First Draft: August 2002

The South Korean Crisis of 1997 and its Aftermath: The Legacy of the Developmental State and the Importance of State capacity in Post-Crisis Adjustment

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Paper prepared for delivery at

VI. ERC/METU International Conference in Economics, 11-14 September, Ankara, Turkey.

I would like to express my gratitude to Ziya Onis, whose extensive comments have been invaluable in the evaluation of this paper. All remaining errors and shortcomings are mine alone.

Abstract

The East Asian, particularly the South Korean, crisis has not been an anticipated one. The East Asian experience in the 1970s and 1980s consisted of high growth based on export competitiveness and large capital account surpluses. While performance was perhaps weakening in some of these economies following their exposure to financial globalization, returns on assets were generally high. Yet, the continuation of high levels of investment in the region was clearly facilitated by a heavy reliance on external financing. Towards the mid-1990s, these economies became increasingly dependent on short-term foreign borrowing and portfolio flows, which, if suddenly withdrawn, as indeed it was subsequently the case, would cause very real effects on the macro-economy. The massive reversal of capital flows clearly did not fit the profile of the "traditional" balance of payments crisis in which monetary and particularly fiscal policy generated unsustainable current account deficits. What was quite paradoxical from a traditional IMF perspective is that in none of the most seriously affected East Asian countries had budget deficits in of a problematic nature. In fact, a number of the countries in the region even recorded budgetary surpluses. It was not surprising, therefore, that the East Asian crisis has sparked a large body of literature seeking to explain causes of this unusual crisis, re-igniting fundamental debates about the respective roles of governments and markets, at both the national and international level, in the process.

Since the East Asian economies are generally characterized as blessed with an activist developmental state, the role of the developmental state has became one of the contentious issues emerging from the debates concerning the causes of the crisis. When the Korean crisis first broke out in November 1997, many commentators regarded this as the proof of its famous state-led economic system has reached its limit and what needed to cure the country's economic ills was to ditch the inefficient and corrupt state-directed economic system and create in its place a "genuine" market economy. The aim of the paper is threefold. Firstly, it examines the extent to which the developmental state itself was the cause of the crisis. Secondly, it attempts to provide a critical perspective on the role of the IMF in the post-crisis period. Thirdly, attention is focused on the underlying dynamics of the strong recovery process in the post-crisis era in South Korea, a pattern that makes a strong contrast with other "emerging markets." A central argument is that although the old-style of the developmental state in Korea has significantly declined, it still possesses a substantial amount of state capacity. Indeed, the legacy of the developmental state has been instrumental in South Korean comparatively successful adaptation to the environment of financial globalization in the post-crisis era.

Key Words: • Neoliberal globalization • Financial crises • Korean crisis • IMF restructuring • Developmental state • Korean development • Political economy

1. Introduction

The East Asian economies were for years admired as some of the most successful emerging market economies, owing to their rapid growth and the striking gains in their populations' living standards. As a result, these economies were collectively taken by analysts to represent a model that offered valuable lessons to countries seeking to overcome the challenges of late development. All of a sudden in July 1997, however, they become mired in a severe financial crisis, the magnitude of which would have seemed inconceivable just months before even to the most knowledgeable and insightful observers of the region. Following the financial crisis, the East Asian economies have gone from being cited for their remarkable success in development to being widely condemned for the mess they found themselves.

Poor performance and risky financial policies were not notable features of East Asia's economic ascent before the crisis – quite the opposite. Prior to the crisis, their macroeconomic "fundamentals" looked fine. They had low inflation, budget surpluses or only small deficits, and their foreign exchange reserves were either stable or rising. They were growing fast. East and Southeast Asia accounted for a quarter of world output, but *half* of world growth over the 1990s and almost *two thirds* of world capital spending (Wade and Veneroso 1998). Considered by observers to be an important contributor to "the East Asian miracle," the corporate sector was generally viewed as being very competitive and adept at exploiting new market opportunities. The rapid and sustained growth of the Asian economies coupled with their relatively high interest rates and stable exchange rates made the region attractive to many investors. As a consequence, Western banks and portfolio investors had been providing funds to Asian firms with debt ratios that would have been unacceptable in the West. As Radelet and Sachs (1998b) suggest, '[m]uch of the economic activity supported by the capital inflows was highly productive...[and there]...were few, if any expectations, of a sudden break in capital flows. By early 1997, markets expected a slowdown even a devaluation crisis — in Thailand, but not in the rest of Asia.' Nevertheless, a sudden and rapid reversal of short-term capital flows took place in the latter half of 1997.

The most startling development was the collapse of the region's prototypical "miracle economy," South Korea (hereinafter referred to as Korea). There were several underlying problems besetting the Korean economy, at both macroeconomic and microeconomic level (especially within the financial sector). But, these problems had been well-known for years, and were not severe enough to warrant a financial crisis of the magnitude that took place. In fact, well into November, many foreign investors were "optimistic" about the future of Korea's economy. Only two weeks later would they become negative and leave all at once, taking their money out of investments almost regardless of whether they were good or bad.[1]

The massive reversal of capital flows clearly did not fit the profile of the "traditional" balance of payments crisis in which monetary and particularly fiscal policy generated unsustainable current account deficits. What was quite paradoxical from a traditional IMF perspective is that Korea did not have budget deficit but indeed recorded a budgetary surplus and ran a giant current account surplus.[2] The savings rate was one of the highest in the world, monetary expansion was moderate and inflation rate was only 4 percent (see Table 1). It was not surprising, therefore, that the East Asian and particularly the Korean crisis has sparked a large body of literature seeking to explain causes of this unusual crisis. Since the East Asian economies are generally characterized as blessed with an activist developmental state, the role of the state has became one of the contentious issues emerging from the debates concerning the causes of the crisis.

[1] See, particularly, Radelet and Sachs (1998a, 1998b) and Park (1998).

[2] Wade and Veneroso (1998) point out that Korea's current account surplus of $3.7 billion dollars in December 1997 was equivalent to something like 15 percent of Korean GDP when annualized at the post-devaluation exchange rate of 1,600 won to the US dollar.

Interpretations of the Asian crisis have coalesced around two rival stories: the end of the Asian mode of capitalism story about internal, real economy causes; and the panic triggering debt deflation in a basically sound but under-regulated system story that claims the structural flaws inherent in world financial markets in the absence of adequate regulation. According to the former view, this crisis reflects excessive government intervention in markets, especially financial markets that drove rapid economic development but also brought the corruption and moral hazards that eventually led to the crisis. According to the latter view, this crisis was not caused by too much government regulation, but by too little. It was excessive liberalization, not the traditional East Asia model that had failed. Thus this crisis has re-ignited fundamental debates about the respective roles of governments and markets, at both the national and international level.

Before the financial crisis, the Korean economy and its form of governance were heralded as one of the most successful examples in capitalist economic history. However, in the aftermath of the financial crisis, Korea's economic governance has become the target of international criticism. Many commentators regarded the crisis as the proof of its famous state-led economic system has reached its limit and what needed to cure the country's economic ills was to ditch the inefficient and corrupt state-directed economic system and create in its place a "genuine" market economy. Missing the financial rationale behind it,[3] the government credit allocation process was now seen as corrupt, a problem captured by the phrase "crony capitalism." From this perspective, the fast paced liberalization of the Korean economy and its rising integration with global markets in the early to mid 1990s was the *trigger* but not the *cause* of the crisis. Liberalization merely exposed the underlying rot within (Crotty and Lee 2001).

The argument that "structural" aspects of the East Asian model were not at the root of the crisis is well put by Radelet and Sachs (1998a, 1998b) and Stiglitz (1999a, 1999b). This is not to say that these economies did not have structural weaknesses. But, as Stiglitz (1998) points out, 'financial crises break out with some regularity in economies ranging from Scandinavia to the United States, regardless of form of economic management and standards of transparency.' It is true that the Korean development model contained some of elements which gave rise to the current crisis. But, it needs to be recognized that this model also contained the very dynamic elements which made the "miraculous" growth over such a short period possible. Corruption and cronyism did not increase suddenly in the late 1990s to create the financial crisis. As Yilmaz Akyuz, Director of the Division on Globalization and Development Strategies at UNCTAD, points out, '[t]he institutions and relationships people blame are not new, what is new is the opening of financial flows' (Akyuz 2000).

The neo-liberal triumph in the 1980s gave way to the radical structural change of the international political economy. Starting in the early 1980s, fashionable opinion held that unfettered free markets, a reduced role for the state, and integration into the global economy provided the best formula for development. In policy circles, this formula came to be known as the "Washington Consensus." International financial institutions, the World Bank and the International Monetary Fund (IMF), pressed developing countries to conform to this formula as a condition of their loans (Levinson, 2000). However, this formula that regards market liberalization as the key to "prosperity for all" seems as a false hope. Nobel laureate in economics, James Tobin, makes the remark that 'South Koreans and other Asian countries—like Mexico in 1994-95—are…victims of a flawed international exchange rate system that, under U.S. leadership, *gives the mobility of capital priority over all other considerations*'[4] (Emphasis is original). Similarly, underlining the link between capital market liberalization and crises, Wade and Veneroso (1998) suggest that '[t]he rush to capital liberalization in the early to mid 1990s without serious institutional support stands out as the single most irresponsible act in the whole crisis.' According to Joseph E. Stiglitz, who is the winner of the 2001 Nobel Prize in Economics and served as chief economist and vice president at the World Bank during the height of the 1997 Asian financial crisis, in the East Asian countries '[f]inancial markets were highly regulated...[and]...those regulations promoted growth. It was only when these countries stripped away the regulations, under pressure from

[3] This issue will be taken up later in section III.
[4] James Tobin, "Why we need sand in the market's gears," *Washington Post*, December 21, 1997.

the U.S. Treasury and the IMF, that they encountered problems'[5] (Stiglitz 2002). Even the previous Managing Director of the IMF, Stanley Fisher, in one of his speeches[6] had admitted adverse effects of an earl liberalization saying 'capital market liberalization for countries that were at earlier stages of development than most of the world are very risky, very dangerous and can have very adverse effects.

As a result of the free market, *laissez-faire* agenda of the multilateral institutions, the 1990s witnessed a boom in short-term lending[7] by international banks to developing countries[8] and this "hot money" flows has exerted destabilizing effects on both the financial system and the real economy (Singh 2000; Boratav and Yeldan 2001). These financial flows are liquid and are attracted by short-term speculative gains, and can leave the country as quickly as they come. This means national governments have become increasingly at the mercy of global financial markets. As Akyuz (1998) suggests, '[t]he liberalization of financial markets in many East Asian economies without governments strengthening their regulatory and supervisory systems is an important factor contributing to the climate of over-investment and excessive private sector speculation.' Consequently, 'the last half-decade has been a period of new crises, characterized by more speculation and what many have called "casino capitalism." In East Asia and Latin America at least, contagion – "being in the 'wrong neighborhood'" – has become more pronounced, with (the) crises otherwise unexplainable' (Jomo 2002).

Unlike many other previous crises, the source of the problem in the Asian crisis was not imprudent government but an imprudent private sector. Most of the East Asian countries were running budget surpluses. They had tight monetary policies, inflation was low and falling (Stiglitz 2000). In view of this rather different circumstance, the IMF staff appear to have misdiagnosed the crisis and proposed inappropriate remedies (for example, further financial liberalization, large fiscal austerity, a steep rise in real interest rates). Moreover, market confidence, which was of critical importance in the evolution of the crisis, is unlikely to have been helped by the IMF policies. 'The Fund immediately called for the closure of insolvent finance companies and banks without seeming to worry about how uninsured depositors were to be treated, which triggered bank runs; and it identified fundamental structural problems which had to be fixed before growth could resume, sending a message to investors that the economies were basically unsound' (Wade 2000: 8). All these factors seem to have made things worse and deepen the crisis rather than to cure. Stigliz (2000), for example, suggests that '[a]ll the IMF did was make East Asia's recessions deeper, longer, and harder. Indeed, Thailand, which followed the IMF's prescriptions the most closely, has performed worse than Malaysia and South Korea, which followed more independent courses.'

The aim of this paper is threefold. Firstly, to examine the extent to which the developmental state itself was the cause of the crisis. Secondly, to provide a critical perspective on the role of the IMF in the post-crisis period. Thirdly, to reveal the underlying dynamics of the strong recovery process in the post-crisis era in Korea, a pattern that makes a strong contrast with other "emerging markets." The paper is organized as follows. Section II portrays how the Korean developmental state emerged and functioned. Section III highlights the importance of external finance and its control in Korea's economic development. Section IV investigates the role of Korea's financial liberalization in the Korean crisis. Section V questions the relevancy of IMF prescriptions to overcome the crisis. Section VI looks at the factors that have an effect on the decline of the Korean state. Section VII examines the role of the state in the strong recovery process. The last section summarizes and concludes.

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[5] Wade and Veneroso (1998) give a similar account of the crisis: 'It happened partly because of excessive financial *deregulation*, including, above all, allowing banks and firms to borrow abroad without any government controls or coordination.'

[6] The speech is made at the Jackson Hall meeting of the Federal Reserve in August 2000.

[7] Of course, such speculative flows are not new. However, what is new presently is the speed with which the destabilizing effects of these financial flows are transmitted on a global scale (Singh 2000).

[8] By 1997, nearly 60 percent of all outstanding international bank claims on developing countries had a remaining maturity of less than one year, and some 50 percent of all new loans from international banks had maturities of one year or less, a much greater proportion than at the beginning of the decade. The volume of short-term debt grew fastest in East Asia, followed by Latin America (Dadsush, Dasgupta and Ratha 2000).

2. The Korean Developmental State

In contrast to a "market-rational" state's concern with rules of the game and traditional notions of efficient resource allocation, some theorists argue that strong states are required both to usurp the market's role in resource allocation and to ignore standard indicators of static comparative advantage and efficiency. In particular, following Johnson's (1982) work, neo-statist political scientists and development economists emphasized the importance of a particular kind of state – a developmental state which consciously distorted markets. For instance based on her study of Korea, Amsden (1989) argued that late industrializers should get important prices "wrong" in order to direct resources into targeted activities that reflect a country's dynamic comparative advantage. Similarly, Wade (1990) suggested that the difference in investment in the East Asian newly industrialized economies is due to government actions to constrain and accelerate the competitive process. These theorists are distinguished from their neo-classical adversaries by the contention that differences in state capacity largely explain variation in economic performance among latecomers. Although they acknowledge that "where there are rents, there are rent-seekers," their solution is not to remove the state but to block unproductive rent-seeking behavior.

Rather than relying on free competitive markets, state steering of the economy was the main form in East Asia. The beneficial role of the state was so obvious that even one of the prominent advocate of neoliberal view, the World Bank, had to admit this in the East Asian context by releasing a book named *The East Asian Miracle.* The book acknowledged that 'in most of the East Asian countries, in one form or another, the government intervened – systematically and through multiple channels...[and this intervention] ...resulted in higher and more equal growth than otherwise would have occurred' (*World Bank* 1993: 5-6). Among the East Asian countries Korea's success was so indisputable that it demonstrated to those not ideologically committed to neoliberalism that there were practical, superior alternatives to the free market development model (Crotty and Dymski 1998). As Delhaise (1998: 101) indicates, 'South Korea's achievements in the last 35 years are absolutely stunning, with no parallel in any other country on the planet.' Korea was one of the poorest countries in the world immediately after the Korean War. Even in 1960, after the damage inflicted during the war had been repaired, Korea's per capita GNP was still only US$80 in current prices. At that time, few, if any, observers held out much hope of improvement for Korea's poverty-stricken economy (Song 1997; Kim and Hong 1997). This all changed however and Korea's economy has experienced one of the most rapid structural transformations that has ever occurred. As a result, within a single generation, Korea has escaped the vicious circle of poverty and achieved as low as 2 percent unemployment rate in 1996. An average annual GNP growth rate of about 10% between 1965 and 1980 laid the foundations for this spectacular success. If we exclude the OPEC and centrally planned economies, Korea had the fifth highest growth rate of real GNP in the world in the 1960s and the highest in the 1970s and for some of the 1980s (Minns 2001). Korea's export performance attest to the speed at which Korean firms have acquired increasingly more diverse and more sophisticated industrial capabilities. Currently, Korea is among the world's most competitive suppliers of many skill and technology intensive products and competes with advanced economies in a wide range of industrial products.[9]

The military coup d'etat of May 1961 was a major turning point in Korean economic history. Park Chung Hee, who led the coup and became a supreme ruler until 1979, had a strong commitment to economic development. Under Park's rule, the Korean state 'always perceived itself as a mediating agent and facilitator for bringing about industrial change, through arm-twisting, subsidies or public enterprises as the circumstances demanded' (Rodrik 1995: 85). As soon as it came to power, the Park regime moved swiftly to prepare some institutional grounds for its political-economic agenda. One of the first moves was to nationalize all the banks and thereby gain exclusive control over the allocation of investible funds in the economy. Subsequently new state-owned banks were set up over a period of

[9] For example, next to the US, Korea is the second most important country in the world in electronic memory chip technology (Singh 1999) and is the fourth largest producer of automobiles in the world economy (Erdogdu 2001).

time, resulting in full state control over investment loans. In 1961, the Park regime established the Economic Planning Board (EPB) for economic planning, foreign capital management, and statistics. Consequently, through a series of 5-year economic plans established and implemented by the EPB, the state guided Korean companies toward the sectors considered strategic for the national economy, either in terms of creating self-sufficiency or to foster competitiveness in the international economy (Chang 1994).

Until the late 1980s, the government was in all respects the architect and principal player in the Korean statist model, while the banks and business corporations were its agents. In particular, the tripartite relationship established among the government, banks and the *chaebol*[10] has been the core aspect of the Korean economic development model. The state carried out necessary policy reforms conducive to rapid economic development and aimed to establish a synergistic interaction between itself and the market. The state was careful to allocate the scarce capital to industries that would generate the highest growth for the overall economy. To assure that investment was of the right magnitude as well as allocated efficiently, the government tightly controlled and coordinated the investment plans of the *chaebol* that dominated Korea's economy.

The Korean government manipulated the decisions of the private sector in a quite direct and discretionary manner. According to Pack and Westphal (1986: 99), 'the Korean government can be seen as having adjudicated between suppliers and users, weighing costs and benefits from a collective standpoint and often intervening to reward cooperative players and punish uncooperative ones.' Korean governments, in consultation with business leaders, identified the next rung in the technology ladder the country had to climb to develop successfully, and helped selected firms enter and prosper in targeted industries through credit allocation at below market interest rates, research and development assistance, and temporary protection from domestic and foreign competition. The state actively promoted certain industries with a potential long-run comparative advantage through and beyond the infant industry stage and subsequently exposed them to international competition. In addition, it spread or socialized the risks attached to long-term investment, and steered the allocation of investment by methods which combine government and entrepreneurial preferences (see particularly, Pack and Westphal 1986; Amsden 1989; Woo 1991; Chang 1994). In this environment lumpy and long-term investment projects were undertaken which would probably not have been undertaken in an economy with free trade and capital movements. As a result of having a developmental state, Korea avoided the pitfalls that beset many other countries pursuing a technologically advanced industrial development and by effectively applying performance criteria it forced private sector companies to be internationally competitive in a relatively short period of time.

It is evident that the state played the key role in Korea's rapid economic growth. However, Kang (2002) reminds us, this was not necessarily intentional and rather than economic, political considerations dominated policymaking in Korea. According to Kang (2002: 178), 'politics drove policy choices even at the height of Park Chung-hee's rule, that bureaucrats were no independent of political interference in setting policy, and that business and political élites wrestled with each other over who would reap the rents to be had... Producing public goods was often the fortunate by-product of actors competing to gain the private benefits of state resources..' Because the number of actors were small, competition for rents were not so great and this reduced the total social cost.[11]

3. External Finance Dependence of Korean Economic Development

In the early period of economic development in Korea, capital was extremely scarce and domestic saving was equivalent to less than 2 percent of GNP in 1960-62, well below savings levels in many other developing countries. Since Korea's defense expenditures were relatively high and it had to

[10] *Chaebol* is a Korean term for the highly diversified, family-controlled conglomerates.

[11] Much rent seeking entails competing with other actors to win rents and then building entry barriers and other mechanisms to protect those rents. A group that has exclusive access to the rent markets has lower information costs and can collude over time with other rent seekers to lower costs (Kang 2002).

import oil and many other industrial raw materials, to augment domestic saving Korea needed to import a significant amount of foreign capital. Thus, the Korean economy became highly dependent on foreign finance for rapid economic development. By 1962, foreign capital was financing an astonishing 82 percent of total investment, and Koreans felt that such dependence, if allowed to crystallize, would impede their long-term development efforts (Delhaise 1998). When combined with the structural political uncertainty due to the presence of problems with North Korea, an extremely tight control on capital outflow was seen as absolutely necessary – those who engaged in capital flight could be sentenced to death in extreme cases.[12] At the same time, the government almost completely controlled foreign borrowing and the use of the borrowed capital with a view to minimize what it considered "unnecessary" or "wasteful" use of scarce foreign exchanges (Chang and Yoo 2000).

The Park regime followed a general export promotion policy in the early 1960s. Despite a decade of unprecedented economic growth, this policy ended in 1973. The government made a critical decision to shift resource allocation towards development of heavy and chemical industries (HCI). A great effort was made to raise domestic savings to finance the HCI drive, but the amount of domestic investment in Korea has almost always exceeded the amount of domestic savings. As a result, Korea borrowed heavily from abroad and total debt rose from $4.3 billion to $20.5 billion during the HCI drive but remained constant at the beginning and end of the HCI drive as a percent of GNP, from 34% in 1972 to 32% in 1979 (Amsden 1989). Since Korea's economy was sufficiently productive, a big increase in debt did not result in a heavier debt burden.

Korean financial system has long operated within the context of industrial policy and the government tightly controlled financial institutions to mobilize financial resources for economic development. Although the Korean government had a great aversion to running public debt, it ran a relatively loose monetary policy and provided cheap finance as many firms as possible in the belief that cheap finance is essential to compete internationally. Such an environment was also regarded as crucial in sustaining the "investors' confidence" necessary for continued high investments and industrial upgrading. In this process, the financial rentier class was "repressed," as reflected in the low profitability of financial institutions. Underlying such a regime of "financial repression" was the view of the then ruling elite that the financial rentier class was at best a "necessary evil" and at worst a parasitic group damaging the industrial enterprises necessary for national development (Chang and Yoo 2000).

The government used the financial sector as a distributive channel to allocate nation's scarce resource to export-oriented strategic industries based on its assessment of their contribution to the nation's industrialization (Kim 1998). Since credit was more likely to be awarded to those with some track record, the loan allocations necessarily favored established firms, and the *chaebol* in particular (Rodrik 1995: 86). The government provided the *chaebol* in the targeted sectors with massive financial support in the form of policy loans that carried low interest rates. To this end, the government directed more than half of the bank credit through state owned banks. More important was the government's implicit risk sharing with private firms in making investments (Nam *et al.* 1999; Wong 2000). Throughout the 1960s and 1970s, it was usual for the state to guarantee the international loans taken out by major Korean firms. This practice was seen as a practical policy for achieving rapid economic growth because the international finance market did not widely recognize emerging Korean firms as being credit-worthy (Heo and Kim 2000).

The combinations of easy access to capital and implicit government guarantees of *chaebol's* investments encouraged Korean firms to borrow heavily. This led to debt/equity ratios that would be considered unsafe in many liberalized, Anglo-American style economies, but were not inconsistent with leverage ratios in other bank-based systems such as France, Italy and the Scandinavian countries

[12] According to Chang and Yoo (2000: 105-24), central to this regime of control were the so-called Foreign Exchange Concentration System, under which all foreign exchange had to be surrendered to the central bank, and the Foreign Exchange Management Act, which put severe restrictions on the use of foreign exchange (e.g., limits on overseas remittances, on overseas real estate acquisition, or even on expenditure on foreign tourism, which was severely restricted until the late 1980s).

(Crotty and Lee 2001). The high degree of leverage left corporate sector vulnerable to a rise in interest rates and a reduction in cash flows.[13] As Wade and Veneroso (1998) suggest, '[s]uch a financial structure requires cooperation between banks and firms, and considerable government support. The trick is to buffer firms' cash flow and supply of capital against "systemic" shocks, while not protecting firms from the consequences of bad judgement or malfeasance. Restrictions on the freedom of firms and banks to borrow abroad, and coordination of foreign borrowing by government, are a necessary part of this system.' Thus, the government partially–and strategically–closed capital account. In this way it maintained a cleavage between the domestic economy and the international economy with respect to financial flows (Wade 2000). Until the outbreak of the Asian crisis, the government was able to insulate the highly levered real sector of the economy from severe financial distress through its control over capital flows, even in the face of several large external shocks.

It needs to be recognized that aggressive foreign borrowing is fine if loans are screened and monitored by capable institutions and used for productive purposes (and if short-term borrowing is not accompanied by long-term lending). But intensified financial liberalization in the 1990s made Korea's economic structure increasingly vulnerable to external shocks since it reduced the state's crucial role of control and coordination. While the size of external debt was not an unsustainable level given Korea's economic growth potential, the rapid increases in short-term debt and term-mismatches resulted from the absence of prudential supervision were clearly signaling possible foreign exchange liquidity problems. The following section examines the process of capital account liberalization in Korea and how this increased the vulnerability of the Korean economy.

4. The Role of Korea's Financial Liberalization in the Crisis of 1997

As documented above, Korea has borrowed heavily from abroad to finance its ambitious domestic investment projects and this obviously made Korea very vulnerable to external shocks. In order to reduce risks, the Korean government used to control all the internal and crossborder financial flows very tightly. This tight control, however, was not enough to make Korea immune from financial crises. Since the early 1960s, the Korean economy has experienced three big surges in foreign borrowing, all of which ended up in a debt crisis. The first debt crisis, during 1970-72, was the result of the introduction of a McKinnon-Shaw-style financial reform in 1965. The second episode, during 1980-82, was the outcome of the HCI drive, which was financed by the cheap oil money following the first oil shock and abruptly ended by the world recession following the second oil shock. The third is, of course, the 1997 crisis (Chang and Yoo 2000).

Since the Korean state successfully monitored financial activities, it could avoid any serious setbacks until 1980. Financial liberalization measures that were taken in the immediate aftermath of the 1980 crisis did not change the basic nature of the Korean financial system. However, a number of structural changes occurred to create pressures for fundamental changes in the financial system as a result of a powerful coalition of interests inside and outside of Korea in the 1980s. First, the importance of nonbank financial institutions started to increase rapidly from the mid-1980s, and by the late-1980s their importance in the financial system started to outweigh that of the banks. Given that these institutions were subject to much less strict governmental regulations, the government's grip on the financial system increasingly weakened. Second, the large trade surplus generated between 1986 and 1989 made the existing mechanisms of capital-account control problematic. The large trade surplus generated excess liquidity in the system, prompting the government to relax restrictions on foreign exchange use (Chang and Yoo 2000). Consequently, controls on current-account transactions were dismantled and a program of interest-rate deregulation was announced in 1988 (*OECD* 1994: 20-1). Although trade surplus disappeared subsequently, the surge of capital inflows in the 1990s provided the justification for the continued relaxation of regulations on foreign exchange holding and use, until the system was finally reduced to near insignificance in 1995. Third, from about the late 1980s, the

[13] Wade and Veneroso (1998) point out that the deeper the intermediation of debt (that is, the higher the ratio of bank deposits to GDP and the higher the ratio of corporate debt to equity), the more likely that any depressive shock will cause illiquidity, default, and bankruptcy.

Korean corporations and banks started enjoying sufficient creditworthiness in the international financial markets that they did not need government guarantees anymore. This made them begin to regard government involvement in their foreign exchange transactions as a burden rather than a necessity as before, weakening the government's hold over the financial sector even more (Chang and Yoo 2000).

From the late 1980s, the U.S. government, the IMF, and the World Bank started to put enormous pressure on the Korean government to open up the financial market. The agreement from the March 1992 bilateral talks with the U.S. subsequently formed the basis for the radical 1993 financial liberalization program[14] (Chang and Yoo 2000). In the mean time, the *chaebol* began to make their presence felt in such up-scale global industries as semi-conductors and automobiles; Samsung, for example, became the world's largest chip-maker. By the early 1990s they believed they were positioned for a serious run at the U.S. and European consumer markets. To achieve their objectives the *chaebol* had to undertake major new investments in Korea and elsewhere that were so large they could not be financed through profits or equity issues. To help raise the needed funds, the *chaebol* successfully pressed the government to deregulate domestic financial markets, then proceeded to increase domestic borrowing dramatically. Of particular importance, the government licensed 24 new merchant banks between 1994 and 1996—some with substantial *chaebol* ownership interests, and in a shocking reversal of tradition, left these banks virtually unregulated (Crotty and Dymski 1998). The *chaebol* also needed assured access to foreign markets, which was probably the main reason behind the neoliberal leaned Kim Young Sam Government's bid to enter the Organization for Economic Cooperation and Development (OECD) in 1993. This application subjected Korea to further external demands for financial market liberalization and opening up. Korea complied with these demands and succeeded to become an OECD member in 1996. But a series of liberalization and opening-up measures taken in the early 1990s finally resulted in a fundamental change in the Korean financial system. The changes included, among other things, interest rate deregulation, abolition of "policy loans," granting of more managerial autonomy to the banks, reduction of entry barriers to financial activities, and, most importantly, capital account liberalization, something that Korea's previous plans of financial liberalization had characteristically failed to include (Chang and Yoo 2000).

Korea's capital account transactions opened up precisely in the most vulnerable area – short-term foreign capital flows to the financial sector and to the *chaebol*. Moreover, in the process of capital account opening, the distinction between long-term debt and short-term debt, and between FDI and portfolio investment, were ignored (Lim 1999: 437). Capital market liberalization reduced the effectiveness of the Korean state's most powerful control instrument: *financial control*. In a sense, capital market liberalization can be considered as a critical turning point in terms of the state's ability to intervene. This would also mean a loss of control over the investment pattern. With regard to the state's architecture, there has been a dismantling of the EPB, the key pilot agency of industrial transformation since the 1960s. Kim Young Sam Government first marginalized and then abolished the EPB, creating the Ministry of Finance and Economy (MOFE). Consequently, the Korean government abandoned its traditional role of coordinating investments in large-scale industries and announced that no more state-led economic plans and macroeconomic Keynesian strategies would be devised. The long-term sectoral industrial policy, the main function of the developmental state, eventually came to an end. Instead, the government planned a much longer-term economic and social blueprint up to the year 2020, avoiding macroeconomic management in industrial policy (Kim 1999). This made it easier for market failure to manifest itself in excess capacity in automobiles, shipbuilding, petrochemicals, and semiconductors.

Since Korea grew up with tightly repressed (controlled) financial system, Korea's financial institutions had no expertise in credit analysis, risk management, and due diligence. They also had little experience in foreign exchange and securities trading and international banking in general. Since they

[14] Stiglitz (2000) suggests that the IMF and the U.S. Treasury Department pushed liberalization in Korea in 1993 over the opposition of the Council of Economic Advisers and this contributed to the increased global economic volatility. As a result, according to Stiglitz, 'Korea, and the world, paid a high price.'

nurtured in the tradition of direct control, the supervisory authorities were in a similar situation. In other words, the government eliminated and relaxed its monitoring of foreign borrowing activities and capital accounts, but failed to replace them with a proper new system of prudential regulation to safeguard the stability and soundness of financial institutions (Park 1998).

Relaxation of state discipline over the *chaebol* and reduced control of the financial market produced a dramatic increase in foreign capital, much of it short-term and speculative. As financial liberalization accelerated, domestic financial institutions were given greater freedom to manage their assets and liabilities, in particular to borrow from world financial markets. In the 1960s and 1970s their loans were controlled and only approved by the state for specific purposes associated with the Five Year Plan of the time. But taking full advantage of the new freedom from these restrictions, *chaebol* borrowing rose in the 1980s and, in the 1990s, became truly out of control (Minns 2001). Because of the interest rate differences between Korea and the rest of the world, Korean banks and other financial institutions found it profitable to borrow money in the international market and lend it to domestic borrowers (Wade 1998). In many cases the *chaebol* used their enormous interlinked property holdings as collateral and loans were granted on this rather than on the merit of the investment plan. Their complicated structures enabled them to disguise poor performance and the real level of their debt (Minns 2001). Most of the finance was subject to short-term payback clauses, but invested in long-term projects. Some conglomerates developed debt to equity ratios of more than 20 to 1 (Wade 2000).

Since the *chaebol* could now borrow easily from international markets without asking permission from the government, Korea's external debt nearly trebled between 1993 and 1997 (from $44 billion to $120 billion). This debt buildup was almost twice as fast as that of 1979-85, the period of the country's second financial crisis. Korea's foreign debt grew at 17.8 percent per annum during 1979-85, while it grew at 33.6 percent per annum during 1994-96. More important was foreign short-term credit, which stood at $12 billion in 1993, rose to $32 billion in 1994, $47 billion in 1995, and $67 billion in 1996 (Crotty and Lee 2001). The ratio of short-term debt to foreign exchange reserves rose from 160 percent in mid 1994 to 210 percent in mid 1997 (Wade 2000). This large short-term debt made Korea very vulnerable to external shocks. While Korea's overall foreign debt was not at an obviously unsustainable level, its maturity structure posed a serious problem. The share of short-term debt in total debt rose from an already high 43.7 percent in 1993 to an astonishing 58.3 percent by the end of 1996[15] (Chang and Yoo 2000). Despite central bank efforts to maintain the foreign exchange reserve at a steady level, the won's vulnerability greatly escalated. More problematic, and also not well-publicized, was the fact that about US$23 billion of the official reserves were on deposit with the foreign subsidiaries of Korean banks and much of this was being lent to Korean companies. This meant that these reserves were not available when foreign creditors refused to roll over the outstanding short-term debt (Heo and Kim 2000). On top of all this, the government brought the monetarist view that inflation control should be the overriding priority of macroeconomic policy and that the exchange rate should be an "anchor" for inflation control. This caused a significant overvaluation of the currency, hurting exports (Wade 1998).

Just as Korea was increasing its reliance on foreign capital, the economy was hit by a large magnitude of negative terms of trade shock in the second quarter of 1996. World prices of Korea's key exports, such as semiconductors, steel and ships, fell significantly[16] in 1996 (Moon and Mo 2000). As a result, the terms of trade deteriorated by more than 20 percent in 1996 (Shin and Hahm 1998; Cho 1999). This severely deteriorated profitability of the corporate sector in 1996 and 1997. This shock to the profitability was potentially very dangerous given the over-leveraged financial structure of the Korean corporate sector. By 1996 the 20 largest *chaebol* were showing returns below the cost of the capital they had borrowed (Minns 2001). Consequently, a number of large groups failed in early 1997. After a

[15] The magnitude of this problem can be seen by recalling the fact that during the times of the first and the second crises, this figure never rose above 20 percent and 35 percent respectively (Chang and Yoo 2000).
[16] During the course of 1996, the unit price of semi-conductors fell by more than 70 percent. A rough estimate suggests that the fall of the semiconductor prices alone decreased the value of exports by more than $10 billion (over 2 percent of GDP) in 1996 (Shin and Hahm 1998; Cho 1999).

continued downgrading of the national credibility and the crash in Asian stock markets, Korea faced a severe shortage in its foreign exchange reserves. What finally triggered the crisis in Korea was a chain of events in the rest of Asia, beginning with the devaluation of the Thai baht in July 1997. As the Asian crisis spread, Korea became a victim of self-fulfilling speculative attacks and contagion (Moon and Mo 2000). Around October and November 1997, the whole region was awash with panic. Investors began to pay attention to the term structure of Korea's foreign debt. They estimated short-term debt at $110 billion, more than three times Korea's official foreign exchange reserves (Wade 1998). A run to financial institutions occurred[17] and the Korean won jumped more than twice against US$ from 861 as of January 1997 to 1,737 as of December. Market interest rate rose from 12.2% to 20.1% and share prices index fell from 670 to 386 during the same period (Hahm 1998). A record number of firms went bankrupt, unemployment started to rise sharply. All these developments caused drastic downturn in economic activities and eventually led to an IMF bailout package. The stringent conditions imposed by the IMF meant that accepting the funds Korea had to surrender a large part of its economic sovereignty. The package had been agreed just before the presidential election and 'the IMF insisted that all presidential candidates immediately "endorse" an agreement they had no part in drafting or negotiating - and no time to understand' (Sachs 1997). Thus, starting at the end of 1997, the Korean economy went through the rough experience of being under the IMF program.

5. The Relevance of IMF Prescriptions for the Korean Crisis of 1997

As documented in the previous section, the premature opening of the capital market and the terms-of-trade shock increased Korea's vulnerability and in 1997 what was essentially a liquidity problem turned into one of solvency. The consequent crisis led to the biggest IMF-arranged bailout package[18] in history, with an amount of $58.4 billion. In return for the bailout package, the IMF required a fundamental overhaul of the Korean economy. The core of the IMF program was the immediate implementation of severely restrictive macro policy. It included increasing interest rates, cutting back government spending, balancing budgets and building up foreign reserves. According to Wade and Veneroso (1998), the IMF program went well beyond standard IMF programs, calling for structural and institutional reforms even though they were not needed to resolve the crisis. It required major financial restructuring to make the financial system operate like a western one, though without actually saying so. It demanded the government not to intervene in the lending decisions of commercial banks, and to eliminate all government-directed lending; and to give up measures to assist individual corporations avoid bankruptcy, including subsidized credit and tax privileges. The Fund also required wider opening of Korea's capital account, to enable even freer inflow and outflow of capital, both portfolio capital and direct investment. All restrictions on foreign borrowings by corporations were to be eliminated. The trade regime, too, would be further liberalized, to remove trade-related subsidies and restrictive import licensing. Labor market institutions and legislation would be reformed "to facilitate redeployment of labor." As Wade (2000: 3) has suggested, '[t]he fact that the collapse continued in the face of the biggest bailouts in history suggests that something is seriously wrong with the IMF's bailout strategy.'

Prior to the 1997 crisis, Korea's total foreign debt was among the lowest of all developing nations with only about 30 percent of GDP, the current account deficit was very small and rapidly shrinking (Feldstein 1998). Korea had a budget surplus and its inflation stood at a very respectable 4 percent. This data shows that Korea's economic fundamentals were sound and the problem was clearly a case of temporary illiquidity rather than fundamental insolvency. Under these conditions, it had to be obvious that there was no need for the traditional IMF policy of reduced government spending, higher

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[17] Between June and November, the Bank of Korea's reserve holdings fell by $10 billion, and it sold $12.2 billion in the spot market and made forward sales amounting to $7 billion to defend the won. By the end of November the bank held $7 billion in usable reserves (Park 1998) .

[18] On 3 December, South Korea agreed to a massive Fund program backed by additional resources from the World Bank, Asian Development Bank, and other countries in the region. Within weeks, this package proved inadequate, and on Christmas Eve a new program was unfurled, including additional resources and conditions and negotiations with foreign banks over the terms of a short-term debt restructuring (Haggard 2000).

taxes, and tight credit. As Stiglitz (2002) indicates, 'in an economic downturn, cutting expenditures simply makes matters worse: tax revenues, employment and confidence in the economy also decline.'

Because of all these, the IMF's "big-bang" transformation program for Korea was very controversial and accordingly criticized fiercely by some knowledgeable observers of the East Asian economies.[19] Despite warnings, the IMF ignored that the Korean budget had a surplus and failed to see the danger of fiscal restriction and high real interest rates in economy with high levels of private indebtedness and low inflationary expectations. As Stiglitz (2000) suggests, under such circumstances austerity measures would not revive the economy, it would plunge it into recession or even depression. High interest rates might devastate highly indebted firms, causing more bankruptcies and defaults. The outcome was exactly as predicted. With stiff macroeconomic conditions and unprecedented demands for institutional changes (especially regarding corporate governance but also labor and social welfare), the economy contracted to an unprecedented degree. In a country where 5 percent growth was considered a "recession," the economy shrank by 5.8 percent in 1998, recording the biggest contraction in output since the Korean War (1950-53). Industrial production was especially adversely affected and fell by 7.5 percent (Chang and Yoo 2000). In November 1997 Korea had a GNP of almost \$500 billion and per capita GNP of about \$11 000. It was ranked as the 11th industrial economy in the world. Because of the drastic depreciation of the Korean currency, two months later, its GNP had crashed to \$317.7 billion, its GNP per capita to \$6700 and it dropped to 17th place (Minns 2001). The social consequences of the resulting crisis were particularly severe especially in terms of employment and growth of poverty.

Table 1. Major Macroeconomic Indices of the Korean Economy (%, US\$ bil. at current prices)

Year	1993-95	1996	1997	1998	1999	2000	2001
Gross domestic product (GDP)	–	–	476.6	317.7	405.8	461.7	422.2
Real GDP growth rate	7.6	6.8	5.0	-6.7	10.7	8.8	3.0
Unemployment rate	2.4	2.0	2.6	6.8	6.3	4.1	3.7
Consumer price (year-on-year)	–	–	4.0	7.5	0.8	2.3	4.1
Gross saving ratio	–	–	33.4	33.9	32.9	32.4	29.9
Gross domestic investment ratio	–	–	34.4	21.3	26.9	28.3	26.8
Trade balance	-1.7	-15.0	-3.2	41.6	28.3	16.6	–
Equipment investment growth rate	14.1	7.3	-8.7	-38.8	36.3	34.3	–
Exchange rate (won/\$)	790	844	1,415	1,207	1,145	1,259	–
Government balance/GDP	0.35	0.26	-1.5	-4.2	-2.7	1.05	–
Foreign Direct Investment	–	–	–	8.9	15.5	15.7	11.9
Foreign Reserves	233.7	163.5	8.9	48.5	74.1	96.2	102.8
Total foreign debts	896.0	163.5	159.2	148.7	137.1	136.6	–

Source: Bank of Korea, National Accounts, Ministry of Planning and Budget;
http://www.nso.go.kr/cgi-bin/html_out.cgi?F=x15ad0_r15ad0.html;
http://www.go.kr/mofe/eng/e_di1999000000.htm

During the first half of 1998, the Korean macroeconomic environment stemmed from a stringent monetary and fiscal policy. According to the IMF's logic, high interest rate and tight monetary policy should be continued until Korea's foreign currency market was stabilized. The high interest rates, tight monetary policy, and the abrupt imposition of the 8% BIS (Bank for International Settlements) capital ratio requirement on domestic banks led to a sudden and massive credit crunch in the domestic financial market, depressed Korean firms' cash flow and raised their fixed-payment obligations, forcing them into insolvency (Nam 2000). Massive corporate bankruptcies immediately translated into

[19] Jeffrey Sachs, for example, attacked the IMF program, calling it "folly" and an "indiscriminate punishment" of Korea. He argued that 'the IMF's seal of approval is a seal of doom' (*New York Times,* Dec. 12, 1997). On the other hand, Wade and Veneroso (1998) claimed that the IMF's bail out packages for Thailand, Indonesia and Korea reflected not only their imposition of impossibly ambitious institutional reforms but also their inappropriateness for Asian financial structures.

a dramatic increase in non-performing loans (NPLs) of financial institutions, seriously undermining the soundness of the financial system as a whole. As of the end of June 1998, the estimated total of NPLs of all financial institutions, broadly defined to include loans classified as "precautionary," was about 136 trillion won (32% of GDP), a 58% increase from 86.4 trillion won at the end of 1997 (Nam *et al.* 1999). Increases in non-performing loans of financial institutions, resulted from a serious of large corporate insolvencies, destabilized the financial market. Those firms which survived were forced to pay extraordinarily high real interest rates for credit which led to very harsh cutbacks in output and employment (Nixson and Walters 1999). The labor sector went through dramatic changes, with the introduction of lay-offs. The unemployment rate rose from 2.6% in 1997 to the high point of 8.6 percent in February 1999 (Moon and Mo 2000). Facing uncertainty and insufficient cash flows, firms radically depressed their facility investment more than 40% compared to 1997. Mounting unemployment and the shrinking income level of households were other sources of distress. Unemployment and the decrease in real income were the reasons why consumers could not easily regain confidence. Consequently, consumption expenditures decreased 10-15%, surpassing the decrease in income levels (*HRI* December 1998).

In short, the Fund's initial insistence on fiscal contraction, cuts in aggregate demand, and large-scale institutional reform accelerated debt deflation dynamics by cutting profits and the capacity to service debt (Wade 2000). Only long after the credit squeeze crushed the Korean economy, the IMF belatedly took a U-turn on macroeconomic policy in May 1998 and allowed the Korean government to lower interest rates and pushed it to increase budget deficits. Largely as a result of this move, the speed of the economy's contraction slowed from the fourth quarter of 1998, and by the end of the first quarter of 1999 the economy started to show signs of recovery (Chang and Yoo 2000).

The IMF's high interest rate policy was not effective in achieving the stated goal of attracting foreign investment. The Policy rather served disintegration and restructuring Korean *chaebols* (Kim and Koo 2001). This was, however, had to be expected. As Amsden and Hikino (1998) suggest, '[i]n general, foreign investors arrive when growth has already begun as a consequence of domestic forces; foreign investment lags rather than leads economic recovery.' The IMF's pressure of the Korean government to implement the radical restructuring of Korea's industrial corporations and financial institutions *in the midst of an economic and financial collapse* is another controversial issue. Because it is almost impossible to identify and eliminate weak and inefficient firms and banks when almost every firm and bank faces insolvency and the entire price-profit system is in chaos. Insistence of IMF on shuttering many banks despite the fact that systems of deposit insurance hardly exist led panicky depositors to withdraw their deposits even from sound banks, and hold cash instead. Its insistence on cutting demand and liquidity accelerated the bankruptcy or radical devaluation of the value of firms that were efficient and profitable, as well as those that were not. Radical financial liberalization, on the other hand, incurred very large "transitional" costs and probably more important, it meant to give up the developmental advantages of a high debt system. As Wade and Veneroso (1998) point out '[i]t seems particularly unwise for the IMF to insist that companies receive even more freedom than before to borrow on international capital markets on their own account, without government coordination, when it was their uncoordinated borrowing that set up the crisis in the first place.'

When the crisis broke out in late 1997, the appropriate macro policy response would have been expansionary budgets, low interest rates, and the maintenance of a supply of credit adequate to maintain moderate growth in demand. This is the typical policy response of developed country governments in such situations,[20] as well as the approach taken by Korean governments in all previous crises. Such a policy would have avoided an economic and financial collapse and, in so doing, reduced investor pressure to flee Korea. With appropriate confidence-building measures and sensible macro policy, Korea could probably have got by with a modest slowdown in growth, no credit crunch, and a realistic time horizon of a few years to complete alterations of its economic institutions and practices without unnecessary transition costs (Radelet and Sachs 1998a, 1998b; Wade and Veneroso 1998;

[20] An example for this can be given as U.S. Fed Chairman Alan Greenspan's rapid interest rate cuts in reaction to the U.S. recession and bank credit crunch of the early 1990s.

Stiglitz 1999, 2000, 2001). The structural organization of the Korean economy has currently transformed significantly towards a neoliberal mode. This transformation has not only increased vulnerability of the Korean economy to the external shocks but also reduced the scope for selective interventions so crucial to the catching-up achieved in the earlier period. Jomo (2001) suggests that, instead of implementing more Anglo-American-inspired reforms, Korea now needs to create new conditions for further "catching-up.".

Several authors argued that wrong prescriptions of the IMF was, indeed, intentional and aimed to weaken a basically strong economy, which increasingly perceived by the main creditors of this institution as an economic threat to their dominance in the world economy. Crotty and Dymski (1998), for example, accused the IMF agreement as 'designed to permanently destroy the institutional foundations of the Korean developmental model.' Similarly, claiming those who imposed austerity macro policy knew at the time of its imposition it would have disastrous consequences, Crotty and Lee (2001) argued that '*the collapse of 1998 brought on by IMF policies was a political precondition for the immediate, radical liberalization of the Korean economy'* (the emphasis is original). Jeffrey Sachs voiced another suspicion that the IMF was squeezing Korea so that foreign lenders could 'leave the field of battle unscathed' *(New York Times,* January 8, 1998). Likewise, Stiglitz (2002) claimed that during the Asian crisis, 'the IMF had a different agenda – one that protected the developed countries, their policies and lenders and not "save" the economies of crisis hit countries and their people. Instead of helping the crisis- hit countries deal with the problem and save them from greater devastation, the IMF turned out to be the "main bill collector for the G- 7."' In addition to testifying to the ideological foundations of much of the WB/IMF's condition-laden policies lending policies, Stiglitz denounces the unethical agenda that these institutions impose on all countries that explicitly create conditions favorable to international oligarchs and transnational enterprise. According to Stiglitz (2002), these institutions 'continue to exist because they serve the interests of the financial community and the wealthy.'

This conspiratorial assessment of hidden agendas could easily be shrugged off as baseless — except that this account comes from Joseph E. Stiglitz who can use the anecdotes of an insider to confirm the suspicions of the outsiders. Although Stiglitz is hardly the first person to accuse the IMF and World Bank exacerbating poverty in developing countries, he is by far the most prominent and it is hard to think of anyone better placed to raise these criticism. These accounts on Korea provide support to the view proposed in some other recent studies (see for example, Onis and Aysan 2000; Yeldan 2001; Boratav and Yeldan 2001; Onis and Alper 2002) that an effective regulatory framework at the global level is a major requirement if significant social and economic costs to be avoided in the future. Next section aims to identify the factors that have an effect on the decline of the Korean state's developmental capacity and investigates the possibility of a link between Korea's financial liberalization and transformation of the Korean developmental state.

6. Decline of the Korean Developmental State

Korean state-guided economic model used to be admired for its exceptional long-term development record and seen as a model for many other countries until very recently. In addition to its economic merits, this model has had a number of attractive qualities from a social point of view, e.g. poverty reduction, lifetime employment in large corporations and relatively equal income distribution. In contrast, the alternative Western or American model has acquired some unappealing social characteristics as it is increasingly based on the doctrine of promoting labor market flexibility. Social protection which hitherto workers enjoyed is being greatly diminished and a growing number of jobs are being "informalised" (Singh 1999). The admired Korean developmental state, however, came under great pressure and the leader-follower or principal-agent relationship began to erode in the 1980s. Very success of the Korean state strengthened various class forces, whose demands and intrusion into politics undermined the autonomy of the state (Heo and Kim 2000).

Onis (1995) suggests that '[t]he state, as a political actor, can function to promote needed long-term "economic" changes while limiting political impediments to such policies.' The state, however, is not

a fixed or a coherent actor and cannot achieve economic development in isolation. As Holloway (1994: 29) put it, 'states are a form of social relations which themselves are a reflection of the changing relationship between classes in any given society.' Similarly, Koo (2002) underlines that the state is 'a variable entity with blurred boundaries between itself and society.' As the relationships between classes in society change, so does the particular form in which states appear. In this sense, all states and their institutional arrangements are contingent rather than fixed and subjected to processes of deconstruction and reconstruction. In order to understand how and what extent the Korean developmental state declined, it is imperative first to understand how the Korean state could emerge in the first place.

The state is a mediating entity between the outside world and the domestic society and state capacities are built through the interaction of internal and external conditions. Post-war international climate of Cold War can be suggested as an important external contributing factor for the Korean developmental state to flourish. Korean War (1950-53) had created two countries from the same nation with different political systems. As a result of its strategic interests, the U.S. not only politically supported capitalist South Korea but also provided considerable amount of economic and military aid in the 1950s and 1960s.[21] The still unsolved conflict between the two Koreas and the U.S. aid were instrumental in strengthening the army and the bureaucracy in Korea. Thus, external conditions were helpful for Korean developmental state to flourish. It also needs to be pointed out that virtual lack of natural resources in the country made Korean people very conscious of their vulnerabilities. The perceived external threat and lack of natural resources became not only strong motivating factors for the Korean rapid economic development[22] but also strengthen the legitimacy of the state intervention (Erdogdu 1999, 2002).

The Korean state's ability to implement strongly developmental policies has been closely related to its relatively limited income inequality, a high degree of rule of law, virtually no ethnic or linguistic cleavages (Rodrik 1999). These were very helpful to achieve socio-political stability and social integration in Korea. The caliber of bureaucracy has been a very important reason behind the relatively successful state intervention in Korea. Evans (1995) indicates that to ensure competence meritocratic civil service examinations have been used for recruiting incumbents into the Korean state over a thousand years (since A.D. 788). Despite Korea's chaotic twentieth-century political history, the bureaucracy has managed to preserve itself as an elite corps. Merit-based recruitment and promotion of officials, rather than political appointment, have tended to minimize political manipulation of the bureaucracy. Consequently, the state has been able to attract highly qualified individuals.

Probably the most important reason how the Korean state could follow developmental policies so successfully was, for a time, highly insulated from demands from social classes which might have diverted it from the objective of industrialization. This insulation, or "relative state autonomy," derived from an historical trajectory which left the state in an unusually dominant position in relation to these classes.[23] State autonomy was strong in Korea initially because the distribution of income and wealth was exceptionally equitable by international standards, reducing the need for politicians to contend with powerful vested industrial or agricultural interests and limiting pressure for redistributive policies that might have detracted from growth (Onis 1992; Lukauskas 2002). As Park (2002) suggests, 'Korea was a paradigmatic case of *dirigisme,* which by choice and design gave the central state a tremendous bureaucratic discretion in its relations to society.' Korean state's near-total control of the country's financial assets was the essential source of state strength and autonomy during the 1960s and 1970s. With such control the state could not only direct the flow of financial capital to favored projects, but could, when necessary, withhold funds from recalcitrant capitalists thereby ensuring their "cooperation" (Woo 1991; Ó Riain 2000). But the state's capacity to discipline private sector has not remained intact over time. Economic liberalization and privatization during the 1980s

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[21] See, Amsden (1989); Woo (1991); and Castells (1992).

[22] Another motivation for rapid economic growth in Korea can be suggested as the bitter history of being a Japanese colony during 1915-45 period. This has obviously created a strong resentment towards Japan and it is likely to become a kind of national pride catching up Japan economically.

[23] See, particularly, Migdal (1988) in this respect.

and 1990s gradually weakened state's autonomy since financial control has become a less effective method of controlling the *chaebol* as they turn to direct financing in domestic and foreign financial markets.[24] Consequently, the *chaebol* grew increasingly powerful politically and become unclear as to whether the state controlled the *chaebol* or vice-versa. This was extremely destructive because effective state-led growth requires that key government bureaucracies retain their power to impose decisions on private sector agents even when such agents oppose them (Crotty and Lee 2001).

Another important reason why the Korean state was no longer able to carry out its plans for industrial development with anything like the old certainty or focus was its inability to control the burgeoning working-class movement. High economic growth, as suggested by Lee (1999) 'is often accompanied by labor unrest, disparities in income distribution and environmental degradation. In Korea, however, these problems did not surface during the 1960s and 1970s.' The military authoritarian regimes' effort to build a rich and strong family state successfully struck and mobilized Koreans' traditionally relationship-ridden identities for rapid industrial expansion (Park 2002). During this period, the government got involved in labor-management disputes, intervened and settled disputes, increasing the private sector's dependency on the government. Because the government responded selectively to the actions of labor and management according to its own discretion, a fair and objective rule of law could not be established (Lee 1999). According to Koo (2002), the Korean state 'took a more crude repressive method than a sophisticated corporatist method of labor control.' This repression eventually led to a massive labor unrest and a major democracy movement emerged on the streets in 1987 (Minns 2001). After the labor movement was liberalized and the limited measures for preventing strikes were repealed, any efforts to introduce flexibility into the labor market aroused opposition from labor unions (Lee 1999). The post-democratization process has made the state more responsive to popular demands and has subsequently led to the politicization of economic policy-making process. As the political mapping of the social powers changed, the state élites had to concentrate more on obtaining popular support, unlike the cases of the authoritarian regimes (Kim 1999).

As mentioned earlier, from the late 1980s, the US, the IMF, and the World Bank started to put enormous pressure on the Korean government to open up the financial market. In Korea, that pressure coincided with powerful domestic forces and a growing domestic constituency supported such liberalization (Singh 1999). From the *chaebol's* perspective, they wanted more economic freedom in their foreign operations while maintaining a closed domestic market. They welcomed the financial deregulation since it allowed them to borrow foreign funds more cheaply (Heo and Kim 2000). On the other hand, many Koreans welcomed IMF intervention, believing it would provide them with weapons they could use to bring about the downfall of the *chaebol* and the disciplining of the government. They hoped that increased foreign ownership of Korean firms and banks and the breakup of the *chaebol* empires would drastically reduce the concentration of economic and political power in Korea. Their expectation was that as economic power became more dispersed labor would become stronger and the government more amenable to democratic control (Crotty and Dymski 1998).

There has been also a gradual ideological shift towards liberalism among key government bureaucrats, particularly since the late 1980s. Chang and Evans (2000) stress that an extraordinary large proportion of Korean economists and bureaucrats were trained in conservative, free-market US economic programs.[25] Neoliberalism established itself as the dominant ideology among Korean elite circles, including the elite bureaucracy, somewhere between the late 1980s and the early 1990s. After the outbreak of crisis, internal and external supporters of neoliberalism used an extreme version of the

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[24] The chaebol groups not only maintained favorable access to the state-controlled banks but also controlled various non-banks financial institutions. The top *chaebols* can also use international capital markets at much lower rates than in Korea so that there is no longer any need for them to entirely rely on domestic banks (Kim 1999).

[25] According to Wade (2000), '[t]he training of foreign economists is perhaps the US's single most socially profitable export. The economists go back home convinced that there is only one effective way to organize an economy in today's global realities, a way that corresponds with an Anglo-American model of free, arms-length markets. They set about pushing their own governments to undertake free market reforms in the name of efficiency and progress.' For a similar account see Weiss (1998).

"inevitable breakdown" thesis to argue that a radical free-market restructuring of Korea was the only rational response. Whatever the merits of their position, the outbreak of crisis gave this formidable array of forces the political power to get what they wanted (Crotty and Lee 2001).

It is quite evident today that the liberalization of economic relationships has considerably eroded the capability and possibility for the Korean state to follow its strategic industrial policy and to discipline big business. Liberalization hampered the operations of the Korean developmental state and forced it to retreat step by step. As Crotty and Lee (2002) suggest, it is probably the case that 'Korea may have been pushed onto a long-term low-investment, low-growth trajectory.' According to Chang and Evans (2000: 19), 'the dismantling of the development state was effectively finished by...1995.' This paper suggests that this is an overstatement. Korean liberalizations and resulting decline of state power should never be taken at face value. As Park (2002) suggests, 'Korea's future will have to build on its history and existing institutions, and the transition is not likely to come in binary terms or as a clear-cut change.' Although the Korean state's developmental capacity has significantly declined, the state strength and quality of its bureaucracy along with the social institutions that gave rise to developmentalism have not evaporated and the Korean state still possesses a considerable amount of state capacity. Therefore, the legacy of the Korean developmental state must not be underestimated. Indeed, this paper suggests that the legacy of the Korean developmental state has been instrumental in the comparatively successful adaptation to the environment of financial globalization in the post-crisis era, which will be taken up in the next section.

7. The Legacy of the Korean Developmental State in Post-Crisis Adjustment

As can be observed from the Table 1, Korea has currently made a recovery from the crisis and regained its economic vitality. Not only have Korea's economic fundamentals improved, but also its external vulnerability has been sharply reduced. Although their positive effects on Korea's long-term growth potentials are very questionable, neoliberal restructuring reforms have had a positive impact on confidence, which boosted capital inflows. During 1998-2001, Korea has received a total of 52 billion dollars foreign direct investment, more than twice the amount that landed during the past three decades. Korea's foreign exchange reserves, which were nearly depleted in the depth of the crisis, have been replenished substantially. Its foreign currency reserves of US$115.0 billion as of July 15, 2002 rank as the fourth largest in the world, following Japan, China, and Taiwan (*MOFE* 2002). With the assistance of these swelling reserves, the government fully repaid its IMF loan (US$19.5 billion) in August 2001, three years ahead of the schedule. The nation's current economic health has been widely recognized. Following the Moody's and Fitch upgrades, Standard & Poor's raised the long-term Korean foreign currency rating from "BBB+" to "A-" on July 24, 2002. Korea's foreign currency rating has now been returned to pre-crisis "A"-levels by the three major credit rating agencies.

There is a general agreement that by the mid-1990s serious flaws had evolved in Korea's economic system, and that these flaws caused or at least permitted the imbalances that led to the 1997 crisis. Supporters of neoliberalism argue that these flaws were built into, or *inherent* in, the deep structures of Korea's traditional state-led growth model. They consider the Korean model an anachronism; only a lightly regulated, globally integrated economy can function efficiently in today's world. Thus, the neoliberal restructuring package imposed on Korea by the IMF in December 1997 merely accelerated a transition that was in any case inevitable (Crotty and Lee 2001). This neoliberal restructuring is believed by its supporters to be responsible for what is seen as a near miraculous recovery after 1998.

Unlike the generally held view, this paper suggests that this near miraculous recovery is not because of neoliberal policies implemented after the crisis. It is rather related to Korea's sound economic base established under its state-led development model. In the mid-1990s, Korea had already accumulated considerable amount of technological capabilities and proved its international competitiveness. In addition to its successful shipbuilding industry that since the 1980s has challenged Japan's as the world's largest, Korea had penetrated markets for sophisticated durable goods such as automobiles and computers. In the mid-1990s, Korea was the largest maker of microwave ovens with around 40% of the global market share. It was also the world's top producer of DRAM semi-conductors and color

TVs (*Far Eastern Economic Review* 1995). As a reflection of the technological sophistication and competitiveness it reached, Korean automobile industry had become the world's fifth largest producer in 1997. The consequent crisis hit the industry very hard and domestic demand for cars halved in 1998 (KAICA 1999). Just after the crisis, *Motor Business International* analysts forecasted that it is very unlikely for the Korean automobile production to reach its pre-crisis levels earlier than 10 years. Negative conditions of the crisis, however, could not prevent the Korean automobile industry to reach the pre-crisis production levels very soon. Indeed, it managed to go even further and become the fourth largest in the world just in the next year (Erdogdu 2001). It should be clear that it is unlikely to achieve such a result without having a previously established sound production base, which the Korean state was instrumental in creating the necessary high-investment[26] environment. Babies grow and take care of themselves, so do industries. Korean economy has reached a certain level of maturity and it does not require anymore much government tutelage. But there are, as Weiss (1998: xi) suggests, 'numerous areas where state involvement in the industrial economy remains important and vital to national prosperity, even as economies develop and mature.' Although the signs are increasingly apparent that the old-style of the developmental state in Korea has significantly declined, the Korean state still possesses a substantial amount of capacity and that was, this paper argues, very important in achieving a successful recovery and adapting to the neoliberal globalization in the post-crisis era.

Despite the widely held perception that Korean economy operates within the free market model, the truth is probably somewhat different. Currently, the Korean state do not completely leave economic decisions to the market. As Crotty and Lee (2001) suggest, '[r]ather than "wither away," the Korean state has exercised a higher degree of direct administrative control over the private economy since 1997 than at any time in the past two decades.' For example, the government used its control of banks to force the *chaebol* to shrink their debt-to-equity ratio to a maximum of 200 percent before the end of 1999. At the same time, the government encouraged mergers and swaps among conglomerates (the so-called big deals) in an effort to eliminate excess facilities and develop specialized expertise in core industries. (Lee 1999). Other firms, judged to be troubled if not insolvent, were required to enter into "workout" plans with their main creditor bank, under which the troubled firms could receive additional financial support in return for restructuring efforts (Moon and Mo 2000: 30). The government also put pressure on the *chaebols* to eliminate their intra-group mutual loan guarantees by 2000 (Chang and Park 1999). The most drastic measure involved the bankruptcy and dismantling of the Daewoo Group, the third largest business conglomerate in South Korea.

As a result of these measures, radical corporate restructuring has taken place. First, the five top *chaebol* met the deadline for reducing their debt-equity ratios to 200 percent or less by the end of 1999. Samsung reduced its debt equity ratio from 366 percent in 1997 to 96 percent in 1999, while Hyundai, LG, and SK reduced their ratio to 199 percent. Second, in order to reduce their debt-equity ratios, these *chaebol* were encouraged, even by the president himself, to sell off some of their subsidiaries. This administrative guidance led to a sharp reduction in the number of affiliated firms. For example, the Hyundai Group, the largest business conglomerate in South Korea, downsized the number of its subsidiaries from 63 in 1998 to 26 in 1999, exceeding its original objective of 30, whereas the Samsung Group reduced from 65 subsidiaries in 1998 to 40 in 1999. LG and SK undertook sweeping measures to reduce the number of their affiliates, in order to meet the government guideline on debt-equity ratios (Moon and Mo 2000).

Although Korea's economic recovery performance of 1999 and 2000 has been very strong, it is unlikely that Korea will be able to sustain its high growth in the coming decades. The restructuring policies designed and pressed by the multilateral institutions did not aim to restore its previously very successful state-guided model. Instead, those neoliberal policies designed to dismantle the Korean developmental state and establish a free market economy. Such transformation has been achieved quite successfully, although as a consequence inequality has risen significantly and condition of the majority of the population deteriorated. As a result of its now largely neoliberal economic system,

[26] Prior to the crisis, Korea is known for very high and sustained level of investments, amounting more than 30-40% of its GDP.

Korea has been diverted from its sustainable high-growth path. As Crotty and Lee (2001) suggest, 'the rate of capital accumulation in Korea may well be experiencing a pronounced secular decline. If this turns out to be the case, the Korean "miracle" will certainly have ended in 1997.' Nevertheless, we need to recognize that irrespective of whether Korea currently possesses a developmental state or not, it has made the transition from a low-end exporting economy to one that is increasingly high-tech. It has world-class technology and infrastructure in the information and telecommunications areas. It is a leader in communication technology and usage,[27] notably in the CDMA field (Jin 2002). Moreover, Korea is fast developing a reputation as the world's laboratory for digital technology, boasting among the world's most advanced broadband and wireless internet markets (*Financial Times*, May 15, 2002). Since Korea has acquired diverse and sophisticated industrial capabilities, it has now considerable international competitiveness. As a result, it is currently more likely for Korean economy to perform better than many other economies.

8. Concluding Remarks

Until the late 1980s, the government was in all respects the architect and principal player in the Korean statist model and the tripartite relationship established among the government, banks and *chaebols* has been the core aspect in this economic development model. Korean model worked very well about three decades. By the late 1980s, however, a powerful coalition of interests inside and outside Korea had come to support the radical liberalization of Korea's economy. In the decade preceding the crisis, this coalition greatly weakened the Korean developmental state's control over crucial dimensions of domestic and cross-border economic activity. By the mid-1990s, the Korean economic system had lost its coherence. The government no longer had the tools or the political mandate to monitor and control the broad contours of economic life. Yet the Korean developmental state has still possessed a considerable amount of state capacity. Indeed, the legacy of the developmental state has been instrumental in South Korean successful adaptation to the environment of financial globalization in the post-crisis era.

A central argument of this paper is that the current widely held thesis of the root cause of the Korean crisis lies in its *dirigiste* capitalist model is seriously mistaken. The reality is that the Korean crisis has been closely related to inappropriate acts of liberalization from the late 1980s through the mid-1990s. In this period, the state ended its control of *chaebol* investment decisions, substantially reduced control of domestic financial markets, and liberalized short-term capital flows. The removal of virtually all restrictions on cross-border capital flows meant a dramatic increase in the influence of foreign capital in Korea's economy. Towards the mid-1990s, Korean economy became increasingly dependent on short-term foreign borrowing and portfolio flows. In the absence of sufficient foreign exchange reserves, the Korean economy was rendered vulnerable to the risks of currency and investor exit. Once these risks were realized, Korean government found its ability to maneuver very limited. Thus, the fundamental reason for the crisis is to be found not in too much, but rather in too little government control over the financial liberalization process.

Several aspects of the Korean economic development strategy which were very successful in the past became major sources of weaknesses, after Korea integrated into the neoliberal global system. One of these weaknesses appears as the tendency of Korean corporations to rely heavily on borrowed capital to finance their ambitious investment projects, which led to over-leveraged debt-equity ratios. This was, indeed, intentional and the result of cheap finance policy of the state to generate high levels of investment in high-growth industries. Although this strategy had the danger of over-investment, it worked quite well in the past. Because, the Korean state had the ability to control and discipline the *chaebol* and thus it could avoid any serious setbacks. Liberalization measures applied since late 1980s, however, has considerably eroded the capability and possibility for the Korean state to guide investment decisions of private companies. By further opening the economy to capital inflows as the neoliberal tenor of the bailout required, the vulnerability of the Korean economy to future crisis was

[27] Over 57% of Koreans regularly log on to the Internet. More than 60% of the Internet users is connected to broad-band, high-speed internet service, making Korea number 1 in the world (Jin 2002).

exacerbated. Nevertheless, it can be suggested that the IMF pressed reforms were not altogether inappropriate for Korea's stage of development and they are unlikely to cause too much harm for the Korean economy. This is because of the fact that Korean companies have acquired diverse and sophisticated industrial capabilities and they are increasingly becoming exporters of high-end products. As a result, the Korean economy can be suggested as well equipped to perform better than many other economies under the neoliberal global economic system.

To conclude, unbridled financial liberalization was the contributory factor that precipitated the Korean crisis along with many other cases. The 1997 crisis was largely due to inappropriate and rapid liberalization that led to the private sector's excessive reliance on hard currency-denominated foreign loans, along with the failure on the part of government to control portfolio investment flows. The restructuring of the Korean economy after the crisis according to free market, *laissez-faire* agenda of the IMF was inappropriate and exacerbated the downturn. As a consequence, a heavy price was paid by the Korean people. The Korean case suggests that regulatory and supervisory institutions are absolutely needed to avoid or minimize the risks involved with financial liberalization, both at the national and international levels. The solution may involve regulation of international credit creation and of short-term capital movements. Moreover, if it is wanted that not only the powerful few but the majority of the world's population benefit from globalization, the rules of the international economic order should aim at international economic stability rather than at maximum free movement of goods and capital.

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