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Research in Progress 19

# THE CHANGE OF THE FINANCIAL SYSTEM AND DEVELOPMENTAL STATE IN KOREA

Kang-kook Lee

February 1999

UNU World Institute for
Development Economics Research
(UNU/WIDER)

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## ABSTRACT

This study examines the role of institutions and their change related to the rapid economic development and the 1997 Korean financial crisis. In Korea, the government built a state-led financial system through the 1960s and 1970s and a specific government-bank-business relationship based on it. It promoted economic growth by allocating financial resources controlled by it to targeted industries or firms, with discipline over business achieved through these institutions. However, as the economy developed, this financial system and the relationship between the government and business changed. While the government's control of finance weakened, the economic power of *chaebols* grew stronger, and their relationship changed from dominance and discipline with co-operation to regulation and conflicts. Accordingly, former institutions could not work well, but there was no proper reformulation of them and they failed to evolve to match these changes. The banks failed to monitor business and the problems in banks and *chaebols*, including the bad corporate governance, grew serious. Subsequently, the rapid and incautious financial liberalization with these problems led the Korean economy into economic crisis in 1997. Institutional reforms and new institution building are urgently required, but must be adopted under adverse circumstances.

# I INTRODUCTION

Korean economic growth was said to be 'miraculous' in that it was one of the fastest in the world and succeeded in transforming the industrial structure with a relatively equitable income distribution. But the economic crisis of 1997 jeopardized the success of the Korean economy and made this miracle seem a mirage. In late 1997, the currency was depreciated to half of its value and the government agreed with the International Monetary Fund on US$56 billion bailout finance. These experiences make it necessary to reconcile the Korean miracle and the 1997 economic crisis.

There are many arguments about economic development in East Asian countries, including Korea, and recently many explanations for the economic crisis in this region have appeared. Basically, opinions about the economic success are divided into the state-centric and market-centric theory but recently a new approach has emphasized institutions and tried to overcome the dichotomy of the state versus the market (Amsden, 1989; World Bank, 1993; Aoki *et al.*, 1997). The argument that makes a point of the cozy relationship latent between banks, large firms and the government and the excessive state intervention is confronted with the argument that there have been insufficient state regulation and incautious financial liberalization (Chang, 1998; Krugman, 1998). Each theory seems to explain the aspect of the Korean economy to some extent but we need to make a more consistent analysis.

In this study we will present an interpretation about the rapid economic development of Korea, focusing on specific institutions constructed by the state and show the change and degeneration of these institutions which led to the economic crisis in 1997. In Korea, the state-led financial system was an essential institution for economic development and the government could build a specific government-bank-business relationship with control, discipline and co-operation based on it. These specific institutions built by mixing the state and the market mechanism functioned as a kind of quasi-internal organization on the whole economy (Lee, 1992). This strategy promoted rapid economic growth by allocating financial resources into priority industries and big business despite some problems such as high indebtedness and bad corporate governance of business and weakness of banks. As the economy developed, the financial system and the relationship changed causing this specific institution to operate not as well as it had previously. Yet, there was no reformulation of the former institution nor was there the building of a new and proper one. The problems grew more and more serious, coupled with the incautious financial liberalization leading the Korean economy to economic crisis in 1997. From this analysis on the crisis in the Korean economy we may learn what role the government should perform to promote and sustain economic development and thus provide an important lesson for other developing countries.

In section 2 we will critically survey arguments about the economic success of Korea and argue for the importance of institutions for economic development. Next, we will examine specific institutions and their operation in Korea with reference to an industrial policy and financial system in section 3. And in section 4 we will show the evolution of the financial system and the degeneration of institutions of the developmental state. Lastly, we will

analyse the economic crisis of 1997 and redefine a new role of the state for further development.

## II THE KEY OF THE 'MIRACLE': ARGUMENTS ABOUT ECONOMIC SUCCESS

### 2.1 The debates on the causes of the successful economic development of Korea

The rapid economic development in East Asia including Korea interested many people and raised many theories and debates about it. We can divide them into two categories according to which mechanism they stress, namely the state or the market.

The neoclassical arguments emphasize free market operations that are not distorted by state intervention as a key of economic success. Early theories argue that the economic development in East Asia including Korea is due to following the market principle by minimal state intervention and market liberalization, or if any those interventions were self-canceling or market-preserving (Ballassa, 1988). But these arguments are refuted by many real experiences: in reality there was such heavy state intervention that it cannot be expressed just 'getting the prices right' (Amsden, 1989; Wade, 1990). After these critiques, they presented more elaborate analysis named 'market friendly state intervention' approach (World Bank, 1993). According to this, important factors of economic success in East Asia were macroeconomic stability and the export growth, along with institutional structure for growth, high savings and investment on human and physical capital, and the efficient resource allocation based on the market and exports. This position is more realistic in that it acknowledges a positive role of the state and various state interventions in economic development, and it properly points out the state intervention used competition based on 'contests' for exports. But it argues that the state intervention should be market friendly in its scope and manner and that selective intervention failed. This evaluation about the performance of industrial policy is very ambiguous and even differentiation between market friendly/selective intervention is not easy (Amsden, 1994; Toru, 1994; Felix, 1994; Lal, 1997). It does not examine the nature of the market itself and still supports market conforming policies, assuming an ideal market like neoclassical arguments.[1]

The alternative position is summarized as 'developmental state theory'. It argues that government intervened in the economy intentionally and heavily, even getting the prices wrong in East Asian countries and these strong interventions were the most important factor for economic development (Amsden, 1989, 1992; Wade, 1990, 1995; Singh, 1995). Strong industrial policy—such as the selective promotion of industry, financial control, various trade protection etc.—is presented as a key of economic success. The conditions for successful state intervention in the developmental state were related to the embedded autonomy and effective capacity of the state (Leftwitch, 1995; Evans, 1995; Ahrens, 1998).

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[1] In reality the market as such is embedded in broad social system and even the appearance of market itself demands proper institutional conditions mostly provided by government. Moreover, other institutions are essential for market operation because it is always incomplete for problems related with transaction cost and information, which are more serious especially in developing countries. (Granovetter, 1985; Stiglitz, 1989; North, 1990).

First, the state in East Asia has strong autonomy because there were no strong interest groups like landowners, capitalists, and workers and there was a long and strong bureaucratic tradition that led to the strong administrative capacity of the state. Second, a specific relationship between the state and the society was also essential factor to avoid government failure. The close and co-operative relationship between the government and private sector mitigated information problems and the mechanism of government's discipline over business like subsidies in return for performance limited rent-seeking. In addition, the principle of shared growth and external threat were also thought to be helpful for good governance and implementation of policy for development (Campos and Root, 1996; Root, 1996; Vartiainen, 1995). These arguments are more realistic than the market friendly one and indicate the important role of the state for economic development. It is noteworthy that it seriously takes notice of the relationship between the state and the society beyond a naive statist perspective.[2] But it should consider the change in this relationship and how the developmental state must evolve more extensively during economic development.

In debates about economic development between the market and state, more recent theories, the so-called 'new institutional economics', make a point of the importance of institutions. This perspective thinks that the market is significantly imperfect due to transaction or information costs and collective action problems so that institutions are essential. Especially in developing countries, these problems are more serious and the proper role of institutions like the government is necessary for economic development[3] (Lin and Nabli, 1995, Harris *et al.*, 1995). The state can play an important role for economic development through intervention in the economy, complementing the imperfect market by various measures such as an industrial policy or financial restraint. While this complementary view between the state and market existed before, New Institutional Economics is more elaborate theoretically about the market and institutions (Putterman and Rueschemyer, 1992; Dutt *et al.*, 1994). This approach includes various perspectives about the role of the state and market for economic development in East Asia. For example, some emphasize the importance of the market presenting the 'market enhancing approach' about East Asian economic development (Aoki *et al.*, 1997, Stiglitz, 1996). They argue that the government's role is to facilitate the development of private-sector institutions that overcome failures in the market. To them, state intervention in the market can 'enhance' it by helping to solve co-ordination problems.[4] Meanwhile, 'new institutionalist theory of state intervention' emphasizes that neither the market, nor the state, nor any other economic institution is perfect as a co-ordination mechanism because of transaction costs. In this

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[2] The limit of state-centric theories or developmental state theories was said to be lack of attention of the relation between the state and the society, in that these are conformed mutually. (Migdal, 1994) Recently they notice the importance of this relationship and mention 'embedded autonomy' or 'interdependence' (Evans, 1995; Weiss and Hobson, 1994), but they do not analyse the change of this relationship extensively yet. (Haggard, 1998)

[3] Actually New Institutional Economics includes so broad branches but in this study we define NIE as an economic theory related with transaction or information costs and collective action or co-ordination problems about economic development. (Langlois, 1986; Williamson, 1975; Stiglitz, 1989; Nabli and Nugent, 1989; Aoki *et al.*, 1997)

[4] To them, the state intervention apparently seen as market distorting can be interpreted market conforming if it has several conditions, but this naming like 'market enhancing' seems to be related with their neoclassical market centric perspective. Actually, the discrimination between market-distorting and market-enhancing is ambiguous, and what is more important is not this discrimination but how the government builds specific nstitutions mixing the market and the state.

perspective the state may resolve the co-ordination problems at a lower cost than the market in certain cases, which is close to the developmental state theory (Chang, 1994). The latter seems to be more consistent with the experiences of Korea in that the government built institutions mixing the market and the state and performed strong roles beyond market co-ordination. But it does not consider enough how the state makes specific institutions at the level of the whole economy, and how these institutions change along with the change of economy. While they all explain the important function of institutions in reducing transaction costs, they lack a theory for the origin and the change of institutions. Especially, they seem to overlook the importance of power relationships between the agents in institutions.[5] We will analyse institutions built by the government mixing the state and the market, focusing on the financial system and the change of these institutions noticing the power relationship in them.

## 2.2 Beyond the state versus market: institutions for the 'miracle' in Korea and their change

Institutions are usually understood as the rules of the game of a society composed of the formal rules and the informal constraints and the enforcement characteristics of each (North, 1997). More broadly they are defined as a set of constraints which govern the behavioral relations among individuals or groups, including formal or informal organization, markets, contracts and cultural rules (Nabli and Nugent, 1989). The function of institutions is to economize by reducing transaction and information costs and solving collective action problems and thus overcoming broad market failure. In developing countries where these problems are more serious they affect economic development; various good institutions like a capable bureaucracy, rule of law, and so on, are essential (Alesina, 1997; Rodrik, 1996). But actually institutions not only complement the market but also themselves can be a mechanism of economic co-ordination, which means institutions are beyond the market or the state. It is the organization structure that we should consider, which controls the economy encompassing more than the market which is also organized by, and gives effect to, the institutions[6] (Samuels, 1995). Here, the role of the state is most essential in that as a central part of institutional complex, it can construct specific institutions and further determine the path of development, given its ability to enact or enforce the rules of the game. The relationship between the state and the society, the so-called embedded autonomy of the state, or power relationship between agents in institutions makes a significant effect on the formation and operation of institutions, as East Asian countries show (North, 1989; Khan, 1995). Meanwhile, the organizations or agents in them are apt to accommodate themselves, to react and further try to change them which raised an inter-dynamic between institutions and organizations (North, 1995).

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[5]Lack of consideration about the change of institutions and the problems of politics or conflicts between agents in institutions are indicated as limits of New Institutional Economics by many people. (Bardhan, 1989; Toye, 1995; Bates, 1995) These limits are due to neo classical bias which try to explain institutional change based on the rational choice of individuals. In reality institutions for economic development are constructed intentionally by the state and its change is much related with relationship between the state and the society. (Grabowski, 1989; Matthews, 1986), for which the recent developmental state theory which emphasizes the relationship between them may be useful. (Evans, 1995)

[6] Here, we consider much broader 'institutional economics' which encompasses both markets and institutions. It pursues analyses of the social forces which condition and channel the formation of markets; the institutions which constitute and operate through markets; the economy as a system encompassing more than the market and undergoing systemic evolution. Namely, this approach is more interested in the problems of power in institution and the change of institution. (Samuels, 1995)

Institutions are not static but dynamic evolving and changing over time. According to new institutional theorists, when there is a change of transaction costs resulting from the change of external factor prices or technology there is a demand for institutional change. In reality, besides these factors, the change of power relationships in institutions also may have impacts on the efficiency of institutions. But even in this situation the change of institutions is not so easy because there must be collective action or effort of the state for institutional change, usually blocked by various factors (Lin and Nugent, 1995; Nabli and Nugent, 1989). This change of institution is especially difficult when there are already established interests of dominant agents and resistance, and agents tend to depend on established institutions which leads to institutional inertia[7] (Matthews, 1986). Meanwhile, economic development itself can influence various factors relevant to institutional change including the power relationship and may affect the efficacy of institutions, which means there is a dynamic interaction between institution and economic development. So there can be a situation when former institutions can no longer operate well due to the change of economy and power relationship, which we may call 'institutional degeneration'. This situation demands a reformulation of institutions and a new institution building for further economic development, which also depends on the politics and power relationship (Bates, 1995).

Some theorists find the specific institution in Korea at the whole economy and call it 'quasi internal organization' (QIO) according to Williamson's theory about hierarchy. They argue that a kind of QIO was constructed that was constituted by the government and large enterprises in which there were hierarchical relationships and a set of implicit contracts (Lee, 1992). The government in Korea built a co-ordinating hierarchical organization between government, banks, and businesses by governing finance and allocating it to some businesses. This organization performed the role of internal capital market efficiently in developing countries because such markets suffer from underdevelopment (Stiglitz, 1989). This internal organization can be efficient in handling information imperfections in that the bounds of rationality are extended due to its hierarchical structure and this removes uncertainty by co-ordination of the decisions (Williamson, 1975). The government and large private enterprises could share the information through various channels, which led to the market mode of policy implementation to reduce transaction costs. For this organization to operate efficiently, an outward-oriented development strategy is important, since competition in world markets is necessary to ensure that this organization is committed to economic growth and makes efficient allocation of credits. Meanwhile, the usefulness of this quasi-internal organization will diminish as economic development proceeds because of organization failure and the completing of the market and private sector. More recently, financial liberalization has been analysed in this perspective (Lee and Haggard, 1995; Dalla and Khatkhate, 1995). This analysis properly focuses on specific institutions related to financial control of the government, and considers the change of them like financial liberalization. But it overlooks several problems this institution raised and the importance of the power relationship and does not consider the change extensively. In Korea, the government's control over finance was certainly an important factor for economic development. But the dominance of the government waned along with economic

[7] So there can be many relatively inefficient institutions and institutions have the character of so-called 'path dependency' due to the complementarities or network externalities. And there is even the case that efficient solutions may not be known, or even if known, may be ruled out by the idiosyncracies of a given society's historical endowments (North, 1997).

development, and the degeneration of former institutions followed.[8]

We will develop this argument analysing specific institutions like the state-led financial system and government-bank-business relationship in Korea. We will explain how these institutions worked well for the rapid economic development, but at the same time we will point out the problems and evolution of them. In Korea, the state constructed specific institutions in which the government allocated financial resources to specific sectors to promote large private investment. The government disciplined businesses reducing rent-seeking activity by the peculiar mechanism of subsidy based on performance. For the operation of this institution the government's hegemony over business with control of finance was essential and the state-led financial system was the most important factor of these institutions (Zysman, 1983; Woo, 1991).[9] It encouraged the formation and growth of big conglomerate firms *(chaebols)* and achieved rapid economic development. But also gave rise to problems such as very bad corporate governance and corporate capital structure that made them vulnerable to shocks. The repression of management autonomy and insolvency of banks demanded more state intervention via regulation to tackle them. Meanwhile, as the economy developed and the financial system changed, the former institutions degenerated and could no longer operate well due to the growth of the power of the *chaebols*. But the reform of institutions was not easy because of the resistance of the *chaebols* and the government's dependence on established institutions. It failed in building a new institution and merely dismantled former institutions, which brought about the economic crisis. We will analyse these institutions and their change in section 3 and 4 nore extensively.

## III THE DEVELOPMENTAL STATE IN KOREA AND ITS OPERATION

### 3.1 The industrial policy in Korea

Many researchers find that the Korean government intervened in the economy heavily beyond macroeconomic regulation via an industrial policy— a policy promoting particular industries of emerging comparative advantage to secure international competitiveness of those industries and further economic development. There are many theoretical arguments for it and recent new institutional economics emphasizes broad market failures due to transaction costs and co-ordination problems and the necessity of the state intervention. But when state intervention also has serious problems of government failure due to rent-seeking activities and information problems, the state must solve these problems. In Korea

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[8] Willamson did not consider the importance of power but himself pointed out the importance of monitoring against opportunism in internal organization. (Williamson, 1975) Meanwhile radicals think that power is important in origin of institution like a firm and critiques of NIE argue that it is important in institutional change. (Toye, 1995) For economic development in developing countries, especially this power relationship between government and business is important in origin and even operation of institutions.

[9] The state intervention in this process was not replacing the whole market but building specific institutions compounding the state and the market mechanism and operating them. The government intervened into financial market and allocated financial resources distorting market prices but at the same time this preferential allocation was based on performance in the market. .This mechanism is called 'contest' mixing competition and test or 'contingent rent'. (World Bank, 1993; Aoki *et al.*, 1997)

the state could ease these problems thanks to strong government discipline and co-operation with the private sector (Amsden, 1989; Chang, 1994). In implementing this policy, the government used many measures such as entry restriction, import protection and tax preferences but, above all, financial measures like preferential loans from the state-led financial system were the most important.[10] There are various phases of Korea's industrial policy: export promotion policy since 1964, heavy and chemical industrialization 'big push' during 1973–9, state-led rationalization programmes during 1979–82, various liberalizations after the mid 1980s and high technology promotion policy after the late 1980s. We will analyse the phase and content of industrial policy focusing on financial measures below.

Industrialization in Korea started with the military government that emphasized economic development as the most important purpose. It adopted an export promotion strategy to industrialize the economy from 1964 responding to the reduction of aid, shortage of foreign currency, and limits on import substitution policy.[11] Among many measures it adopted for export promotion, finance for export promotion was the most important.[12] There were strong efforts to support exporters by export credit programmes when capital and financial markets were underdeveloped and informal directives to persuade banks to lend to exporters. The government established a short-term export credit system with automatic approval of loans by commercial banks to those who had export letters of credit in 1961. Its coverage expanded continuously including imports of raw materials and intermediate goods for export, and later various schemes were consolidated into the Regulation of Export Financing in 1972 (Table 1).

The subsidy in interest rates in export credit and also the share of export loans in total loans were so large that the exporters got great benefits. The rent created in export loans increased from 0.3% of GNP in 1963 to 1.7% in 1970, 3.0% in 1975 and 4.7% in 1980 (Cho, 1997). Following this, exports in Korea grew rapidly. Of course, other policies such as exchange rate or fiscal subsidy may have affected this growth, but it is certain that export loans promoted exports in Korea changing the incentive structure of the private sector. The subsidized loans were crucial to enabling exporters to fill foreign orders and to explore foreign markets. Only after the mid 1980s with a current account surplus and financial liberalization, the government reduced them and excluded large corporations

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[10] This means that we can't divide directed credit, export promotion, and industrial structure transformation. The World Bank cannot understand this point and they conclude that industrial policy which they define narrowly as policy to transform industrial structure was not a success in Korea. (Singh, 1995)

[11] Of course in Korea, there was not only simple export promotion policy but also elabourate import substitution strategy in this period in perspective of long-term development of industry. The government promoted the export and this growth of export increased the demand of raw material or productive factors for backward industries. When this demand was large enough the production of backward industries, which was import substitution industry, was started in Korea as in case of textile, synthetic fiber, petrochemical industries. This growth of import substitution industry was helpful to mitigate the deficit of current balance and contributed to the deepening of industrial structure. So, the government adopted a kind of 'double track type' industrialization with export promotion and import substitution which have virtual spiral effects each other. Meanwhile, this effect of HCI in the 1970s was ambiguous because HCI was centralized to final products but its effect on current account was certain.

[12] Various measures included pecuniary incentives like depreciation of the exchange rate, subsidy in tax, tariff etc. and non-pecuniary incentives like political commitment, administrative support. In 1967 when total export subsidies peaked the total interest rate subsidy related with preferential loans was 2.3% of the total value of exports, far exceeding the fiscal subsidy of 1.0% and the ratio between financial and fiscal subsidies to export was about 7:3 from 1965 to 1980. (Cho and Kim, 1997)

from them. Besides the character of the subsidy, the export credit had the specific character of a discipline mechanism as well because the government provided financial resources on the basis of previous export performance in operating this programme. Exporters had to exceed a specified level of exports from the previous year to be eligible for export credit and the general trading companies who had favourable access to them had to renew their licenses each year based on export performance. In this process the government consulted with exporters closely about various financial schemes to promote export (Amsden, 1989; Sakong and Jones, 1980).

TABLE 1 EXPORT LOANS IN KOREA (%)

| | 1961–5 | 1966–72 | 1973–81 | 1982–6 | 1987–91 |
|---|---|---|---|---|---|
| EL/Total Loans by DMB | 4.5 | 7.6 | 13.3 | 10.2 | 3.1 |
| EL/Total policy loans | n.a. | n.a. | 20.4 | 16.5 | 4.5 |
| EL by BOK/Total EL | n.a. | 66.3 | 73.0 | 64.5 | 45.3 |
| EL interest rates (1) | 9.3 | 6.1 | 9.7 | 0.0 | 10-11 |
| General loan interest rates (2) | 18.2 | 23.2 | 17.3 | 10-11.5 | 10-11.5 |
| (2) – (1) | 8.9 | 17.1 | 7.6 | 0-1.5 | 0-0.5 |

Source: Bank of Korea, Economic Statistics Yearbook, various issues; in Cho and Kim (1997).
Note: EL = export loans, n.a. = not available.

In the 1970s, the government promoted a heavy and chemical industrialization (HCI) policy with great enthusiasm. The government established the Heavy and Chemical Industry Promotion Committee, and the Planning Office, and enacted various plans to promote priority sectors such as steel, chemical, non-ferrous, machine, shipbuilding, and electronics. HCI policy had several backgrounds such as the limits on industrialization based on labour-intensive light industry; changes in the international economic situation including export growth of other late developing countries; changes in the international division of labour; and political and defense considerations. The government decided to promote HCI with high-growth potential and linkage effects in order to tackle these problems and promote economic development further. For HCI policy, the government mobilized all possible measures including financial measures like special funds, policy-based credit, fiscal measures like tax and tariff subsidy, and the provision of industrial infrastructure (Stern *et al.*, 1997). In particular, it emphasized the economies of scale and large investment preventing excessive competition in these industries, which as a result encouraged the *chaebols*.

As with the earlier export promotion, financial measures were the most crucial in HCI policy which included establishment of special funds and expansion of policy-based loans and rediscounts of the Bank of Korea (BOK). The government tried to promote investment by financial subsidies in HCI on which the private sector took a negative stance because of too large scale of investment, long gestation periods and high uncertainty. The National Investment Fund (NIF) was established to finance a large amount of long-term investment in HCI in 1973. The sources of funds were mostly private financial institutions that mobilized funds by receiving deposits or issuing national investment bonds. They were mostly allocated to HCI and power industries to finance equipment and working capital according to the Fund Act, with preferential conditions such as long loan periods and low interest rates. Although the NIF's share of total bank loans to HCI was 6% in 1974, it increased continuously reaching 25% at the end of 1970s—in equipment loans in HCI its share was about 70% (Table 2).

TABLE 2 NATIONAL INVESTMENT FUND IN KOREA: SOURCES AND LOANS BY SECTOR, INTEREST RATES

| Sources (%) | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|---|
| Public fund | 16.5 | 16.3 | 15.6 | 18.9 | 18.5 | 18.1 | 21.1 | 20.7 |
| DMB | 58.7 | 47.4 | 60.6 | 60.6 | 63.8 | 66.5 | 63.0 | 65.8 |
| Insurance company | 24.8 | 26.3 | 23.8 | 63.8 | 17.6 | 15.4 | 15.9 | 13.5 |
| Loans (%) | | | | | | | | |
| HCIs | 54.8 | 44.7 | 58.4 | 73.8 | 69.6 | 71.7 | 67.7 | 70.5 |
| Power | 27.1 | 40.5 | 24.9 | 19.8 | 25.4 | 22.7 | 27.4 | 23.9 |
| Agriculture and etc. | 18.1 | 10.8 | 16.7 | 6.7 | 5.0 | 5.6 | 4.9 | 5.6 |
| Total (billion won) | 63.0 | 119.0 | 178.0 | 219.0 | 402.0 | 457.0 | 438.0 | 543.0 |
| Interest rates (%) | | | | | | | | |
| NIF | 9.0 | | | 14.0 | 16.0 | | 22.0 | |
| Bank's general loans | 15.5 | | | 18.5 | 21.0 | | 26.0 | |

Source: Bank of Korea, Ministry of Finance; reformulated in Cho and Kim (1997), Lee (1996).

In addition to the NIF, the government expanded policy-based loans with preferential interest rates to HCI by revision of the Banking Act and Bank of Korea Act from 1970. The Bank of Korea expanded its rediscount facility to support HCI, allowing bills acquired by qualified firms in HCI and associated with raw material imports for HCI.[13] The government poured various policy-based loans (from development institution like the Korean Development Bank) into HCI and tried to increase foreign capital and allocate it to HCI as well.[14] The 1970s saw the completion of the state-led development financial system to allocate capital mostly to HCI in line with the second phase of the industrial policy. The volume of credit destined for HCI grew rapidly and the share of policy loans also soared from 44% in 1970 to 68% in 1980, with the share to HCI in total policy-based loans to manufacturing industry increasing to above 90% in the late 1970s (Lee, 1996; Table 3).

It is certain that the government succeeded in promoting investments in HCIs rapidly and transforming the industrial structure and composition of exports (Chang, 1994). There was also a sort of discipline mechanism in this policy including a rigid examination in process of entry permission (Kim, 1997). But there are many arguments about the real performance of HCI policy. Supporters emphasize that the rapid growth in these industries was impossible without state intervention pointing out the growth rate, effects on the current account and technological capability (Amsden, 1994; Singh, 1995; Lal, 1997). Critics underscore the relatively slow growth of TFP in HCI and distortion of resource allocation in the economy which led to overcapacity and serious recession in 1979–80 (Corbo and Suh, 1992, World Bank, 1993; Lee, 1996; Stern *et al.*, 1997). It is difficult to evaluate this selective HCI policy because it had promoted investment in targeted industry and further economic development and also had some bad effects.[15] However, we should notice that as

[13] It also increased the maximum loan period for equipment investment from 8 to 10 years considering the long gestation period in HCIs and enacted 'Guide to Bank Loans' to induce more lending by banks to HCIs

[14] Beside these, various measures to mobilize financial resources in public such as freezing the curb market and promoting the short-term financial market and capital market were adopted. These were also related with HCI big push policy that demanded tremendous capital.

[15] The arguments about TFP have serious problems related to measurement. (Rodrik, 1996; Kwon, 1994) and

a result of this policy the financial sector grew more vulnerable and *chaebols* grew too strong which, in itself, was destructive to former institutions.

TABLE 3 SHARE OF CREDIT BY BANKS AND AVERAGE COST OF BORROWING BY SECTOR (%)

| | 1972 | '73 | '74 | '75 | '76 | '77 | '78 | '79 | '80 | '81 | '82 | '83 | '84 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| HCIs | n.a | 36 | 32 | 66 | 56 | 61 | 56 | 59 | 60 | 53 | 69 | 59 | 56 |
| Light | n.a | 64 | 68 | 34 | 44 | 39 | 44 | 41 | 40 | 47 | 31 | 41 | 44 |
| HCIs (A) | 10.5 | 8.7 | 10.3 | 10.2 | 10.1 | 11.5 | 10.1 | 12.5 | 17.5 | 17.5 | 15.3 | 12.9 | 14.4 |
| Light (B) | 13.3 | 10.9 | 10.6 | 12.2 | 13.7 | 14.3 | 15.9 | 16.6 | 20.1 | 19.6 | 16.9 | 14.6 | 14.5 |
| (B)- (A) | 2.8 | 2.2 | 0.3 | 2.0 | 3.6 | 2.8 | 5.8 | 4.1 | 2.6 | 2.1 | 1.6 | 1.7 | 0.1 |

Source: Bank of Korea, Financial Statement Analysis, various issues; Economic Statistics Yearbook; in Cho and Cole (1983, pp. 129), World Bank (1987).

Note: The average cost of borrowing is defined as the interest paid plus the discount, divided by total borrowing, which includes all sources: bank, NBFI, bond, foreign, and so forth.

The Korean government intervened not only in the promotion of investment *ex ante* but also in management of it *ex post* as a form of reorganization and state-led mergers in industry. In the economic recession after the enthusiastic HCI policy and investment boom, it intervened in industrial sector directly through the Reorganization of Heavy and Chemical Industries Programme in 1979–81. It tried to compel firms to merge and to regulate entry and business in order to solve the overcapacity problem in HCI.[16] Financial measures were again an important tool in this procedure; major firms got special loans, guarantee of payment and debt-equity swaps by the Korean Development Bank and even a moratorium on bank-loan repayment amounting to 1.1 trillion won. This direct government intervention is thought to have played the role of discipline mechanism over the *chaebols* (Chang, 1994) but it also increased the economic power of *chaebols* because almost all programmes were done in a preferential way by outsider takeover.[17] This policy shows that the government intervened in the economy sometimes replacing the market even at firm level if necessary based on strong financial control, transferring difficulties of the industrial sector to the financial sector.

After the 1979–82 recession, the keynote of industrial policy in Korea changed to

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some argue that this might have been due to a rapid increase of equipment investment with low technology and time lag of TFP growth in this sector thinking that growth itself is more important in developing countries. (Ito, 1997) Meanwhile there are critical arguments about policy capture in HCI policy that the protection of domestic market against competition was long enough to lower efficiency (Auty, 1994) and HCI was centralized into consumer goods not capital goods. But the government's role in take off stage of these industries was certainly essential to promote at least quantitative growth in these industries in spite of problems it raised.

[16] Power generating-equipment, car, heavy-electrical-machinery, naval diesel engine, electronic-switching system, copper-smelting were included here. In this process there were serious conflicts between firms and government and even foreign capital, but after 1981 the government succeeded in reorganizing these industries and it raised capacity rates and profit rate which led to continuous high investments. (Jang, 1997) Meanwhile, These conflicts were due to strategic response of business which already grew strong to get preferential support as large as possible and conflicts about authority of management between domestic and foreign capital. (Rhee, 1994)

[17] In fact the 30 largest *chaebols* took over 56 of 78 firms and they made an effort to get maximum support from the government in this process.

emphasize the free market operation and liberalization considering problems of the strong state intervention (Leipziger and Petri, 1993). With a macroeconomic stabilization programme, there was significant import liberalization from 1984, and liberalization of investments with the Industrial Development Law after 1985 which incorporated former promotional laws to relax regualtion on entry and investment. The government also tried to encourage small and medium enterprises and subsequently supported high technology promotion now, emphasizing private participation and functional supports in implementation of policy rather than sectoral targeting. But even in this changed industrial policy it also used mostly financial measures. While it still regulated several industries that were targets of rationalization, after the rationalization period each *chaebols* continued to promote investment rapidly in the 1990s.[18] Without proper reform of the *chaebols* and financial sector, the withdrawal of government investment co-ordination might lead to serious problems.

In summary, the Korean government intervened in the industrial sector to promote economic development through various forms of industrial policy such as export promotion, HCI promotion, and even state-led merger programmes. These policies were to promote investment *ex ante* and manage it *ex post* in priority industries by large financial support. This support was related to the performance of firms, and it played a specific discipline mechanism in preventing a serious rent-seeking problem. Actually it was impossible without the state-led financial system, and that we will analyse.[19] But, with all this success in rapid industrialization by this interventionist policy, it also sowed serious problems in banks and increased the economic power of *chaebols*.

### 3.2 The state-led financial system in Korea

While financial repression theories argue that financial repression is bad for economic development, a mild financial repression may in fact be helpful. The financial restraint hypothesis argues that state intervention in the financial sector—such as regulation of interest rates and entry of banking, and finance allocation—may promote economic development by creating a kind of rent beneficial for the stability of the banking system and the firms (Stiglitz and Uy, 1996; Cho, 1997). Financial markets are naturally incomplete because of incomplete information to raise the credit rationing, which is more serious in developing countries. Besides, long-term dynamic efficiency related to the performance of firms is more important than short-term allocative efficiency for economic

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[18] Target industries included automobiles, coal-mining, dyeing, ferroalloys, heavy construction machinery, heavy electrical equipment, naval diesel engines and textiles (1986.7-1989.6), and fertilizers (1987.12-1990.11) There were regulation on entry in automobiles, diesel, ferroalloys, heavy electrical and reduction of capacity in ferroalloys, and abolition of obsolete capacity in textile.

[19] This Korean industrial policy based on the state-led financial system was at last to promote private investment by increasing expected profit rate with several measures and decreasing risk of investment which led to 'high profit-investment nexus' (Akyuz and Gore, 1996). Of course high investment does not guarantee high growth and increase of efficiency for which the competition in the external market and discipline mechanism of the government were important. With all, it might lead to excessive investment then the government tried to reorganize it rapidly based on financial control like the case of 1979-80 recession in Korea. Meanwhile, the overinvestment which was an important factor for the crisis in 1997 was promoted by the *chaebols*' economic power without proper discipline and co-ordination mechanism by the government. It shows that the importance of the quality of investment not just quantity that is more and more important as the economy developed and the new mechanism to promote it. Especially the 1997 crisis was related with foreign capital not controlled by the government, and this led to come out as currency crisis, which could no more handled by the government in former way.

development. For these reasons, government intervention in the financial market like directed credit can be justified (Hellman *et al.*, 1997; Stiglitz, 1993). The Korean government intervened in the financial market controlling and allocating capital directly like this view suggests, but its intervention was much stronger. Moreover, the government made a great effort to create a new financial market—like the second financial sector or capital market to mobilize public financial resources to the utmost—overlooked by financial restraint theory. We will examine the specific institutional structure in the Korean financial sector built by the government to mobilize and allocate financial resources for industrial policy, which may be called the 'state-led financial system'.

In Korea, this system was intentionally constructed by the Park government in the 1960s, and strengthened in the 1970s, to support its economic development plan. It took various measures to control all financial resources and allocate them to the priority sector: nationalization of commercial banks, control over the central bank, establishment of special financial institutions and control over foreign capital. At first, all commercial banks were nationalized in effect and separated from business. In 1961, most of the equity capital of commercial banks, formerly owned by a few industrialists, was transferred to the government, and it controlled the management of them.[20] The government also seized the authority of monetary policy from the BOK with the BOK Act of 1962. It stipulated that the BOK governor was to be appointed by the president on the recommendation of the Ministry of Finance (MOF), control of foreign exchange was transferred from the BOK to the MOF, the MOF was empowered to direct the BOK to purchase securities issued by government agencies with redemption guarantees. In this way the government made the central bank tool of financial policy for economic development. It also established several development institutions and specialized banks to handle policy loans including the Industrial Bank of Korea in 1961, the Citizens National Bank in 1963, the Korea Exchange Bank in 1967, and the Korea Development Fund Company, and strengthened their roles. Especially, it increased the capital base of KDB and allowed it to provide guarantees for foreign borrowing, to supply working capital loans, and to grant long-term loans to the government and KDB-owned enterprises under the amended the KDB Act in 1962.

Control over foreign capital was a very important tool for control over finance and business when foreign capital with lower interest rates was deficient in the early days of development. The government induced foreign capital through various acts from 1960, including the Foreign Capital Inducement Act in 1966 after normalizing its relations with Japan. This act allowed commercial and specialized banks to guarantee private sector foreign borrowing and issue repayment guarantees for it without prior authorization from the national assembly. These measures increased foreign capital loans and inflow of foreign capital. The ratio of payment guarantee on foreign borrowings to total deposit money bank loans increased from 11% in 1965 to 71% in 1967 and 94% in 1970, (Choi, 1996) and the ratio of foreign debts to GNP also soared from 6.1% in 1964 to 15.1% in 1967, 27.1% in 1969 and 33.9% in 1972. Since foreign borrowing was possible only on approval of the 'foreign capital inducement committee' of the government it could control and allocate them to specific industries.

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[20] Various measures like the confiscation of illicit wealth and 'law of temporary measures about financial institution' were taken by the government. By this law, voting rights of any one private shareholder of a commercial bank were restricted to no more than 10% of total votes and the government controlled the appointment of major bank managers and determined the budget of the banks. This measure was essential to establish control of the government over private business.

Meanwhile, the government reformed the financial sector extensively in 1965, which is usually thought to be market-oriented. It raised the one-year time deposit rate from 15% to 30% and loan rate from 16% to 26% in the name of 'interest rates realization', covering the deficit of banks by payment of interest on the bank's required minimum reserves from the central bank. The purpose of this reform was to attract private savings into banks from the informal curb market. It was so successful that private savings and bank loans soared rapidly over the next four years, the growth rate of bank loans rose from 10.9% during 1963–4 to 61.5% during 1965–9. These changes seemed as the liberalization and deregulation of the financial sector, but in effect they strengthened the government's control over the financial sector because the banks were controlled by it. There were also many exceptions related to special loans such as export and agricultural loans, which meant it was only to mobilize private funds into the banking sector. Moreover, the government turned to a low interest rate policy again after the '8.3 measure' in 1972 after the 1971 recession when many firms resorted to the curb market and went bankrupt. The low interest rates policy—with preferential interest rates to support the industrial sector—continued consistently throughout the 1980s.

In allocating financial resources in the priority sector, the government used various policy loans, defined as loans with preferential interest rates and availability supported by the central bank's automatic rediscounts. They were financed by funds mobilized by DMBs (deposit monetary banks), external borrowings and government funds, and allocated in line with specific purposes as a form of export loans, loans to small and medium enterprises, housing loans, etc.[21] The share of policy loans in Korea was so high that from 1961 to 1970 the ratio of policy loan except commercial bills discounted to all loans was above 65%, and during 1973–91 the ratio of it to all deposit banks loans was over 60% (Choi, 1996). From the 1970s to the mid 1980s, export loans held the largest share of total policy loans supplied by DMBs, and other loans including loans for machinery, special equipment funds, and foreign currency loans allocated to mainly HCI captured large shares. The government used policy-based loans extensively to allocate financial resources to priority industry like export industry or HCIs[22] (Table 4). And it shows well the specific government-business relationship that included the control and co-ordination at a time based on the state-led financial system.[23] But these policy loans and industrial policy mostly benefited the *chaebols* who dominated the export industry and HCIs which led to financial regulation over them.

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[21] This definition about policy loans has rather broader meaning. Narrower definition of policy loans includes specific loans by deposit monetary banks like export loan, equipment fund in export industry, housing loans, loans to agriculture/fishery/livestocks and loans by KDB. Broader definition consists of this narrower definition plus commercial bill discount by deposit monetary banks which is rediscounted automatically by central bank and foreign currency loans and others and EXIM loans. These are mainly allocated according to priority sectors, and here financial supports by the government to bailout insolvent firms which is allocated to specific firms is not included.

[22] These policy loans of banks depended heavily on the central bank, the ratio of central bank support for export credits and commercial bill discounts and agriculture/fisheries/livestock was 70.8%, 49.2%, and 18.5% each during 1973-91 (Cho and Kim, 1997).

[23] In establishing and implementing policy based loans, we can find very intimate co-operation between the government and business and the discipline mechanism like subsidies exchanged for the export performance. The government created a so-called 'contingent rent' allocated based on the performance of firms through 'contest' mechanism with this (World Bank, 1993) and it was so large that it amounted to over 3% of GDP in export loans and 10% in foreign loans in the 1970s (Cho, 1997).

With this control over the financial sector, the government also made an effort to mobilize private capital in the curb market by establishing non-bank financial institutions (NBFIs) such as short-term finance companies, mutual savings and finance companies after 1972 and constructing the capital market. In the recession of the early 1970s when the curb market grew again and liquidity in the financial market was deficient, the government froze the unorganized curb market and allowed various NBFIs. It was a good way of gathering private funds into the institutionalized financial market without weakening government control over the banking sector or raising interest rates of banks, and the less controlled NBFIs grew rapidly compared to the banks. The government also tried to promote the capital market to raise liquidity in the financial system by the 'Capital Market Promotion Act' in 1968, the 'Act To Promote Public Firms' in 1972, and the '5.29 Measure to Make Firms Open' in 1974 stipulating strong regulation over non-public firms. There was also a consideration to reduce high debt ratio of firms due to excessive borrowings from banks. With this, it built the so-called credit control system and principal transaction bank system to improve the capital structure of firms by controlling loans. In Korea, various financial markets, including the direct financial market, were also constructed and promoted by the government itself, but later it weakened the government's financial control.

Meanwhile, the government shifted the risk of the industrial sector to the financial sector by various bailouts and state-led mergers with preferential finance. As we mentioned before it undertook corporate bailout programmes in the 1970s and 1980s several times to ride out recessions and avoid major financial crises. Various financial support for the industrial sector were certainly the most important tools in these procedures, so that banks and depositors usually took on the cost of restructuring firms and industries. In response to the serious recession when the firms turned to the curb market, the government issued the Economic Emergency Decree in 1972 after consultation with leading businessmen. It included a moratorium on the payment of all corporate debt to the curb market and extensive rescheduling of bank loans at a reduced interest rate to bail out the debt-ridden corporate sector.[24] Even after the 1980s when financial liberalization was developed, the government decided to bail out insolvent firms to avoid financial instability and unemployment, making creditor banks write off bad debts, extend debt maturity and replace existing debt with a longer-term debt at a more preferential rate. This shows that the financial system in Korea played a risk-sharing role between the government and private sector in economic development.

To sum up, the state-led financial system in Korea mobilized funds and allocated them selectively and preferentially to promote investment, and took on the risk of investment failure in the industrial sector. In this process the government controlled and disciplined industrial firms. But although it succeeded in promoting economic development by promoting and managing investment, it also raised many problems. First, since the burden was mostly imposed on banks, they grew vulnerable with decreasing rates of return and competitiveness and large bad-loans. Besides, banks did not have management autonomy and could not monitor or discipline firms by an examination of investment. Second, this financial system urged firms to heavily depend on cheap loans which made them

[24] It was also a tool to reduce too many non-performing loans of banks at least apparently. Banks could change non-performing loans to general loans at least on the book in this procedure, and in practice after these measures reported non performing loans of banks fell significantly.

vulnerable during recession and the *chaebols* which had bad corporate governance. Meanwhile, the initial strong government control was weaking due to changes in the financial market and the growth of the *chaebols*.

TABLE 4 SHARE OF POLICY LOANS BY DEPOSIT MONEY BANKS AND SPECIAL BANKS (%)

| | 1973-81 | 1982-6 | 1987-91 | Average 1973-91 |
|---|---|---|---|---|
| DMB policy loans (A) | | | | |
| Government funds | 7.5 | 7.4 | 8.0 | 7.6 |
| NIF | 4.3 | 5.1 | 3.0 | 4.2 |
| Foreign currency loans | 21.1 | 19.7 | 19.4 | 20.3 |
| Export loans | 21.3 | 16.9 | 5.2 | 16.2 |
| Commercial bill discounted | 8.0 | 13.9 | 16.5 | 11.6 |
| Special funds for SMCs | 5.9 | 5.6 | 6.5 | 6.0 |
| Loans for AFL | 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 | 100.0 | 100.0 | 100.0 | 100.0 |
| Loans by special banks (B) | | | | |
| KDB loans | 91.9 | 71.7 | 83.7 | 84.8 |
| (NIF) | (25.7) | (18.5) | (7.9) | (19.5) |
| EXIM loans | 8.1 | 28.3 | 16.3 | 15.2 |
| (NIF) | (2.5) | (4.7) | (2.3) | (3.0) |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| (A) / DMB loans | 63.0 | 59.4 | 59.5 | 61.2 |
| (B) / NBFI loans | 48.0 | 32.3 | 15.3 | 35.9 |
| (A) + (B) / domestic credit | 48.9 | 40.8 | 30.9 | 42.4 |

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

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

### 3.3 The institutions of the Korean developmental state

This strong industrial policy, with financial measures to promote investment and manage it in priority sectors, was successful in promoting economic development despite many problems, and its base was surely the state-led and development-oriented financial system intentionally constructed by the government. The government built a specific institution that performed the role of internal capital market called 'quasi internal organization' that included the government, large businesses, and the banks. In this institution the government acted like a headquarters of a company using financial institutions like a financial department, and firms ran a business-like operation division of 'Korea Inc.'. Each sub-organization or agent in the institution, including big businesses and banks, adapted to this specific institution within the given constraints therein. We will examine the operation of each sub-organization and the relationship between them below.

In the beginning, we should note the character of the state in Korea which is said to have

strong autonomy and administrative capacity different from many other developing countries.[25] While states in many developing countries tend to be captured by interest groups, the Korean state was not captured by interest groups at least in the initial stage of economic development and it succeeded in limiting rent-seeking activity. Certainly it originated from several socio-historical conditions such as weakness of interest groups by land reform and relatively equal distribution (Leftwitch, 1994; Ahrens, 1998).[26] In addition, the Korean state had such good bureaucracy that its capacity to implement policy was also strong due to the bureaucratic tradition and reform efforts therein. But even if it was very autonomous, it was never a 'predatory state' which maximized its revenue at the expense of the whole economy. The Korean state had also the character of embeddedness with society, the state coordinated closely with the private sector (Lal and Myint, 1994; Evans, 1995; Weiss and Hobson, 1995). Meanwhile, the external political pressure of the 'Cold War' and the strong intention of political leaders were also important (Gunnarson, 1996; Vartiainen, 1995). This embedded autonomy and the capacity of the state were important factors of a successful developmental state to build and operate the state-led financial system and the specific government-bank-business relationship. Here, the role of the state was institution-building and institution-operating, as an important constituent of it. Its control over financial resources was the most important economic leverage which gave the state strong disciplinary power over private firms which depended on heavy debt. Of course, the state not only dominated them with discipline but also encouraged them with support and co-operation.

Business in Korea, especially large businesses grew rapidly by tremendous financial support by the government. The *chaebols*—conglomerates that have a diversified corporate structure and centralized and internalized ownership structure—were raised by the export promotion and HCI strategy of the government. They entered into priority industries and increased investment in line with the industrial policy which increased the rate of return by financial support since the 1970s (Lee, 1997). In this process they also increased efficiency and competitiveness by competition in the external market, several disciplines like subsidies exchanged for performance, investment co-ordination and bailout programmes consolidated with financial supports and internalization of deficient productive factors through diversification.[27] Besides, there was close consultation and a co-operative relationship between the government and business about economic policy to prevent information problems (Fukagawa, 1997). That is, they grew based on the support and discipline as well by the government in the specific institution, including the state-led financial system (Wade, 1995; Amsden, 1992).

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[25] In this regard we could call Korean state as 'Gershenkronian Developmental State' which was development oriented for late industrialization like many people name the state in developed countries in golden age as 'Keynesian Welfare State' and after 1980s as 'Schumpeterian Workfare State'. (Jessop, 1993)

[26] Equal distribution of income contributed to prevent excess representation of demands of interest groups or social groups and mobilize them to grow economy. It is called 'shared-growth' principle. (Campos, 1996; Rodrik, 1996) But, we should notice that the government made strong repression on especially labour class with anti communist ideology, so mobilization of people in Korea was very compulsory not based on any participation. Actually, after the end of 1980s demands of democratization and serious struggle of labourers were very important factor to destroy former developmental state in Korea. (Jeong, 1997)

[27] We can find the government's discipline over business in several cases including the policy loans exchanged for the performance like export loans, the government's rigid examination of investment project in HCI, the government's regulation to make the firms in import substitution industry supply materials for export industry at international price, and even various state-led merger programmes. Most of them were implemented based on the financial measures.

TABLE 5 COMPARISON OF DEBT/EQUITY RATIO OF MANUFACTURING

| | 1963-5 | 1972 | 1983 | 1985 | 1988 | 1991 |
|---|---|---|---|---|---|---|
| Korea | 95.5 | 313.4 | 360.3 | 348.4 | 296.0 | 306.7 |
| USA | -- | -- | 104.0 | 121.0 | 138.2 | 147.3 |
| Japan | -- | -- | 323.7 | 289.1 | 243.6 | 220.5 |
| Taiwan | -- | -- | 173.5 | 136.5 | 108.5 | 97.9 |

Source: Bank of Korea.

But the state-led financial system to support their investment made them heavily depend on external debts making them vulnerable in recession (Table 5). And they sought not profit but growth maximization and diversification so that they might receive loans more based on cross-loan guarantee practice and, even, reduce the risk of bankruptcy.[28] Their corporate governance was so poor that sometimes even incorrect management decisions were not be checked and monitored by an internal monitoring mechanism (such as a the board of directors and audit system, or externally such as capital market and financial institutions). These problems certainly originated in the centralized and distorted ownership structure and the limit of monitoring of banks due to the state-led financial system. Their efforts to get more and more credits based on diversified corporate structure kept their ownership structure centralized and internalized. This concentrated ownership structure also conferred economic power on the owner to help him in consultation with the government. As the *chaebols* and their financial power grew more and more, the government was unable to discipline them.

In this institutional setting, banks were in effect agencies of the government to implement industrial policy, they performed the role of mobilizing and allocating capital in priority industry and even taking on the risk of industry. Banks operated with strong regulation and support by the government such as entry, interest rates, policy loans and rediscount, special central bank loans. They did not have management autonomy and could not examine investment and loan for it and thus monitor business when the government controlled finance and business so strongly. Actually, the banks did not need to make these strong protection and regulation efforts, they merely requested guarantees in giving credit[29]. It might not be such a big problem in an economy which is not complicated and the control and discipline of the government were effective. But government control and the banks grew weaker in the financial system which might make the problems more serious without reform. Meanwhile, the heavy burden which the banks took on in the state-led financial system during economic development led to the demand of financial liberalization.

The government in Korea built a specific institution compounding the state and market mechanism in which it encouraged and disciplined big business controlling finance, which was successful for economic development. In this institutional structure there was a specific government-bank-business relationship, the government's dominance and discipline over businesses with co-operation and support, and strong control over banks. Of course there were conflicts between them, but they were not serious when the government's

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[28] Cross loan guarantee is a specific financial practice in Korea when the firms belonging to *chaebols* got a credit from banks, other firms guaranteed it, and this way, *chaebols* centralized credit to themselves. It was caused by the fact that banks cannot examine loan and give loans based on mostly guarantees.

[29] On this point financial restraint hypothesis has problems in explaining Korean case. They argue that protection in banking industry made banks more stable and created rent, but too strong control of banks led to many problems of banks in Korea. This theory may be fit for Japanese case where main bank could monitor business of so called keiretzu. (Hellman *et al.*, 1997; Aoki et al, 1994)

control over finance was strong. However as the economy developed, the financial system changed and the power of the *chaebols* increased, the conflicts and strategic action between them deepened. Actually, this specific institution could not but change along the economic development and the inevitability of change of the institution lay in the success of the institution as such.

# IV THE CHANGE OF THE FINANCIAL SYSTEM AND THE GOVERNMENT-BUSINESS RELATIONSHIP

## 4.1 The change of the financial system in Korea

### *4.1.1 The development of financial liberalization after the 1980s*

In the early 1980s, serious problems of overcapacity in HCIs, unbalanced growth between large and small firms, and vulnerability in the financial sector of the global economy appeared (Corbo and Suh, 1992).[30] In response to this crisis, the government reduced the economic intervention with a stabilization programme but it also tried to solve problems with stronger intervention in the financial sector. It made an effort to liberalize and deregulate the financial sector, and adopted several formal measures of deregulation on interest rates and entry, operation of financial institutions, reduction of policy loans and privatization of commercial banks. But the government did not establish the autonomy of bank management but continued to intervene in the financial sector in interest rates and in state-led bail out programmes in the mid 1980s. After 1993, financial liberalization and the opening up in Korea developed in practice, weaking government control further.

Under the financial liberalization programme, the government first sold its shares in all nationwide commercial banks during 1981 and 1983 restricting ownership by a single shareholder to 8% to prevent bank domination by *chaebols*. Next, it chartered two joint-venture commercial banks with Korean and foreign partners in 1982 and 1983. It continued to loosen regulations on chartering NBFIs and deregulated entry of the financial industry, allowing establishment of NBFIs in 1982, establishment of life insurance companies in 1987, establishment of local financial institutions in 1989 and transformation of short-term finance companies to banks in 1991. At the same time, the government continued to broaden and diversify services provided by banks and other NBFIs. These started with the expansion of operations of NBFIs to mobilize private capital, but as it weakened banks further the government allowed banks to diversify services. As a result, the competition in the financial sector between the banks and NBFIs got stronger but NBFIs attained superiority over banks thus further weakening government financial control.

The most important financial deregulation was about interest rates and policy-based loans.

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[30] But there is another argument that this crisis was overaccumulation crisis due to the decrease of profit share based on wage increase and decrease of capital productivity (output-capital ratio) based on rapid mechanization. It points out that low capacity rate was general in all industries not in HCIs and overcome of this crisis was not due to the stabilization policy but repression over wage rates and investment reorganization programme that increased capacity rates. (Jang, 1997)

The government continuously introduced deregulation of various interest rates and reduced policy loans, at least formally, from 1982. In 1982, preferential interest rates applied to various policy loans like NIF or export loans were abolished and all bank loans rate was unified at 10%. Besides, it allowed financial institutions to set their own interest rates within a given range in 1984 and deregulated several interest rates in the organized financial sector. But the interest rate was still low compared with the market rate and the interest rate gap between the banks and NBFIs maintained along the 1980s. In 1988, most bank and non-bank lending rates and some long-term deposit rates were decontrolled including corporate bonds, commercial papers (CP), and certificates of deposit (CD)[31] and several interest rates were again deregulated in 1991. But even after these measures, the government continued to intervene and maintain interest rates still lower than market rate to promote industrial investment[32] (Amsden and Euh, 1993). It was not until after 1993 that fundamental deregulation on interest rates was realized with the 'Three-Stage Blueprint of Financial Reform', including interest rate deregulation, reform of policy loans, and liberalization of capital accounts. It had various backgrounds such as the handicaps of banks, change of investment financing of firms, and consideration of the global financial market with joining of OECD and international pressures.[33] The government proposed deregulation of interest rates in almost all areas from 1993 to 1997, starting with deregulating interest rates on all loans except for policy loans, all long-term deposits, corporate bonds, and so forth in 1993.

For policy loans, while the share of policy-based loans remained high along the 1980s, there was a significant change of the structure after the late 1980s. Export credits fell significantly mostly due to the large corporations with large current account surpluses. Since 1988, large corporations have been excluded completely from export credit programmes and BOK has excluded the commercial bills of large corporations from the bills eligible for BOK rediscounting after 1989 (Table 6).

Meanwhile, political democratization and consideration of social equity increased demand for the change of the targets of policy loans. Policy loans to the small and medium corporate sector (SMC) were significantly increased and benefited further because of intensified credit control over large business groups.[34] This made the share of loans to SMCs in total loans by deposit money banks increase from 31.5% in 1985, to 48.1% in 1988, and 55.5% in 1990. Many policy loans were now made available to previously disadvantaged sectors like agriculture and housing. Accordingly, there was a large change

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[31] This made short-term money market that had interest rates more near to market rate grow and diversify further, which also brought about diversification of investment finance of firms not controlled by the government.

[32] For instance it attempted to bring down nominal interest rates of commercial banks in 1989 and of NBFIs in 1990 as interest rates rose rapidly in recession.

[33] QIO theorists argue that the rapid financial liberalization after 1993 was the effort of the government acknowledging the uselessness and limit of QIO due to the organization problem like insolvency of banks and the change of investment financing of private firms (Dalla and Khatkhate, 1995). But they don't think that the efficient operation of QIO was possible based on strong government dominance over firms and it played a role of discipline mechanism to firms. The problem was the government did not build other proper institutions or relationship between business and banks when the QIO already changed and former institutions operated no more.

[34] SMCs had benefit in loans by various measures such as intensified minimum portfolio requirement for SMC loans set by the government, rediscount on export bills and commercial bills associated with SMCs by the BOK and consequently policy loans to them grew rapidly after late 1980s.

in the share of policy-based loans from support for big business to SMCs and social demands, which meant that the influence the government could made on big business through financial control weakened (Table 6).

TABLE 6 PROPORTION OF EXPORT LOANS REDISCOUNTED BY THE BANK OF KOREA (WON PER DOLLAR OF EXPORT)

| | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|
| Large firms | 740 | 670 | 175 | 0 | 0 |
| SMCs | 740 | 700 | 520 | 450 | 550 |
| Won/dollar rates | 890 | 861 | 792 | 684 | 680 |

Source: Bank of Korea, The 40-year History of the Bank of Korea; in Cho and Kim (1997).
Note: SMCs = small and medium corporations.

But the government tried to control banks more strongly even after financial liberalization. Besides the intervention in interest rates, there was more direct intervention in the banking sector during large-scale restructuring of industrial firms in the mid 1980s. There were state-led mergers and liquidations of 78 inefficient firms between 1986–8 (manufacturing, foreign construction, and shipping industries). As the problems of insolvency of firms, especially in construction and shipping industries, and the insolvency of banks caused by it grew serious, the government tried to solve these by direct intervention at firm level. To induce state-led mergers and takeovers by sounder firms the government gave takeover firms large financial support by banks including moratorium on bank-loan payment, interest payment exemption, and more 'seed money' loans. Total support amounted to above 7.2 trillion won—about 2.3% of GNP—and banks were also supported by the government that resumed special loans of BOK with low interest rates in 1985. The government depended on the control of banks established in former days to solve problems in the industrial and financial sectors, but it made real reform of the banks difficult.

With regard to the financial market opening, the government took a gradualist approach during the 1980s (Park, 1996). There were some measures such as the basket-peg exchange rate system in 1980, interest and currency swaps in 1984, the establishment of the Korea Fund in 1984. It was spurred with the large current account surplus during 1986–9. The government adopted a Market Average Exchange Rate system in 1990 and changed the foreign exchange management to a negative system. After accepting the obligation of the IMF article VIII in 1988 it facilitated investment by foreigners in domestic securities by various measures, so that from 1992 foreigners were allowed to purchase Korean stocks and the government also authorized the operation of foreign securities companies in Korea. Especially in 1992 the government agreed with the US government on a 3-phase financial opening scheme and announced the '3-stage Blueprint of Financial Reform' in 1993 including more measures of financial opening until 1997 which led to rapid financial opening later.

In sum, financial liberalization from the 1980s was 'regulated deregulation of the financial system' which had a stop-go character. Not until 1993, extensive financial liberalization developed especially in financial opening (Dalla and Khatkhate, 1995). In this process the government control over finance such as banking sector continued to manage whole economy to prevent a real financial reform. The most serious problem was that it never

established the management autonomy of banks such as autonomous loan examination or the appointment of directors necessary for new discipline and monitoring system over *chaebols*. The experience of Korea shows that when the government solved economic problems relying on institutions established in former days, a real reform and new institution building was very difficult. But the control of the government over business also weakened due to the change of policy loans and financial market structure during financial liberalization process. The government tried to continue to control the financial sector, but at the same time it was losing its former strong control as the state-led financial system came to an end.

TABLE 7 CHANGE OF POLICY LOANS OF DEPOSIT MONEY BANKS (%)

| | 1971 | 1975 | 1980 | 1985 | 1990 |
|---|---|---|---|---|---|
| Government funds | 15.7 | 8.5 | 6.1 | 8.7 | 7.7 |
| NIF | -- | 3.3 | 5.0 | 5.6 | 2.3 |
| Foreign currency loans | 30.1 | 21.1 | 31.5 | 19.1 | 18.2 |
| Export loans | 15.3 | 20.9 | 20.9 | 18.2 | 4.3 |
| Special funds for SMCs | -- | 3.9 | 9.3 | 6.5 | 6.3 |
| Loans for AFL | 10.5 | 6.9 | 5.1 | 6.4 | 7.2 |
| Housing loans | 5.9 | 6.8 | 11.4 | 15.1 | 16.5 |
| Others | 22.5 | 28.5 | 10.8 | 18.5 | 36.2 |
| Policy Loans Total (A) | 522.0 | 1625.0 | 8238.0 | 17236.0 | 45844.0 |
| A/total loans | 46.1 | 40.9 | 49.1 | 44.4 | 61.4 |

Source: Economic Planning Board, Indicators of Korean Economy.

Note: If we consider that commercial bills discounted (omitted here) were means of policy loans to SMCs, policy loans to SMCs were much more, A is measured by billion won.

### *4.1.2 The change of the structure of the financial sector and financing of firms*

With the financial liberalization, the change of the financial market itself following economic development played a large role in weakening the government's control over finance and business. The growth of NBFIs, stock market and bond market changed investment financing of the firms and reduced the share of finance controlled by the government. Ironically it was also the product of government policy which tried to mobilize financial resources to the utmost and solve the excessive debt problem of firms. First, NBFIs in Korea grew rapidly after the late 1980s to account for over half of the financial market, including deposits and loans. The government originally allowed them to be established in 1972 to attract capital in the curb market and more in the financial liberalization process. They include such various financial institutions as investment and finance companies, merchant banking corporations, mutual savings finance companies and insurance companies mainly in short-term financial market. Relatively weak government control over them compared with the banks in interest rates and policy-based loans gave them advantage over banks and they offered interest rates close to the market rate with new financial instrument. But since they were mostly dominated by *chaebols*, rapid growth of them strengthened their financial power weakening the government control (Leipziger and Petri, 1993; Table 8).

The direct financial market, including the stock market and corporate bonds market, also grew rapidly to increase their share in the total financial market due to the effort of the government. In order to deepen these markets and attract savings, the government tried to induce firms to go public and issue bonds since the 1970s. It enforced ceilings on debt-equity ratio and forced big companies to mobilize funds in these markets to prevent excessive concentration of borrowings to them and mitigate the problem of bad capital structure. In addition, the government tried to spread share ownership by promoting the stock market in the late 1980s considering the demand for democratization. Various efforts were made by the government like tax incentives, support for stock market institutions, clampdown on speculation, and employee share ownership to grow these markets in the 1980s (Amsden and Euh, 1993; Choi, 1996). Thanks to these measures, they grew rapidly, and especially in the late 1980s the stock market soared with current account surplus and increased personal incomes. After 1990 there was serious slump and Korean firms still preferred external borrowings, but the importance of these markets in the whole economy was increased (Table 8.).

TABLE 8 BANKS' AND NBFIS' SHARE OF DEPOSIT AND LOAN MARKETS (%)

| | 72 | 74 | 76 | 78 | 80 | 82 | 84 | 86 | 88 | 90 | 92 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Deposits | | | | | | | | | | | |
| Banks | 81.7 | 77.3 | 76.1 | 74.5 | 69.1 | 64.3 | 56.3 | 49.4 | 44.3 | 40.5 | 36.2 |
| NBFIs | 18.3 | 22.7 | 23.9 | 25.5 | 30.9 | 35.7 | 43.7 | 40.6 | 45.7 | 59.5 | 63.8 |
| Loans | | | | | | | | | | | |
| Banks | 77.4 | 75.5 | 74.4 | 67.8 | 63.8 | 62.2 | 57.9 | 56.3 | 51.5 | 49.7 | 48.3 |
| NBFIs | 22.6 | 24.5 | 25.6 | 32.2 | 36.2 | 37.8 | 42.1 | 43.7 | 48.5 | 50.3 | 51.7 |

Source : Bank of Korea, Monthly Bulletin, various issues.

Consequently these changes of the financial market structure led to the change of investment financing in the corporate sector. Korean firms still depended on external funds heavily even in the 1990s and the ratio of external funds is rather higher than other countries accompanied by a high debt ratio of firms.[35] But the structure of external funds changed with the change of the financial market structure, and especially the shares controlled by the government fell. Indirect finance, borrowing from financial institutions, continued high but borrowing from banks controlled tightly by the government decreased because of the growth of NBFIs. While, the share of direct financing including stocks and corporate bonds in the financing of the corporate sector increased after the mid-1980s with the growth of these markets. In addition, firms diversified their financing and adopted various ways like commercial paper mainly issued by large firms belonging to *chaebols*. Foreign borrowing which was possible on the government guarantees also felled rapidly after the 1980s, and after the late 1980s the increase of external credit ratings of private firms made foreign borrowing possible even without the government guarantees like issuing foreign bonds.[36] In the end, the total of borrowings from banks and foreign

[35] The ratio between external funds in Korea was 81.7% in 1975, 81.1% in 1980, 62.9% in 1985, 72.9% 1990 and 71.3% in 1992. That in Japan was 49.4% during 1975-1979 and 41.0% during 1980-1984, and that in U.S. was 30.3% during 1975-1979 and 25.8% during 1980-1985.

[36] Korean firms are now issuing foreign bonds after Samsung electronics in 1985, and from 1985 to 1994 the

borrowings the government could control reduced and it made the government control over financing of corporate sector much weaker (Table 9.).

TABLE 9 GROWTH OF CAPITAL MARKET IN KOREA (BILLION WON)

| | 1980 | 1985 | 1987 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|---|---|---|
| Stocks | | | | | | | |
| Companies listed | 352 | 342 | 389 | 626 | 669 | 686 | 688 |
| Capital 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 |
| Value of stock traded | 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 | | | | | | | |
| Issuers | 434 | 1213 | 1457 | 1504 | 1603 | 1862 | 2070 |
| Face value | 1649 | 7623 | 9973 | 15396 | 22068 | 29241 | 32696 |
| Value of bonds traded | 246 | 660 | 5327 | 4378 | 2455 | 1394 | 453 |

Source: Korea Securities Dealers Association

In this process, it was the *chaebols* that strengthened their power over finance. They could get capital because of huge current account surplus and borrow foreign capital without government guarantees in the late 1980s. In addition, since they owned most NBFIs, their financial power was getting much stronger and despite the limit to share ownership, major *chaebols* owned the most shares of banks in reality.[37] Now, the government could not affect their investment decisions and financing effectively. They continuously centralized bank loan into themselves based on cross loan guarantees in the 1980s and demanded much further financial liberalization and deregulation thinking that the government's financial control was a burden on their free investment. They wanted to dominate banks directly, which led to the argument about so-called 'finding owner' of banks in financial liberalization. The development of financial liberalization after the 1990s was heavily affected by these demands.[38]

The late 1980s was a transition period in the Korean economy. In this period, the change of financial market structure thanks to the government policy itself and economic development weakened the government's control over finance and business. The state-led financial system came to an end in effect which led to an important change in relationship between the government and business from control and co-operation to conflicts. Now the former institution could not operate well and degenerated, which we will analyse below.

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amount of it was over 4.9 billion dollars. Meanwhile, the government increased this foreign capital inflow uncontrolled by it after 1994 with further deregulation in capital opening.

[37] In 1988 top 30 *chaebols* owned 12 of total 25 security companies, 18 of total 35 insurance companies, and 13 of 38 investment companies. There was limit of 8% which was reduced to 4% in 1994 to *chaebols*' share ownership of banks, but almost all of the *chaebols* had shares of banks and since most banks' shares were owned by these *chaebols* above 30% it is possible for *chaebols* to dominate banks with collusion between them.

[38] The government was so concerned about that when *chaebols* dominated banks, centralization of credit and bad capital structure problems grew more and more serious that it maintained the ceiling to ownership of banks. With this and conflicts in financial industry, there did not developed in financial liberalization in the late 1980s. But after 1990s the government policy turned to allow *chaebols*' dominance over finance and promoted further financial liberalization.

TABLE 10 CHANGE OF EXTERNAL FUND FINANCING IN CORPORATE SECTOR IN KOREA (%)

| | 1970 | 1975 | 1980 | 1985 | 1988 | 1990 | 1992 |
|---|---|---|---|---|---|---|---|
| Indirect finance | 39.7 | 27.7 | 36.0 | 56.2 | 27.4 | 40.9 | 36.3 |
| Borrowing from banks (A) | 30.2 | 19.1 | 20.8 | 35.4 | 19.4 | 16.8 | 15.1 |
| Borrowing from NBFIs | 9.5 | 8.6 | 15.2 | 20.8 | 8.0 | 24.1 | 21.1 |
| Direct finance | 15.1 | 26.1 | 22.9 | 30.3 | 59.5 | 45.2 | 41.4 |
| Treasury bills | 0.1 | 0.8 | 0.9 | 0.8 | 5.3 | 3.1 | 3.3 |
| Commercial paper | 0.0 | 1.6 | 5.0 | 0.4 | 6.1 | 4.0 | 7.6 |
| Corporate bonds | 1.1 | 1.1 | 6.1 | 16.1 | 7.5 | 23.0 | 12.5 |
| Stocks | 13.9 | 22.6 | 10.9 | 13.0 | 40.6 | 14.2 | 15.9 |
| Foreign borrowings (B) | 29.6 | 29.8 | 16.6 | 0.8 | 6.4 | 6.8 | 5.0 |
| Others | 15.6 | 16.4 | 24.5 | 12.7 | 6.7 | 7.1 | 17.3 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| (A) + (B) | 54.8 | 48.9 | 37.3 | 36.2 | 25.8 | 23.6 | 20.1 |

Note: Others include government loan and corporate credit.
Source: The Bank of Korea, Understanding of capital circulation in Korea.

## 4.2 The degeneration of the institution in Korea

### *4.2.1 The change of the government-bank-business relationship in Korea*

Institutions in Korea were initially run well based on the dominance of the government over finance and business but not free from conflicts, which grew serious when the power relationship changed. Between the government and business, there was an interdependence that *chaebols* needed the government's support and the government also needed the growth of *chaebols* and economy. But, each tried to maximize his own benefits adapting itself to it and even to change it in its own beneficial direction, which brought about a strategic interaction and even conflict between them (Schelling, 1980). Actually, the government and *chaebols* behaved strategically depending on the other's own resources like an economic performance, provision of political fund of *chaebols*; vision about economy, financial supports of the government which determine their strategy and at last the bargaining power to decide the direction of change (Pfeffer and Salanicik, 1978; Kim, 1988). When the government had power and resources the businesses depended on there was less conflict and the institution operated well.[39] But as the economy and financial system changed, former institution and relationship based on the dominance and discipline with co-operation could not be sustained. Since the 1980s conflicts and strategic interactions between them about various regulations had appeared and intensified reflecting the changed financial system.[40]

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[39] According to resource dependence theory, every organization must rely on the environment to supply the resources required for organizational survival and it become dependent on and vulnerable to external control when they must rely on other organizations for a crucial resource. Of course, as changes occur in the structural characteristics of the environment the degree of dependency and power within the exchange relation shifts. (Pfeffer and Salancik, 1978) While, for business the most crucial resource to depend on is capital and the structure of finance played the most important role in controlling them. (Stearns, 1990)

[40] These conflicts and strategic action between them did not appeared until the 1970s when the government's

TABLE 11 THE SHARE OF SALES AND VALUE ADDED OF *CHAEBOLS* (%)

| | | 1977 | 1981 | 1985 | 1990 | 1994 |
|---|---|---|---|---|---|---|
| Sales | Top 5 | 15.7 | 21.5 | 23.3 | 21.4 | 24.6 |
| | Top 10 | 21.2 | 28.4 | 30.6 | 27.1 | 32.1 |
| | Top 30 | 34.1 | 39.7 | 40.8 | 35.0 | 39.6 |
| Value added | Top 10 | 20.1 | 20.4 | 24.1 | 22.8 | 26.5 |
| | Top 30 | 29.1 | 30.8 | 33.1 | 30.0 | 33.9 |

Source : Korea Development Institute

First, *chaebols* grew more and more based on various financial supports in the former institutions and their own size as such. (Table 11.).
This concentration of economic power and excessive dependence on external debts made the government regulate them since the 1970s establishing credit control and main transaction bank system and this regulation continuously strengthened in the 1980s (Lee, 1997; Nam, 1996).[41] These regulations reduced the share of bank loans to the 30 largest *chaebols* gradually, but their share of all loans including NBFIs did not fall and centralization of direct financing to *chaebols* grew more serious. Moreover, the bad capital structure and excessive diversification of *chaebols* did not improve (Nam, 1996). The government's financial regulation on *chaebols* was not in effect since the financial system already changed. Based on the growth, the *chaebols* continuously spoke up their demands through suggestion of the Federation of Korean Industries to the government for various deregulations in financial sector (Lee, 1997). In particular, they requested the ownership of banks, abolition of the credit control system and more financial opening in financial liberalization programme, to increase their own capacity to finance big scale investment without the government regulation. Actually, after the recession in 1990, the credit control system was so much criticized to block international competitiveness by *chaebols* and began to be relaxed. Besides, the rapid deregulation over *chaebols* and further financial liberalization after 1993 reflected these requests exactly.

Meanwhile, the *chaebols* continued high and risky investments and diversified aggressively depending on heavy external debts, expecting if they were too big then the government could not let them go bankrupt, which opposed to the government intention to specialize them. It raised serious conflicts between them over investment decisions and entry of industries like petrochemicals, cars, communications and steel after 1990 when the industrial rationalization programme ended But *chaebols* accomplished their purpose against the government that had already lost financial control. The government tried to

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control over finance and business was so storing but started to appear in reorganization programme in HCIs and state-led bailout programme in the 1980s and grew serious more and more in various regulations on *chaebols*. (Rhee, 1994) Some argue that the relationship between them changed from dominance to symbiosis or the autonomy of the government still sustained. (Lee, 1997; Kim, 1988) But after the late 1980s the government regulation over *chaebols* mostly failed and the relationship changed to conflicts and *chaebols*' predominance especially after 1993.

[41] From 1974, the government tried to improve the capital structure and make them go public constructing credit control and principal transaction bank system. Besides in 1980 it forced *chaebols* to repay borrowings by selling their non-performing real estate and urged them to specialize their business by selling their non major business. But these measures had only temporary effects and the government enacted the Fair Trade Act in 1986 preventing direct cross shareholding and limiting the total amount of investment of firms belonging to *chaebols*. And it continued financial regulation over *chaebols* with strengthening former credit control system by enacting this system in 1984, adoption of a strong basket control to limit the shares of bank loans to the targeted *chaebols* in 1988, forcing the *chaebols* to sell non-operational real estate in 1989, and reducing their cross loan guarantees in 1993.

induce the specialization of *chaebols*' business with financial regulation in credit control system only to fail.[42] In the petrochemical industry the government could not coordinate competitive investment of *chaebols* and all major *chaebols* entered into this industry, and in car industry Samsung tried to enter and succeeded it in 1994 against the strong opposition of the public. It led to serious overcapacity, an important factor in the economic crisis. This overinvestment surely originated in the absence of investment co-ordination of the government after 1990s and the bad corporate governance structure of *chaebols*. Despite the growth of *chaebols* against the government, the corporate governance was still very bad: the ownership structure of *chaebols* was so centralized that over 40% of shares are owned by owner and the firms belonging to them by cross shareholding between firms; the monitoring of the banks was not yet established due to the relics of the government financial control (Table 12.).

TABLE 12 THE STRUCTURE OF OWNERSHIP AND VARIOUS RATIOS OF TOP 30 *CHAEBOLS*.

| | 1991 | 1993 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|
| Equity ratio | 19.8 | 19.0 | 19.9 | 20.5 | 18.5 |
| Internal Ownership ratio | 47.0 | 43.4 | 43.3 | 44.1 | 43 |
| Share of cross holding | 32.9 | 33.1 | 32.8 | 33.8 | |
| Personal holding | 14.1 | 10.3 | 10.5 | 10.3 | |
| Profit rate | | 1.04 | 2.5 | 0.2 | -0.00 |
| Debt-equity ratio | 369.8 | 348.4 | 348.8 | 387.8 | 449.4 |

Note: 30 largest *chaebols* in 1993, 49 ones in other years, and value of 1997 is estimation in profit rate.
Source: Bank of Korea

The banks were getting weaker against NBFIs, but they were still controlled by the government strongly taking a heavy burden of various policy loans even after financial liberalization. The government still tried to control the banks using them as a tool of economic management even when the state-led financial system was coming to an end and its control over business weakened significantly. Profit rate of banks continued low in the 1980s to make them run business only based on the government's support, moreover non-performing loan problem grew serious from industrial bankruptcy (Park, 1994). It was the most serious problem that the management autonomy and the new discipline and monitoring system over business to prevent the bad management of *chaebols* were never established. Although there existed a credit control system and primary transaction bank system, in this system the government only formally regulated over investment decision of *chaebols*, without a new discipline or monitoring over management of them. The principal transaction bank in this system was only a subordinated organizations of the Office of Bank Supervision and Examination being obligated to collect information and report to the government with the implementation of credit control, and the bank-business relationship was only that of the formal supervisor and the supervised not autonomous and co-operative relationship like Japanese main bank system (Nam, 1996). What is worse, in practice most shares of banks were already owned by major *chaebols*.

[42] In reality the change of financial system made it no more possible, rather the most effective measures to induce specialization was compulsory industrial restructuring in state-led merger programmes with tremendous financial supports, which is impossible after the 1990s.

Thus in Korea the relationship between the government and business changed from dominance and discipline with co-operation based on financial control, to regulation and conflicts due to the change of financial system. The *chaebols* who had serious problems urged the government to promote further deregulation continuing the bad management and the government could not regulate them effectively. But with all these changes, the government failed in establishing a new discipline and monitoring system over business due to the absence of banks' monitoring or reform of the corporate governance. It was this reform and new institution building that this change of the financial system and relationship between the government, business, and banks demanded.

### *4.2.2 The further deregulation and dismantling of institutions after 1990*

However, after 1993 the new government's policy was only to promote deregulation over *chaebols* and finance to dismantle former institutions still more in the name of 'market principle', which directly led to economic crisis. First, there was a significant change of *chaebol* policy of the government from regulation to mitigate concentration of economic power and disperse ownership of *chaebols*, to deregulation and further supports for *chaebol* after 1993 influenced by *chaebols*' power and market ideology. Now, the government could no more discipline or even regulate big *chaebols*. There was such deregulation as further relaxation of credit control system in 1993, that the government allowed the redemption of credit control for 'major business' of groups and relaxed the criteria for selecting business groups from 50 largest groups to 30 largest.[43] In addition, in 1996 this criterion was more relaxed to include only 10 largest *chaebols* and various regulations related with real estate purchasing, equity ratio were repealed. With this, the government also promoted the ownership of banks by *chaebols*. It expanded the limit on the share ownership of banks in 1994 under several conditions to prevent *chaebols*' ownership, but when actually only *chaebols* could have capacity to own large banks this could not but lead to *chaebol*'s bank ownership.[44] In addition, in 1996, it adopted many measures to deregulate higher ranking *chaebols*' entry into NBFI sectors like life insurance companies, merchant banking companies, and investment trust companies. Meanwhile, regulations over *chaebols* by the Fair Trade Act about reduction of cross loan guarantees also receded in recession and resistance of *chaebols* in 1996. The government announced the adoption of several measures for improvement of corporate governance of *chaebols* such as strengthening small owners' right, adoption of the external director in 1996, but they were only formal and not in effect.

In the financial sector, after 1993 the government promoted financial liberalization and openness significantly without proper regulation. The government licensed merchant banks that treated mainly foreign capital during 1994-1996, which was said to be involved with corruption, without any proper supervision over them. Besides, it announced various measures to open capital market in 'blueprint of financial reform' of 1993 when it decided to join the OECD (Dalla and Khatkate, 1995). In December of 1994, it adopted significant

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[43] Already in recession of 1990 there were redemption of credit control for 'major firms' of *chaebols* in 1991. Actually, in this system *chaebols* selected as their major firms who had large demand of capital and which were owned by the owner privately to get credits from banks to utmost and promote their scale.

[44] So called, 'entrepreneur system specialized in financial sector' reduced the limit of share ownership from 8% to 4% and allow financial entrepreneur to own 15% of banks excluding *chaebols* but there was no applicant for this system since 1995 because there was no one who could own banks but them. After economic crisis the Korean government allowed *chaebols* to own banks after all in 1998.

deregulation over foreign capital market : allowance of commercial foreign loans of firms, expansion of limits on foreign bonds issuing of domestic firms, allowance of them related with equity, expansion of foreign investment on domestic securities, and deregulation on foreign borrowing related with export and so on. In 1995, former Foreign exchange Concentration System, under which all foreign exchange had to be surrendered to the central bank was effectually repealed. The government announced to implement financial opening even sooner than the original plan. These increased foreign borrowings of the *chaebols* and banks rapidly, and the inflow of foreign capital into private sector was now no longer controlled by the government (Table 13.). But this capital might have outflowed at the shocks in the globalized international financial market, accordingly it was very dangerous when *chaebols* and banks were vulnerable.

The Kim government dismantled former institution by deregulation on *chaebols* and incautious financial liberalization without any new institution building, which reflected the predominance of chaebols over the government. It worsened a serious situation that the former control and discipline over *chaebols* disappeared and another never established. Finally, the shocks raised by problems in *chaebols* triggered the outflow of capital that flowed into Korea heavily thanks to the incautious financial opening, which led to currency and financial crisis.

TABLE 13 THE SHARE OF FOREIGN CAPITAL IN FINANCING

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| Corporate sector | 6.8 | 4.1 | 5.0 | -2.2 | 4.9 | 8.4 | 10.2 |
| Financial sector | 1.2 | 6.6 | 1.2 | -0.4 | 4.8 | 9.2 | 10.7 |

Source : Bank of Korea.

## V THE KOREAN ECONOMIC CRISIS AND NEW ROLE OF THE STATE

### 5.1 The background of the economic crisis in 1997

Already many arguments were presented about the East Asian crisis including the Korean case. For the East Asian crisis there appeared two different approaches, one emphasizes problems of fundamentals of these countries and another notices the attitude of international investors more (Krugman, 1998; Radelet and Sachs, 1998). However, now there is broad agreement that the economic crisis in this region was due to the rapid outflow of foreign capital because of domestic moral hazard like speculation in real estate or overinvestment of the private sector and external shock.[45] For Korean crisis, current neo classical view thinks that the causes of the crisis were mostly the cozy relationship and the excessive state intervention (Brittan, 1998), whereas revisionists argue that the crisis originated in underregulation of the government in rapid financial liberalization (Chang, 1998; Stiglitz, 1998). But the former argument does not consider enough that the Korean economic success as such was based on the state intervention, whereas the latter overlooked the broad change of institutions and structural problems in the Korean

[45] The issue was if there was problem of so-called fundamental. All acknowledged even if there were not so serious problems in macroeconomic fundamentals, there were other problems of fundamental related with microeconomics of the private sector

economy. We will analyse the economic crisis in Korea of 1997 examining problems of the industrial and financial sector which were outcome of degeneration of former institutions we pointed out.

As many people recognize, the apparent cause of the Korean crisis in 1997 was in the financial sector. Like other Asian countries, there was a large capital inflow into Korea as a form of foreign borrowing after the rapid financial openings after 1993 and its rapid outflow caused a currency crisis. Consequently, firstly we should point out that careless liberalization and opening of the financial sector without proper regulation and supervision over financial institutions was a decisive factor of the crisis. The Korean government controlled external financial flows tightly and it continued even after financial liberalization programme of 1980s (Park, 1996). But after 1993, the new Kim Young-Sam government accelerated financial liberalization programmes especially with various measures about foreign exchange liberalization and capital market opening as we examined. The demands of *chaebols*, the pressure of American government and the OECD played roles in this. After these significant deregulation measures, foreign debts soared in Korea fromUS$44 billion in 1992 toUS$120 billion at the end of 1997, with external liabilities including the offshore borrowings of the Korean banks and borrowings of the overseas branches and subsidiaries amounting toUS$170 billion. It was not that big compared to other countries but rapid growth of short-term debt was a serious problem which was dangerous in globalized financial market.[46] The share of short-term debt in total debt was already high 43.7% in 1993 and rose to 58.2% in 1996 (Table 14).

TABLE 14 THE GROWTH OF FOREIGN DEBT BY TERM IN KOREA
($ BILLION, %)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|---|
| Total foreign debts | 317 | 391 | 428 | 439 | 568 | 784 | 1045 | 1208 |
| Short-term debts | 143 | 172 | 185 | 192 | 304 | 453 | 608 | 513 |
| Long-term debts | 174 | 219 | 243 | 247 | 264 | 331 | 437 | 695 |
| Ratio of short-term debts | 45.1 | 44.0 | 43.2 | 43.7 | 53.5 | 57.8 | 58.2 | 42.4 |
| Current balance/GDP | -0.9 | -3.0 | -1.5 | 0.1 | -1.2 | -2.0 | -4.8 | -3.9 |

Source : Bank of Korea, Bank of International Settlement.

This rapid growth of dangerous short-term foreign debt was due to several factors. There were more rigid conditions to borrow long-term capital than short-term capital due to more extensive liberalization in short-term capital. And firms and financial institutions preferred short-term borrowing, expecting lowering of domestic interest rates and improvement of their credit ratings and conditions of borrowing in international financial markets after the financial opening and joining the OECD. With these, the growth of merchant banks in the Kim government's financial liberalization, that borrowed mostly short-term foreign capital and lent long-term in international financial market, was an important factor.[47] The Kim government licensed 9 merchant banks in 1994 and 15 of them in 1996, but they didn't have much experience and, even worse they were not properly supervised. Of course the

[46] Korea's debt/GNP ratio was about 25% in 1997, while this was 57% in Indonesia, 33% in Thailand, 70% in Mexico in 95 (World Bank, 1998)

[47] They borrowed short-term foreign capital about 64% and lent long-term about 85%. (Chang, 1998)

high ratio of short-term foreign debt as such is not a problem, for example Taiwan had a higher short-term foreign debt ratio than Korea. And though the financial market opening was an important condition for economic crisis it does not lead to the rapid outflow of foreign capital and economic crisis without any problem. The problem is that this capital was invested irrationally in Korea.

Behind the problems of financial sector there were problems in industrial sector in which the bad management of *chaebols* led to several bankruptcies in 1997. In spite of very low rate of return, they promoted investment heavily and diversified continuously in the 1990s. (Table 15).

TABLE 15 COMPARISON OF PROFIT RATE AND THE GROWTH OF INVESTMENT OF MANUFACTURING IN KOREA, TAIWAN, AND JAPAN (%)

| | | 88 | 89 | 90 | 91 | 92 | 93 | 94 | 95 | 96 |
|---|---|---|---|---|---|---|---|---|---|---|
| Profit Rate | Korea | 4.1 | 2.5 | 2.3 | 1.8 | 1.5 | 1.7 | 2.7 | 3.6 | 1.0 |
| | Taiwan | 5.0 | 3.8 | 4.5 | 4.0 | 3.4 | 2.9 | 4.9 | 5.1 | |
| | Japan | 5.5 | 5.8 | 5.3 | 4.0 | 2.9 | 2.3 | 2.9 | | |
| Growth of equipment investment | Korea | 26.8 | 16.5 | 25.7 | 11.6 | -14 | -4.0 | 56.2 | 43.5 | |
| | Japan | 30.4 | 16.8 | 19.2 | 8.0 | -20 | -22 | -8.4 | | |
| Growth of total asset | Korea | 15.8 | 24.0 | 23.8 | 22.6 | 12.3 | 11.2 | 16.9 | 19.3 | 15.0 |
| | Taiwan | 11.1 | 15.3 | 11.7 | 19.1 | 8.9 | 8.1 | 12.5 | 15.1 | |

Note : Profit Rate was measured by ordinary income/sales and ordinary income is operating income + net non-operating income, where financial costs are the most important.
Sources : Bank of Korea, Bank of Japan

Many facts show that the efficiency of investment and productivity of Korean firms was very low after the late 1980s because of bad and excessive investment.[48] But they recklessly continued to expand their businesses after the 1990s mainly based on foreign short-term debts through NBFIs.[49] In particular, the problem of so-called over and cross investment was getting more and more serious in the major industries of Korea such as automobile, petrochemicals and steel. It was partly due to the excessive competition between *chaebols* after the end of investment co-ordination by the government and liberalization of entry in each industry after 1989. Each *chaebol* tried to enter these

[48] Especially while the operate income/sales rate of Korean firms was not so low in comparison with other countries, but because of the high debt ratio the net profit/sales rate considering financial costs was very low, which might be justified. But we can find the fact that efficiency of investment fell in Korea after the late 1980s from several facts. Firstly, income/asset rate (ROA) fell continuously after the late 1980s in Korea because of the decrease of sales/assets (rate of assets turning) due to high and bad investment. Secondly, the capital/output ratio which represents capital productivity went down seriously after the late 1980s to be responsible for a fall of the profit rate and capital productivity in several manufacturing industry in Korea is about the half of that of America. (Jang, 1997; Mckinsey, 1998) This reflects the limit of growth led by capital input, without the innovation in technology and organization by specialization in major industry which were necessary for Korean industry. Meanwhile, for *chaebols* the profit rate is lower than the average of manufacturing sector, for example the ROE of the 30 largest firms belonging to *chaebols* is 4.53%, which is much lower than that of American firms, 20.79%. Most of *chaebols*' ROE is lower than the interest rate in reality.

[49] In addition to very high debt ratio we mentioned before, the *chaebols* had serious problems about structure of debts. Their fixed ratio which is fixed assets/capital is very high about 220% in comparison to about 110% of Taiwan and 140% of Japan, and floating ratio which is floating assets/debt is low about 95% in comparison to about 120% of Taiwan and 130% of Japan.

industries based on high debt from financial institutions and the incumbent *chaebol* raised investment more to keep their status (Table 16.).

TABLE 16 TRENDS IN FACILITY INVESTMENT IN KOREA

| | 1983-91 | 1992-3 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|
| All industries | 20.0 | -1.0 | 36.7 | 37.9 | 17.3 |
| Manufacturing | 29.6 | -8.9 | 56.2 | 43.5 | 17.1 |
| The 'six' industries | 20.3 | -6.8 | 68.2 | 48.7 | 25.1 |
| Non-manufacturing | 10.1 | 15.5 | 9.5 | 26.9 | 17.7 |

Notes : The 'six' are petroleum refining, petrochemical, iron and steel, electrical and electronics, automobile and shipbuilding
Source : KDB, from Chang *et al.* (1998)

With this, *chaebols* continued to diversify even in recession after the 1990s. The number of firms included in the top 30 *chaebols* increased from 616 in 1994 to 767 in 1996 and They added over 100 firms in 1996 when profit rate was only 0.2%. This bad management originated in the bad corporate governance of *chaebols* in which the decision of owner could not be checked or monitored in any way and the situation in which the government could not discipline *chaebols* any more. The change of financial system and relationship between the government and business with the failure of reform of *chaebols* and financial sector brought out these problems. Even worse, a serious cozy relationship between some *chaebols* and the government appeared in the Kim government.[50] Of course there was an overinvestment problem like this in former days, but the enlarged scale of economy relative to reduced government control over finance and especially dependence on foreign debts in globalized international financial market kept the government from solving this problems in former way. Now, the government could not handle problems and it led to the currency crisis.

In 1997, there broke out several bankruptcies of major *chaebols* in Korea, cross loan guarantees turned bankruptcy of one firm into the chain bankruptcy of whole firms in *chaebols*. Starting with Hanbo's bankruptcy which was related to the cozy relationship with the government in January, 7 of 30 biggest *chaebols* in Korea went bankrupt this year. These bankrupt *chaebols* had in common high debt ratios over 500% in average and the excessive diversification into their non-major business.[51] The bankruptcies made the non-performing loan problem of the banks even more serious and the financial sector more vulnerable, which deteriorated trust about Korean economy.[52] In this dangerous situation,

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[50] The moral hazard argument is more relevant to the *chaebols* than financial institutions in Korea in that *chaebols* thought that they were too big to fail and expected the government's help like coordinated finance. While, despite this corruption in the Kim government, we cannot say that since the Kim government crony capitalism started in Korea. There were many corruptions even in former government, such as Samsung's commercial car production, decision of the second mobile communication operator, the plan of strengthening military force, construction of power generation and so on in the Roh government. We should consider the broad change of relationship between the government and business and the degeneration of institutions in Korea before the Kim government.

[51] In practice, 5 of 10 *chaebols* whose debt-equity ratio of was over 500% went into bankrupcy in 1997, that of several bankrupt *chaebols* was over 1000% with Jinro's 3081%, Halla's 2065%, New core's 1224% and they all excessively diversified into their non major industries.

[52] In September of 1997, all non performing loan of banks was estimated 28.2 trillion won, 6.2% of all bank loans, but according to U.S. criteria it amounted to about 15% of all bank loans. Moreover all loans to insolvent *chaebols* from financial sector in 1997 amounted to 3.2 trillion won, 1.8 trillion of them was from banks and 1.0 trillion of them was from merchant banks, which made whole financial sector very vulnerable.

even the government policy was not proper. For instance, it tried to make Kia, which was an insolvent car company, a public company and also made serious mistakes in foreign currency administration like a false announcement about foreign currency holdings only to aggravate foreign investors' confidence in Korea more. These events with the contagious effect of Asian currency crisis led to refusal to rollover of foreign borrowings and at last currency crisis of Korea. This crisis originated in demise of institutions of developmental state in Korea due to the change of the financial system and the relationship between the government and business. In this changed situation, the government could no more discipline and control over *chaebols* and another mechanism for it never established either. Deregulation in *chaebol* policy, failure in investment co-ordination and rapid financial opening without proper regulation in the Kim government due to demand of *chaebols* and free market ideology only worsened the problems. It did dismantle former institution without constructing a new and proper institution, and finally ended up with the economic crisis.

### 5.2 The reform of the economy and new role of the state

The government should have reformulated former institution and build a new one when former institution degenerated in order to prevent the crisis, and it was not the market already dominated by *chaebols* but the government that could do it. Of course this task was very difficult since the government was almost captured by the strong *chaebols* after the 1990s unlike previous developmental state which had strong autonomy. But as the economy develops, reforms to reformulate institutions are essential. First, for the financial sector, most of all the government should establish the management autonomy of banks to monitor business independently from the government control by giving them the right to appoint their own directors and examine loans and by reducing the burden of policy loans. The independence of the central bank from the government would do much to help with the reduction of the excessive financial control of it. With this, efforts to regulate and supervise over soundness of the financial sector and flow of the foreign capital by establishing good supervision system, not the reckless deregulation in the name of the market, were crucial. Proper supervision by the government becomes more important after it promoted further financial opening.[53] Now, it is necessary for the government to reduce the excessive financial control that was important in former institution but no more efficient and at the same time to regulate them properly *ex post*.

Meanwhile, the reform of the industrial sector, especially for *chaebols*, is also important to tackle serious problems in them. Already the government tried to induce a kind of voluntary reorganization of business between them and this investment co-ordination in private sector consulting with the government may be helpful.[54] Besides it tried to reduce excessive debt ratio and cross repayment guarantee practice of *chaebols* along the demand of the IMF. However, the most important reform for the *chaebol* is about the notorious corporate governance based on centralized and internalized ownership structure that led to

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[53] But the financial opening scheme imposed by the IMF on Korea is so excessive that we are concerned that rapid move of foreign capital would bring about serious instability of the economy. In order to prevent it, the government should try to regulate speculative short-term capital movement strongly.

[54] The Korean *chaebols* agreed each other on voluntary merger called 'big deal' in major industries like petrochemical, semiconductor and so on which have serious overinvestment problems recently induced by the government. This is rather similar to state-led investment reorganization programme after the crisis of 1979-80 even if this time it is private-led. (Cho-sun Il-bo, 1998. 9.3) But, its range and scale was not that big because of *chaebols*' resistance which made people suspicious of the will of government.

the bad management and even bankruptcy. For this, internal and external monitoring mechanism over the management must be established. Particularly, more radical measures including the change of current ownership structure, management participation of workers or banks are necessary. Formal measures now adopted by the government like activation of the role of board of directors, expansion of the right of small owners, and activation of M&A would be ineffectual in current situation. But at present, the government does not consider these measures to reform the corporate governance structure and they are not expected to be realized considering *chaebols*' strong power.

Based on these reforms the government should reformulate the relationship between the government, banks and business and establish a new one. In former institution, it was somewhat hierarchical in which the government dominate and discipline business based on the control of banks. But when this institution did no more work well, more parallel relationship between banks and business with the government regulating banks *ex post* is required. For this, the government should reform the current principal transaction bank system which does not play a role of monitoring and discipline over business but just a regulation of them, into more efficient Korean type main bank system like Japanese one. This new institution based on autonomous and co-operative relationship between the business and banks may solve the serious information asymmetry problem and improve corporate performance by close monitoring and credit analysis (Nam, 1996). The establishment of management autonomy of banks and independence of banks from the government and *chaebols* are essential, when big *chaebols* have so strong power to even dominate banks. Since there is already a very intimate relationship between the banks and business and the bank-based financial system with shallow growth of capital market in Korea, mere adoption of the western style market-based financial system is not realistic. After all, the new role of the government is again to build this new and proper institution different from former degenerated one by the radical reforms. And it would be impossible by mere dependence on the market which is very incomplete and already dominated by the *chaebols*. This reform and new institution building requires hard efforts of a competent government which itself should be also innovated, founded on mobilization of democratic demands of people to overcome the strong resistance of *chaebols*.

In reality in Korea, after the economic crisis and the IMF bailout finance the new government is trying to reform the whole economy according to the policy advice of the IMF. The IMF demanded that the government should implement a very restrictive macro policy and structural reform and liberalization policy in micro economy, thinking that economic crisis was due to the excessive state intervention and chronic cozy relationships. These micro economic policies for restructuring of *chaebol* and financial sector include rapid restructuring of insolvent financial institutions and further opening in financial sector. For *chaebols*, they covered strengthening the management transparency by adoption of combined financial statements, relaxation of excessive dependence on debts by abolition of cross repayment guarantee and activation of M&A by opening capital market (IMF, 1997). They make sense to some extent. But, besides the serious problems of too restrictive macroeconomic policy that was not fit for East Asian countries, this microeconomic reform policy also has a serious limit to reform the economy fully. It does not consider the importance of institutions and a proper institution building, just emphasizing the logic of the market like liberalization and market opening too much. Especially, they lacked the necessary reforms over *chaebols* and the consideration of the new relationship building between the bank and business. It is the reality that the biggest *chaebols* expand their

business centralizing financial resources into themselves even after the crisis and the government allowed them to own banks which would make the banks' monitor over *chaebols* impossible.[55] For further development, radical reforms over the financial sector and *chaebols* beyond current reform policies are required and it would also depend on the power relationship or politics.

## VI CONCLUSION

We have analysed the institution for economic development and its degeneration and failure of new institution building that led to the economic crisis in Korea focusing on the change of the state-led financial system and the relationship between the government, bank and business. The Korean government succeeded in promoting economic development by building a specific institution that played a role like internal capital market based on state-led financial system. In this institution, it dominated and disciplined business with co-operation controlling the finance and overcame serious government failures related to rent-seeking and information problems. But at the same time this institution encouraged big businesses that had many problems and deepened vulnerability in financial sector. As the economy developed and the financial system changed, the relationship between the government and big business also changed and this institution no more worked well, which worsened the problems. However, the government failed to reformulate degenerated institution and build a new and proper one, but only dismantled former institution in the name of the market. Strong demand of *chaebols* was the most important factor for it and dependence of the government on former institution to solve economic problems was also responsible. This failure of new institution building led Korean economy to the economic crisis in 1997 when the government promoted incautious financial liberalization without a proper regulation.

This experience of Korean economy gives many lessons about institutions, their change, and a proper role of the state for economic development and its maintenance. Firstly, institutions constructed by mixing the state and market beyond the mere dichotomy of them can play a significant role for economic development, for which the relationship between agents in them is very important. Secondly, the efficiency of the institution changes and it even degenerates due to the economic development itself and the change of the power relationship. It must be reformulated in this situation adjusted to the change. Here, the role of the state is to build this specific institution and the relationship between

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[55] In particular, these neo liberal policies are insufficient to solve serious problems of corporate governance of *chaebols*. The biggest 5 *chaebols* had strengthened their economic power even after the crisis, the burden of which has gone to mainly small and medium sector companies and labourers. In addition, the government decided to allow *chaebols* to dominate banks this year repealing the limit to share ownership of banks, which would support *chaebols* more and be harmful for reform of the economy. These policies do not consider a proper relationship between the banks and business at all and overlook a proper institutional framework at the whole economy for further development. Meanwhile, some even argue that these IMF policies are to destroy the East Asian model and transplant the anglo-saxon model into Korea. (Wade and Veneroso, 1998; Crotty, 1998)

the government and business like the Korean case. Yet, the government should not stop at it but reformulate previous institution and relationship to work well. For further economic development it is required for the government to reform institutions continuously along the changing economy as well as to build a good institution. Only hard efforts of the government to overcome the resistance of the vested interest groups based on mobilization of nation people's demand would make it successful.

However, since our concern was mostly about domestic side, in this study we have not examined globalization that affected the role of the state and the change of institutions. For more full understanding of current crisis, we should consider these international factors. Besides, we had better extend our study about institution and its change to other countries in East Asia. For example, Taiwan has not suffered from serious economic difficulty like Korea because it adopted different strategy and have different government-business relationship from Korea. This comparative institutional analysis will show us more interesting points about the success and failure of institutions and their change in economic development.

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