Chaebols was rampant. Before the deregulation, the top 15 Chaebols were not entitled to have shares of NBFIs and the next 15 were only entitled to own up to as much as 50%. In 1988, the top 30 Chaebols owned 12 out of the 25 security firms, 18 of 35 insurance companies and 18 of 38 investment trust companies. All in all, they owned 30% of the shares of the banking sector in 1988.⁶⁸ In May 1996 all Chaebols except for the top 5 were allowed to own and control life insurance companies because all restrictions on owning NBFIs were removed.⁶⁹

⁶⁷ Lee, C.H., Lee, Keun, Lee, Kangkoo. "Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea", p. 7

⁶⁸ Lee, C.H., Lee, Keun, Lee, Kangkoo. "Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea", p. 8

⁶⁹ Lee, C.H., Lee, Keun, Lee, Kangkoo. p. 11–12

TABLE 3F
NBFIs Owned by Chaebols, 1995

Chaebols	Security Companies	Insurance Companies	Investment & Finance Co. and Merchant Banks, others	Others	Total
Top 5 Chaebols	5	5	4	2	16
Top 10 Chaebols	9	7	7	2	25
Top 30 Chaebols	13	9	19	2	43

Notes: Others include Factoring companies, Credit Card Co's. & Credit Unions.

Source: Bank Supervisory Authority of Korea.

Declining control over Chaebol. The shift of financing from government-controlled banks to Chaebol owned financial intermediaries gave Chaebols a certain degree of autonomy from the government in the 1990s. Massive expansion of their industries led to overproduction. The administration tried to direct the manufacturing agendas of firms, but ministerial coordination and government directives were not significantly adhered to. The administration attempted to retain control over the industrial directions of the Chaebols by imposing stiff fines if they deviated from the general strategic plan. Policies were made to reduce the scope of the Chaebol's activities by allowing each Chaebol group a maximum of three companies to specialize in businesses it had the strongest comparative advantage and growth-potential.⁷⁰ Another policy involved the disposal of shares held by the owner families.⁷¹ But the conglomerates endured suits and paid the fines rather than risk higher returns from their business ventures. Control over Chaebols became less since they were significantly gaining ground in financing their own agendas.

Many major coordinating institutions were merged with other institutions. One of them was the Economic Planning Board. In 1993, the EPB was merged with the Ministry of

⁷⁰ Lee, C.H., Lee, Keun, Lee, Kangkoo. p. 9

⁷¹ Lee, C.H., Lee, Keun, Lee, Kangkoo. p. 9

Finance to form the Ministry of Economy and Finance in 1994.⁷² Furthermore, the Ministry of Economy and Finance that was formerly under the office of the Deputy Prime Minister was demoted to an organization that was headed by a minister. And the 5-year economic plan was terminated later in the Kim Young Sam administration.⁷³

Bureaucratic power declined after 1980. In the words of YH Kim...

Korea experienced a radical discontinuity in its civilian bureaucracy and especially its economic cadres, with resulting discontinuities in economic policies. These developments, coupled with a new orientation in economic policy emphasizing a free market ideology, propelled the business leaders into the vacuum thus created, and private enterprise emerged with enhanced powers."⁷⁴

The increasing trend of short-term instruments. With support from the United States and the Chaebols, Chun Doo Hwan established the political foundations necessary for a gradual liberalization of the economy that succeeding presidents built on to sustain the partnership between foreign banks and Chaebols. Less government intervention and control was the economic cure that was supposed to curb the difficult economic situation of Korea. But did this economic remedy do what it was intended to do?

⁷² Chang, Ha-Joon, Evans, Peter. The Role of Institutions in Economic Change, Paper prepared for the meeting of the "Other Canon" group, Venice, Italy, January 13 - 14, 2000. <http://www.othercanon.org/papers/>, P.25

⁷³ Chang, Ha-Joon, Evans, Peter. P.25

⁷⁴ Cho, L.J. & Kim, Y.H.eds. YH Kim., An Introduction to the Korean Model of Political Economy "Korea's Political Economy, An Institutional Perspective" Westview Press Inc., Colorado, Oxford., 1994 p. 52

Total debt as a percentage of GNP increased. In 1974–1978, the economy had been able to correct itself when the oil crisis hit the Korean economy. At this time debt abruptly increased to 40% but was corrected to the 30% range until Park's assassination in 1979. However debt increased abruptly after Chun Doo Hwan took over with his liberalization strategy. The total debt of the Korean economy went up to the 50% range from 1982 to 1984.

Fig 3G

Source: Bank of Korea and Economic Planning Board
Cited in Amsden p.95

Total debt increased at a faster rate after the assassination of Park Chung Hee in 1979. More importantly, short-term debt started to increase in Korea's debt portfolio as well. As it was previously noted, an industrialization strategy necessitated loans that were apt for long-term commitments. Short-term capital—structured to be a long term loan—can derail a well-coordinated industrial agenda because short-term lenders are under no legal obligation to remain providing capital to a firm once the short-term contract expired. Under Chun Doo Hwan's regime short-term capital increased.

Fig 3H

Source: Bank of Korea and Economic Planning Board
Cited in Amsden p.95

Based on these datasets, it appears that South Korea became more debt-laden when the Chun Doo Hwan administration changed the structures of the economic system as it tried to manage the price increases borne by oil hikes. Contrary to Chun Doo Hwan's objectives, the debt increased at a faster rate during his rule. Though long-term loans were predominant, short-term debts began to increase at a higher rate such that it was approximately 27% of the entire debt portfolio in 1984.

The Chaebol and US economic interests were two major factors that pushed the liberalization agenda in the Korean economy. Their actions created the structures to open more taps to global finance and prepared the ground for the Chaebols to pursue their "own industrial agendas". Chaebols created conduits that would funnel capital into their respective business ventures, and in part, this was achieved by creating and buying banks that had access to foreign capital. However the short-term financial instruments they used—combined with a deregulated border especially in the 90s—made the Korean economy vulnerable to capital shocks. The increasing trend of borrowing short-term loans in the 80s was the beginning of instability. Short-term loans (and other instruments such as portfolio capital), was capital that was prone to flight. Increasing trends of GNP are sure signs of productivity growth but they were not an indicator of stability of an economy as it interfaced with the global economy. When capital is free to flow, speculative forces with huge capital resources can overwhelm the financial market and give it a resemblance of abundance, but the very same herd behaviour that brought the capital in the economy can also bring it out as it happened in the crises of 1931 and in 1997.

Chapter 4 Manoeuvres

The role of this chapter is to explain how South Korea committed itself to liberalize the economy from 1980 to 1990. The chapter begins by reviewing the way capital controls were relaxed in the 1990s. Kim Young Sam liberalized the economy, attempting to quell the rampant graft and corruption in the state by subjecting the economy to market discipline. More importantly, the United States encouraged the Kim government to adopt neoliberal economic policies and the deregulation of South Korea's capital accounts was imposed as a condition of membership to OECD. However, the way liberalization took place made short-term loans and portfolio capital the most accessible instrument—instruments more prone to flight.

The Chaebols needed the capital urgently that they raced to own the conduits of short-term capital—NBFIs and merchant banks. The next part of the chapter will feature how Chaebols gained access to foreign short-term capital through these conduits and restructured these loans as long-term capital—which can command higher interest rates. In 1997, capital flight was rampant that Chaebols operations were at a standstill because capital instruments of this kind were hard to acquire because interest rates have soared. With the Chaebol having the largest share of the national income, the shortage of capital eventually ground the South Korean economy to a halt.

This chapter describes how the instability innate in capital liberalization progressed as the financial market was opened wider. The objective of quelling corruption indeed may have been good but accomplishing this by subjecting the economy to the whims of market forces appears to be neglectful of a successful developmental heritage during the Park regime. Deregulating the capital market was the beginning of instability—as it was in many deregulated economies that experienced flight. The remaining parts of the chapter describe how the structures that created instability progressed in South Korea.

4.A Quelling Corruption, creating vulnerability

The regimes of Chun Doo Hwan (1980–1988) and Roh Tae Woo (1988–1993) were often accused of being corrupt. Favours—usually in the form of financial entitlements—were given to relatives or to affiliated industrial cronies. When Kim Young Sam (1993–1998) was elected to office, he vowed to change these relationships by subjecting these economic relationships to the discipline of “arms length” free market financial mechanisms.

In the same manner, corruption was also attributed to the Park Chung Hee regime. However, what transpired during his administration suggests something different. The Park administration made the allocation of capital a consultative process between the state and the private sector. Park created a level playing field for firms to compete on. The monthly consultation meeting between business and the government was the venue for this dynamic. In these meetings, directions were mutually discussed, and collective action in a national scale was planned. More importantly, the EPB used performance standards firms were measured against. The process was transparent to all competing firms for policy loans and other allocations. Essentially firms were in a contest for government allocations with the state enforcing the rules and providing the rewards. The competition was a means to ensure that the process was fair among all parties concerned. When Chun Doo Hwan came to power, the EPB staff was changed to free market inclined bureaucrats. In the name of economic liberalization, they implemented a gradual transition to let market forces work rather than state enforced directions and performance standards. It was the progressive devolution of the EPB and the impotence of performance standards and industrial strategy that turned Korea’s political economy against itself. Without a mutually agreed objective performance standard and the political power to enforce them, the policy loan component was susceptible use as a vehicle to transfer funds through undemocratic and suspicious means.

The Chaebols and the leadership of succeeding presidents Chun Doo Hwan and Roh Tae Woo¹ were closely intertwined. This relationship was fraught with dubious exchanges

¹ Chun Doo Hwan’s classmate (eleventh class military academy graduate), hand-picked by Chun to be his successor. Roh Tae Woo and Chun Doo Hwan belong to a secret organization known as the ‘Hanahwoe’ otherwise known as the “One Association”. It is composed of a small clique of the first four-year graduating class of the Korean Military Academy (or the 11th class from the inception of the military academy). Captain Roh Tae Woo was one of the founding members of the secret association and was the right hand

that Chun and Roh were indicted for corruption. They were also indicted for treason for their involvement in the coup and the massacre at Kwangju. In December 3, 1995 the courts ruled that both Chun and Roh were to be sentenced to death,² though their sentences were commuted to prison terms instead.

Cronies of Chun Doo Hwan did not escape justice. Several family members that had government positions were sent to prison for soliciting illegal funds from corporations. Nine important businessmen, including the chairmen of Samsung, Daewoo and 21 former military officers and aides, were convicted on charges of corruption or assisting the coup in separate but related cases involving political bribes. Most of them received jail terms of three years at the least. The two-year sentence of the chairman of the Samsung group however was suspended.³

Near the end of Roh Tae Woo's term (1993), the nation was well aware of the issues of corruption within their government. Then presidential candidate Kim Young Sam campaigned for major changes in the government especially in the issues of graft and corruption. "Misconduct and corruption are the most terrifying enemies attacking the foundations of our society." (Time, March 8, 1993, p. 19). He was elected and became the first non-military president in February 1993. He created a new cabinet and appointed former dissidents by March of the same year and led a relentless pursuit to rid the government of corruption. This led to more than 1,000 bureaucrats and politicians getting fired or being forced to resign by mid-1993.

Kim Young Sam attempted to quell the corruption by exposing the Korean economy to the discipline of the free market. More "Arms length" financial facilities such as stocks, commercial papers and bonds gave the promise of weeding out corrupt inefficient firms since firms were always threatened by capital withdrawal at any hint of suspicious activity. Opening the economy to international banks who have had more experience in doing due diligence was a way of discerning borrowers who were worthy of loans—a task that used to be performed by the EPB, MOF heads of Chaebols and president Park Chung Hee himself during his rule. The intention may have been good, but exposing firms to the whims of global finance poses a bigger problem—instability. President Kim

man of Chun Doo Hwan. Cited in John Kie-Chiang Oh Korean Politics Cornell, 1999 p. 76.

³ <http://www.answers.com/topic/chun-doo-hwan-1>

Young Sam (1993–1998) ascended to power on the platform of liberalization. In July 1993, he announced the “Blueprint for Financial Liberalization and Market Opening and the “Foreign Exchange Reform Plan” in December 1994. These plans enabled the US to expedite the liberalization process by pushing the administration to allow multi-national firms and banks to take part in Korea’s financial system. Kim signed a bilateral agreement with the United States committing its financial markets to open.

With Kim’s long-standing desire to globalize Korea, the administration implemented policies that were guided by his commitment to join the OECD. Kim was obligated to open its capital accounts as a condition of membership.⁴

The liberalization of the financial system was quick to open opportunities for Chaebols and other businesses to widen the flows of loans into the Korean economy. The measures that were taken were,

- The gradual increase in the limit of foreign investment in the stock market
- Further relaxation of short-term trade-related borrowing;
- And the relaxation of control over the issuance of Korean firm’s securities in the foreign capital market and offshore borrowing.⁵
- Abolition of the annual ceiling on foreign currency loans
- Short-term transactions were deregulated that there were no restrictions nor monitoring of it.⁶

The government maintained some quantitative restrictions on long term borrowing presumably as a lever to control capital flow. The consequent effect was the rise in short-term foreign debts of NBFIs to fuel the corporate demands.

4.B Exposing the economy to global finance through short-term instruments

Interest rates were freed up on short-term loans more than long-term loans, In the same manner, interest rates were freed on assets and liabilities of NBFIs more than banks. This arrangement increased financial fragility and directed short-term capital to NBFIs that were rarely regulated.

On initial glance, interest rate liberalization of Korea seemed to have focused on the liberalization of long-term loans and then proceeded to short-term loans (see Four-

⁴ Korea joined the OECD in 1996.

⁵ Cho, Yoon Je., “The Political Economy of Liberalization and Crisis in Korea”, . p.12

⁶ Lee, C.H., Lee, Keun, Lee, Kangkoo. p. 13

stage liberalization of Interest Rates). However, this was far from what actually transpired. The actual implementation of liberalization deviated substantially from the formally announced liberalization in 1993⁷ where short-term bills such as commercial papers (CPs-3 month duration) were de-regulated *sooner than long-term instruments*.⁸ Yoon Je Cho discusses the discrepancy between the difference of what was announced and what had actually transpired:

The interest rates of short-term bills such as commercial papers (CPs) were formally liberalized in 1991. But it was in 1993/1994 that they were actually completely liberalized. The bank interest rates continued to be controlled through moral suasion or administrative guidance until 1996 despite formal liberalization in 1993. For instance, the bank loan rates (except those policy-based loans supported by the rediscount window of the central bank) were completely liberalized by November 1993. But the movements of the bank loan rates (prime rate) clearly show that they were not fully deregulated. Corporate bond rates had been indirectly controlled until mid-1997, through the control of the volume of issuance despite formal liberalization in 1991. As a consequence, the three-year corporate bond yields were lower than the three-month CP yields in most periods in 1994-97. The banks' prime lending rates were lower than the corporate bond rates throughout most of the periods as well. In the case of bank deposit rates it was not different. Interest rates on time deposits of less than 1 year maturity were liberalized in July 1995, but they were indirectly controlled until the middle of 1996.⁹

The government used M2¹⁰ as the primary lever for monetary control. However, interest rates on three-month commercial papers were not covered by M2.¹¹ CPs were very popular that they became the most favored instruments of NBFIs because they were not controlled.

Short-term instruments like CPs were easier to access. All loans require due diligence, but longer-term loans entailed more time and overhead costs because they entailed higher risks. Consultants had to be hired to create feasibility studies throughout its term, industry analyses, business plans checked against potential risks & strategy papers that it was very cumbersome. Moreover, it entailed the bureaucratic procedure of obtaining permission from the Ministry of Finance and Economy.¹² Short-term instruments were short enough not to entail too much risk so overhead costs from due

⁷ Cho, Yoon Je., "The Political Economy of Liberalization and Crisis in Korea". p.8

⁸ Cho, Yoon Je. p.8

⁹ Cho, Yoon Je. p.9

¹⁰ M2 is a measure of total money supply which includes checkable demand deposits (M1) and savings and other time deposits.

¹¹ Cho, Yoon Je., "The Political Economy of Liberalization and Crisis in Korea". p.9

¹² Chang, Palma, Whittaker (eds.). Financial Liberalization and the Asian Crisis. Palgrave, Great Britain, 2001. p.144-145

diligence were much lower. In many cases due diligence was not required because it was not regulated. If a long-term loan was necessary, it was usual practice for NBFIs to create a facility that had a string of short-term loans (re-rolled or mixed with other CPs) to make-up the entire duration of the long-term loan.

TABLE 4A
Growth of Financial Markets

(unit:%)

	Commercial Papers	Corporate Bonds	Bank Loans	M3
Annual average growth rates (1991-1996)	26.4	18.8	16.2	20.8

Source: Bank of Korea, Monthly Bulletin, various issues

Investment houses known as “dan-ja-hoi-sa”—which specialized in short-term commercial papers and call market loans—had a growth rate of 7.6% in '92 to 16.1% in '95 as a direct result of the administration's entry and interest rate deregulation in 1994.¹³ Also known as merchant banks, they were allowed to loan as much as 150% of their equity capital while commercial banks can only loan as much as 45%.

NBFIs restructured themselves to be able to distribute the short-term loans that were accessed from foreign lenders. 24 finance companies were transformed into Merchant Banking Corporations (MBC) from 1994 to 1996, while banks opened 28 new foreign branches within the same time. Within a short period, many of the financial institutions changed their identities to Merchant Banks because only these financing institutions were able to deal in foreign exchange transactions without being regulated.

¹³ Lee, C.H., Lee, Keun, Lee, Kangkoo. “Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea”, p. 11-12

FIGURE 4B
Number of Financial Institutions

Source: MOFE.

Cited in "Liberalising the capital account without losing balance: lessons from Korea" by Yoon Je Cho and Robert N. MacCauley (2003)

51% of all loans from merchant banks were made by the top 30 Chaebols in 1997. Foreign borrowing by financial institutions increased from USD 1.2 billion in 1993 to 7 billion in 1994, 11 billion in 1995 and 12.6 billion in 1996.¹⁴

Risky term mismatch. There are huge risks in using short-term loans to fund long-term commitments. MBCs borrowed short-term loans at low interest rates and re-lent these as long-term loans with higher interest rates. At the end of the short-term, MBCs were then hard pressed to convince the lender to re-roll the short-term loans, and if not, find other sources to fulfill the long-term schedule of borrowing firms. Having this mismatch puts the borrowing firms at a high risk because foreign lenders are well within their rights to stop lending at the end of the term. This increased the proportion of short-term loans in the nation's foreign debt.¹⁵ From 1992 to 1997, the financial sector

¹⁴ Lee, C.H., Lee, Keun, Lee, Kangkoo. "Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea" p. 15

¹⁵ Cho, Yoon Je., "The Political Economy of Liberalization and Crisis in Korea", . p.10-14

had the largest share of foreign debt amounting to 667 million in 1996. The composition of short-term debt in this sector's portfolio had an average of 55%. The short-term portfolio started increasing at a faster rate in 1994, when Kim Young Sam committed to liberalizing the financial sector.

TABLE 4C
Composition of Foreign Debt

	(unit :US\$ 100 Million, %)					
	1992	1993	1994	1995	1996	1997
Public Sector	56	38	36	30	24	180
(Long-Term)	(100)	(100)	(100)	(100)	(100)	(100)
(Short-Term)	(0)	(0)	(0)	(0)	(0)	(0)
Corporate Sector	137	156	200	261	356	423
(Long-Term)	(47)	(50)	(45)	(40)	(38)	(42)
(Short-Term)	(53)	(50)	(55)	(60)	(62)	(58)
Financial Sector	235	244	333	493	667	605
(Long-Term)	(51.9)	(53.3)	(41.7)	(39.8)	(41.5)	(56.0)
(Short-Term)	(48.1)	(46.7)	(58.3)	(60.2)	(58.5)	(44.0)
Total (A)	428	439	568	784	1047	1208
(Long-Term)	(56.8)	(56.3)	(46.7)	(42.2)	(41.7)	(57.6)
(Short-Term)	(43.2)	(43.7)	(53.5)	(57.8)	(58.3)	(42.4)
A/GNP(%)	14	13.3	15.1	17.3	21.8	27.5

Note : Figures in parenthesis are the percentage share.

Source: Bank of Korea cited in: Cho, Yoon Je., "The Political Economy of Liberalization and Crisis in Korea"

57% (average) of foreign loans made by the corporate sector were short-term from 1992 to 1997. Even before Kim's liberalization project, more than half of the loans made by firms were foreign short-term loans. The rate significantly increased in 1994 from 50% to 55%.

The total amount of foreign debt as a percentage of its GNP grew immensely through the years from 1992 to 1997. In 1993, it only amounted to 13.3%. The portion of debt increased immensely from 15.1% to almost a third of the entire GNP of Korea in 1997.

Foreign borrowing by Chaebol affiliated NBFIs increased from USD 2.66 billion in 1993 to 4.65 billion in 1994, 8.05 billion in 1995, 10.42 billion in 1996 and 18.07 billion in

1997. Over all, Korea ballooned its external debt from USD 428 billion in 1992 to 1,208 billion in 1997.¹⁶

Impact on Financial Structure of Firms. Many companies endeavored to issue bonds and equities in foreign capital markets. However, only the top five Chaebols namely Hyundai, Lucky-Goldstar, Samsung, Daewoo and Sunkyung were established conglomerates that have gained an international reputation and were able to raise long term capital with success in the foreign markets.

The remaining 25 Chaebols and other corporate firms borrowed short-term loans through the MBCs. The maturity structure of these debts were considerably different in comparison to the top 5 Chaebols. The top 5 Chaebols were less dependent on short-term borrowing because they had access to long-term instruments (equities) in the foreign market. Their short-term borrowing started to decline between 1992 to 1996. However, the remaining 30 Chaebols increasingly borrowed short-term loans from 1993 to 1995.

FIGURE 4D
Short-Term Debt/Assets

Cited in Cho, Yoon Je., "The Political Economy of Liberalization and Crisis in Korea".

¹⁶ Lee, C.H., Lee, Keun, Lee, Kangkoo. "Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea" p. 17

Impact on National Financial Structure. The national financial structure however gives a bleaker picture. With the unbridled borrowing of short-term loans in the 1990s, the foreign exchange reserves in the central bank was not even enough to pay for the short-term loans alone. In 1995, Korea already had a short-term/reserve ratio of 1.7, in 1996 the ratio was 2.0, and in mid-1997 when the crisis hit—the ratio was 2.1. The warning signs were already quite clear as early as 1995, yet the borrowing was not managed.

TABLE 4E

**International Claims Held By Foreign Banks (billion \$)
Distribution by Maturity and Sector**

	Total Outstanding	Obligations by Sector			Short Term	Reserves	Short Term/ Reserves
		Banks	Public Sector	Non-bank Private			
A. End 1995							
Indonesia	44.5	8.9	6.7	28.8	27.6	14.7	1.9
Malaysia	16.8	4.4	2.1	10.1	7.9	23.9	0.3
Philippines	8.3	2.2	2.7	3.4	4.1	7.8	0.5
Thailand	62.8	25.8	2.3	34.7	43.6	37	1.2
Korea	77.5	50.0	6.2	21.4	54.3	32.7	1.7
Total	209.9	91.3	20.0	98.4	137.5		
B. End 1996							
Indonesia	55.5	11.7	6.9	36.8	34.2	19.3	1.8
Malaysia	22.2	6.5	2.0	13.7	11.2	27.1	0.4
Philippines	13.3	5.2	2.7	5.3	7.7	11.7	0.7
Thailand	70.2	25.9	2.3	41.9	45.7	38.7	1.2
Korea	100.0	65.9	5.7	28.3	67.5	34.1	2.0
Total	261.2	115.2	19.6	126.0	166.3		
C. Mid-1997							
Indonesia	58.7	12.4	6.5	39.7	34.7	20.3	1.7
Malaysia	28.8	10.5	1.9	16.5	16.3	26.6	0.6
Philippines	14.1	5.5	1.9	6.8	8.3	9.8	0.8
Thailand	69.4	26.1	2.0	41.3	45.6	31.4	1.5
Korea	103.4	67.3	4.4	31.7	70.2	34.1	2.1
Total	274.4	121.8	16.7	136.0	175.1		
Memo Item: Mexico							
end-1994	64.6	16.7	24.9	22.8	33.2	6.4	5.2
end-1995	57.3	11.5	23.5	22.3	26.0	17.1	1.5

Source: Bank For International Settlements

For an investor or a creditor lending to South Korea, it was not difficult to make a decision to stop lending to South Korea. As Joseph Stiglitz notes:

Countries today are encouraged to maintain adequate reserves, to protect themselves against volatility in international financial markets. A key indicator is the ratio of reserves to foreign denominated short-term indebtedness. When the

number falls below unity, investors and lenders become worried and indeed recent econometric work has suggested that this variable provides the best explanation for which countries were adversely affected by the recent global financial crisis (1997)¹⁷

Korea's short-term debt to reserve ratio was 2.1. With this perceived risk, investors and lenders immediately extracted their capital out of the economy for fear that they would not be able to convert their exposures into US dollars. Capital fled the economy at high velocities and in large amounts in 1997 in an effort to save whatever exposures investors had in Korea. Duck Woo Nam in his speech in a seminar on Banking Reform held at the World Bank, October 5, 1998 speaks of Korea's liquidity crisis in 1997...

In the Korean case, liquidity shortage resulted from the excessive borrowing of the short-term fund by the banking and corporate sectors or, to put it another way, a mismatch between short-term borrowing and long-term investment. This in turn was prompted by some degree of liberalization of capital market without having remedied structural weakness of the banking and corporate sector which were highly vulnerable to currency crisis, as well as without having strengthened prudential regulation of the banking sector in response to the financial exposure to the volatile movement of the short term capital across the borders. Although the structural weakness was long standing and was no secret to the international financial community prior to the crisis, the financial crisis in Southeast Asia caused a shift in the expectation and confidence of foreign investors with regard to financial viability of the Korean economy. Once a sign of the liquidity shortage was manifest, the herd instinct and self-fulfilling pessimism overtook the money market, and there was no way to dodge the currency crisis with rapidly dwindling foreign exchange reserves. The currency crisis readily developed into financial crisis, which, in the course of structural reform, further deteriorated into a full-scale economic crisis.¹⁸

Capital controls were not in place in 1997. Central banks in Asia increased interest rates up to as much as 75%¹⁹ during the liquidity crisis. The unusual rise in interest rates however did not persuade investors to stay because foreign exchange traders and investors were not confident that Asian economies had enough foreign exchange to back its payments. The countries that had liberalized and "efficient" financial sectors were hard hit—the very same financial facilities that expedited the inflow also expedited it out. Unlike the Park regime, controls were not in place that it was very difficult to

¹⁷ Stiglitz, Joseph., "Capital Market Liberalization, Economic Growth and Instability" p. 1081

¹⁸ Duck Woo Nam. Website: http://www.dwnam.pe.kr/ma_email02_1.html Duck Woo Nam is the Deputy Prime Minister and Minister of Economic Planning during the Park Chung Hee regime.

¹⁹ Sachs & Radelet. "The East Asian Financial Crisis. Diagnosis, Remedies and Prospects." Harvard Institute of International Development. April, 20 1998, p.34

squelch capital from fleeing Korea's economy. Short-term instruments were the preferred instrument of lending that short-term loans were twice the amount of foreign exchange on reserve—the Bank of Korea did not have the capacity to pay these loans off. Despite being an export powerhouse in the region and a previous decade of high-growth, South Korea did not have the capacity to contain and accumulate foreign exchange in the 1990s. The economy was unstable because there were too many uncontrollable leaks in the financial system.

Chapter 5 Conclusion

This thesis aimed to investigate why capital controls were dismantled in South Korea. The question is of interest because it is possible that South Korea would have been able to prevent the collapse of its economy if capital controls were in place in 1997. The thesis began with a discussion of the political economy of South Korea from the 1950s to the 1970s to understand the rise of the Korea's developmental state. The rise of the developmental state was made possible because economic elements such as the Chaebol were embedded in the network and the state was autonomous—where the developmental state's economic autonomy was manifested in its ability to control capital. The thesis also investigated how neoliberal and geopolitical interests of the United States and the Chaebols shaped events into establishing an economic platform that enabled the US and Korean financial market to be compatible—a liberalized financial market.

This conclusion returns to reflect on a few broader themes, one of them is the viability of capital controls. It considers the viability of capital controls of countries that have actually continued to use controls even in the 'era of liberalisation'. Malaysia was one economy that was able to arrest its economic collapse during the crisis in 1997 and rebounded faster in comparison to other Asian countries. This chapter will also reflect on how China was able to utilize capital controls to prevent its fall in 1997, but more importantly, how it is utilizing capital controls to become an economic superpower today.

This thesis also hopes to inform development policies. It does not provide a 10 step process of how things should be to be a developmental state. All developing economies have a different set of issues and circumstances that one can't make a "one size fits all" theory. However, it is hoped that by calling attention to the economic achievements of South Korea and the fundamental structures that underpinned the state and the forces that attempted to dismantle the state's autonomy, the thesis can at least inform a developing nation of what to expect from these forces.

Conclusion

..if the bulk of investment is under public or semi-public control and we go in for a stable long-term programme, serious fluctuations are enormously less likely to occur”¹

John Maynard Keynes

In the earlier years, the Park Chung Hee administration controlled the strategic directions of the Chaebols. The state was autonomous. The state was the major provider of support—most especially loans—for their development through its stringent control of the financial system. Banks were nationalized. It was well within the state’s power to cease providing privileges if Chaebols did not abide by the state’s directives for development.

The state could afford to be pragmatic with this arrangement. The state was able to maneuver the economic elements within the economy to serve a long-term developmental purpose and engineered an economy that was stable. It was powerful enough to force mergers between firms, focus firms to specific targeted industries, and even had the capacity to close-down firms that created excessive competition.

The allocation of capital to firms was a consultative process in many respects. The biggest state agencies such as the EPB, MOF, the Bank of Korea, heads of the Chaebols, and the Blue House met regularly to assess their strategies and saw to it that targeted firms were supplied with the capital they needed to expand. Firms were measured by a set of performance standards set by these principals—where the state enforced the rules and leveled the playing field for firms in the same industry to compete for state allocations and privileges.

¹ Moggridge, Donald ed., Vol.27. Activities 1940–1946: Shaping the post-war world: Employment and commodities. London, Macmillan, NY, Cambridge University Press P. 26
Found in Crotty, James. “On Keynes and Capital Flight”, Journal of Economic Literature Vol.XXI (March 1983) p.60

The developmental state of Park Chung Hee nurtured powerful industrial conglomerates that can challenge the state. A handful of them were responsible for more than one half of South Korea's GNP, yet they remained docile to the dictates of the state industrial policy. This became possible because Park Chung Hee controlled the economic lifeline that kept these conglomerates operational. Non-compliance meant the closing down and dismemberment of the Chaebol by the state.

FIGURE 5A Financial Flow during the Park years

Financial System in Korea's Developmental State

As Chaebols progressed, their priorities changed when they saw opportunities in the global economy. Their frequent transactions in the global economy enabled them to discover manufacturing lines that would have increased their profits, and arguably, were very well equipped to do. Chaebols were economic engines that were completely

capable to pursue high-growth industries that were not in the industrial plan of the state. The state would have cut-off its supply of capital if Chaebols engaged in manufacturing ventures that were not a priority of the state, but the Chaebol's freedom to pursue their own expansion agendas carried more weight. And so, they sought other sources of capital in anticipation of the state's reprisal.

The United States was closely linked to the political economy of South Korea. They were after all the main military power maintaining the military balance within the Asian region. Korea was important because it was a key strategic point in maintaining US hegemony. But US investors and bankers were also interested in being a part of the economic revolution that was happening in Korea. The regimes of Carter and Reagan have continually pried the Korean economy open to enable US economic interests to participate in Korea's economy.

The interests of US capital and Chaebol were conveniently matched and structurally supported by Chun Doo Hwan. In turn he needed the support of these power structures to secure his presidency of South Korea—quid pro quo. The conditions in 1980 were dire—an economic crisis was felt by all, the public was indignant over the coup and the massacre at Kwangju, and there was a threat of a military incursion from the North if the nation continued to become more unstable. The threat of an upheaval seemed very forthcoming to Chun Doo Hwan. To fortify and guarantee his leadership, the Chun administration brokered an economic relationship between both these power structures to secure the nation and his presidency. Chaebols needed capital that was sourced from entities other than the state to bump start an ailing economy. Chaebols sourced them from American bankers who were awash with petro-dollars eager to find a refuge in profitable businesses. The South Korean economy became the venue for this economic partnership. US geopolitical objectives and financial assets came with an assurance that their ventures in Korea were protected by the world's most sophisticated military that then dissuaded any North Korean intentions of launching a military incursion.

The economic structures that Park strived hard to establish were undermined and dismantled after he was assassinated. It was inevitable that the political entities that secured Chun's leadership—the Chaebol and the United States—were bound to alter Park's economic structures to enable their economic interests to flourish. Chun Doo Hwan and his officials framed the 1979 economic crisis in South Korea as an unfortunate condition caused by the economic policies created by Park Chung Hee—the global oil crisis notwithstanding. The public was made to believe that Park's policies

were not able to cope with the global economic realities at that time that new economic structures were necessary. This was also a means to parry away blame that was aimed at Chun's leadership as the economic crisis worsened. With this altered economic reality, the state fashioned the national psyche to see the merits of economic liberalism. At that time, it seemed like a viable option because other advanced nations like the US and the UK were advocating neo-liberalism as well. However underneath the rhetoric necessitated an overhaul of Park's robust economic structure to facilitate the neo-liberal interests of the United States and to feed the Chaebol's appetite for finance. Chun commenced the structural change by overhauling the bureaucracy. He appointed US trained economists to replace the bureaucrats at the Economic Planning Board first then the Ministry of Finance in an attempt to establish an economic platform more compatible to the US system of finance. Soon, it then became easier for the Chaebols to access much needed finance to kick-start the economy. To its detriment however, capital controls were progressively dismantled across the years upon US insistence. Chun's actions started the momentum to liberalize the Korean economy.

The state lost its autonomy. The power-relationships between the state and the Chaebols began to change when the Chaebols were able to find alternate sources of funding. The deregulation of finance in the 1980s and the 1990s progressively allowed the Chaebols to access capital from foreign markets, and enabled them to even purchase the conduits of unregulated capital—the NBFIs. Chaebols were not obliged to work with the state since they had new capital sources from foreign banks and investors. Chaebols ventured into manufacturing goods that were very profitable but generally did not serve a national development purpose in the same intensity as it was during the Park years. Soon, most of the institutions governing the relationships between the Chaebols and the state became devolved. The 5-year plan, the strategy and the criterion by which companies are judged to receive policy loans, were not adhered to. Other departments like the EPB were merged with other departments. Most of the departments that held the reins of Korea's former development agenda were devolved.

FIGURE 5B Financial Flow in the 1980s and 1990s

However, accessing other financial sources came at a very high price—instability. The Korean economy was considerably opened to enable foreign capital to flow into and out of the economy. The manner in which financial liberalization evolved made short-term instruments the favored instrument to supply capital. Risky term mismatches became prevalent as a result. NBFIs acquired low interest short-term foreign capital and was re-lent as long-term capital with higher interest rates. This was risky because NBFIs will be left to scuttle for other sources of finance to provide the long-term capital needs of borrowing firms in the event of a liquidity crisis. Highly leveraged Korean firms were prone to be insolvent if NBFIs were not able to find sources of capital.

Short-term capital became the most unmonitored instrument. It appears that the state was oblivious to it—the state did not even have enough foreign exchange to pay off all the short-term loans in the Korean economy. The preponderance of cheap short-term capital used for long-term commitments; the openness for US denominated capital to enter and flee from Korea; and an economy that is highly-leveraged with a short-term to reserve ratio beyond 2, make a highly unstable and volatile environment and increased the likelihood of capital flight to happen. This mix of events and policies set the path towards the economy's liquidity crisis in 1997.

The Chaebols were a very potent force in the 1980s and the 1990s that they held the Korean economy in a tight grip that the Chun Doo Hwan administration did not pursue a committed and structured liberalization program for Korea after his US sponsored ascension to power. It appears that the Chaebols were also reluctant to pursue a committed liberalization of the economy because they still had large obligations—i.e. low interest policy loans—made from the previous regime. These conglomerates were highly leveraged that their debt payments would have increased severely to the point of making these conglomerates insolvent if interest rates increased through liberalization.

It appears that short-term instruments and portfolio investments became the alternative to pay for their obligations besides stocks. Similar to using a credit card to pay for another credit card bill, Chaebols used short-term instruments to cover their other obligations because short-term instruments were easier to acquire. It is perhaps with this reason that short-term instruments were deregulated first.

Many have charged the crisis in Korea to the haphazard liberalization of its financial market that encouraged the short-term borrowing spree. In one sense this can be true if one were using a free market analysis. However, it does not follow that Korea will be more stable if the economy liberalized properly. The market merely wants increased rates of return at the soonest possible time. Often, it has aimed to pursue this regardless of socio-economic costs. A natural by-product of liberalization—whether haphazard or not—is the potential instability of the economy because it is subject to the whim of the market—especially when a state wants to pursue socio-economic goals. Whereas capital will flow into an economy if interest rates are high, and the stock market is bullish; and flow out if the government wants to pursue deficit spending for schools, hospitals and lower its interest rates for firm expansion.

This then brings the issue of control. Liberalized states structure their economies to increase their rates of return for investors. The means to this end have often been inconsequential especially when states sacrificed social safety nets and economic progress—in a developmental sense. Increasing the rates of return invite capital to stay and give a “semblance of economic stability and progress” so long as the rates of return are stable or increasing. In this situation, the holders of capital wield power because it can use economic stability as a hostage. Investors mold the directions of firms, bourses, banks and economies to their liking with the unspoken threat of capital withdrawal if they did not comply.

This then begs the question—Is the market free after all? who controls the market? One can only speculate. Herd behaviour among bankers and investors has been the cause of numerous downfalls of economies this century. Institutions that guide this herd must have the power to mobilize large amounts of capital into any free economy. Capital has recently been consolidated and concentrated to lesser fund managers such that the collusive en masse movement of capital has the potential to cause the rejuvenation or downfall of any open economy. It is an instrument of foreign policy. Perhaps it is with this reason that there is so much effort made by international financial institutions to keep the gates of capital to any economy open. The market also provides the “perfect cover”. It is very difficult to know who started the herd behaviour because it is blurred, lost, unequivocally understood and accepted as “the market”. One can only speculate and investigate this phenomenon further.

On the viability of Capital Controls

The stress test for the effectiveness of capital controls can be determined by the state’s ability to react to capital shocks. The Asian financial crisis is an event that would unveil the vulnerabilities and the strengths of their financial sectors. Malaysia and China, at that time, were often criticized by institutions like the IMF for not complying with their financial prescriptions. These states contained capital within their territories with a judicious use of specific controls.

Malaysia

We asked the international agencies to regulate currency trading but they did not care, so we ourselves have to regulate our own currency. If the international community agrees to regulate currency trading and limit the range of currency fluctuations and enables countries to grow again, then we can return to the floating exchange rate system. But now we can see the damage this system has done throughout the world. It has destroyed the hard work of countries to cater to the interests of speculators as if their interests are so important that millions of people must suffer. This is regressive.²

Malaysian Prime Minister Datuk Seri Dr. Mahatir Mohamad

Prime Minister Mahatir was very skeptical of neo-liberal prescriptions to contain capital flight in the wake of the massive withdrawals from the Asian region. The IMF advocated a contractionary monetary policy. Aware of what might happen, Mahatir implemented his set of capital controls early in 1997. Malaysia implemented regulations that prevented banks from exposing themselves to the vagaries of foreign exchange volatility (i.e Banks borrowing in US dollars and lending in the local currency are subject to exchange risks when the US dollar appreciates against the ringgit that more ringgit is necessary to pay off the same dollar denominated loan). The Malaysian government also placed a cap on the foreign denominated loans that companies made from these banks. None of these policies were prescribed by the IMF. Michael Camdessus—chief of the IMF—and various pundits in Washington including Treasury Secretary Robert Rubin often criticized Malaysia as having a weak banking system.³

In 1998, the massive outflows were placing pressure on the ringgit to depreciate against the dollar. In September of 1998, the state pegged the ringgit at 3.80 to the dollar to maintain domestic stability. Interest rates were lowered to keep the economy churning and decrease the incidences of firms bankruptcies. To defend this position, the government tightened restrictions. Among them, transfers of capital abroad by residents were limited and the government froze the repatriation of foreign portfolio capital for twelve months. This twelve-month freeze was designed not to send a hostile message to investors, but was carefully communicated as a contingency measure to assure the stability of Malaysia's financial system.⁴ Domestic credit facilities to non-resident

² New Straits Times, September 2, 1998. Cited in Bello, Walden et.al (ed). Global Finance. Zed Books, London and New York. 2000. p.142

³ Sitglitz, Joseph. Globalization And Its Discontents W.W. Norton & Company, London, NY, 2002. p.124

⁴ Sitglitz, Joseph. p.124

correspondent banks and non-resident stock brokerages were not allowed as well (where previously 5 million Ringgit was allowed).⁵

Malaysia recovered faster in comparison to other Asian nations. The downturn of the Malaysian economy was shallower and had lower debts to leave future generations to pay off—Joseph Stiglitz observed.⁶ The reflation of the economy was primarily owed to the low interest rate policies it maintained in the heat of the crisis rather than relying on policies which entailed the government borrowing from international financial institutions. Despite a seemingly hostile hold on capital leaving during the crisis, Malaysia was still able to attract foreign investment because it maintained a stable economy.

China. China is an example where capital controls played an important role in staving off a crisis. China was able to enact active countercyclical macro-policies, avoid a recession and maintained vigorous growth rates averaging 7.8% in 1998.⁷ The state deemed it was not necessary to increase interest rates to levels that “killed the economy in order to “save” it from capital flight”.⁸ The Chinese used a combination of FDI and domestic savings as a source of capital. FDI brought along with it the technology, and management that gave the Chinese government the assurance that their foreign exchange would be kept within the economy for the long-haul.

Officials believed that FDI was a better source of capital than foreign debt that 90% of foreign capital in China is FDI. The Latin American crisis in the 80s was still a vivid and tragic memory among many in the Chinese government that they did not want their economy to be hostage to various conditionalities dictated by international financial institutions.⁹

⁵ Bello, Walden et.al (ed). Global Finance. Zed Books, London and New York. 2000. p.141

⁶ A statement based on the studies made by Kaplan, E. and Rodrik, D., “Did the Malaysian Capital Controls Work?” working paper no. W8142 National Bureau of Economic Research, Cambridge, Mass., February 2001. Found in Stiglitz, Joseph. Globalization And Its Discontents W.W. Norton & Company, London, NY, 2002. p.125

⁷ Stiglitz, Joseph., Capital Market Liberalization, Economic Growth and Instability. p. 1080

⁸ Stiglitz, Joseph. p. 1080

⁹ Bello, Walden et.al (ed). Global Finance. Zed Books, London and New York. 2000. p.177

The government also prevented the inflow of short-term loans. The Chinese had a long-term economic programme that needed a continuous flow of committed capital. Short-term loans can undermine this undertaking that the government only allowed 20% percent of its loans to be short-term.¹⁰ The Chinese government strictly monitored the inflows and outflows of capital. Many registration, approval and authorization procedures for FDI were put in place to assure that the central bank had enough foreign exchange to maintain the stability of its economy, and, at the same time, assure investors that they can extract their profits at a prescribed schedule.

The Ministry of Foreign Trade and Economic Cooperation is one of the main agencies of the government that authorizes the FDI in China. Investors must present foreign exchange risk and the sources of foreign exchange along with other governmental and legal documents to be able to get an approval from this agency and conduct business.

The State Administration of Foreign Exchange oversaw the process of conversion of foreign exchange to RMB. It designated special foreign exchange banks for investors to open special foreign accounts when it conducted business in China. Incomes from outward FDI must be repatriated to China within six months before the end of the fiscal year from the host economy. Foreign exchange authorities also have the power to repatriate even the operating capital of Chinese firms conducting business abroad. Application for foreign loans had to go through layers of authorization in the Ministry of Foreign Trade and Economic Cooperation. Local governments applied for loans through this window. Loans from the IMF, WB and the Asian Development Bank (ADB) were coursed through the Ministry of Finance. Firms, enterprises and industries received the authorization for foreign loans through the State Administration of Foreign Exchange before they could borrow abroad.¹¹ All loan applications were assembled by the State Development Planning Commission. This agency created the plans for annual foreign borrowing, and is authorized to determine the total amount and allocation of the borrowing after it reconciles it with the applications of different departments and provincial governments. Loans equal to and in excess of 100 million USD are approved by the State Council, while local governments and departments approve loans less than 100 million USD.¹²

¹⁰ Bello, Walden et.al (ed). p.178

¹¹ Bello, Walden et.al (ed). Global Finance. Zed Books, London and New York. 2000. p.180

¹² Bello, Walden et.al (ed). p.182

The Chinese financial system was not yet up to par with global standards as international financial institutions would claim. It had to go through several layers of approvals, and registration procedures before the capital could either be brought in or taken out. Special agencies such as the State Administration of Foreign exchange was a specialized institution that assured that China's foreign exchange balance was in good standing. Ironically, it was this "bureaucratic" financial system that was the barrier that prevented capital from fleeing China in 1998.

To date, capital controls are very much still in use especially by China—a country that continues to have one of the largest surpluses in the global economy while the US deficit continues to grow larger. This relationship is very reminiscent of an economic relationship between Germany, Japan and the US that led to the breakdown of the Bretton Woods System in 1972, the Fed's interest rate hikes in 1978, and the Plaza Accord in 1985. Some skeptics have the opinion that the 1997 Asian financial crisis was a means to the same end—that is, reversing flows back to the US without increasing interest rates. China has been frequently visited by dignitaries from the US to lower the value of the Yuan with the intent of establishing an "equilibrium" among states again. How this reversal¹³ will happen is another topic in global political economy that is worth investigating.

More Research

It was earlier suggested that capital has been more consolidated into fewer principals who can collusively mobilize capital into any liberalized financial market and either rejuvenate or plunge an economy further into crisis—perhaps in the same way a company in the stock market can be "pumped and dumped". In a larger scale this can be an instrument of foreign policy. Institutions like the IMF gain control of the assets of the economy in crisis and control their policies by imposing stiff conditions to receive loans. Moreover, these conditions pry an economy open to be more susceptible to speculative attacks. This condition inaugurates another cycle of crisis and borrowing which then enlarges the IMF's control of an economy. The capital control we have seen in South Korea during the Park years, China and Malaysia was a means to prevent this crisis and

¹³ In Feb. 27, 2007, the S&P/TSX composite index tumbled 364 points to close at 13040 because of a major sell-off in China's market spooked investors around the world. The DOW Jones industrial average slid by 416 points to 12216, a record low in four years. India's main stock index tumbled 4%, Singapore's dropped 3.7%, Japan's fell 2.9%, South Korea's lost 2.6%, and Hong Kong's slipped 2.5%.

borrowing cycle.

The condition of a developmental state and capital controls cannot just be met by any developing economy—some economic conditions are necessary. Here are just a few—starting capital should be available. The sufficient and sustainable influx of foreign exchange to fuel the developmental activities of the nation have to be present. Korea was privileged because they were supported with finance and aid from the US since Korea was Washington's means of establishing its geopolitical interests in the Asian region. For a developing country like the Philippines, foreign remittances from overseas workers are the main bread and butter of the economy. Encouraging the inflow of foreign remittances can increase the capital base of the Philippine economy to commence the economic activities of a developmental state. Venezuela's oil export revenue is a large capital base that can fuel the activities of a developmental state as well. An agency that Keynes suggests—in the form of the EPB and the MITI—is essential in creating a strategic plan and control mechanism to allocate capital to research and transformational (i.e. translation from concept to shop floor and tooling) activities essential for dynamic comparative advantage. More importantly, the autonomy and embeddedness that Evans discusses earlier are the most crucial conditions in creating a developmental state. The state's autonomy is essential in curbing the path of a nation's political economy from today's predominantly neoliberal orientation to a developmental state. Research with the indicators and parameters suggested perhaps can inform policies in developing economies.

Much research should be also done on those who mobilize capital. It is important to either confirm or deny the speculation. Questions like was there intent to “pump and dump” or were they just market forces? Who are the fund managers? What are the political inclinations of the managers and their principals? From whom do they get their directives? Whom do they collude with? What is the source of their capital? How do they consolidate the capital? What are their investment habits? What is their strategy? When and where does capital get mobilized? Capital leaves a transaction information trail that can be accessed in privileged government agencies. Transaction information can be obtained in the same manner that government security agencies like FINTRAC trace the sources of funding and exchanges of terrorist and criminal elements.

Control: What if?

The main issue is control over the economy. It is possible that the economy of South Korea would have landed softly and had the capacity to impose policy over the Chaebols if it had returned control over the flows of finance. The Park administration exercised control over the fate of Chaebols through its control of capital allocation. Through a consultative process that involved the state and the Chaebol, firms earned their right to receive loans by living up to a mutually accepted performance standard. The relationship essentially enabled the state to enforce its prescriptions with the state in a dominant position—as it did in the 1970s. This relationship is similar to the way the WB and the IMF force a country to adhere to its prescriptions as a condition for bail out loans. However, the reality is the state's policy for Chaebols to “shape-up” became toothless when finance was liberalized.

It is the opinion of many that some firms received more than what was necessary so loans were used in a way that made them inefficient or insolvent. Arguably there were some flaws in the system if one were to use the “rate-of-return in the short-run” method to evaluate highly leveraged firms. Such was the case of the steel industry—it was insolvent. However, investment in strategic industries like steel should be also seen as a public good, in the same way that the government spends a large budget on the military and roads. It is difficult to imagine an armed forces or public works that was insolvent. The steel industry, though capital intensive, had to be funded because it is a *necessary* industry for the construction of ships, arms, machines and the automobile industry among many. The steel industry had to exist for these industries to evolve—industries that were essential for the industrial dynamism necessary in economic growth and innovation.

Authorities could act more pragmatically in the developmental state. Though there is evidence to suggest that some firms were not performing up to state expectations, it did not necessarily mean that these inadequacies could not be remedied or corrected over time in the developmental state. The Korean developmental state was efficient in a way that the free market was not able to attain, it acted and controlled *collective problems* pragmatically—e.g. the stabilization drive during the oil crisis in 1974, HCI, etc. The Korean developmental state would have approached the liquidity crisis pragmatically as well. Whether capital comes in the form of FDI or external loans, key to a stable economy is the regulated release of foreign exchange to its foreign lenders or

investors so long as the reserves do not compromise the stability of the economy. If control was in place, the leadership could have tweaked the system to modulate or outrightly prevented the outflow of capital in 1997. One of the main objectives of the developmental state during the Park regime was to assure that its balance of payments were in good standing. There was a strong vigilant effort to guarantee that there was enough foreign exchange to sustain the economic activities of the nation even if it had to borrow its way out of a deficit. It was quite obvious that there was an absence of vigilance in the events leading towards the liquidity crisis. The warning signs were already clear way before—when short-term to reserve ratios were already beyond unity (1995)—that contingency measures necessary to stop the leaks should have been in place to stave-off the outflows of capital. However, Kim's commitment to open the capital account only gave the opportunity for investors to recoup their capital exposures while there was still foreign exchange left. In other words, access to foreign exchange was on a first come first served basis since foreign exchange was scarce. Capital controls similar to the emergency measures that Malaysia imposed would have stifled this run on foreign exchange.

The Big Push for industrialization necessitated the firm control of the economy, and the financial structures that Park created assured that the Big Push would come to fruition. However there are those who argue that the structures Park created were not necessary anymore now that conglomerates have attained a certain degree of success in the global market. It is believed that the free market is enough to attain its financial needs. Despite the inadequacies and criticisms that have been cast on the developmental state and its capital controls, the DS structure could have enabled the state to curb a calamity in the magnitude of Korea's liquidity crisis in 1997. The pragmatism and control of a DS is necessary in a global economy that can send and extract billions from an economy at the press of a button.

Bibliography

- Adelman, Irma. Practical Approaches to Development Planning: Korea's Second Five-year Plan, Johns Hopkins Press., Baltimore., 1969.
- Akyuz, Yilmaz. Financial Liberalization: The Key Issues. UNCTAD Discussion Paper No. 56 March, 1993
- Amsden, A (1989). Asia's next giant: South Korea and Late Industrialization. New York: Oxford University Press. 1989
- Amsden, Alice and Euh, Yoon-Dae. South Korea's 1980s Financial Reforms: Good-bye Financial Repression (Maybe), Hello New Institutional Restraints. World Development. Vol.21, No.3 Great Britain, 1993
- Asiainfo.,
http://www.asianinfo.org/asianinfo/korea/history/military_revolution_and_the_tir.htm
- Barry, Andrew. Slater, Don. "Introduction: The Technological Economy". Economy and Society Vol. 31 Number 2. May 2002
- Bello, Walden et.al (ed). Global Finance. Zed Books, London and New York. 2000
- Brenner, Robert. The Boom and The Bubble. Verso Books, London, NY, 2002
- Chamarik, S., Goonatillake S. Technological Independence - The Asian Experience, The United Nations University Press, 1994.
<http://www.unu.edu/unupress/unupbooks/uu04te/uu04te0e.htm#3.%20the%20republic%20of%20korea>
- Chang, Ha-Joon. Globalisation, Economic Development and the Role of the State, Zed Books, London, 2003
- Chang, Ha-Joon et.al. (eds). Financial Liberalization and the Asian Crisis. Palgrave, Great Britain, 2001
- Chang, Ha-Joon. Industrial Policy and East Asia - The Miracle, The Crisis, and the Future, paper presented to the World Bank Workshop on Re-thinking the East Asian Miracle, San Francisco, 1999
- Chang, Ha-Joon, Kicking Away The Ladder, Anthem Press, London. 2002

- Chang H.J., "The Political Economy of Industrial Policy in Korea", Cambridge Journal of Economics, 1993, 17
- Chang, Ha-Joon (ed). Rethinking Development Economics, Anthem Press, London., 2003
- Chang, Ha-Joon and Grabel, Ilene. "Reclaiming Development", Fernwood Publishing, Nova Scotia, 2004.
- Chang, Ha-Joon, Evans, Peter. The Role of Institutions in Economic Change, Paper prepared for the meeting of the "Other Canon" group, Venice, Italy, January 13 – 14, 2000. <http://www.othercanon.org/papers/>
- Chang, HJ. Rowthorn, R (eds.), The Role of the State in Economic Change, Clarendon Press, Oxford 1995
- Cheng, Tun-Jen. "Political Regimes and Development Strategies: South Korea and Taiwan," in Gereffi and Wyman (eds.). Manufacturing Miracles: Paths of Industrialization in Latin America and East Asia. Princeton: Princeton, University Press. 1990
- Chibber, Vivek., Reviving the Developmental State? The Myth of the National Bourgeoisie. <http://repositories.cdlib.org/uclasoc/trcsa/20/>.
- Cho, L.J. & Kim, Y.H., Economic Development in The Republic of Korea, The East West Center, Hawaii., 1991
- Cho, L.J. & Kim, Y.H.eds. Korea's Political Economy, An Institutional Perspective, Westview Press Inc., Colorado, Oxford., 1994
- Cho, Y.J., Kim, J.K. Credit Policies And the Industrialization of Korea World Bank Discussion Papers 286, The World Bank, Washington, D.C., 1995
- Cho, Yoon Je., The Political Economy of Liberalization and Crisis in Korea, Graduate School of International Studies, Sogang University, Korea, 1999
- Cho, Yoon Je., Financial Crisis of Korea: A Consequence of Unbalanced Liberalization?. Graduate School of International Studies, Sogang University, Korea, 1999
- Cho, Yoon Je. Financial Reform Experience of Korea. Graduate School of International Studies, Sogang University, Korea, 1998
- Clifford, M. Troubled Tiger, ME Sharpe, Inc. 1998, NY.
- Collier, P., Mayer, C., "The Assessment: Financial Liberalization, Financial Systems, and Economic Growth" Oxford Review of Economic Policy, Vol.5, No. 4.
- Crotty, James. The Case for Capital Controls, Political Economy Research Institute., University of Massachusetts, Amherst, MA., 2000
- Crotty, J., Lee, K. "Is Financial Liberalization Good For Developing Nations? The case of South Korea in the 1990s". Review of Radical Political Economics 34(2002) 327–334. Economics Department, University of Massachusetts, Amherst, MA 01003, USA. www.elsevier.com/locate/revra.

- Crotty, James and Lee, Kang-Koo. Korea's Neoliberal Restructuring: Miracle or Disaster?, Political Economy Research Institute, University of Massachusetts, 2001
- Crotty, James. "On Keynes and Capital Flight", Journal of Economic Literature Vol.XXI (March 1983)
- Culpeper, Roy, President of the North-South Institute. Ottawa Canada. Limits to Globalization: Implications of the Asian Crisis. Address to The Toda Institute for Global Peace and Policy Research Tokyo, Japan, September 15, 1998.
http://www.nsi-ins.ca/ensi/news_views/speech03.html
- Cummings, Bruce., "The Asian Crisis, Democracy and the end of Late Development" in Pemepel T.J. (ed)., The Politics of the Asian Economic Crisis, Cornell University Press, Ithaca, NY. 1999 p. 30-33
- Dasgupta, Biblap. Structural Adjustment, Global Trade and the New Political Economy of Development. Zed Books, London and New York, 1998
- Duck Woo Nam. Website: http://www.dwnam.pe.kr/ma_emain02_1.html
- Evans, Peter. Embedded Autonomy, Princeton University Press, 1995
- Fischer, Bernhard and Reisen, Helmut, "Toward Capital Account Convertibility," OECD Policy Brief, no. 4 (Paris: OECD Development Centre, 1992)
- Frank, Ellen., Capital Flows and Exchange Rate Policy, in Foreign Policy in Focus, Vol. 4, No. 17, June 1999, Albuquerque, New Mexico.
- Gilpin, Robert, The Challenge of Global Capitalism. Princeton University Press, 2000
- Gowan, Peter, The Globalization Gamble: The Dollar-Wall Street Regime and its Consequences, <http://www.gre.ac.uk/~fa03/iwgvf/files/9-gowan.rtf>.
- Haggard, Lee, Maxfield eds. Byung, Sun-Choi, "Financial Policy and Big Business in Korea" found in, The Politics of Finance in Developing Countries. Cornell University Press., Ithaca and London. 1993.
- Haggard, Stephan and Maxfield, Sylvia. "The Political Economy of Financial Internationalization in the Developing World", International Organization., Vol. 50, No. 1 (Winter 1996)
- Haggard, S. and Moon, C., Institutions and Economic Policy: Theory and a Korean Case Study in World Politics Vol. 42, No.2 (January 1990).
- Hart-Landsberg, Martin., SOUTH KOREA: THE FRAUDULENT MIRACLE., Monthly Review, 12/1/1987, Monthly Review Press. New York
- Helleiner, Eric. States and the Reemergence of Global Finance, Cornell University Press., Ithaca and London, 1994

- Henderson, J., Hulme, D., Philips, R., Kim, M.K., Economic Governance and Poverty Reduction in Asia. Globalisation and Poverty, 2002. Downloadable from <http://www.gapresearch.org/governance/ecogovpovelim.html>
- Johnson, Chalmers, MITI and the Japanese Miracle. Stanford University Press, Stanford California, 1992
- Jones, L., Sakong, I., Government, Business, and Entrepreneurship in Economic Development: The Korean Case, Cambridge and London; Harvard University Press.
- Kang, David. "Bad Loans to Good Friends: Money Politics and the Developmental State in South Korea", International Organization 56. 1 Winter 2002. The IO Foundation and MIT.,
- Kang, David. South Korean and Taiwanese Development and the New Institutional Economics, International Organization 49, no.3 (summer 1995):555-87
- Kang, David. Crony Capitalism. Corruption and Development in South Korea and the Philippines., Cambridge University Press., 2002
- Kang, David Transaction Costs and Crony Capitalism in Asia, Tuck School of Business, Dartmouth College, May 10-11, 2002
- Keynes, John Maynard., The General Theory of Employment, Interest and Money. NY: Harcourt, Brace and World, 1964
- Keynes, John Maynard, "National Self-Sufficiency," The Yale Review, Vol. 22, no. 4 (June 1933)
- Kie-Chiang Oh, John Korean Politics, Cornell, Ithaca and London, 1999
- Kim, Yun Tae., "Neoliberalism and the Decline of the Developmental State", Journal of Contemporary Asia. 10/1/1999.
- Kim, C. I. Eugene South Korea in 1985: An Eventful Year Amidst Uncertainty, in Asian Survey, Vol. 26, No. 1, A Survey of Asia in 1985: Part I. (Jan., 1986)
- Krugman, Paul., The Case for Stabilizing Exchange Rates. Oxford Review of Economic Policy, Vol.5, No.3, Oxford University Press.
- Kwon, Eundak., "Financial Liberalization of South Korea", Journal of Contemporary Asia. 3/1/2004.
- Kwack, Sung Y. ed., "Korea's Economic Takeoff in Retrospect," in The Korean Economy at a Crossroad. New York: Greenwood Press, 1993
- Kwon, Jene (ed). Yoon Je Cho, Financial Policy in Korea and Taiwan., in Korean Economic Development Greenwood Press., NY. 1990.
- Lal, D, "The Poverty of Development Economics", London, Institute of Economic Affairs. P.222 found in Chang H.J., "The Political Economy of Industrial Policy in Korea " Cambridge Journal of Economics 1993, 17

- Lee, C.H., Lee, Keun, Lee, Kangkoo. Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea, Institute of Economic Research, Seoul National University in its series Working Paper Series no 31. March, 2000,
- Lee, C.H., Lee, Keun, Lee, Kangkoo. "Chaebol, Financial Liberalization, and Economic Crisis". Institute of Economic Research, Seoul National University in its series Working Paper Series no. 31. March, 2000,
- Machi, Miki. The Role of the State in the Development of Chaebols in South Korea. Research Essay, Norman Patterson School of International Affairs, Carleton University, Ottawa.
- Mandelbaum, Michael, The Fate of Nations, Cambridge University Press, 1988
- Mason, Edward S., et al. The Economic and Social Modernization of the Republic of Korea, Cambridge: Council on East Asian Studies, Harvard University. 1980.
- New York Times, 14 April 1980. Cited in Woo-Cumings, Slouching toward the Market: The Politics of Financial Liberalization in South Korea, in Capital Ungoverned: Liberalizing Finance in Interventionist States, eds. Michael Loriaux, Meredith Woo-Cumings, Kent E. Calder, and Sofia A. Perez (Ithaca, New York: Cornell University Press, 1997)
- Panitch, Leo et.al. (ed), The Globalization Decade. The Merlin Press Fernwood Publishing. London 2004
- Park Chung Hee., The Country, The Revolution, and I. Hollym Corporation, Korea., 1970.
- Pempel, T.J. (ed). The Politics of the Asian Economic Crisis, Cornell University Press, Ithaca and London, 1999
- Robert A. Blecker, Taming Global Finance: A Better Architecture for Growth and Equity (Washington, DC: Economic Policy Institute, 1999)
- Sachs, Jeffrey and Radelet, Stephen., East Asian Financial Crisis: Diagnosis, Remedies, Prospects an article published by the Harvard Institute for International Development. April 20, 1998.
- Sachs, Jeffrey. Trade and exchange rate policies in growth-oriented adjustment programs, Harvard University, February 1987
- Sachs, Jeffrey (et.al) (ed). The Asian Financial Crisis, MIT Press, Cambridge, Massachusetts, 2000.
- Singh, Ajit., Capital Account Liberalization, Free Long-Term Capital Flows, Financial Crises and Economic Development, Queens College, University of Cambridge www.networkideas.org/feathm/dec2002/Ajit_Singh_Paper.pdf
- Singh, Ajit. How did East Asia grow so fast? Slow Progress Towards an Analytical Consensus, No. 97, UNCTAD, February 1995
- Shorrocks, Tom., "Korea"., Foreign Policy In Focus, Vol. 3 No. 1, February 1998., <http://www.fpif.org/>

- Song, Byung-Nak., The Rise of the Korean Economy. Hong Kong, Oxford, and New York: Oxford University press.1990
- Stiglitz, Joseph. Capital Market Liberalization, Economic Growth and Instability. World Development Vol. 28, No. 6., Elsevier Science Ltd. 2000.
- Sitglitz, Joseph. Globalization And Its Discontents W.W. Norton & Company, London, NY, 2002
- Streech, Wolfgang and Thelen, Kathy. Institutional Change in Advanced Political Economies. www.graduateschool.unimi.it/allegati/Streeck%20and%20Thelen%20chapter%20PDF_8.pdf
- Wade, Robert. Governing the Market, Princeton University Press, New Jersey.1990
- Wade, Robert. The Asian Debt and Development Crisis of 1997-?: Causes and consequences., World Development Vol. 26 no.8, Elsevier Science, Ltd. Great Britain, 1998.
- Wade, Robert, Japan, The World Bank and the Art of Paradigm Maintenance: The East Asian Miracle in Political Perspective. New Left Review, no. 217
- Woo-Cummings, Meredith (ed). The Developmental State. Cornell University Press., Ithaca and London., 1999.
- Woods, Ngaire (ed) The Political Economy of Globalization. St. Martin's Press, New York 2000
- White, Gordon ed. State Intervention in South Korea, "Developmental States in East Asia", St. Martin's Press, NY. 1988.
- Wolfe, David and Holbrook, JA. The Innovation Systems Research Network (ISRN): A Canadian Experiment in Knowledge Management. March 18, 2005, www.sfu.ca/cprost/docs/ISRN%20SPP%20paper%20v4.1.pdf
- Woo, Jung-en (Meredith Woo Cummings), Race to the Swift, Columbia University Press., New York., 1991
- World Bank. The East Asian Miracle Economic Growth and Public Policy. Oxford University Press., 1993 N.Y.
- World Bank (1989), World Development Report 1989: Financial Systems and Development, NY, Oxford University Press
- Yamamura, Kozo and Hatch, Walter., A Looming Entry Barrier: Japan's Production Networks in Asia. NBR Publications: NBR Analysis: vol 8, no. 1: Essay. The National Bureau of Asian Research, 1997
- Yamamura, Kozo and Hatch, Walter. Asia in Japan's Embrace. Cambridge University Press. 1996