
The South Korean Economy until 1997

In the aftermath of the Second World War, the United States encouraged the development of a market economy in the South, though the state played a prominent role in what developed, perhaps reflecting the dirigiste character of Japanese colonial administration, Korea's lack of historical experience with capitalism, and President Syngman Rhee's use of state-generated rents to solidify his power base politically.¹ Indeed, an important theme that has run throughout South Korean economic history has been the critical role of the state, its role in the generation of rents, and the politicization of the distribution of these rents. This political-economic tendency will be relevant when possible South Korean responses to developments in the North are analyzed later in this book.²

Economic policy during the Rhee presidency lacked any overarching rationale or coherence. Following the Korean War (and a similar reform in the North), a major land reform was carried out in the South in 1954. This led to productivity gains in the agricultural sector, but these were undermined by the government's policy of "three lows"—low grain prices, a low (i.e., overvalued) exchange rate, and low interest rates (Cho 1994). The results were misallocation of capital and recurrent balance of payments crises. The trade regime was characterized by considerable barriers, including an import licensing system and multiple exchange rates for different activities. These policies, together with an export-import-link

1. See Jones and SaKong (1980) and Woo (1991) for examples.

2. SaKong (1993) and Cho (1994) both provide excellent overviews of postwar South Korean economic development.

system, encouraged rent-seeking behavior and the development of giant conglomerates, or *chaebol*.³ The maintenance of negative interest rates inhibited the development of the banking sector (which was permitted little freedom from government control) and encouraged the channeling of capital to large politically influential borrowers. As the prominent South Korean economist Cho Soon observed: “The most notable feature of the [South] Korean economy during the 1950s was its dependence on US economic aid” (Cho 1994, 13).

This assistance was not entirely without merit, however. It helped reconstruct the physical infrastructure, which had been devastated during the war. South Koreans were able to expand their skill base through cooperation with the United States. American aid directly contributed to the rapid expansion of education within South Korea and made overseas training and education possible for thousands of Koreans (Westphal et al. 1981), including some of its future economic policymakers. Some transfer of technical skills and management techniques undoubtedly occurred through close contact with US military forces, but its significance is difficult to assess. Likewise, local firms certainly benefited from participation in local military procurement programs and later from offshore procurement programs during the Vietnam War (Rhee 1994). In the 1950s, the human capital embodied in the South Korean labor force was quite high relative to its low level of per capita income.⁴

Economic Policy in the 1960s

The Rhee government collapsed in April 1960 and was replaced by a government under Chang Myon, who in turn was overthrown in a coup by General Park Chung-hee in 1961. Park had a clear view of modernization through extensive contact with Japanese and American educational and military institutions.⁵ However, his seizure of power lacked popular legitimacy, so he turned to economic development as a means of mobilizing

3. Leff (1978) defines these as “a multi-company firm that transacts in different markets but which does so under common entrepreneurial or financial control.” The family-dominated nature of these firms and their non-transparent financial practices distinguished the *chaebol* from contemporaneous Western conglomerates. Rather, they appear to be more like the prewar Japanese *zaibatsu*, with which they share a Chinese ideograph and with which South Korean leaders were well acquainted. One major difference, however, is that the *zaibatsu* were typically built around a bank, while the South Korean *chaebol* are dependent on state-dominated financial intermediaries.

4. Jones and SaKong (1980) observed that, while in 1961 South Korea was ranked sixtieth among seventy-four developing countries in terms of per capita income, it was ranked fourteenth according to a measure of socioeconomic development.

5. For a highly readable account of economic policy during the Park years, see Clifford (1997).

popular support and used the threat posed by the North as a justification for the ruthless pursuit of his goals.

After two years of poor economic performance, the government began a fundamental reversal of policy in 1963. The basic philosophy underlying the revised First Five Year Plan reflected a strong commitment to industrialization and an important role for the state in this process.⁶ Exports were seized upon as a barometer of success. As one observer put it, "they were the only statistics that couldn't be faked." The government would set the basic economic development goals and would selectively intervene to ensure their attainment. Although most economic activity would still be carried out by private firms, the state would complement or replace them as needed. Export targets were formulated in considerable detail by product, market, and exporting firm.

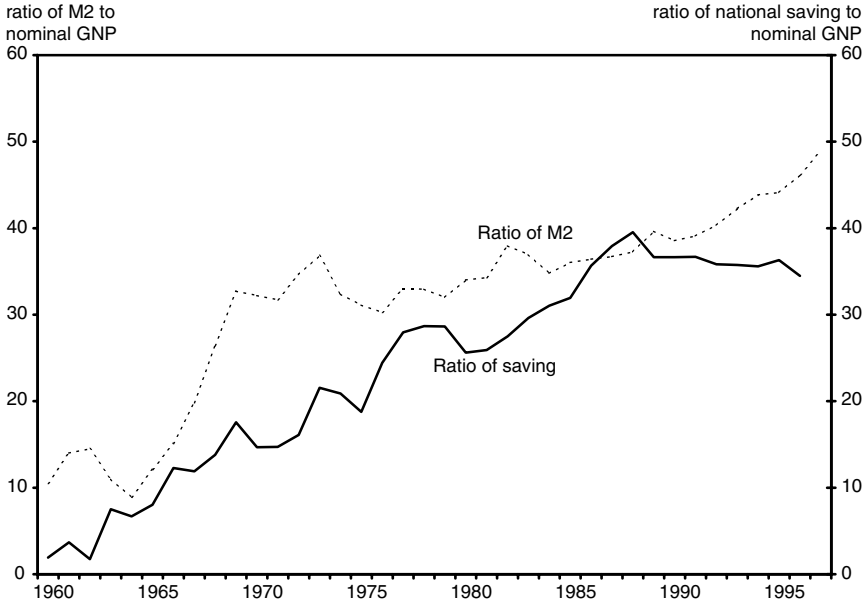
The most important reforms were the unification of the exchange rate and the devaluation of the currency in 1964. At the same time, the government began to introduce a wide range of export promotion measures. A government-subsidized organization, the Korea Trade Promotion Corporation (KOTRA), was established to promote exports and to perform market research. Exporters were provided exemptions from duties on imported intermediates, tax incentives, preferential access to capital, special depreciation allowances on imported capital equipment, and a variety of non-pecuniary awards.⁷ These policies and institutions paralleled those that had been implemented in Japan.

While the trade regime was being recast toward emphasis on exports, reforms were also implemented in other areas of economic policy. In 1963 the military government revised the labor laws to discourage the establishment of independent labor unions. Instead, it encouraged the organization of unions within a centralized system that was established

6. As with the prior Rhee and Chang regimes, state intervention was also used to generate funds to consolidate political power. As Clifford (1997) describes it, the economy that Park and his followers built was in essence a continuing criminal enterprise. Criminal gangs often force initiates to engage in some ritualistic criminal activity (such as a violent attack on a random passerby). The purpose is to create a shared bond of criminality, reciprocal obligation, and organizational cohesiveness built around each member's shared vulnerability to exposure to the authorities. South Koreans operated in an environment characterized by a plethora of infrequently enforced laws which, if actually followed, would make economic (and indeed normal) social life virtually impossible. The result was to induce virtually everyone to run afoul of at least some stricture, becoming, in principle at least, a criminal. This creates an enormously powerful mechanism for social control and produces correspondingly large incentives to conform to the wishes of the powerful. The result is the rule of men, not of law. It also lends itself to abuse of the legal system as an instrument for political retribution. Kirk (1999) contains a detailed account of politicized prosecutions during the 1990s.

7. These provisions were calculated on the basis of gross, rather than net, export volumes, and thus encouraged the importation of semi-finished products for assembly and reexport.

Figure 2.1 Financial development



Sources: Bank of Korea; World Bank, *World Development Indicators*.

so as to facilitate government control. This system was tightened further in 1971 by legislation banning strikes, making virtually any form of collective bargaining or action illegal (Haggard 1990, Cho 1994).

The financial system still bore a strong imprint from the colonial period.⁸ Financial reform began in 1965 when interest rates were raised, encouraging saving and financial deepening as well as more efficient use of capital. The national saving rate doubled in five years, and the ratio of M2 (a broad definition of the money supply) to GNP nearly tripled over the same period (figure 2.1).

This policy regime remained largely in place through the late 1960s and the Second Five Year Plan. There was an expansion of export promotion measures, including generous wastage allowances on duty-free imports and reduced prices for electricity and rail transport.⁹ The export-import-link system allowed exporters to earn rents through the importation of restricted items. Overall, the trade regime could be characterized as modestly biased toward exports, with established industries receiving roughly

8. See Cargill (1999) for a comparison of the Japanese and South Korean financial systems.

9. The excess wastage allowances on duty-free imports for export production allowed export oriented firms to divert these duty-free inputs into the production of goods for local sale, to their competitive advantage in the domestic market.

neutral incentives, while a few infant industries were actively promoted (Westphal and Kim 1982).

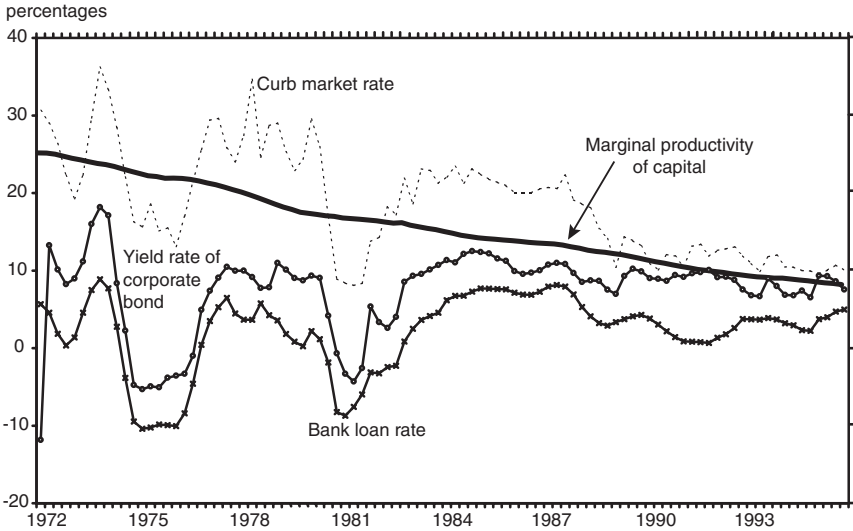
Economic Policy in the 1970s

In 1972, President Park, who had been reelected for a third term, pushed through the repressive *Yushin* (Revitalization) constitution, which essentially made him president for life. This was followed in 1974 by the death of Park's wife, Yook Young-soo, who was killed in a botched assassination attempt on the President's life by a *Chochongryun* member. Park subsequently became increasingly withdrawn and, in the atmosphere of sycophancy that surrounded him, out of touch with South Korean reality. However, concerned with the threat from the North and unconvinced of the strength of the US military commitment to the preservation of the South, he launched a heavy and chemical industry (HCI) drive in an attempt to steer the composition of industrial output toward more engineering-intensive products. The aim was to upgrade South Korea's export profile and reduce reliance on imported arms. Opportunities for inefficiency, incompetence, cronyism, and corruption, which had always been present in the state-led model, now dramatically increased in scale. The government began attempting to orchestrate enormous capital-intensive projects, playing the *chaebol* off against each other while contending with the effects of the first Organization of Petroleum Exporting Countries (OPEC) oil shock. The result, not surprisingly, was a decline in macroeconomic performance.

The financial liberalization policy was reversed in 1972, when interest rates were lowered and direct government control of the banking system was increased in order to channel capital to preferred sectors, projects, or firms. The government had earlier implemented industrial promotion policies for selected industries, but in the 1970s these efforts were intensified. In order to finance large-scale projects, special public financial institutions were established, and private commercial banks were instructed to make loans to strategic projects on a preferential basis. By the late 1970s, the share of these "policy loans" had risen to 60 percent (Yoo 1994).¹⁰ These loans carried, on average, negative real interest rates, and the annual interest subsidy grew from about 3 percent of GNP in 1962-71 to approximately 10 percent of GNP on average between 1972 and 1979 (Pyo 1989). The detrimental impact of credit rationing was moderated by short-term foreign capital inflows and the existence of a large curb market, which provided non-preferred customers with capital, albeit at high interest rates

10. The definition of "policy loans" is imprecise, and various sources report significantly different figures. See Cho (1994) for a discussion of this issue.

Figure 2.2 Real interest rates



Source: Cho and Koh (1996).

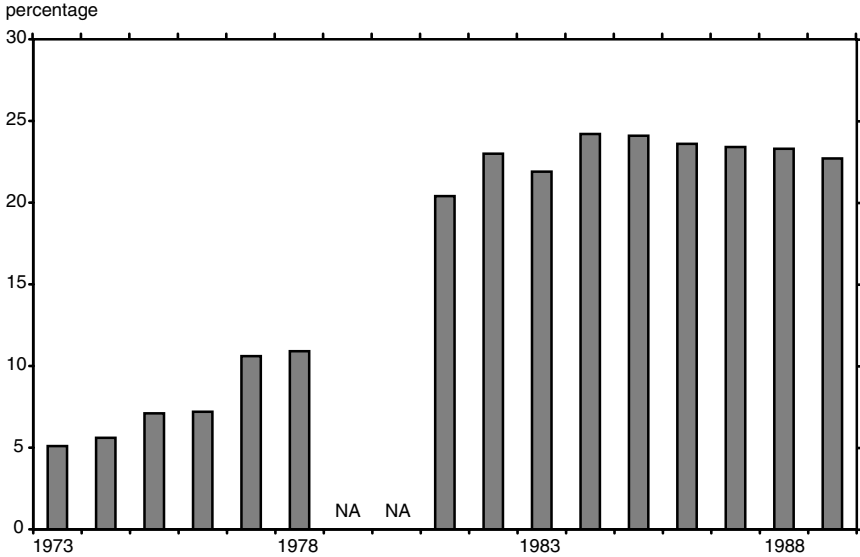
(figure 2.2). Capital channeling policies were augmented by extensive tax incentives for the priority industries. It is estimated that the effect of the special tax measures was to reduce the marginal corporate tax rate from 50 percent to 20 percent for the targeted industries. These industries also received trade protection. As might be expected, allocative efficiency declined, and the marginal product of capital was lower in the favored sectors throughout the 1970s (Yoo 1994).

Although some of the more excessive incentive schemes were scaled down, export promotion remained a primary policy goal. Indicative export targets were reemphasized. Firms not achieving them were not subject to penalty, but the targets were sometimes negotiated jointly with wastage allowances. There is also some evidence that firms achieving their targeted goals could expect more favorable tax treatment (Westphal and Kim 1982).¹¹

As a consequence of these credit, tax, and trade policies, Yoo estimates that during the late 1970s around 80 percent of fixed investment in the

11. The government also encouraged the establishment of general trading firms along Japanese lines, granting them special administrative and financial benefits and special allowances for foreign exchange. The notion was that these firms could capture scale economies in international information gathering and marketing and promote exports. In fact, the trading company share of exports did rise, exceeding 50 percent in the 1980s. Interestingly, these firms were almost exclusively *export* oriented. Unlike their Japanese counterparts, they did not intermediate large volumes of imports (Cho 1994).

Figure 2.3 Share of GDP due to top 10 *chaebol*



Source: SaKong 1993, table A.21.

manufacturing sector went to the favored heavy and chemical industries (Yoo 1994). During the first three years of the Fourth Five Year Plan (1977-81), investment in basic metals and chemicals was 130 percent and 121 percent, respectively, of the targets for the entire period, while textiles and other light industries received only 50 percent and 42 percent, respectively, of their planned investment (Balassa 1990).

These policies gave rise to serious moral hazard problems, as large *chaebol* could undertake ever larger investments, confident that the government would not permit large projects in priority sectors to fail. Statistics on the *chaebol* do not exist for the 1960s (because of lack of balance sheet data), but SaKong (1993) documents that the share of the top ten *chaebol* in South Korean GDP rose from 5 percent to 23 percent in the decade between 1973 and 1982 (figure 2.3). The system encouraged the *chaebol* to diversify by offsetting possible losses in some ventures with secure profits in others. As might be expected, allocative efficiency declined, and the marginal product of capital was lower in the favored sectors throughout the 1970s (Yoo 1994). Park and Kwon (1995) show that during the HCI drive the establishment of oligopolistic positions by the *chaebol* retarded technological change. Once scale economies were taken into account, total factor productivity (TFP), correctly measured, actually turned negative.

It is difficult to assess the welfare implications of the industrial promotion policies of the late 1970s, given the lack of counterfactual evidence

on what would have occurred in their absence. Nonetheless, the fall of allocative efficiency and the relatively weak export performance of South Korea relative to similarly endowed economies have led even ardent proponents of the interventionist strategy (e.g., Pack and Westphal 1986) to conclude that the HCI policy was a failure. A more general evaluation of the selective intervention strategy concluded that in most cases the targeted sectors did not meet the criteria for successful intervention (Noland 1993a). There were also undesirable macroeconomic effects: The expansionary credit policy aggravated inflation, while low real interest rates encouraged disintermediation and stagnation of the financial sector. By 1978 the economy was overheating. In the following years, the economy was further rocked by the second oil shock. Export growth, which had begun to slow in 1978, actually turned negative in 1979. Social unrest began to increase, and in the fall of 1979 rioting occurred in Pusan and Masan—cities where rioting had preceded the fall of the Rhee government in April 1960—prompting the economic technocrats to formulate a stabilization plan.

Economic Policy under President Chun

The Park era came to a close on 26 October 1979 with his never fully explained assassination by Kim Jae-kyu, the head of the Korean Central Intelligence Agency, during what amounted to a palace coup. Over the course of the next year, a group of more junior military figures supplanted the generals of Park's generation, with General Chun Doo-hwan emerging as the authoritarian ruler. Given the condition of the economy at the end of the 1970s, economic technocrats were already attempting to introduce a stabilization policy and reverse the worst excesses of the HCI drive.¹² As the military men sorted themselves out, in January 1980 the economists initiated a textbook austerity plan.

Chun faced the same dilemma that Park had faced earlier: his rise to power lacked popular legitimacy (indeed, it had been accompanied by large scale violence, most notably in the city of Kwangju), and he needed prosperity to buy legitimacy. Park Chung-hee was brutal, but this was balanced by pragmatism and a strong sense of direction. The same could not be said about his successors. Chun Doo-hwan and his cronies more or less stumbled into power, driven more by intra-military rivalries and narrow career interests than by any real sense of where they wanted to take the country.¹³ Facing deteriorating economic performance, which was

12. Yoo (1994) goes so far as to argue that the reversal of the heavy and chemical industries policy was the greatest policy achievement of the period.

13. See Clifford (1997), Gleysteen (1999), and Wickham (1999) for accounts of Chun's rise to power.

exacerbated by the second oil shock, Chun and his fellow officers turned to the technocrats to fix the economy and shore up their political legitimacy.¹⁴ This group, led by Kim Jae-ik, director general of the Economic Planning Board's (EPB) planning bureau and later Presidential Secretary for Economic Affairs, implemented a policy of macroeconomic stabilization through which they began to liberalize and deregulate the South Korean economy. This policy shift was ratified in the Fifth Five Year Plan (1982-86), marking a movement away from interventionist strategy. The increases in trade protection that had accompanied the industrial promotion policies of the late 1970s were reversed. The government also undertook liberalization of the financial sector. Commercial banks were denationalized, but the state retained the right to appoint boards of directors and senior officers. There was, however, an easing of direct government control of banks and non-bank financial institutions. The share of "policy loans" in domestic credit was reduced from approximately 45 percent in the period 1974-82 to 35 percent in 1983-88. Commercial banks were required to extend at least 35 percent of their loans to small and medium-sized firms to compensate for the effects of the earlier policy. Interest rates were deregulated, resulting in renewed financial deepening as depicted in figure 2.1.

The nascent reform movement was dealt a tragic blow on 9 October 1983 when Kim Jae-ik and sixteen other South Koreans, including Deputy Prime Minister and EPB head So Sok-jun, Minister of Energy Suh Sang-chul, and Minister of Commerce and Industry Kim Dong-whie, were killed in Rangoon, Burma by North Korean commandos in a bombing aimed at Chun, who escaped unhurt. The predictable reaction in Seoul to the bombing and the Soviet downing of flight KAL007 in September 1983 was to hunker down. Though liberals within the government continued to press for change, the reform movement lost momentum. Without any overarching vision, corruption, present throughout the Park era, exploded.¹⁵ Reformers continued to make progress in the trade and financial arenas, and in 1985 they attempted to rein in industrial policy interventions with the introduction of the Industrial Development Law (which replaced directed credits with research and development support as the

14. Chun literally scheduled early morning tutoring sessions. Perhaps there is something peculiarly Korean about this. It is hard to imagine the typical military dictator staying up late to study for his early morning economics lesson. See Clifford (1997) for details.

15. In the aftermath of the Rangoon bombing, the Chun government set up a foundation ostensibly to provide for the victims' families. As with previous governments, the private sector was used as a source of funding for political patronage. The Federation of Korean Industries estimated that quasi-taxes averaged between one half and one percent of sales during the administrations of Chun Doo-hwan and his successor Roh Tae-woo (Clifford 1997). Both were convicted on corruption charges during the presidency of Kim Young-sam, who later pardoned them—a decision that *his* successor, Kim Dae-jung, supported.

prime instrument of industrial policy) and the simultaneous repeal of selective intervention laws. Nevertheless, the government continued to intervene in the economy, restricting Samsung's entry into the automobile market, while rescuing *chaebol* heavily involved in shipbuilding, machinery, and other sectors of excessive investment (Leipziger and Petri 1993). Moreover, by 1986 the negative external shocks of the early 1980s had been reversed, and the South Korean economy received a boost in the form of the "three blessings"—the fall in the oil price, the fall in world interest rates, and the appreciation of the Japanese yen. As the economy again boomed, the enthusiasm for reform, never great, slackened.

The Democracy Pledge and Twenty-five Years of Development

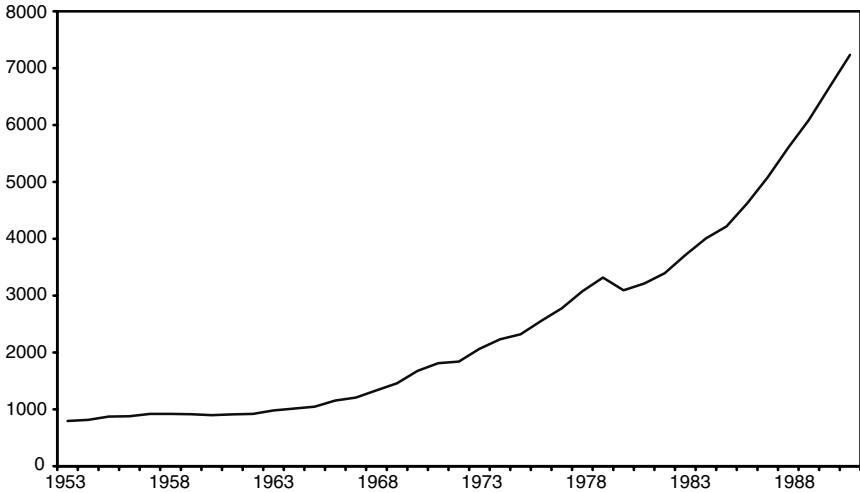
Rising expectations politically and economically circumscribed Chun's room to maneuver. Ironically, the groundbreaking for authoritarian rule's grave had occurred in October 1979, when, during the closing days of the Park regime, Seoul Mayor and Park appointee Chung Sang-chon announced that the city would enter the competition to host the 1988 Summer Olympics. With national prestige on the line and his own legitimacy in question, Chun could hardly back away from Park's commitment. The organizing committee, led by Hyundai founder Chung Ju Yung, proceeded to apply itself to the task of winning the bid with a single-mindedness that would be a model for years to come. When the International Olympic Committee (IOC) voted in September 1981, Seoul won.

The securing of the 1988 Olympic bid had two implications. First, as surely was foreseen in 1979, it necessitated a further upgrading of Seoul's infrastructure, essentially raising it to developed country level. The second impact was perhaps more profound, and surely unforeseen: Hosting the Olympics made it effectively impossible for Chun to use his usual repressive tactics to handle social discontent. In 1987, with the Seoul Games only a little more than year away, rioting interrupted a number of sporting events. There was talk in the IOC of moving the games elsewhere.

Chun was already in trouble domestically. The world spotlight severely limited his options. His response was to call an election and introduce constitutional changes which essentially tilted the rules in favor of his long-time confidant and hand-picked successor, General Roh Tae-woo. The election of Roh would presumably reduce the building social pressures while allowing the highly unpopular Chun to live out his post-leadership life in relative peace. However, rather than acting as a safety valve, Roh's 29 June 1987 democratization pledge signaled a shift toward more permissive government and revealed a reticence on the part of the authorities to crack down due to international scrutiny associated with the upcoming Olympic Games. This gave rise to an unprecedented upsurge in

Figure 2.4 Purchasing power adjusted real GDP per capita

US dollars (constant 1985
international prices)



Source: Summers and Heston 1991.

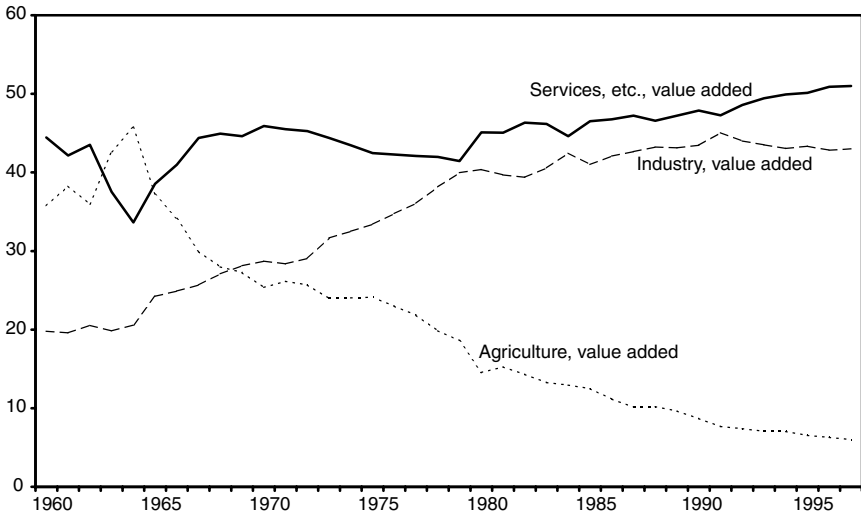
social mobilization. In December 1987, Roh prevailed in a three-way contest against two longtime opposition civilian politicians, the more conservative Kim Young-sam and the more liberal Kim Dae-jung, and assumed the presidency in time to host the Olympic Games. From the Roh administration forward, economic policymaking in South Korea would be subject to far greater popular demands and scrutiny.

In this respect, the 29 June 1987 democratization pledge represented a watershed in South Korean economic history. What is undeniable is that, in the quarter century following the 1963 reforms, the South Korean economy had undergone a tremendous transformation. Real per capita income growth averaged 7 percent a year, and the level of per capita income more than quintupled (figure 2.4). The share of agriculture in the economy fell from more than 45 percent in 1964 to just over 10 percent in 1988, offset by the rise in manufacturing (which doubled its share of output over this period) and, to a lesser degree, services (figure 2.5). The share of exports in GDP increased from less than 5 percent in 1963 to more than 35 percent in 1988 (figure 2.6). Imports rose by a similar amount. The figures document a dramatic opening of the South Korean economy.

The question naturally arises as to what explains this performance. As noted earlier, South Korea in 1963 surely had a far higher level of human capital than suggested by the level of per capita income, and human capital accumulation, at least in part, had been financed by relatively

Figure 2.5 Structure of output

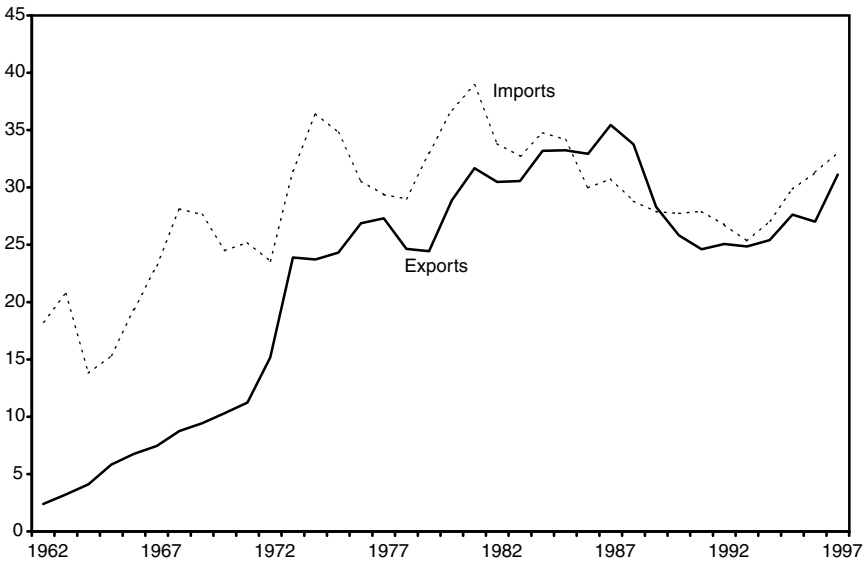
percentage of GDP



Source: World Bank, *World Development Indicators*.

Figure 2.6 Exports and imports as a share of nominal GNP

percentage



Source: Bank of Korea.

generous American aid.¹⁶ In Park Chung-hee, South Korea had a leader with clear ideas of what he wanted to accomplish in terms of economic development and military preparedness. The institutional structures that Park created facilitated achievement of goals established by the government without a lot of expenditure on direct inducements or enforcement. The country was also blessed with a thin layer of highly competent technocrats, many of whom had been educated in Japan or the United States. (The importance of sheer competence at the top cannot be overemphasized. South Korea was lucky to have a small but enormously important cadre of decision makers who had some understanding of how a modern society was supposed to work—policymakers who through exposure to educational opportunities abroad had some notion of where they were heading and how to get there—an advantage that many other contemporaneously developing countries simply did not have.) Although there were considerable disagreements over policy (often between the US-educated economists on one side and Park and his fellow officers on the other), one gets the impression that these were disagreements over strategies to attain shared development goals—not fundamental differences about modernization.

The emphasis on exports was key because it offset two inherent dangers in the South Korean economy: the inability to exploit scale economies or technological development in a small, poor, domestic market and the inherent tendency for firms to build up anticompetitive positions in a small market. By emphasizing the world market over the domestic market, South Korean policy facilitated the exploitation of scale economies and the production of goods that might not have even had a domestic market (color televisions in the 1970s, for example). The world market also provided an incontrovertible yardstick by which success could be measured. Although firms might be able to exploit market power or political connections domestically, they would have a much greater difficulty doing this on the world stage.

The country then needed institutional mechanisms for transforming the latent productive potential of the economy into goods that the rest of the world wanted to buy.¹⁷ Foreign direct investment (FDI) does not appear to have been very important in this regard. Until the late 1970s, South Korean policy effectively discouraged foreign direct investment by imposing minority ownership requirements, requiring technology transfers (in the absence of any intellectual property rights enforcement), and

16. Tuition-free primary education was made compulsory in 1949, and within a decade 96 percent of South Korean children were enrolled (Y. Lim 1999). During this period, the government devoted around three-quarters of its education budget to primary education. This had a low foreign exchange content. Aid was useful in financing higher education and study abroad, as well as acting as overall balance of payments support.

17. See SaKong (1993) for an overview of these issues.

imposing strict export performance requirements (SaKong 1993). Not surprisingly, most foreign investment in South Korea took the form of commercial loans, not direct investment. Even if it were assumed that all FDI went into the manufacturing sector, it would have accounted for less than 5 percent of the manufacturing capital stock in 1970 (Westphal and Kim 1982). Indeed, FDI flows into South Korea were small relative to those experienced by other developing countries such as Brazil, Mexico, and Taiwan, and there does not appear to be any strong correlation between sectors that attracted FDI and those that enjoyed subsequent export success.¹⁸ Looking at detailed microeconomic data, Baily and Zitzewitz (1998) argue that the restrictions on FDI retarded technological development in South Korea, though they admit that the South Koreans achieved technological mastery in sectors in which comparators such as Brazil did not.

Similarly, the evidence on the importance of technological licensing in spurring exports is mixed (Westphal et al. 1981). Subcontracting unrelated to foreign direct investment and contact with foreign trading companies may have been of greater importance.¹⁹ Rhee et al. (1984) reports surveys done in the 1970s indicating that capital goods suppliers and buyers of output were leading sources of technology transfer. With respect to the former, Westphal, Kim, and Dahlman (1985) report that South Koreans developed a considerable amount of technical competence through contact with capital goods suppliers, including the training of engineers abroad. Likewise, Westphal et al. (1981) gives several examples of foreign buyers assisting South Korean exporters with product design and process technology.

It is apparent that, through whatever channels, the South Koreans attained a certain level of technological and managerial competence that provided the basis for the exploitation of international trade opportunities. Government policy attempted to develop this base through a variety of supportive measures. Starting in the mid-1960s, potential exporters were granted access to inputs at world market prices and to trade finance through the previously described mechanisms, which were administered in a relatively non-discretionary and automatic way. Free trade zones, introduced in the 1970s, appear to have been of little importance, generating a *de minimis* share of exports. Bonded warehouses were of somewhat greater importance, accounting for roughly 10 percent of trade (Rhee 1994). The exchange rate was kept competitive, if not artificially underval-

18. Kim and Hwang (1998), who looked at more recent experiences in the semiconductor and pharmaceutical industries, ascribe a considerable role to FDI in technology transfer.

19. Although South Korean trading firms eventually came to intermediate more than half of South Korean exports, these were not established until 1975. Thus it is hard to argue that they facilitated exports in the early part of the export boom.

ued. South Korea also benefited from the rapid growth of world markets during the postwar period.

The resultant changes in the composition of trade were astounding. In 1963, non-fuel primary products accounted for fully half of South Korea's total exports, and the third largest export item was human hair wigs. Twenty-five years later primary product exports had fallen to 5 percent. Engineering products, which had made up only 5 percent of South Korea's exports in 1963, were more than 40 percent a quarter century later. Products such as motor vehicles, which were not even manufactured in 1963, were major export earners a generation later (Noland 1991a).

Once the economy was able to access world demand, it took off. Kim and Roemer (1979) estimate that total factor productivity increased 4 percent annually between 1960 and 1973, with 1.6 percentage points of this explained by human capital accumulation and the remaining 2.4 percentage points a pure productivity increase. Looking at a slightly longer and more recent sample period, Kwon (1986) similarly concludes that total factor productivity averaged 3 percent a year in the two decades from 1961 to 1980. Of this, 45 percent could be attributed to technological change, 38 percent to scale economies, and 17 percent to increased capital utilization. Baily and Zitzewitz (1998) estimate that TFP growth (unadjusted for changes in human capital or labor force quality) exceeded 3 percent annually in the 1980s. Across industries, this pattern of technological advance was correlated with success in global markets (Dollar and Sokoloff 1990). Indeed, Nam (1999) argues that access to world markets and avoidance of the domestic demand constraint causally explains TFP growth.

However, Kwack (1999), while obtaining the standard result of 3 percent TFP growth through the 1970s and 1980s, calculated that TFP growth began to slow around 1990, falling below one percent a year.²⁰ Moreover, he argues that this adversely affected export competitiveness and profit margins, ultimately contributing to problems in the financial sector. We return to this issue in chapter 6.

Precrisis Economic Policy, 1987 to 1997

The Roh government and the successor government of Kim Young-sam continued a gradual process of liberalization both internally and externally. Internally, the focus was on product, labor, and financial markets, the latter also having an important external dimension. Trade and financial policies were the keys to South Korea's interaction with the rest of the world.

20. See this source for citations of additional estimates of Korean TFP growth.

Product Market Policy

The distinguishing feature of South Korean product markets has been the prominence of the *chaebol*. In positive terms, such organizations might be considered an institutional response to conditions of scarce managerial or human capital and limited financial markets. This organizational form could also have been derived from rent-seeking behavior generated through state intervention in the economy, and a number of the *chaebol* had originated from business-government relations during the Rhee regime of the 1950s.²¹

The *chaebol* really took off under Park, however, especially during the HCI drive of the 1970s (figure 2.3). Park's growth-oriented policy, pervasive regulations creating entry barriers (and thus protecting incumbents from competition), and penchant for sole-sourcing important infrastructural and other large-scale government supported projects in effect socialized risk and created opportunities for cross subsidization across different business ventures. This facilitated the *chaebol* tendency to enter otherwise unrelated lines of business.²² Under Park, the number of subsidiaries of the top thirty *chaebol* grew from 126 in 1970 to 429 in 1979, indicating that diversification had been driven by growth. Just prior to the crisis, in July 1997, the largest five *chaebol* had on average 52 subsidiaries spread across 30 industries, a truly extraordinary degree of diversification (Yoo 1999, table 5).²³

The government-business symbiosis had implications for finance, economic efficiency, and social equity. On the financial side, the development strategy of administrative guidance required state domination of the financial sector. The strategy required an emphasis on indirect finance, limitations on foreign participation in financial markets, and domestic firm access to foreign finance. If the government was going to channel capital, it had to limit capital markets to institutions that could be dominated if not controlled, and it had to limit the firms' financing options to those institutions. Presumptively less compliant foreign banks could not be allowed into the market in any significant way, for, if they were allowed to establish a significant presence, they would undermine the domestic banks operating under the burdens of "policy lending." Thus the financial

21. See Jones and SaKong (1980).

22. A study done by the Korea Fair Trade Commission (KFTC) in the late 1980s found that in nearly all 89 industries surveyed, incumbents were protected by some kind of governmentally created barrier to entry (Graham 1996). Cho (1994) argues that the establishment of government supported firms in upstream industries inevitably led to the creation of vertically integrated firms. He contrasts the South Korean experience with Taiwan's, where upstream industries were encouraged through publicly owned, not privately owned, firms.

23. The figures are not much different if the broader sample of the top 30 *chaebol* are considered; they averaged 27 subsidiaries spread across 20 sectors.

system had to be built around a relatively small number of South Korean financial intermediaries, and corporate finance had to be largely limited to borrowing from those intermediaries.

There were multiple implications of these policies. First, the firms emphasized growth, not profitability, since risk was socialized and increased borrowing made further borrowing advantageous under the “too big to fail” notion promoted by the government’s routine interventions. From the standpoint of a lender, the bigger the firm the more credit-worthy the firm, since size increased the likelihood that the government would intervene in the event that the firm got into financial trouble (which the government did on a fairly routine basis, especially in the late 1960s and early 1970s).²⁴ The implication was that firms became extraordinarily leveraged as growth became the name of the game. Loans were the mechanism for growth, and, paradoxically, debt signaled credit-worthiness, a state of affairs that S.M. Yoo (1999) described as “survival of the fattest.”²⁵ E.H. Kim (1990), in a study of corporate finance covering the decade 1977-86, found that “the largest firms have the weakest financial structure” as measured by the degree of equity in their capital structures (342). A corollary to this system of corporate financing was the encouragement of extensive cross-shareholding, cross-loan guarantees, and non-transparency, all of which served to facilitate borrowing. In July 1997, just prior to the crisis, the average debt-equity ratio of the thirty largest *chaebol* exceeded 400 percent (Yoo 1999, table 9).²⁶ The pattern of cross-finance is particularly pernicious as it sets up a set of private incentives for inside shareholders that are socially suboptimal and indeed disadvantageous to outside shareholders (S.M. Yoo 1999).

Given the self-reinforcing nature of the system, it is unsurprising that, over time, the favored conglomerates accounted for a growing share of national output and borrowing. As SaKong (1993) documents, the *chaebol* accounted for a steadily rising share of national output from the early 1970s to the mid 1980s. Moreover, the increase in share was positively associated with *chaebol* size. The share of national output accounted for by the top five *chaebol* grew more rapidly than the top ten’s share did, which in turn grew more rapidly than the top 30’s share. On average, the ten largest *chaebol* grew 28 percent a year during the 1970s. Hyundai, generally the largest in the late 1970s and 1980s, grew at 38 percent

24. See E.H. Kim (1990), Cho (1994), and E.M Kim (1997).

25. As E.H. Kim (1990) documents, this was reinforced by the tax code. Corporate interest payments are tax deductible, while dividends to shareholders are not. This reduces the after tax cost of debt relative to equity for the corporation. Likewise, the personal income tax code encourages the holding of debt instruments, since interest earnings are taxed more lightly than dividend earnings.

26. By the end of 1997, it stood at 500 percent, and 600 percent if the debt of subsidiaries were included on a consolidated basis (Claessens, Ghosh, and Scott 1999).

annually, while Daewoo, the youngest of the top five *chaebol* (founded in 1967), grew an astonishing 54 percent annually during this period (E.M. Kim 1997).²⁷ At the time of Daewoo's collapse in 1999, it alone reportedly accounted for 5 percent of South Korean GDP.

Economic policymakers were not unconcerned by this pattern of developments, and they responded by attempting to limit *chaebol* access to bank lending, to restrain their anticompetitive tendencies, and to encourage the growth of small and medium-size enterprises (SMEs). None of these attempts can be regarded as particularly successful.

In 1974, the government issued an emergency decree to attempt to limit *chaebol* access to bank finance and to encourage direct finance through capital markets. Later that year, the government adopted the Prime Bank System, reminiscent of the Japanese main bank system, in which the largest lender was given the responsibility of monitoring business performance and borrowing from all sources. In theory, the *chaebol* were supposed to get prime bank permission when they purchased real estate or entered new lines of business and were to sell off unused land holdings or issue new shares to obtain permission. In reality, these rules did little to constrain *chaebol* behavior.²⁸

In 1984, the government moved to strengthen this regime by temporarily freezing bank credits to the top five *chaebol* and setting credit ceilings for the top thirty. As a result, over the next several years their share of borrowing dropped considerably. This was offset, however, by increased borrowing from non-bank financial intermediaries, with the share of non-bank borrowing by the top 30 *chaebol* reaching 45 percent by 1991 (SaKong 1993). In 1986, as part of its overhaul of competition policies, the government introduced new rules to limit cross-investment and cross-shareholding. The rules would also prevent the *chaebol* from creating new businesses and from inflating their capital base without actually increasing their equity base. The government further restricted the *chaebol* by introducing ceilings on the amount of equity investments that the top 30 could make in other firms and the amount of mutual debt guarantees that could be undertaken.

Despite these attempts to rein in the financial practices of the largest *chaebol*, these firms continued to expand to the point where their financial practices posed a systemic risk to the domestic financial system. Indeed, the *chaebol* share of bank lending actually increased in the aftermath of the financial crisis, as risk-averse bankers, faced with considerable

27. It should be noted that success is not guaranteed. There have been considerable changes in the size rankings of *chaebol* over time. See E.M. Kim (1997), table 4.1 for some evidence of this. However, prior to the collapse of Hanbo in January 1997, only one major *chaebol*, Kukje, had been allowed to fail (in 1985), and even then the government-led restructuring imposed no real burden on its creditors.

28. See Jwa and Huh (1998) for an analysis of the prime bank system.

uncertainty about South Korea's economic future, increased lending to the *chaebol* under the "too big to fail" theory. The effect can be seen in the travails of Daewoo, which, allowed to go bankrupt, reportedly doubled the amount of non-performing loans in the already weak South Korean banking system (to be discussed in greater detail in chapter 6). Indeed, as Leipziger (1988) presciently put it, "Korea had no satisfactory 'exit policy' and no institutions capable of managing it" (124).²⁹ The real defect in the *chaebol* system has been the lack of capital market discipline in the market for corporate control and ultimately the absence of an exit mechanism in the form of effective bankruptcy procedures.³⁰

The growth of the *chaebol* had efficiency implications as well. Their dominance of a wide variety of products and sectors created anticompetitive possibilities, including mutual forbearance, reciprocal dealings, and other restraints on competition based on intra-group transactions of products, services, and financial resources. Park and Kwon (1995) show that the growth of the *chaebol* reduced competition in product markets, increasing markups and slowing technological change. According to the Korea Fair Trade Commission, 326 firms in 140 markets were designated in 1996 as "market-dominating" based on a criterion of market size and market share.³¹ Moreover, considerable regulatory authority is granted formally or informally in South Korea, and investigation of the industry associations by the Korean government found a majority engaged in anticompetitive practices.³²

Over the years, the government has attempted a number of policies to spur competition. Competition policy got its start in 1975 when the

29. The sad and disturbing thing about Leipziger's (1988) analysis of industrial restructuring is that it could have been written a decade later—nothing really changed.

30. As observed by the OECD (1999), the precrisis bankruptcy process was cumbersome and prone to abuse by delinquent firms. As an indicator of this, more than half the reorganization cases completed between 1993 and 1995 had been filed more than five years earlier, and less than a quarter of the firms had successfully emerged from reorganization. As a consequence, lenders often preferred to reschedule debt rather than going through the relatively ineffective legal procedure.

31. "Market dominance" is deemed to exist in markets of more than 50 billion won when the largest firm's share is greater than 50 percent or the top three firms' share is greater than 75 percent, when any firm with less than a 10 percent share is excluded from the calculation. It should be noted that "market-dominating" firms are not limited to the *chaebol*, and, in one recent year the top 30 *chaebol* accounted for less than half of the turnover in these highly concentrated markets (OECD 1996).

32. In 1994 South Korean authorities investigated 68 industry associations and found that 48 of the associations had been engaging in anticompetitive or unfair practices. The following year Korean authorities investigated 218 industry associations and ordered them to revise 369 anticompetitive or unfair measures or practices. In 1996, the Korean government announced that it would begin regulating not only collusion among rival firms, but among trade associations as well (USTR 1999).

government enacted the Price Stabilization and Fair Trade Act. This was introduced not to improve competition *per se*, but rather to limit the inflationary consequences of anticompetitive behavior (Leipziger and Petri 1993). Unfair trading practices were defined in terms of price movements rather than in terms of anticompetitive behaviors. The regime was strengthened in 1980 with the Antitrust Act, which outlawed a number of horizontal restrictions on trade (such as the formation of cartels) as well as vertical restraints on trade (such as retail price maintenance) and established the Korea Fair Trade Commission (KFTC) as an enforcement agency (a task it shares with the Antitrust Division of the Korean Department of Justice). In 1986, competition policy was further strengthened with rules designed to limit economic concentration by restricting inter-company ownership, and, for the first time, anticompetitive mergers by business groups.

Until 1994, however, the KFTC was under the authority of the Economic Planning Board (EPB), and competition policy concerns were subordinated to other economic policy goals. Graham (1996) argues that attempts to impose competition policy restraints on the *chaebol* were routinely undercut by industrial policy proponents who successfully inserted numerous exceptions into competition policy legislation. As one observer put it, “the laws had many loopholes,” and KFTC enforcement proved toothless.³³

The law was amended in 1986 and in 1994, when the Korea Fair Trade Commission (KFTC) became a legally independent regulatory body reporting to the Prime Minister. Its fortunes received another boost with the election of Kim Dae-jung. A revised Fair Trade Act passed the National Assembly in 1999 in the wake of the financial crisis. It is hoped that this will rejuvenate the KFTC, which has been generally regarded as lax in its enforcement of existing law. Since the crisis, the KFTC has stepped up its initiation of cases involving abuse of market power, collusive activities, trade association activities, unfair trade practices, and unfair subcontracting practices (Leipziger 1999, table 4).³⁴

The government has repeatedly tried to get the *chaebol* to specialize in core competencies and to spin off some of their far-flung subsidiaries.³⁵ “Specialization policy” was introduced in 1991, strengthened in 1993 and 1995, and received a further boost with the financial crisis in 1998.³⁶ Yet

33. The June 1996 conviction of three senior KFTC officials for accepting bribes in return for favors did not strengthen the agency’s image.

34. For example, the KFTC launched an extensive probe of 62 companies for unfair dealings with subcontractors in October 1999.

35. See K. Kim (1999).

36. According to the KFTC, through the first 18 months of the crisis the market seemed to be accomplishing what the government could not: The top five *chaebol* launched 451 new

the government's attempts to prune the *chaebol* have largely failed.³⁷ Perversely, the attempt to orchestrate the so-called "big deals" business swaps in response to the crisis would have the effect of further concentrating particular firms' dominance of certain sectors; Hyundai dominance in trucks is a case in point.³⁸ Likewise, beginning in the mid-1970s, the government introduced various measures to promote small and medium-sized enterprises, but these have not been particularly successful.³⁹

The third implication of *chaebol* growth was political in a broad sense. The tight relationship between business and the state contributed to the perception that political connections (if not outright corruption) were the key to business success—not intrinsic competence. This was particularly true since the emphasis on bank finance, combined with the policy loans, interest rate ceilings (which existed until 1988), and administrative guidance (which continued thereafter) created excess demand for loans and credit rationing. Given the state dominance over the banking system, credit was in part allocated on the basis of personal and political connections, as well as outright bribery. This delegitimized the accomplishments of the *chaebol* (especially given the lack of popular legitimacy of their government counterparts). This surely has contributed to the sense of popular alienation and disaffection that has bedeviled South Korean industrial labor relations as discussed in the section on labor market policy that follows.

Labor Market Policy

During its period of rapid industrialization, South Korea experienced a rapid shift out of rural employment into manufacturing and services. Accompanying this was a rise in recorded female labor force participation.

firms through separation, with another 33 launched by *chaebol* ranked below the top five (*Korea Times*, 20 October 1999).

37. Leipziger and Petri (1993) discuss two interesting examples of this phenomenon. In 1989, the government became concerned that the *chaebol* were soaking up an excessive share of bank lending for speculation in the real estate market, exploiting their access to subsidized capital. Ultimately, the government bought their "excess land holdings" at "handsome prices." In 1991, having imposed a ceiling on *chaebol* access to subsidized bank loans, under the pressure of deteriorating economic conditions the government tried to increase the amount of credit available for productive investment by allowing each *chaebol* to exempt three "core sectors" from the ceiling. Not surprisingly, the *chaebol* selected their most capital-intensive sectors, leading to rapid increases in investments in petrochemicals and semiconductor fabrication.

38. USTR (1999) reports that US industries, including semiconductor and telecommunications firms, have raised concerns about precisely this anticompetitive impact of the "big deals."

39. Similarly, Graham (1996) cites another perverse case in which restrictions on *chaebol* entry into new sectors actually gave rise to monopolies.

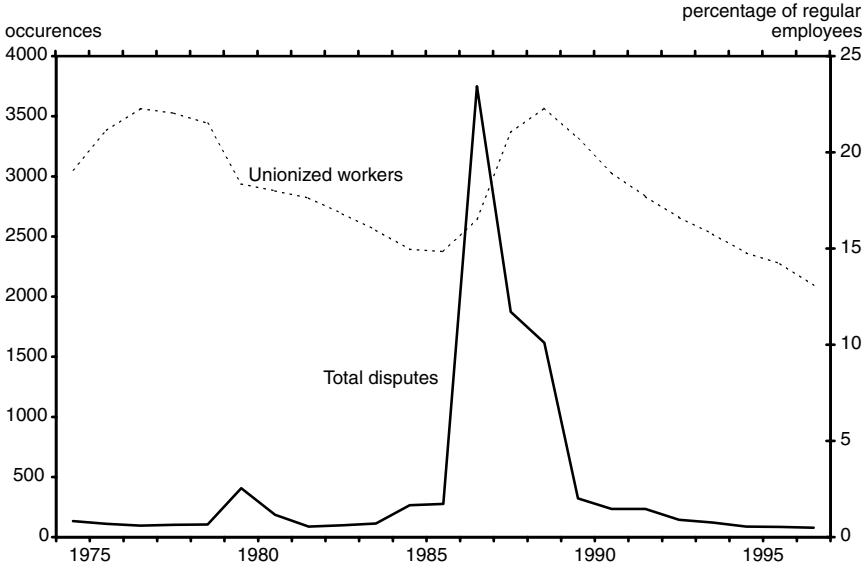
Hours worked were quite long, and few envied South Korea's safety record. Yet South Korea appeared to achieve "growth with equity." Measured wage inequality was low by international standards, as might be expected in the case of an industrializing labor-abundant country rapidly increasing its exposure to international trade, though there is some reason to question the South Korean government statistics on this point (cf. Lindauer 1997).⁴⁰ In certain respects, South Korean labor markets developed a dualistic structure in which the industrial employees of the major *chaebol* occupied a privileged position relative to similarly skilled workers (i.e., they were able to capture some of the rents accruing to the *chaebol*).⁴¹ Characterization of South Korean labor market rigidity has typically been focused on this part of the labor force, though at the macroeconomic level the South Korean labor market has been relatively flexible in terms of wage-setting compared to other OECD countries (Jeong 1997), and nowadays the frequency of turnover is reasonably high relative to OECD countries (D.G. Shin 1999). During the Rhee government, South Korea copied its early (and largely inappropriate and ignored) labor laws from those of developed countries. In the early 1960s, the Park regime enacted a series of changes that circumscribed union activities. As noted earlier, independent trade unions were effectively banned in 1971. The Korean labor movement subsequently developed a dualistic structure, with government-approved unions on the one hand and informal or underground unions on the other. Although the labor laws were revised in the early 1980s, the reforms did not adequately address this situation. "Third parties" were prohibited from intervening in labor disputes (some of the unofficial unions had grown out of religious organizations, and student radical groups were sometimes interested in inserting themselves into enterprise disputes). Industrial unions were reorganized along Japanese lines as company unions to discourage strikes. Union-shop clauses were abolished. The minimum number of workers required to organize a union was increased. Consequently, the official unionization rate fell from 20 percent of the labor force in 1980 to less than 16 percent in 1985 as these provisions took hold and workers became increasingly disaffected with the officially approved unions (figure 2.7). The labor laws underwent further revisions in 1986 and 1987, partially liberalizing unionization in the context of political democratization, but, after an uptick in the late 1980s, membership has continued to decline to the point that a smaller share of the South Korean labor force is unionized than is the case in the United States.

Roh's 29 June 1987 announcement of political liberalization set off an explosion of repressed labor discontent. South Korea experienced more

40. For analyses of broader labor market issues such as safety, gender roles, rural-urban migration, and income distribution not covered in this section, see C.S. Kim (1990), J.G. Yoo (1990), B.S. Lee (1994), Lee and Lindauer (1997), and Kim and Son (1997).

41. See Park (1999) for a nice discussion of labor market dualism.

Figure 2.7 Unionized workers and labor disputes



Sources: South Korean Ministry of Labor; National Statistical Office Database.

strikes in July and August 1987 than in the previous 25 years combined. Nearly 70 percent of manufacturing establishments with ten or more employees experienced some kind of labor dispute in the second half of 1987. The number of labor-management disputes surged from 276 in 1986 to 3,749 in 1987 before falling to 1,873 in 1988, to 1,616 in 1989, and back to the levels of a decade earlier by 1990 (figure 2.7).

Resolution of these disputes was impeded by the coexistence of *de jure* and *de facto* unions, and by the reluctance of public officials to enforce the highly unpopular laws on the books. The government's effective withdrawal from any attempt to guide the labor market outcomes left firms and workers to settle disputes without the benefit of a clear legal or institutional framework. Accordingly, various legal and extralegal means were used to settle disputes, sometimes causing the spread of conflict and distrust.⁴² The problems were exacerbated by the fact that many of the disputes involved oligopolistic *chaebol*. The negotiations could be likened to those between bilateral monopolists, and thus involved the disposition of potentially enormous economic rents. Moreover, labor's fundamental dissatisfaction with existing aspects of industrial relations meant that union demands were far-ranging, calling not only for wage increases, but union autonomy, fair labor practices and legal reforms, and

42. See Cho (1994), Clifford (1997), and Vogel and Lindauer (1997) for examples.

liberalization of a management style characterized by one observer as “authoritarian paternalism” (Park 1990). The high stakes, the broad diversification of the *chaebol* (which obscured the relationship between the economic vitality of an individual enterprise and that of the firm as a whole), and the inexperience of the negotiators on both sides were all factors that contributed to difficulties in resolving these disputes. Passion was fed by an abiding sense of grievance. Some observers linked this to the rapid increase in wealth inequality and relative deprivation of the working class that occurred in the 1980s (Vogel and Lindauer 1997).⁴³

By 1990 this turmoil had burned itself out, and the level of disputes had returned to their historical levels. However, the labor law revisions undertaken by the Roh government in the wake of this unrest left a number of contentious issues unresolved. At the national level, only one organization, the Federation of Korean Trade Unions (FKTU) formed under the Park regime, was recognized, despite the fact that the Korean Confederation of Trade Unions (KCTU), heir to the “unofficial” or “democratic” unions of the 1980s, boasted 1.5 million members and significant influence in some of South Korea’s largest enterprise unions.⁴⁴ “Third parties” (including the KCTU) were still restricted from intervening in labor disputes, and industrial unions were restricted in their ability to take part in the activities of company unions. Teachers and most government employees were prohibited from organizing, and the definition of “essential service” workers who were prohibited from striking was relatively broad. Lastly, unions were prohibited from engaging in political activities. At the same time, employers regarded restrictions on layoffs and dismissals as impediments to economic restructuring and efficiency. (The restrictions on layoffs were justified by the lack of a state-provided social safety net. While this institutional arrangement was acceptable during periods of rapid growth, the privatization of the social safety net was more onerous in downturns. Moreover, it could actually work against the interests of workers. As Stiglitz (1999) points out, in a life-time employment system the labor market may interpret separation from a current employer as a signal of an individual’s poor quality.)

Aspects of South Korean labor law were incompatible with the conventions of the International Labor Organization, which South Korea joined

43. As Lindauer (1997) observes, during the 1970s and 1980s, there was a considerable increase in the concentration of wealth, due largely to capital gains on land ownership. Between 1974 and 1989 land values appreciated at an estimated rate that was three times as fast as GNP, and in some years capital gains exceeded total GNP growth. These increases in wealth were enormous and were concentrated in a few hands—in 1988 the top one percent of the income distribution owned 44 percent of the total land value; the top 10 percent owned 77 percent of the land.

44. The KCTU was not granted formal legal status until November 1999, ending the FKTU’s official monopoly on the trade union movement.

in 1991. In 1995 a presidential commission was appointed to review labor practices, and, in late 1996, the government unveiled a new set of labor law revisions. South Korean practices were also inadequate from the standpoint of the Organization of Economic Cooperation and Development (OECD), which the Kim Young-sam government wished to join. In 1995, a presidential commission was appointed to review labor practices, and the government unveiled a new set of labor law revisions in late 1996. These highly controversial revisions ran into significant opposition in the National Assembly, however. The ruling New Korea Party attempted to justify certain provisions of the legislation as required for OECD membership, though this was not the case. On 26 December 1996, the ruling party was reduced to calling a surreptitious dawn quorum of the National Assembly to pass the legislation without objection by the absent opposition Assembly members. After a nationwide strike ensued, the revision of the labor laws was canceled (Young 1997). This uneasy peace continued until the financial crisis forced further revisions in labor laws (as discussed in chapter 6).

Trade Policy

The domestic economy interacts with the world economy through the channels of international trade and finance. As the financial reforms in South Korea had an important international dimension, and international capital movements played an important role in the financial crisis, we will first discuss first trade and then finance in the following section.

Historically, the South Korean economy has been characterized by pervasive regulation, non-transparency of implementation, and rent seeking. Unsurprisingly, foreign firms have often found it difficult to penetrate this market. The metaphor “peeling an onion” has been used to describe the process of stripping away the layers of legal and bureaucratic impediments to access. Nevertheless, over the past two decades considerable progress has been made in liberalizing international trade.

Border Measures

The Sixth Five Year Plan (1987-91) reinforced the existing trend toward liberalization, which was given additional pressure from the United States and the successful conclusion of the Uruguay Round of global trade talks in 1993. In 1980, the average tariff was 24.9 percent, and nearly one-third of imported products were under some sort of quantitative restriction. By 1993, the import-weighted average tariff had fallen to 10.6 percent, and less than 2 percent of imported products were subject to quantitative restriction (PECC 1995, table A.3). As an outcome of the Uruguay Round negotiations, average tariff rates in the manufacturing sector were reduced to levels only slightly higher than those imposed by developed countries

Table 2.1 South Korean tariff rates (percent)

Sector	Pre-Uruguay Round	Post-Uruguay Round
Metal mining	2.05	2.05
Coal mining	9.21	2.79
Oil and gas extraction	10.71	10.79
Stone and other nonmetallic minerals	3.92	2.29
Food and other kindred products	14.76	8.98
Tobacco products	100.00	65.50
Textile mill products	27.64	18.05
Apparel products	29.48	19.05
Lumber and wood products	8.25	6.85
Furniture and fixtures	26.21	8.58
Paper and allied products	11.40	0.24
Printing and publishing	4.40	0.14
Chemicals and allied products	18.34	6.73
Petroleum and coal products	8.69	5.67
Rubber and miscellaneous products	27.88	9.15
Leather and leather products	22.09	10.40
Stone, clay, and glass products	25.29	12.50
Primary metal industries	16.61	7.71
Fabricated metal products	22.69	11.42
Industrial machinery	18.26	11.85
Electrical machinery	20.33	6.79
Transportation equipment	4.21	3.31
Instruments and related products	20.02	9.08
Miscellaneous manufactures	27.74	8.66
Total	16.29	7.71

Note: Data organized by Standard Industrial Classification (SIC).

Source: USTR.

(table 2.1).⁴⁵ Accompanying the tariff cuts were reductions in quantitative barriers. Outside of agriculture, the percentage of product categories covered by quantitative import restrictions is virtually nil (APEC 1995). South Korea also lowered, by as much as 30 percent, special luxury taxes that had the effect of repressing imports, though special taxes on problematic items such as automobiles remain.

45. Yoo (1993) has analyzed the determinants of South Korean protection. While the results varied somewhat depending on econometric specification, he found that in general the degree of protection depended on factors affecting the "demand for protection," the "supply of protection," and the government's own bureaucratic objectives. In particular, protection was positively associated with demand factors such as the number of workers in an industry and the industry concentration ratio. Protection was positively related to share of output exported and negatively related to share of output purchased by consumers, both reflecting domestic opposition to protection. The extent of protection also was related to the government's own agenda, with agriculture, infant industries, and sectors with high import penetration ratios all receiving protection.

Table 2.2 Estimates of tariff-equivalents of Korean agricultural NTBs, 1992 (percent)

Product	Collected tariff rate ^a	Nontariff barrier ^b	Tariff equivalent of tariff and NTB ^c
Beef	20.1	148.9	169.0
Pork	20.8	30.2	52.0
Poultry	20.1	44.9	65.0
Dried onions and garlic	52.5	206.9	259.4
Dried beans	30.0	463.8	493.8
Nuts	34.6	199.2	233.8
Peppers	38.9	261.1	300.0
Barley	34.9	389.5	424.4
Corn	2.6	362.4	365.0
Milled rice	5.0	590.0	595.0
Malt	35.1	263.9	299.0
Soybeans	3.0	538.0	541.0
Peanuts	40.3	215.8	256.1
Oilseeds	34.8	458.3	493.1
Dairy products	21.5	128.6	150.1
Leaf tobacco	19.9	51.1	71.0

a. Collected tariff rate is measured as tariff revenue divided by total import value, using average annual exchange rate for 1992 (\$1 = 780 won).

b. The nontariff barrier equals the tariff equivalent of the total difference between domestic and foreign prices, minus the tariff rate.

c. The tariff equivalents of the product categories comprising several subitems with different tariff equivalents are derived by taking the weighted average of individual products' tariff equivalents based on their production values for 1992.

Source: N. Kim 1996, table 2.17.

Agriculture remains substantially protected, however. Although South Korea has been a major agricultural importer, most imports are accounted for by bulk commodities due to quotas and other barriers that effectively exclude foreign producers from markets for high value-added or processed agricultural products.⁴⁶ Indeed, calculations by N. Kim (1996) indicate that the tariff equivalents of non-tariff barriers in agriculture can be hundreds of times the nominal tariff rates (table 2.2).

46. Items of particular interest to the United States include fruits, vegetables, grains (e.g., rice and barley), poultry, and beef. In 1989 Korea agreed to improve access for orange juice, distilled spirits, and cherries, to disavow quantitative trade restrictions on 62 agricultural and fisheries products, and to remove 243 other restrictions over the period 1992-97 on a phased basis. Imports of several products were subsequently restricted by phytosanitary barriers (e.g., pecans and strawberries) or customs clearance problems (e.g., grapefruit).

In the case of beef, a General Agreement on Tariffs and Trade (GATT) panel ruled in 1989 in response to a complaint initiated by the United States that Korea's beef quota was inconsistent with the GATT balance of payments exception. In the following year the United States, Australia, New Zealand, and South Korea agreed to a phased opening of the Korean beef market, beginning with a relaxation of the quota and followed by the establishment

The implementation of tariff-rate quota (TRQ) schemes is an area of particular international concern. Under its Uruguay Round commitments, South Korea established TRQs to provide for minimum access in previously closed markets or to maintain pre-Uruguay Round access. In-quota tariff rates have been low, but foreigners have complained that over-quota rates have been prohibitively high.⁴⁷ In the politically contentious rice sector, South Korea agreed to a minimum market access commitment that would involve imports supplying one percent of domestic consumption in 1995, with this figure rising to 4 percent in 2004. The tariff equivalent is nearly 600 percent. In addition, South Korea was permitted to maintain state trading in a number of products, which potentially negated the impact of tariff cuts, and in other cases South Korea was able to negotiate increases in previously bound tariffs.⁴⁸ Consequently, the implications of the Uruguay Round for South Korean agriculture may prove slight (Johnson 1995). The OECD in its ongoing work on indicators of government assistance estimates that producer subsidy equivalents reached nearly 100 percent in some sectors (table 2.3).

Finally, the discussion thus far has mainly focused on nominal rates of protection. Effective rates of protection take into account the impact of protection of intermediate inputs on the incentives to produce finished products domestically. If, for example, inputs were to be more highly protected than the finished product, then that sector would receive reduced actual protection, since the protection afforded to the finished product would be more than outweighed by the high prices producers were forced to pay for intermediate inputs. More typically, tariffs would escalate (rise by degree of processing) such that effective rates of protection for sophisticated manufactures exceed nominal rates.

in 1993 of a buy/sell system linking certain large buyers directly with producers. The third phase of the beef market liberalization, involving the elimination of all non-tariff barriers and an end to state trading by 2001, was concluded as part of the Uruguay Round. The United States has since complained repeatedly about South Korean implementation of this agreement (USTR 1999).

Additionally, as part of its Uruguay Round commitments, South Korea agreed to phase out import restrictions on a variety of agricultural products of interest to the United States, including pork, chicken, oranges, orange juice, dairy and whey products, apples and apple juice, grapes and grape juice, and other fruit juices. In the same agreement, South Korea was permitted to raise its "bound" tariff rates on these goods to levels not to exceed the domestic-foreign price differential. These tariffs would then be reduced by 24 percent of the base level over a ten-year period.

47. See USTR (1999) for number examples.

48. The United States has raised complaints about the implementation of the tariff-quota schemes. In the case of oranges, for example, the South Korean government designated the country's only citrus cooperative as the sole importer of fresh oranges, creating what appears to be a clear conflict of interest. Similarly, in the case of rice, a state trading organization controls not only importation, but also internal distribution, preventing foreign producers from directly marketing high-quality rice to consumers (USTR 1999).

Table 2.3 Producer subsidy equivalents, 1997
(percent)

Product	Subsidy equivalent
Barley	93
Rice	92
Oilseeds	96
Other crops	92
Milk	71
Beef and veal	67
Pig meat	29
Poultry	73
Eggs	6
Livestock products	49
All products	75

Source: OECD (1999), *Review of Agricultural Policies in Korea*.

Yoo, Hong, and Lee (1993) have estimated the effective rates of protection in South Korea prior to the Uruguay Round (table 2.4). Their results affirm that variations in nominal rates of protection across sectors are manifested in even more highly dispersed rates of effective protection. In the extreme cases of wooden furniture and textiles, effective protection has actually been negative—inputs have been so highly protected relative to outputs that producers have been discouraged from engaging in those activities. On the other end of the scale, rates of effective protection in apparel and electrical machinery have been more than double their nominal rate, providing a big boost for domestic production of these products.⁴⁹

Other Impediments to Trade

Tariffs and quantitative restrictions are not the whole story, however. South Korea has long been a target of antidumping suits brought by foreign competitors. In the early 1990s, South Korea began developing its own antidumping laws and has become an increasingly enthusiastic practitioner.⁵⁰ Unfortunately, negotiators have made little progress in rein- in these impediments to trade. Although the Uruguay Round agreement contains language that should streamline the process, it has done

49. These results are pre-Uruguay Round. Presumably the impact of the Uruguay Round agreement would have been both to reduce levels and to narrow the range of effective protection afforded the manufacturing sector in South Korea. Unfortunately, post-Uruguay Round estimates for South Korea do not exist.

50. See Noland (1998b) for a more detailed discussion of South Korea as both a practitioner of and defendant in antidumping suits, as well as a discussion of other barriers that South Korean exports face.

Table 2.4 Effective and nominal rates of protection, selected sectors, 1990 (percent)

Sector	Effective rate of protection ^a	Nominal rate of protection ^b
Rice	499.6	311.0
Vegetables	13.1	15.4
Fruits	140.1	98.8
Livestock	144.3	43.5
Plywood	5.3	6.4
Wooden furniture	-2.3	4.2
Textiles	-8.5	5.2
Apparel	71.0	29.7
Industrial chemicals	13.6	11.3
Other chemicals	49.4	29.0
Glass and glassware	11.1	10.7
Ceramic products	6.2	7.7
Metallic household articles	18.7	12.9
Other metallic articles	29.0	16.0
General machinery	25.0	17.3
Electrical machinery	77.5	35.4
Automobiles	16.6	14.8

a. The effective rate of protection for sector j is defined as $[VA_j/V A_j^w - 1]$, where VA_j is value added at domestic prices and $V A_j^w$ is value added at world prices.

b. For industrial products, nominal protection is estimated by comparing domestic and foreign prices; for agricultural products, it is the sum of tariffs and the tariff equivalents of NTBs.

Source: Yoo, Hong, and Lee 1993, tables VI-1, VII-1.

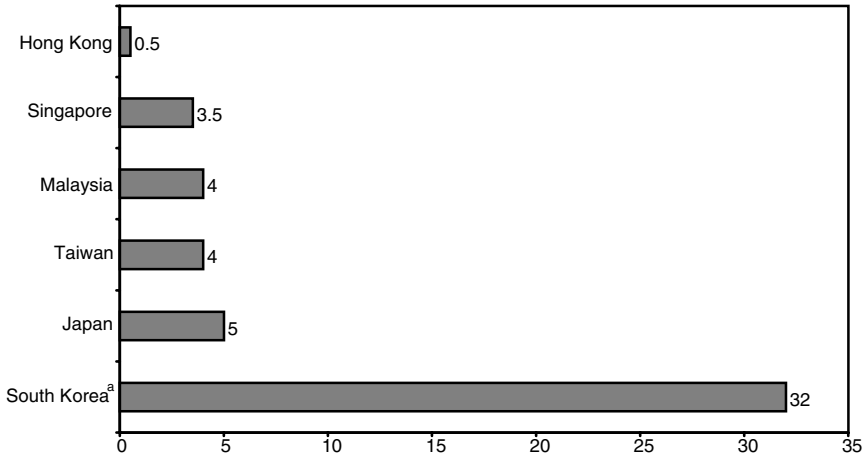
little if anything to alter the fundamentally irrational nature of the permitted practices.⁵¹

The South Korean government also has been in the process of reviewing a variety of laws and regulations—such as the administration of import licenses; standards, testing and certification requirements; and quarantine inspections—which, although not designed to restrict imports, may have that practical effect.⁵² For example, customs clearance delays for agricultural products can take a month or more, far higher than observed in

51. One obvious tack would be for the reinvigorated KFTC to engage in some joint international competition policy initiatives. These have been discussed between the United States and South Korea bilaterally in the Dialogue for Economic Cooperation (DEC), but participants in these negotiations believe that joint activities are a long way off, despite the KFTC's increased autonomy and the public unpopularity of the *chaebol*. On a regional basis, competition policy is the subject of discussion within the Asia-Pacific Economic Cooperation (APEC), though little progress has been made to date. Multilaterally, the European Union and Japan proposed discussing these issues at the 1999 Seattle Ministerial, but US opposition doomed this effort.

52. When the government began its review in 1996, these special laws covered 26 percent of import categories; by the end of 1988, coverage had been reduced to 19 percent (Young 1989).

Figure 2.8 Number of days required for customs clearance of agricultural products



a. Settlement of B/L and application to customers and quarantine office 2 days, quarantine to be filed with Health Bureau 1 day, quarantine test 25 days, forwarding test results 1 day, clearance 2 days, importation stamps 1 day. Recent changes have reduced the number of clearance days for fresh fruit and vegetables.

Source: American Chamber of Commerce in Korea, *Korea: US Trade and Investment Issues 1996*.

other Asian countries (figure 2.8). In the mid-1990s, the South Korean Customs Service implemented a series of reforms designed to streamline procedures. Nevertheless, problems have remained.⁵³ However, many of the problems have appeared to arise not from the behavior of the Customs Service but rather from policies and decisions by the Ministry of Health and Welfare (MOHW) and the Ministry of Agriculture, Forests, and Fisheries (MAFF). The former agency appears not to have been sufficiently socialized in international norms, and the latter appears to have been captured by import-competing interests.⁵⁴

53. USTR (1999) gives examples of arbitrary changes in customs classification, switching products from a tariff-only line to a restrictive TRQ, and rejections of customs clearance applications on administrative grounds (erasure marks on the application, wrong font, etc.). The USTR also alleges that South Korean regulations often require local trade associations to approve import documentation, which requires exporters to share confidential business information with their competitors.

54. USTR (1995) gives the example of an MOHW requirement that each importer of an identical product (e.g., the same brand of canned food in the same size container) go through a separate cumbersome registration procedure. Tarullo (1995) gives the example of medical equipment standards that deviate from international norms and the Customs Service practice of individually opening each device, thus subjecting it to possible contamination. The US medical equipment industry estimates that \$200 million in sales are lost due to these practices. Problems have continued to fester, and the United States and Korea have been through multiple rounds of consultations through the WTO. See USTR (1999) for details.

Foreign observers have long identified standards, testing, labeling, and certification requirements apparently drafted without reference to international norms and effectively targeted only toward imported products as the most onerous secondary barrier (USTR 1999 and American Chamber of Commerce in Korea (AmCham) 1999). Although significant progress has been made in the 1990s, foreigners claim that these methods have still been used to discourage imports. Many of the complaints have related to agricultural imports, medical equipment, pharmaceuticals, and cosmetics. Exporters have reported unduly restrictive and arbitrary phytosanitary requirements. In many cases importers have been denied requests for scientific data upon which imported food shipments have been rejected (see box 2.1). Following the submission of a Section 301 petition by the US beef and pork industry in May 1995, the United States initiated formal consultations under the GATT's successor World Trade Organization (WTO) dispute settlement mechanism with particular regard to the shelf-life restrictions mandated by the South Korean government. In July 1995 this led to a bilateral settlement in which South Korea agreed to phase in the common international practice of manufacturer-determined sell-by dates for most food products. According to the United States Trade Representative (USTR), some problems still remain (USTR 1999).

In the past, South Korea maintained a variety of practices to encourage domestic firms in government procurement, but these have been narrowed by its implementation of the WTO Agreement on Government Procurement. South Korean authorities estimate that, of total government procurement of \$3.8 billion in 1998, approximately \$1.3 billion was covered by the WTO code.⁵⁵

Trade reform has been pursued in other areas as well. In recent years, new patent, copyright, and trademark laws have been enacted, a patent court has been created, and resources devoted to enforcement have been increased. Even the USTR admits that "there has been some improvement over the past several years on the removal of pirated and counterfeit goods from the Korean market" (USTR 1999, 282), though, of course, problems remain.⁵⁶

Liberalization of the automobile sector is an issue of great sensitivity in South Korea. In 1997, South Korea became the world's fifth largest manufacturer of automobiles and its third largest exporter. Although it

55. South Korea has been building a new international airport at Incheon, which has become a recent point of contention with the United States. The United States has asserted that the airport's construction should come under the government procurement code, while the South Korean side has argued that the airport authority is not subject to the WTO code. In February 1999 the United States sought formal consultations in the WTO, and, unable to reach an agreement with South Korea, requested in May the formation of a WTO dispute settlement panel. In May 2000 the panel ruled against the US.

56. See AmCham (1999) for a judicious discussion of this issue.

Box 2.1 The Strange Case of Sausages

In March 1994, South Korea barred entry of a shipment of frozen heat-treated pork sausages when the sausages were arbitrarily reclassified and the legal shelf life was reduced from 90 to 30 days. (The government-mandated shelf-life system, itself an anachronism practiced by few other countries, affected US exports of a variety of processed foods.) This action was the catalyst for the filing of a Section 301 complaint by US producers. (US officials were unwilling to take the case to the General Agreement on Tariffs and Trade (GATT) for fear that a US victory in this case would hurt chances of congressional passage of the Uruguay Round, where critics were claiming that the GATT's successor, the World Trade Organization (WTO), would be able to strike down US health and safety laws. Once the Uruguay Round passed Congress, US officials were willing to use the WTO to resolve the issue.) As for the sausages themselves, the South Korean importer who was stuck with them unloaded them in China.

The importer was less lucky in the popcorn case. The following year an export shipment by a small US producer was impounded for more than six months then rejected on the grounds that it had high levels of e-coli bacteria. No test results were furnished to substantiate this judgement, and the exporter was denied the right to resubmit new tests indicating that there were no bacteria present. The Korean authorities also dismissed the argument that the high temperatures needed to pop popcorn would kill any bacteria. South Korean authorities eventually announced that it was the fault of the importer who had self-certified the absence of e-coli bacteria, though, as it turns out, standards did not even exist for e-coli bacteria on popcorn. In the end, the importer was stuck with the popcorn and the exporter was out \$50,000 (USTR 1996). The value of time spent by government officials and private lawyers attempting to resolve this undoubtedly exceeded the value of the shipment. These practices delay importation, contribute to deterioration (which ironically may be a potential public health concern), raise costs, and discourage imports.

Through the 1990s the South Korean government took steps to try to improve the transparency of its standards setting practices, and these have been subject to bilateral consultation under the auspices of the US-ROK Dialogue on Economic Cooperation (DEC). The Uruguay Round agreement on sanitary and phytosanitary restrictions and the improved dispute settlement mechanism have greatly increased the likelihood of resolving these issues. Indeed, the specter of a WTO case appears to have contributed to resolving the sausage dispute.

possesses the most rapidly growing market in Asia, it has continued to severely circumscribe access to its own market, where imports make up less than one percent of consumption. (In contrast, in the United States, non-North American imports account for 15 percent of consumption in the United States, with Korean imports alone accounting for 2 percent.) The importation of Japanese cars was banned until South Korea, in the context of bilateral negotiations with Japan in the WTO, agreed to lift the prohibition at the end of 1999. This date was brought forward six months

to mid-1999 as part of the IMF package negotiated during the financial crisis. Importation of other, non-Japanese autos has also been discouraged.⁵⁷ More directly, the US government has been concerned about tariffs (currently 8 percent), discriminatory internal taxation (based on engine size), various standards and certification requirements, residual restrictions on US firms' consumer financing activities, and certain aspects of consumer auto loan financing in Korea. These were subject to bilateral Memoranda of Understanding concluded in 1995 and 1998.⁵⁸

Services

In a relative sense, the services markets remain generally less open than the goods markets, though, as in the case of goods, there has been a trend toward significant liberalization, in large part through a combination of multilateral negotiation and bilateral pressure. (Discussion of crisis-driven financial services liberalization will be deferred until chapter 6.) There is a considerable overlap between services and investment, since often one cannot be efficiently undertaken without the other.

South Korea has historically restricted foreign providers' access to its services markets through a "negative list" system, but over time this list has been narrowed considerably. Private construction and engineering markets were opened to international competition in 1996, and the public works market was opened to foreign providers in the following year.⁵⁹ In advertising, foreign firms have historically complained about the state-affiliated monopoly, the Korea Broadcast Advertising Corporation (KOBACO), which allocates television and radio advertising time. However, the crisis has led to an excess of supply over demand, and both

57. In 1990 the South Korean government launched an "austerity" or "anti-consumption" campaign. Limitations were placed on promotional activities in response to government administrative guidance, and purchasers of imported automobiles were threatened with tax audits. South Korean officials explained that the campaign was against ostentatious and excessive consumption, not imports *per se*, but a number of examples suggest that this was not entirely the case. A lingering problem from this period has been the perception, publicly denied by the National Tax Administration in 1994 and reiterated in 1995, that the purchase of an imported car would result in a tax audit. President Kim Young-sam again publicly stated in 1996 that the purchase of a foreign car would not result in a tax audit, but in 1997 Korean negotiators admitted that the practice had continued, terming it a "mistake" (*Inside U.S. Trade*, 29 August 1997).

58. Under current law, South Korean banks are not allowed to hold title on cars as collateral on loans for auto purchases. As a consequence, some consumers default on the loans, and it is difficult for the banks to seize the cars. US automakers argue that this has impeded the development of a car loan market and thus has depressed the demand for cars, especially luxury cars.

59. AmCham (1999) and USTR (1999) report that difficulties encountered by US firms since liberalization have been largely "cultural," not legal, in nature, and they report few complaints about access.

AmCham (1999) and USTR (1999) report that KOBACO has shown considerable flexibility in dealing with foreign providers. Quotas on foreign content imposed on movie theaters, as well as on broadcast and cable television, continue to be a source of complaint.

The major area of current focus continues to be financial services, however. South Korea implemented a series of reforms in banking, securities, and insurance associated initially with its application to join the OECD, and later as part of its strategy for coping with the financial crisis. In banking, although a significant number of restrictions on foreign banks have been removed, foreign banks continue to complain that their activities have been restricted by South Korean assessment of capital reserves based on the local, rather than the parent, entity and the slow and non-transparent process of regulatory approval for the introduction of new products.

Investment

Restrictive policies toward inward FDI have been significantly liberalized. Historically, South Korea had discouraged foreign investment (and access to its services markets) through a “negative list.” Foreign investment was restricted through equity participation or other requirements, though over the years the pervasiveness of these barriers has declined.⁶⁰ As a consequence of these restrictions, South Korea has stood out as one of the few countries in the world where minority participation (rather than majority ownership) is the dominant form of foreign direct investment.⁶¹

However, the government of Kim Dae-jung has made increased foreign investment a priority, both as a response to the financial crisis and as a way of diluting the pervasive presence of the giant *chaebol* in the South Korean economy.⁶² In November 1998, the government enacted the Foreign Investment Promotion Act. It explicitly established the principle of

60. In 1980, less than half of five-digit Korean Standard Industrial Classification (KSIC) sectors were unconditionally open to foreign direct investment (FDI). Since 1989, 79 percent of these sectors were open to FDI, 16 percent were conditionally open, and five percent were closed. Openness has been highest in manufacturing (98 percent), lowest for agriculture (20 percent), and in between for services (62 percent). In 1994, 87 percent of these sectors were open to FDI, including 98 percent of manufacturing and 76 percent of service sectors. As a consequence of the financial crisis (discussed in more detail in chapter 6), a number of restrictions on foreign direct and portfolio investment, especially in the services sector, were lifted in 1998 and 1999. Remaining statutory foreign investment restrictions are mainly related to national security, cultural protection, and protection of the agricultural and fisheries sectors. See J.D. Kim (2000) for further details.

61. This has begun to change since the financial crisis and the liberalization of foreign investment laws, however. Indeed, much of the inward FDI surge has taken the form of foreign firms buying out their local joint venture partners.

62. See Ahn (1999), Beck (1999), J.D. Kim (1999), and Kang (1999) for analyses of these policy changes.

national treatment, further narrowed the “negative list,” broadened the scope of tax incentives available to foreign investors, simplified approval procedures, and established foreign investment zones.⁶³ Once established, foreign firms are accorded national treatment.

Foreign investment ceilings in financial markets have been largely eliminated, with the exception of a few parastatal enterprises that are in the process of privatization and a few specified sectors, such as education, media, and beef wholesaling. Other recent reforms permit hostile takeovers and increase foreigners’ ability to take significant minority positions in publicly traded South Korean firms.

Outside agriculture, restrictions on foreign land ownership, long a source of complaint, have largely been lifted. Because of these legal changes and the financial crisis, foreign investment in the South Korean economy has grown rapidly in recent years (figure 2.9).⁶⁴ Research by J.D. Kim (1999) demonstrates that this investment has had important beneficial spillover effects to the South Korean economy.

Several years ago, the present author wrote an evaluation of South Korean trade policies (Noland 1998b). This treatment is considerably shorter. The Uruguay Round agreement, bilateral pressure, the financial crisis, and the relatively liberal policies of the Kim Dae-jung government have contributed to considerable reform of South Korean trade policy. Many of the old barriers have been lowered, narrowed, or eliminated completely. In both the goods and services areas, trade liberalization has not only played its conventional role of improving the efficiency of resource allocation, but importantly may have served as a check on the exercise of market power by the giant *chaebol*, which have disproportionately received trade protection in the past. A similar trend of liberalization driven by both internal and external forces has been underway in the financial sector.

Pre-crisis Financial Policies

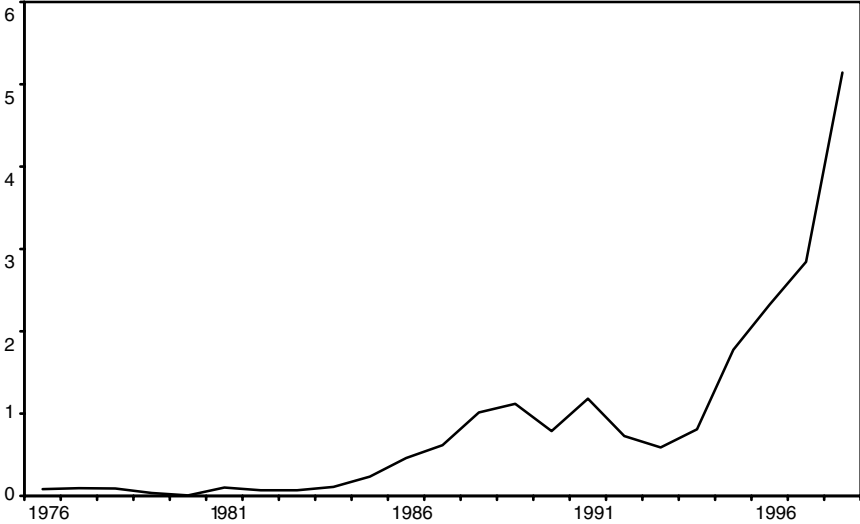
Since the founding of the republic, South Korea had maintained highly regulated and repressed financial markets, emphasizing indirect finance through the state-dominated banking system and capital controls to delink

63. The government can reject foreign investment not in “negative list” sectors only for one of five specific reasons and within sixty days of notification. Otherwise, the investment can proceed. These reasons include: protection of national security; maintenance of public order or the protection of public health, morality, or safety; fulfillment of obligations relating to international peace and security; prevention of monopolistic or predatory practices in the domestic market; and violation of Korea’s Antitrust and Fair Trade Law.

64. The data in figure 2.9 are based on actual investment and are somewhat lower than the data on investment approvals released by the Bank of Korea. The recent experience with foreign direct investment is discussed in more detail in chapter 6.

Figure 2.9 Foreign direct investment

net inflows (billions of US dollars)



Source: World Bank, World Development Indicators; Korea Economic Institute of America, *Korea Insight* Vol. 1, No. 5 August 1999.

domestic financial markets from the global market. These were the twin pillars of President Park's state-directed, capital channeling model. However, pressure for liberalization developed over time from both from domestic firms disadvantaged in international competition by high domestic interest rates and limited options for corporate finance and from foreign governments promoting the interests of their own financial providers. Some South Koreans genuinely believed that the benefits to be gained through more efficient financial markets were outweighed by the potential destabilizing macroeconomic effects, or that South Korean financial firms were not yet ready to compete with foreign firms (e.g., Park 1995, Park and Song 1996).⁶⁵ Others probably opposed liberalization out of self-interest, since liberalization would erode their privileged posi-

65. For example, Park and Song (1996) write: "Korean policymakers have been reluctant to liberalize the capital account rapidly. There is concern that devastating macroeconomic instability would result from a sudden opening up of financial markets. In contrast, efficiency gains to the economy from liberalization are considered to be relatively small, possibly even insignificant, and at best realized in the long run" (p.14). Park (1995) states that: "Domestic financial institutions have little competitive advantage over their foreign counterparts. At best Korea's financial sector remains an infant industry and may need market protection" (p.7). These authors were affiliated with the South Korean bank-supported Korea Institute of Finance (KIF).

tion within the South Korean financial system. The outcome of this tension was a political compromise resulting in a gradual, uneven, and ultimately problematic liberalization program that lasted a decade before being overtaken by the 1997 financial crisis.

The Sixth Five Year Plan (1987-91) reinforced the existing trend toward financial sector liberalization. The process received a further boost in 1993 with the introduction of multiyear financial plans, including one that was promulgated in 1995 and was scheduled to run through 1999. Additional reforms were announced as part of South Korea's 1996 accession to the OECD. A Presidential Commission for Financial Reform was established in January 1997 to propose broad recommendations for the modernization of the financial system. It issued three reports that year.⁶⁶ The 1995 multi-year plan and South Korea's application to join the OECD became the focal points in the battle over reform.

The Structure of Banking

South Korean financial institutions include bank and non-bank deposit taking institutions, investment and insurance firms, and equity markets.⁶⁷ On the lending side, South Korean banks faced some competition from an underdeveloped commercial paper market, and in some areas, such as automobile finance, from consumer lending institutions. Historically, foreign banks' activities were highly restricted, though as part of the liberalization program they were allowed to open multiple branches.⁶⁸

The trend was toward a diminution of overt state involvement. The share of state banks in lending fell over time and accounted for only 13 percent of loans in 1996. Policy loans, which contain a significant subsidy element, became less important over time, declining to 18 percent of bank credit and 5 percent of all lending in 1995.⁶⁹ Moreover, these loans were increasingly concentrated in the public financial sector, with the share at 39 percent and rising. However, the commercial banking sector was still

66. See Cargill (1999) for a summary of these reports.

67. Between 1994 and 1996, the government more than doubled the number of merchant banks, licensing 24 new ones. Of these, 15 were converted from relatively weak finance companies. Haggard (2000) reports the astonishing fact that three of these were insolvent *at the time that they were licensed*. These institutions were not subject to the same ownership limitations as the commercial banks, and some were controlled by *chaebol*. Moreover, they were subject to less regulatory oversight. These institutions later played an important role in the financial crisis, lending aggressively and speculating in financial markets in Southeast Asia, Russia, and other emerging markets.

68. In 1996 the government announced plans to permit foreign banks to establish wholly-owned subsidiaries around late 1998, as well as to let them into the credit card business.

69. Figures on policy loans vary from source to source due to the imprecise definition of a policy loan. The figures cited are from the Bank of Korea as reported by the OECD. Some South Korean analysts report significantly higher figures.

more dependent on policy lending than the rest of the non-state financial system, with policy loans accounting for 18 percent of commercial bank lending.

In parallel to the reduced state efforts to channel capital, the commercial banks were privatized in the mid-1990s. There was movement away from direct government appointment of senior bank managers, though the government still did not permit complete autonomy either in the selection of senior management or in operational decisions regarding portfolio allocation.⁷⁰ The legacy of state involvement was further manifested by overstaffing and an implicit guarantee of lifetime employment. Returns on assets were low, relative both to returns observed in other countries and to the returns achieved by foreign banks operating in the South Korean market.

Perhaps as a consequence of continued state involvement in the banks, it was widely believed that the government would not permit a bank to fail, and indeed none ever had.⁷¹ A deposit insurance scheme involving non-risk-adjusted uniform premiums was introduced in 1996. (The possible moral hazards created by the implicit state guarantee and the provision of non-risk-adjusted insurance will be taken up in chapter 6.)

Commercial banks were supervised by the Monetary Board, the governing body of the Bank of Korea and the Office of Bank Supervision, which also regulated other financial institutions under the delegated authority of the Ministry of Finance and Economy. (Securities and insurance were supervised by similar boards under the Ministry.) The core commitments of South Korean bank regulation were the adoption of the Bank of International Settlements (BIS) capital adequacy guidelines and the CAMEL system (Capital adequacy, Asset quality, Management ability, Earnings quality, and Liquidity level), based on US regulatory practices. The 1993 introduction of a “real name” law relating to bank account and property ownership represented a significant step forward in that, as it would in principle give regulatory officials much greater information with which to combat malfeasance by bank insiders.

Interest rates have been deregulated over time, beginning in 1988.⁷² Deregulation has appeared to have real effects on interest rates. There was a narrowing of the differential between interest rates and corporate

70. For example, as the stock market declined in late 1996, bureaucrats issued “window guidance” requiring that banks hold on to their stocks to support share prices. They did—and increased their ultimate losses.

71. In 1996, regulatory authorities were authorized to order poorly managed financial institutions to merge with other financial institutions. The Ministry of Finance and Economy (MOFE) or the deposit insurance agencies would also be authorized to force poorly managed firms to take self-defensive measures such as increasing capital or selling off stock holdings.

72. Prior to the crisis, only 17 percent of bank deposits (less than 5 percent of total deposits) and 3 percent of domestic loans were subject to direct rate regulation.

bond rates as shown in figure 2.2. Yet the impression remained that, although interest rates were formally deregulated, the commercial banking sector was still subject to administrative guidance. It was expected that additional international capital market liberalization would contribute to further interest rate reduction, and that real rates would continue to reduce gradually as the capital stock grew and the marginal product of capital declined (figure 2.2). The deregulation of banks and non-bank financial institutions, together with the growth in stock and bond markets, led to a withering of the curb market, which declined to less than 10 percent of domestic credit.

In 1993, the government expanded the scope for short-term foreign currency borrowing by allowing firms to borrow abroad directly or through South Korean banks to finance the importation of capital goods. With interest rates relatively high in South Korea, and continued restrictions on firms' ability to issue long-term bonds or secure long-term loans in foreign markets, firms were encouraged to increase their reliance on short-term foreign borrowing, and South Korean banks were encouraged to step up their won-lending activities. This was to play a significant role in the subsequent crisis.

Capital Markets

Although some government policies inhibited their development, long-term capital markets were large. (Short-term capital markets were relatively small and underdeveloped.) Daily turnover in the stock market was the sixth largest in the world. At its peak, stock market capitalization reached a quarter trillion dollars, making it the 16th largest in the world, and stock market capitalization as a share of national income was higher than in some OECD countries, despite policies that favored debt over equity finance.⁷³

In 1990, the government established a quarterly quota on new issues. At times, more than 300 firms waited for permission to issue stock.⁷⁴ This

73. As noted earlier, tax policies encouraged the issuance of debt over equity shares. Figures on the valuation of the stock market should be taken with a grain of salt due to the extensive web of cross-holdings, which would tend to inflate valuations.

74. In February 1985, the Japanese yen began a rapid appreciation against other currencies, particularly the US dollar. As the relative cost of production in Japan rose, Japanese firms responded by moving production offshore, mainly to South Korea and Taiwan. As growth slowed, Japanese monetary authorities pursued a policy of aggressive monetary expansion, cutting the official discount rate to its then-historical low.

Rapid monetary growth and low interest rates, together with a still appreciating currency, facilitated the creation of an asset market bubble and an outflow of capital, much of it going to South Korea. At this time the won was pegged to the US dollar. The real depreciation caused by yen appreciation, combined with the inflow of capital and technology from Japan, created a kind of "hyper competitiveness" and emergent macroeconomic imbalances (Balassa and Williamson 1990). Soon South Korea was experiencing an asset bubble similar to Japan's; between 1985 and 1989 the money supply increased by 105 percent, the price

repression of the normal functions of the capital market gave rise to corruption as firms resorted to bribery to get their shares listed.⁷⁵ At the core was a positive list system through which anything not explicitly permitted was prohibited. This hampered the introduction of new instruments throughout the financial sector. The Ministry of Finance and Economy indicated that it would end the quota system, permit the listing of stock futures contracts, widen the permissible daily trading bounds for individual stocks, abolish fixed commissions on stock trades, and clarify the rules on mergers and acquisitions. Nevertheless, it prevented the introduction of derivative instruments that would enhance firms' ability to manage risk in both the foreign exchange and equity markets.

Foreign participation in the stock market was also restricted. The government limited the amount of shares that foreigners could hold in individual stocks in the aggregate and individually.⁷⁶ As a consequence of this segmentation, the shares held by foreigners often traded at a premium over the shares held by domestic residents. The government refused to permit screen-based trading for foreign held shares and did not allow publication of stock market price indices for those shares, creating an illiquid market that conveyed abnormal profits to dealers with price information.⁷⁷

The long-term bond market was large, with the corporate bond market five times as large as the government bond market, in part due to favorable tax treatment. The government discouraged the development of an efficient auction and a secondary market for government bonds. No swap,

level rose by 3 percent, and the stock market went up by 458 percent, becoming the ninth largest in the world by 1989. Eventually, South Korea came under both market and political pressure to revalue. As it did, stock prices fell. The quota on new listings was in response to this.

75. In June 1996, the governor of the Securities and Exchange Commission (SEC) and a director of MOFE were arrested for taking bribes to get firms listed. Six other SEC executives were forced to resign.

76. Initially this was set at 10 percent in January 1992 and subsequently raised to 12 percent in December 1994, 15 percent in July 1995, and 18 percent in April 1996. In June 1996, the government announced a further phased opening that would increase the ceiling to 20 percent in 1996, and three additional percentage points annually thereafter to 29 percent by 1999. The MOFE added that it might abolish the ceiling entirely in 2000 if "economic circumstances" were appropriate. The ceiling was raised on schedule to 20 percent in October 1996 and to 23 percent in May 1997, but then the plan was overtaken by events and the ceiling was raised to 26 percent in November 1997, to 55 percent in December 1997, and finally to 100 percent in May 1998. A similar pattern occurred for the ceilings on ownership by individual foreign investors.

77. In an attempt to invigorate the over-the-counter (OTC) market, the government announced that it would begin to allow foreign investors to purchase shares "directly" in addition to the current practice of investing "indirectly" through a mutual fund reserved for foreigners. The OTC market, established in 1987, has had a yearly trading volume roughly equal to the daily volume on the Seoul stock exchange.

bond, or interest futures markets existed. Foreigners were only eligible to purchase a limited number of corporate bond issues. The government announced in August 1996 that foreign investors would be allowed to invest in convertible bonds issued by large corporations beginning in 1998, but that full opening of the bond market would be delayed until the differential between South Korean and overseas interest rates, at that time 6 to 7 percent, narrowed to 2 percentage points. Of course, there was no guarantee that this would ever occur.

Participation in South Korean capital markets by foreign firms was also limited. Foreign securities firms were permitted to own up to 10 percent of the paid-in capital of South Korean securities firms, and were allowed in 1995 to establish branch offices or joint ventures. In June 1996, the Ministry of Finance and Economy announced a new proposal to eliminate the 10 percent limit on ownership and to permit foreign firms to open wholly-owned subsidiaries in December 1998.

On the outflow side, capital outflow by residents was largely liberalized, though some restrictions have remained in place. Domestic residents were permitted to invest in foreign stocks in the 13 largest markets through mutual funds. In reality, actual investments were minuscule, and South Korean residents' portfolios were highly concentrated in won-denominated assets.

The Liberalization Plan

Out of the OECD application process came a multiyear, phased, financial liberalization plan to break down some barriers within the domestic market and to liberalize capital outflows before capital inflows. As planned, domestic residents would be free to purchase foreign securities and to establish foreign currency bank accounts in 1998. Domestic firms would no longer be required to obtain prior approval to be allowed to issue foreign currency-denominated equity-related securities (warrants), but rather would be subject only to a reporting requirement.

Non-residents would be allowed to issue won-denominated securities, and the ceiling on non-residential purchases of equities would continue to be raised. Also, friendly takeovers would be permitted by 1997. Restrictions on foreign purchases in the bond market would be partially removed, with restrictions on purchases of short-term debt lifted before restrictions on investment in long-term bonds. In respect to short-term capital flows, non-residents would be allowed to open won-denominated accounts at overseas branches of South Korean banks. This liberalization of short-term capital flows prior to lifting of similar restrictions on long-term flows created an incentive to rely on short-term financing and would come back to haunt South Korea, as discussed in chapter 6.

Restrictions on both inward and outbound direct investment would be partially eased. Foreigners would be allowed to buy land freely in some

sectors (though they would still need the permission of local authorities in others). Limits on outbound FDI were to be lifted gradually.

With regard to the participation of foreign financial institutions in South Korean markets, foreign banks and securities firms would be allowed to establish more branches and offices, respectively. Foreign insurance companies would be permitted to hold own-currency-denominated cash or securities as well as won-denominated assets. Foreign equity participation in investment trusts and asset management companies would be introduced in a controlled manner, with all restrictions to be removed in 1998.

In short, the plan amounted to a continuation of the ongoing liberalization process on a variety of fronts, though many of its provisions would leave the government with significant discretion. It was unclear what controls would remain in 1999, the terminal year of the plan. At the end of 1995, domestic market interest rates had largely been freed (a year ahead of schedule). However, the government still regulated the portfolios of commercial banks. It still owned a large number of financial institutions (of which the Korea Development Bank was the largest), and state-owned financial institutions dominated some markets (such as mortgage lending). According to the OECD, remaining restrictions continued to impede the flow of capital from commercial banks to other financial institutions, including the privately owned non-bank institutions, which it identified as the most dynamic part of the Korean financial sector. Government control over the introduction of new instruments had retarded the adoption of innovations in the securities market, and would be expected to continue to do so under this plan. Despite the decline of policy loans, the central bank would still act as a source of subsidized lending to preferred borrowers. Foreign participation in South Korean financial markets would continue to be circumscribed, and access by residents to international capital markets would still be restricted. Under this plan, the South Korean financial system would have remained among the most repressed in Asia.

Reservations to OECD codes are permitted, and in the financial services area, the average acceptance rate of financial liberalization codes is 89 percent; South Korea used its exceptions remit liberally, accepting only 65 percent of the OECD's financial system codes (though in fairness, some of these exceptions were scheduled for phaseout by 2000) (Dobson and Jacquet 1998). As will be seen in chapter 6, events were to force a degree of liberalization which was unforeseen by South Korea's financial market architects.

Conclusions

In the four decades following the devastation of the Korean War, South Korea transformed itself into a prosperous democracy, becoming the first

country in the postwar period to make the transition from a developing to a developed country. Yet the country's politics and economy still bore the imprint of the development model that President Park Chung-hee had forged decades earlier. Technological capability, capital accumulation, and access to world markets powered South Korea's rapid development and income growth. But the model, which had proved so successful in transforming a backward economy into a world beater, was of questionable value as South Korea approached the technological frontier. As the economy entered the 1990s, it possibly contained the seeds of its own destruction.

The *chaebol*, the product of the large-scale state intervention in the economy, posed a systemic risk to the increasingly fragile financial system that had been built around them, and the government had proved unable to formulate any effective response. Labor, repressed under Park, was restive, as a bubble in the asset markets generated increasingly obvious disparities in wealth and opportunity. And the foreigners, who had been willing to cut South Korea economic slack during the Cold War, increasingly demanded that South Korea play by the developed country rules appropriate to its newly achieved status. As we will see in chapter 6, this combination of fragile institutions and growing demands was to prove incapable of withstanding the internal and external forces at play.