An Analysis Of The Causes Of The Korean Financial Crisis In 1997

1997年韓国の金融危機に関する構造分析

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Key words: Developmental state model, Chaebol, Financial crisis, Demodisaster state, Demoprosperity state.

キーワード：先進国モデル、チァィボル、金融危機、デモデサスター•ステイト、デモプロスペリティ•ステイト

Abstract

The Korean financial crisis of 1997 had many contributing factors both internal and external. External factors included the collapse of South-east Asian currencies in a domino effect starting with the Thai Baht, and the crippling of the main economic engine in the region, Japan, through economic mismanagement, which left the rest of the region vulnerable to the vagaries of global finance. Internal factors included an incompetent government under Kim Young Sam, a domestic economy dominated by the huge conglomerates (chaebol) which attempted to remain competitive through a strategy of high risk short-term borrowing, fiscal mismanagement by financial institutions, and the growing pains of a fledgling democratization process.

要約

韓国の 1997 年の金融危機の要因には国内外にわたることが多かった。国外の要因の中には、タイ・バーツに始まるドミノ効果の中での東南アジア諸国の通貨の崩壊と、地域の主要な経済エンジンである日本が経済政策の誤りから低迷し、地域全体を国際金融の変動に対応できなくしたことが含まれていた。国内の要因に含まれていたのは、キム・ヨン・サム下の能力を欠いた政府、ハイリスクの短期借入戦略によって競争優位を保とうとする巨大なコングロマリットに支配された国内経済、財政当局による誤った財政政策、そして揺籃期にある民主化が痛みを増す過程にあることであった。

Introduction

Until the twentieth century Korea managed a fine balancing act between more powerful neighbours retaining its own identity and borders. Similar to these neighbours, the 'Hermit Kingdom' pursued a policy of isolationism which only ended when Western civilisation forced open the doors.

The twentieth century witnessed calamitous changes for Korea. First, it suffered the humiliation of becoming a Japanese colony from 1910 to 1945. Second, defeat of Japan in 1945 did not bring about a restoration of Korean independence and territorial integrity, instead Cold War politics divided the country into north and south along the thirty-eighth parallel, leading to a bloody civil war from 1950 to 1953 which achieved nothing territorially, leaving behind only death and economic devastation.

From the ashes of the Korean War an 'economic miracle' took place. The south, with massive financial help from the United States, in particular, set about economic reconstruction, adopting a developmental state model similar to Japan's. However, unlike Japan where the military was reduced to a subordinate role, the Korean War and fragility of national security led to the rise of a powerful military which eventually seized power in 1961. It was the military regime of Park Chung Hee which because of its dictatorial grip on the country was able to implement a policy of rapid industrialisation transforming a predominantly agricultural economy into a leading, highly urbanised, industrial state in a little over three decades.

Industrialisation and emergence as a leading actor in the global economy also brought about political change with the replacement of military rule by a civilian administration in the early 1990s and a greater democratisation of political and social structures.

By the mid 1990s the South Korean success story was on a par if not greater than the Japanese one. Similar to the Japanese, spoilt by decades of economic success, the reality of the impending economic crisis of 1997 failed to register even in the higher echelons of power until it was too late. The subsequent collective humiliation felt of an International Monetary Fund bailout had a major psychological impact on the Korean nation as a whole from which it is still coming to terms with.

In this paper I will briefly discuss the immediate causes which led to the financial crisis of 1997 and then analyse pre-crisis political and economic developments as well as external factors which contributed to the events of 1997.

The 1997 Financial Crisis

The immediate causes of the financial crisis of 1997 can be put down to the accumulative effect of three key factors: the high ratio of short-term foreign loans, the high profile bankruptcies of some leading chaebol and the domino effect of the South-East Asian financial crisis.

Companies had borrowed heavily from financial institutions to pursue aggressive expansionary policies to enhance competitiveness. They had also gone for quick and easy profits by investments in real-estate and stock-market speculation. The average gearing ratio of many leading chaebol was almost four hundred percent at 3.87 which compared very unfavourably with the average debt-equity ratio of 0.85 in Taiwan, 2.0 in Japan and 1.6 in the United States, leaving Korean firms highly vulnerable to the vagaries of economic factors outside their control.

As a result domestic financial institutions which had borrowed money from foreign banks on a short-term basis to finance corporate expansion were themselves overstretched. In January 1997, a leading chaebol, Hanbo Steel, declared bankruptcy, the first in a decade, after the government was unable to bail out the company because of its huge debts. This unnerved both financial institutions and markets since the belief was strong that chaebol were ‘too big to fall’.

After the high-profile bankruptcy of yet another chaebol, Kia Motors, confidence in the South Korean economy started to crumble. Foreign credit rating agencies such as Standard and Poor began to downgrade South Korea’s overall creditworthiness. Domestic commercial and merchant banks were suddenly faced with a liquidity crisis caused by the non-performing loans and their own inability to borrow from abroad. The banks en masse began to call in their loans and suspended any further borrowing. This triggered more bankruptcies, undermining confidence further in the South Korean economy.

At the same time in South-east Asia a full-blown economic crisis began to unfold in July. The economies of South-east Asia had pegged their currencies to the US dollar resulting in their over-valuation and making their exports less competitive as the dollar strengthened. The perceived weakness of the economies led to speculation on the exchange markets and the collapse first of the Thai baht and then one by one other currencies in the region as the herd mentality took over and investors began to sell their holdings.

By November, the South Korean government had no choice but to ask the World Bank and IMF to help it out of its economic crisis with the largest bailout in history, a major humiliation for a country which had prided itself in its economic success story.

These three factors alone do not explain why the crisis happened since the real economy at the time was in a relatively sound state compared to other countries which experienced financial crises. The current account deficit had been significantly reduced from the previous year, 1.9 percent of GDP compared to 4.8 percent, much lower than countries such as Mexico and Thailand which averaged eight percent at the time of their crises. Inflation was fairly stable at 4.4 percent. Most of the South Korean borrowings were in tradable sectors rather than real estate. The annual budget had been in balance, the public debt amounting to only three percent of GDP, the best among OECD countries. The foreign debt was around twenty-five percent at the time of the crisis, much lower than the World Bank threshold of forty-eight percent. The debt service ratio was 5.4 percent in 1995 and 5.8 percent in 1996, well below the benchmark of eighteen percent and much lower than Mexico (24.2), Indonesia (30.9) and Thailand (10.2) in 1995. Even short-term debt had dropped from 58.2 percent at the end of 1996 to fifty-eight percent on the eve of the crisis in June 1997.

To understand why the crisis occurred, a closer analysis of the pre-crisis economic and political developments as well as other external factors is necessary.

The Chaebol and Labour

Cooperation between government, industry, financial institutions and the bureaucracy through implementation of a rapid industrialisation programme led to a distorted industrial landscape. The authoritarian governments deliberately pursued a policy of financial and regulatory support to the chaebol which came to dominate the economy at the expense of developing a vibrant small and medium-sized industrial sector. Showing characteristics of socialist countries' state-owned enterprises these behemoths were unwilling and unable to adapt rapidly to the changing economic circumstances. Taiwan was able to avoid the financial crisis because its small and medium-sized enterprises were better able to exploit the new opportunities which opened up in China through rapid decision-making and ability to relocate where necessary.

The chaebol developed close links with politicians and bureaucrats creating a world of corruption and cronyism enabling them to receive preferential financial support in the form of loans to pursue the goal of rapid industrialisation. The government's encouragement of financial institutions to underwrite the loans created an environment where the chaebol were prepared to take high risk strategies because they felt confident that in times of trouble the government would guarantee the loans. The chaebol themselves were organised as groups of companies inter-linked through a system of cross-shareholding and loan guarantees leading to a lack of transparency in the system which not only discouraged foreign investors but also prevented the companies and the authorities from realising the perilous state of many chaebol finances until it was too late.

The long recession under Roh Tae Woo and the fear of losing their competitive edge, sandwiched between technological innovators such as the US and Japan and the newly industrialising labour-intensive economies, led the chaebol to follow a high risk strategy of massive investment and expansion in the 1990s through mergers and acquisitions as well as increased production facilities predominantly in established industrial sectors rather than innovative ones reducing profitability as they competed against each other in already saturated markets. These companies reached dangerous debt/equity ratios of almost four hundred percent at the time of the crisis.

As global rankings showed[1] Korean corporations were also losing their competitive edge because of other factors. There had been a major investment in research and development jumping from 0.77 percent of GDP in 1980 to 2.4 percent in 1994 but in real terms the $9.8 billion in 1994 lagged far behind the US which spent $160 billion and Japan $134 billion in 1993.[2]

Another key factor to the sharp decline in profitability was the rapid increase in the cost of wages after the moves towards democracy in 1987.

Labour has a history of strong activism since the formation of the South Korean state. When Park Chung Hee came to power in 1961 he suppressed labour activism under his pro-business rapid industrialisation drive. He created an umbrella union organisation, the FKTU, based on industries. Allegedly independent and safeguarding the interests of its members, it was in fact a mouthpiece for government support of big business. Radical labour activists were excluded and independent unions banned resulting in a weak organisation which lacked support among the working classes. The chaebol created their own unions outside the FKTU which also helped to weaken and divide labour.

Under Chun Doo Hwan the anti-labour laws were further strengthened, closing previous loopholes such as 'third party' involvement in disputes, barring workers from having more than one union and banning unions from political activity.

During the period of rapid industrialisation and an export-driven economy labour was asked to sacrifice now for a better tomorrow. As long as the economy delivered growth and an ever-improving standard of living the authoritarian regimes of Park and his successors were able to control opposition within labour. The end of authoritarian rule in 1987 opened the door for suppressed labour discontent and activism to come out in the open. There followed an explosion of work stoppages and strikes for higher wage demands which resulted in alienation of the labour movement from the general public as industrial action threatened to derail the economy.

Leading the demand for higher wages were the chaebol unions. Similar to the industrial structure, the union movement was dominated by the chaebol unions who were able to exploit the weakness of the chaebol - the interdependence of group structure. Like the British car industry of the 60s and 70s a strike or work stoppage in one subsidiary would affect the whole group. Chaebol management gave in rather than face crippling losses through strikes. Wages and other benefits increased rapidly. The rate of increase of unit labour cost was 8.3 percent in 1994 compared to 0.8 percent in Japan and 2.4 percent in Taiwan. The average monthly wage in 1987 was $400, $1000 in 1992 and $1500 in 1997.[3] However, the increase in wages and benefits created a greater disparity in incomes between those workers based in chaebol and the workers in small and medium-sized companies who were not in a position to make the same kind of demands as the chaebol unions. The wage ratio gap between smaller companies and chaebol was ninety percent in 1986 and seventy-one percent in 1991.[4]

Although higher wage demands did contribute to the loss of competitiveness in Korean industry, in some labour-intensive industries such as clothing and textiles and the less labour-intensive industries of semi-conductors and machinery Korea retained its competitive edge. Also 1987 was the worst year for labour disputes with 3,749 cases, drastically reducing thereafter with only 144 in 1993 and 78 in 1997.[5]

Government, Financial Institutions, Bureaucracy and Civil Society

South Korea is an example of a successful 'demodisaster' state which is attempting to change to a 'demoprosperity' paradigm of government.

The 'demoprosperity' paradigm supports the idea that only through liberal democratic structures can a state develop a successful economy in the long term. Liberal democratic institutions and practices are essential for the development of a free market economy. Key elements of a liberal democratic structure and free market economy are the respect for individual rights, liberties and the rule of law as well as the establishment of a system of checks and controls making the state less intrusive but also more accountable, responsive and transparent in its actions.[6] The paradigm is in essence the Western model of capitalism, as epitomised by the American state.

According to the 'demodisaster' paradigm or 'authoritarian prosperity' theory, the 'demoprosperity' paradigm is suitable for industrial states which have mature democratic institutions but is a poor model for developing countries to follow. Only through an authoritarian political system can a developing country instigate the kind of economic policies which will lead to a rapid process of industrialisation. Democracy, on the contrary, because it encourages debate and differences of opinion can lead to stalemate in the political decision-making process and potential instability, even chaos within the system. Moreover, interest groups are able to lobby and influence decision-making in their favour at the expense of the majority distorting markets and weakening overall economic performance.[7]

Under the successive democratically elected governments of Roh Tae Woo and Kim Young Sam, South Korea struggled to initiate the change from a 'demodisaster' state to a 'demoprosperity' state as economic conditions clashed with the desire to introduce reforms.

Under Roh Tae Woo South Korea experienced a long recession as Korean companies struggled to sell their products during a global downturn, increasing protectionism as well as competition from newly industrializing economies. Economic performance also suffered because of democratisation as labour tested its new-found freedoms and because of Roh's inconsistent economic policy as he vacillated between reforms to liberalise Korea's economy and efforts to help industry out of the recession.

In 1993 Kim Young Sam succeeded him promising more rapid deregulation of the economy and democratic reforms under the banner of 'segyehwa' as Korea prepared to enter the 'rich man's club' of OECD countries. Under his government the economy recovered posting credible economic growth with reduced inflation and unemployment but the improved economic performance was engineered by a growing mountain of foreign debt as Korean industry pursued expansion. The foreign debt rose from $43.9 billion in 1993 to $160.7 billion in 1996 although improved somewhat in 1997 to $153 billion.[8] The high build up of foreign debt was matched by a major drop in foreign reserves from $20.2 billion in 1993 to $12.4 billion in 1997.[9] At the peak of the crisis when reserves were needed to prop up the economy there was less than $8 billion available which led to the liquidity crisis which brought the South Korean economy to its knees.

The financial crisis of 1997 which resulted from the reckless industrial expansion built on mountains of debt was not the first time that South Korea had shown itself willing to take risks with the economy to achieve growth and to stay competitive.

Beginning with Park Chung Hee economic policies were instigated which led to rapid industrialisation and economic growth but in the 1970s his push for industrialisation based on heavy and chemical industries known as the Yushin period although achieving high economic growth created chronic current account deficits as well as high inflation which coupled with rising oil prices and international interest rates almost caused the economy to fail. The fact the economy did not fail rebounding strongly under Chun Doo Hwan may have helped to reinforce the belief that the Korean economic success story would continue indefinitely. Had the economy failed then, possibly the same errors in economic policy and the complacency shown by both government and industry in the 1990s would not have taken place.

The Kim administration proved to be fairly incompetent in handling the economy. Kim himself knew little about economic affairs and instead left the running of the economy to his aides. There was no continuity of economic policy as he constantly changed personnel in the cabinet- the average tenure in office of the deputy prime minister in charge of finance and economy was eight months.

In their attempts to meet the requirements of the Uruguay Round of world trade negotiations and admission into the OECD they introduced policies to deregulate the economy which had been poorly thought out. First, they abolished the Economic Planning Board by incorporating it into the Ministry of Finance and Economy in the name of rationalisation. The EPB, a key element in the developmental state planning system, had been responsible for the supervision of the economy. Second, they abandoned the system of five-year economic plans. Third, they accelerated the curtailment of selective industry policy which Roo Tae Woo had started. These policy decisions removed key structures of the state's ability to influence economic policy and to monitor the economy accurately. This proved crucial as industry no longer had restraints on policy decisions resulting in over-capacity of production and falling profitability.

Kim Young Sam introduced measures to deregulate the financial institutions to meet international standards but his reforms did not go far enough. Instead of creating a financial system which was properly supervised and transparent in its dealings, the old industry-business links remained. He created new merchant banks and lifted restrictions on borrowing which the chaebol took full advantage of in their efforts to remain competitive. They acquired controlling shares in the merchant banks and had direct access to borrowing abroad. The financial institutions in turn did not question the loan requirements of the chaebol creating a mountain of debt which was predominantly short-term in foreign borrowing and long-term in lending. Previously where the government would have monitored the situation and taken corrective measures, this time it was oblivious to the perilous state of both chaebol and financial institutions. The high financial costs of servicing the short-term debt further reduced the profitability of the chaebol.

Kim's government also failed to end the close links between politicians and credit allocation, in fact, the situation worsened after the curtailment of the selective industry policy as chaebol scrambled to maintain their share of government money. Whereas previously chaebol had been treated equally by industrial sector, some were now seen as been 'closer' to the administration than others, in particular the manufacturing industry which had been relatively free of crony practices became sullied in the public eye.

Hanbo Steel was a good example. despite poor business prospects they were able to raise loans to build a new plant through their political connections. In fact the Hanbo Steel bankruptcy had major repercussions for the Kim administration as Kim's son, Kim Hyun Choi, as well as other politicians within and outside the administration were implicated in the scandal destroying the image the Kim administration had tried to cultivate of being above the corruption and sleaze politics of previous governments. The damage done to the authority of the Kim administration hampered its ability to deal with the crisis as it unfolded.

Another factor which inhibited the competitiveness of the chaebol was bureaucratic red tape. In 1994 it took 530 days to build a plant in Korea once the decision had been made. The company needed to prepare reels of documents and approval from countless government departments. In contrast it took only 145 days in the US, 188 days in Taiwan and even in Japan with a bloated bureaucracy it took only 284 days.[10]

The Ministry of Finance and Economy came under a barrage of criticism during the crisis not just for failing to monitor the huge buildup of debt, it also failed to produce accurate statistics on the foreign debt creating additional panic in the foreign exchange markets even after the IMF bailout had been agreed.

The move towards a 'demoprosperity' state also meant Kim Young Sam was more sensitive to public opinion and the media which also led to prevarication when strong leadership was required. He tried to introduce labour reforms to end 'lifetime employ ment' practices and make it easier for companies to fire employees. The tripartite commission which was set up to reach a compromise failed to deliver. In exasperation Kim tried to railroad the laws through the legislature but failed because of opposition from both labour and opposition parties. The industrial strife cost the country about $3 billion in lost output at the beginning of 1997 and reduced the popularity of the Kim government to a record low.

The case of Kia Motors was another good example. Public opinion went against the decision to let the group go bankrupt especially after it emerged that the deputy prime minister, Kang Kyungshik, had an interest in seeing the group fail which would benefit Samsung, a chaebol he had close ties to. The three-month delay and the final decision to bail out the company sent the wrong signals to foreign investors at a critical juncture in the developing crisis damaging the government's credibility further.

External Factors

The South-east Asian crisis with the run on the Thai baht is regarded as one of the root causes of the financial collapse of so many countries in the region but the role of Japan in bringing initial instability to the region cannot be underestimated.

In the 1970s and 1980s the Asia-Pacific region was the darling of investors as the region experienced phenomenal rates of growth. The main engine for that growth was Japan which had led the way in developmental state economic policy. The 1980s saw Japanese exports create massive trade surpluses. Global recession and resentment against the way the Japanese were flooding markets with little reciprocity in return led to growing protectionist sentiment in the West as the fear grew that Japan would conquer the world. Resentment was also directed at other Asia-Pacific countries such as Korea which were following the Japanese model of success. Agreement was reached among leading industrial nations to allow the yen to strengthen in value to help reduce the trade surpluses. The immediate effect was to swell company values and profits leading to a glut of money which the companies used in wild speculation in real estate and the stock market. At the same time the government fearing recession had eased monetary restraints making borrowing easier. The domestic stock market and real estate reached unrealistic and unsustainable levels. When the government finally moved to restrain borrowing it led to the bursting of the economic bubble. The stock market plummeted from a high of over 30,000 to less than half. Companies were suddenly saddled with large debts and negative equity, the banks were overburdened with large non-performing loans. Since then the Japanese economy has struggled to come out of the recession and deflationary spiral.

With the main economic engine crippled, with foreign investor confidence dented, the rest of the region was more vulnerable to an economic downturn. Not only was Japan the main engine of growth for the region it was also a major player in foreign direct investment and government assistance. The Japanese banks already saddled with huge non-performing loans were hoping investment in the region would help to bail them out of their own difficulties but they were also very nervous and ready to pull out at the first sign of difficulty.

The South-east Asian crisis caused by a loss of confidence among investors in first Thailand and then elsewhere created a herd mentality mainly led by Japanese institutional investors who called in their short-term dollar loans. This was particularly true in the case of Korea.

The IMF and World Bank also played a role in inadvertently bringing about the financial crisis in 1997. Like the Korean government it initially denied that Korea was in financial difficulties which did nothing to calm investor confidence as the Korean currency lost value and the stock market dived reducing company assets and making loan repayments doubly difficult leading to further bankruptcies.

In August 1997 the Japanese authorities proposed a $100 billion bailout fund to help Asian economies in difficulty but the US torpedoed the idea because it did not want to see the establishment of a rival to challenge existing institutions such as the World Bank and IMF which were western controlled. Also the US was afraid that to establish the fund would require major capital withdrawals from the US as the world's leading debtor nation further destablising the world financial markets.

Another factor which contributed to Korea's economic demise was pressure on Korea to liberalise its markets through the WTO and OECD organisations in the name of globalisation. Kim embraced the idea and went about half-dismantling the developmental state without putting other structures in place to replace the positive aspects of the system.

Conclusion

The immediate cause of the Korean financial crisis can be put down to three key factors: the large short-term foreign debt of Korean chaebol and financial institutions, the high-profile bankruptcies of leading chaebol such as Hanbo Steel and Kia, and the South-east Asian financial crisis which all came together to cause investor confidence to evaporate leading to pressure on the Korean currency and stockmarket and the calling in of the short-term loans therefore generating a major liquidity crisis at a time when Korea's foreign reserves were at a perilously inadequate level to support the economy. As I have tried to argue there were many underlying factors which created the environment for the financial disaster. First, the government of Kim Young Sam proved itself incompetent in economic matters through its inadequate planning of reform in the process of dismantling the developmental state. The reforms were not only badly planned, they also did not go far enough leaving the whole system in a kind of limbo state of semi-reform. Like a bad mechanic he dismantled the car but forgot how to put it back again.

He failed to initiate the reforms needed because of the pressure of vested interests and public opinion. When he attempted to stamp his authority by trying to bulldoze through key labour reforms, he failed miserably leaving his government weak to deal with the impending crisis.

Although he revived the economy after the long recession under Roh Tae Woo, the recovery was based on a mountain of foreign short-term debt and inadequate foreign reserves.

Second, the chaebols played a major part in the events of 1997. They adopted financial strategies which lowered their profitability and made them very vulnerable to external pressures. They scrambled to borrow easy money in short-term foreign loans to promote a risky strategy of rapid corporate expansion which mainly consisted of mergers and acquisitions and over-production depressing prices and lowering profitability. They built up levels of debt which were unsustainable in the misplaced belief that they were too big to fall and that the government would bail them out in times of trouble. Their intricate webs of cross shareholding and loan guarantees masked the true extent of the debt levels until it was too late. Their cosy relations with both government and bureaucracy helped continue corrupt practices and cronyism which undermined the government's ability to govern.

Third, labour contributed to the growing unprofitability of the chaebols by holding them to ransom, exploiting their weakness, their interdependence, to demand ever higher wages and conditions which in the long-term reduced their competitiveness against rival nations. Labour also showed intransigence in accepting reforms of the labour laws which threatened their interests but which would in the long-term benefit the country.

Fourth, the financial institutions showed themselves to be very fiscally irresponsible by having inadequate checks made of the financial viability of potential clients and their loan requests and allowing the situation to develop where they were vulnerable to the recall of short-term foreign loans with long-term domestic loans which were inadequate to cover a sudden withdrawal. When the crisis hit they were caught in a liquidity trap with many non-performing loans.

Fifth, although Kim was to blame for dismantling certain bureaucratic institutions which had been the backbone of the developmental state, it is also true the bureaucracy, in particular, the Ministry of Finance and Economy, proved itself incompetent in handling the economy. Reforms of the bureaucracy did not go far enough to remove the levels of red tape which hindered the competitiveness of Korean business.

Sixth, civil society began to play a greater role in balance and checks against the government causing paralysis of decision-making. Public disapproval of the Kia Motors bankruptcy led the government to eventually back down but affected foreign investor confidence at the same time. Labour used its new found freedoms to resist reforms by the government.

Finally, the demise of the largest economy in the region made the other weaker economies more vulnerable to external factors. The collapse of foreign investor confidence in the region, the domino effect of the South-east Asian crisis played its part in the financial crisis in Korea.

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