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From Full-Blown Democracy to Disaster: The Kim Young-sam Years, 1993-97

Reform and Growth in the Early Years of the Presidency of Kim Young-sam

In what was the first truly democratic and fully contested election since the early Park Chung-hee years, one of the three Kims, Kim Young-sam, was elected president in 1992 as the candidate of the Democratic Liberal Party (DLP), which had been created by Roh. The election was not pretty. Kim was seen by much of the Korean population as a sellout for joining with Roh to form the DLP in 1990. The spring of 1992 saw student rioting (this in fact had become something of an annual event), and many Koreans feared that the riots might be used by Roh as an excuse for a return to martial law. Kim Dae-jung headed the main opposition party. But there was another opposition party, created and headed by Chung Ju-yung, the chairman of the Hyundai chaebol. In 1992, this party controlled 10 percent of the seats in the National Assembly. Chung's motivation, other than sheer ambition, was to get even for taxes assessed on portions of his estate passed as "gifts" to his children.

A bitter campaign ensued in which Chung accused Roh of creating an economic crisis while Kim Young-sam countered that there indeed had been economic mismanagement but that he was not Roh and would correct it. Chung responded by publicly denouncing Kim Young-sam as a person of limited intelligence. In the end, Chung ruined Kim Dae-jung's chances of election by splitting the opposition vote. Kim Young-sam was elected with 44 percent of the vote, while Kim Dae-jung received 36 percent and Chung only 20 percent. Chung one year later was tried and convicted of illegally using funds from the Hyundai group to finance his election bid. Relations between the Hyundai group and the Kim Young-sam government thus became somewhat frosty during the five years Kim was in office.

Kim Young-sam had answered Chung's charges by campaigning as a candidate who, in spite of the admitted economic mismanagement during the previous administration of his own party, would put things right. Thus, with Kim's blessing, under the five-year plan announced in July 1993 a "Blueprint for Financial Liberalization and Internationalization" was unrolled: it would decontrol interest rates, revise monetary tools, create short-term money markets, and liberalize capital accounts and foreign exchange transactions (see Kwon 1994). This plan was really just the second phase of the four-phase interest rate deregulation plan announced in 1991, and thus it was actually a product of the Roh period. Nonetheless, Kim readily claimed credit for it, especially when the chaebol chairmen united to speak out against it. These chairmen believed that the "Blueprint" would cause interest rates to go up and thereby squelch the growth of their groups. Kim did not entirely discount this possibility, and hence he acted cautiously in implementing the deregulation. However, he also saw that by carrying out the "Blueprint" he could restore some of the public credibility as a reformer that he had lost when he aligned himself with Roh, because its changes went against the publicly stated preferences of the chaebol chairmen. Indeed, in 1993 the chaebol were again out of favor with much of the Korean public because they were seen as responsible for the 1992 "growth recession."

Out of caution, only one element of the second-phase deregulation, the decontrol of interest rates, was executed in July 1993. But when no negative effect on growth was observed, the remaining elements were implemented in November of that year, decontrolling all lending rates except those on policy loans. Deposit rates except for demand deposits were to be decontrolled by 1996, as per the earlier plan, and demand deposit rates were to be "liberalized" (i.e., possibly not fully decontrolled, but nonetheless allowed to respond to changes in other market rates) by 1997; but the 1993 plan left the details of this liberalization unspecified. The plan also called for the "streamlining" of policy loans—which then accounted for about 35 percent of all bank lending—by 1997, again without specifying exactly what this meant.

In October the band of exchange rate fluctuation that was allowed without intervention was widened, and the plan called for its further widening in increments until by 1997 the won would freely float. Also, ceilings on foreign investment in the Korean stock market were to be lifted and gradually eliminated, bond markets gradually opened to foreign investors, and other measures taken to encourage (or at least to reduce impediments to) foreign investment, especially foreign direct investment, in Korea.

Kim Young-sam subsequently announced a series of anticorruption measures that proved to be very popular with the Korean people. In particular, a "real name" system for holding accounts in Korea was adopted, banning accounts established under fictitious names for nefarious purposes. Furthermore, the real owners of such accounts were required to be identified.[1] This was the key element in an effort to end what had become a common practice in Korea: chaebol executives seeking government favor would deposit funds into anonymous accounts held by politicians and senior government officials. Also, politicians and senior officials were required to disclose their personal assets, on the theory that questions raised about outsized assets would help curb the worst abuses (indeed, in the coming months disclosures raised questions that forced the resignations of a number of officials, including the mayor of Seoul). A particularly important result of implementing the real name system was that an account held in the name of Kim Woo-chung (the chairman of Daewoo) containing the equivalent of several million dollars was discovered to be in fact under the control of Roh Tae-woo, the former president. This disclosure paved the way for bringing charges of corruption against Roh; Roh's conviction on these charges is discussed below.

There was intense feeling in Korea that Kim Woo-chung (and other chaebol chairmen found to have been making payments to senior government leaders) should also be brought to trial. Charges indeed were brought against Kim and Samsung chairman Lee Kun-hee as well as eight other chairmen. All were found guilty and sentenced to jail terms—but all the sentences were suspended either by the presiding judges or on appeal. Kim Woo-chung pleaded that he had no knowledge of the bank account under the control of Roh and that in fact his subordinates had set it up without his approval. Accordingly, one of Kim's chief lieutenants at Daewoo, Lee Woo-bok, was forced to resign. Lee, a longtime personal friend of Kim, had exerted some moderating influence at Daewoo on Kim's inclination to expand at any cost; following his departure, this inclination was to go unchecked. Arguably, therefore, one unintended consequence of the anticorruption campaign was to set in train events that ultimately would lead to the complete collapse of Daewoo some years later (see chapter 5).

Kim Young-sam himself tried to set an example by disclosing his own financial assets and noting that he would accept no contributions during his term in office. He vowed to end the close relationship between government and business. All these gestures were to prove somewhat ironic in light of the scandals that involved his family and rocked his administration toward the end of his term.

1. The implementation of the real name requirement was largely the work of Soogil Young, who was then senior counselor to the deputy prime minister and who is quoted later in this book. The implementation of this plan was accomplished outside the aegis of the Ministry of Finance, which generally resisted reforms of this sort.

In 1994, Kim's government took steps meant to make Korea's economy more responsive to market forces and to further reduce the already rapidly diminishing role of industrial policy. The once all-powerful Economic Planning Board (EPB) was downgraded and placed in the Ministry of Finance, which was merged with the Ministry of Economics to create a very large Ministry of Finance and Economics. This reorganization was meant to signal the end of government playing the role of financial intermediation—that is, deciding how investment would be allocated.

The status of the Korea Fair Trade Commission (KFTC) was upgraded. This agency continued to investigate large numbers of violations of the Korean Antitrust Act (KAA), and the total number of cases under review increased from 622 in 1992 to 1,328 in 1997. And even though it continued not to attempt aggressive remediation of violations where these were found, it could keep the chaebol out of sectors if it believed that entry would have harmful effects, under its power to allow or disallow the groups to declare new core businesses. For example, the KFTC blocked an effort by Hyundai to enter the steel industry toward the end of the Kim Young-sam administration. The commission claimed that the move would have enabled Hyundai to become vertically integrated from production of steel to production of automobiles, and thus would have extended the group's market power. Some cynics, however, believe that the real reason for the action was to punish Chung Ju-yung further for entering the political fray in 1992.

These reforms were significant; but mindful of the fate of his predecessor, Kim Young-sam believed that that the top priority of his government should be to produce economic growth and not necessarily to promote reform. As noted above, he had been elected in 1992 during what has come to be known as the "growth recession" in Korea. Few other countries would have called 5 percent real growth per annum a "recession" of any sort. Even during the Roh years, according to Bank of Korea figures (*Monthly Economic Bulletin*, various issues), real growth in Korea had been very high by world standards: it was recorded as 12.0 percent in 1988, while real growth during the 1989 slowdown that resulted in the sacking of Cho Soon was 6.9 percent, a rate that would have delighted most countries. And as previously noted, 1990 and 1991 witnessed growth in the high single-digit range (9.6 and 9.1 percent respectively) but at the cost of renewed inflation. Thus, when measured growth fell to 4.7 percent (later revised to 5.0 percent) in 1992, this drop was seen throughout Korea as a major setback. Accordingly, three months into his administration, rather than implementing the second phase of the interest rate deregulation, Kim cut interest rates. In addition, regulations restricting the issuance of bonds by small and medium-sized businesses were eased in the name of economic stimulus.

Growth responded positively but weakly in 1993 (5.6 percent), and then headed toward 8 percent in 1994, despite the implementation in the fall of 1993 of the "Blueprint" for interest rate deregulation that executives of the chaebol had direly warned would harm growth. Real growth in 1994 in fact rose to 8.6 percent, followed by 8.9 percent in 1995. Moreover, unlike the growth spurt following 1990, the current growth was not accompanied by inflation. And perhaps the ease with which Korea was able to achieve this growth blinded both the government and large Korean firms to the problems that were mounting.

To a large extent, this growth was export-led. In particular, Korean exports benefited from the high Japanese yen, which gave Korean firms competing in export markets against Japanese-made goods a competitive edge. Especially in electronics (including semiconductors), automobiles, and ships, the effects of the high yen—the *endaka*—were spectacular.[2] These three sectors were, in the order just listed, the three largest exporting sectors of Korea in 1993, but all of them faced intense competition from Japanese firms in world markets. The three sectors were, of course, dominated by firms affiliated with the five largest chaebol. Stimulated both by growing world demand and enhanced competitiveness (courtesy of the *endaka*) relative to Japanese firms, in 1993 exports of finished electronics goods by the Korean "big three" (LG, Samsung, and Daewoo) increased by 37 percent over levels of a year earlier, with Samsung alone registering more than a 50 percent increase.[3] In 1993 dynamic random access memory chip (DRAM) exports were $7.7 billion, but they rose to $11 billion in 1994. Total exports of electronics goods by Korea in 1993 exceeded $20 billion. Accompanying this expansion of exports, Korean firms also undertook significant direct investment in overseas markets.[4]

Korean firms all added significant additional capacity to manufacture DRAMs in 1994. Samsung initiated more than $1.5 billion in new capital investment and LG more than $500 million. Some analysts at the time warned that international demand for DRAMs was highly cyclical in nature, that demand in 1993-94 was at the crest of the cycle (see, e.g., Ernst 1995, whose warnings were echoed in the electronics trade publications), and that a downturn was all but inevitable. The downturn in fact did come only 18 months later and helped to precipitate the 1997 crisis.

But in 1993 and 1994, all looked good. Indeed, this continued to be the case in 1995. Largely fueled by fast-growing exports of electronics products and automobiles, the Korean economy grew at an annual compound rate of almost 9 percent in 1995. Capital investment rates, already

2. However, Kang, Wang, and Yoon (2002), using vector autoregression (VAR) techniques, find that Korean industrial output before 1997 was only slightly affected by the yen/dollar rate. This assessment does seem contrary to the received wisdom expounded above that Korean firms in export sectors benefited substantially from the *endaka*.

3. Data from Korean International Trade Association, *Korea Trade Statistics*, various issues.

4. For explanations of this increase in direct investment, and also a review of literature pertaining to Korean FDI in electronics, see Perrin (2001).

high in 1994 (and themselves a major contributor to economic growth), jumped again in 1995. Gross domestic investment, which had hovered between 31 and 33 percent of GDP during the late 1980s, rose into the range of 35 to 37 percent of GDP during the 1993-95 period, a high figure even by Korean standards.[5]

Korea's second-largest export sector in 1993 was automobiles. Expansion in this sector also was rapid and, if one looked beyond the immediate future, arguably ill advised. Between 1992 and 1995, capacity to produce passenger cars in Korea grew by almost 30 percent, from 2.66 million units per year in 1992 to 3.35 million units per year in 1995.[6] But in 1992 domestic demand was only 1.27 million units, while exports totaled 456,000, so that capacity utilization was slightly less than 65 percent. To be sure, domestic demand had been growing rapidly for several years, and the number of automobiles in Korea per person, given per capita national income, was still low by international standards (Rhee 1996). However, as rapid as the growth of domestic demand was, capacity was added even faster, because Korean automotive executives anticipated continued growth of exports. In 1995, the gap between capacity and domestic demand was thus actually greater than in 1992. Domestic automobile sales in 1995 totaled 1.547 million units, while exports were 1.09 million units. Capacity utilization had improved to 78 percent. But whereas in 1992 domestic demand was 47 percent of total capacity and 74 percent of output, in 1995 domestic demand had fallen to 46 percent of total capacity and 58 percent of output. Improved capacity utilization was entirely the result of increased exports.

The largest market for Korean automotive exports was the United States, followed by western Europe. In 1993 and 1994, sales of Korean cars in the United States were helped immensely by the *endaka*, but not in western Europe, or at least not to the same extent. Other major export markets were Latin America and Southeast Asia, where despite high rates of protection and local overcapacity (Wonnacott 1994), Korean imports achieved significant market penetration. In the United States, most Korean cars sold were made by Hyundai, with Kia in a distant second position. Alas, market research done by J.D. Power during the mid-1990s (commissioned by Hyundai) showed that Americans considered Hyundai automobiles to be of low quality and low reliability, even though by objective measures the quality and reliability of these cars had improved sharply since the late 1980s when Hyundai first entered the US market.[7] Interestingly, the same

5. Bank of Korea, *Monthly Bulletin*, various issues.

6. Data from Korea Automobile Manufacturers' Association, *Monthly Automobile Statistics*, various issues.

7. The J.D. Power survey covered 38 makes of cars; Hyundai was ranked number 34 and Kia number 38. In 2002 these results were little different: of 36 makes, Hyundai had risen to 24th, but Kia remained in last place. By that time, Daewoo had begun to sell in the United States; it was ranked 34th.

market research showed that the quality of Hyundai cars was rated higher in the United Kingdom and Germany than in the United States. Hyundai entered Europe at a later date than the United States, and thus the research indicated the importance and persistence of reputation effects.

The main selling feature of Hyundai in both the US and European markets was low price, but beginning in early 1995 a falling yen and rising labor costs in Korea were jeopardizing the ability of Hyundai to maintain low prices in these markets. Also, Korean cars did not embody advanced technological features comparable to those found in Japanese-, European-, and US-made products; this deficiency was in fact the main motivation behind the XC-5 project. In spite of these difficulties, Korean manufacturers expected to double the volume of automobile exports between 1995 and 2000, with the growth necessarily coming from the US and European markets. One can wonder whether these projections were realistic even had the 1997 crisis never occurred. In fact, Hyundai's unit exports to the United States in 1991 proved to be the highest of any year during the 1990s, with unit sales unsurpassed until 2001. Hyundai Motor Company also served a number of smaller markets via foreign direct investment rather than export, mostly in Southeast Asia and Africa. These operations were typically small and, indeed, below what is generally recognized as minimum efficient scale. They survived only because of high tariffs on imported vehicles (Lautier 2001).

After it reentered the passenger car business, Kia recognized that it needed to sell cars at large volumes in order to be competitive with Hyundai. Thus, Kia also looked to the US market, establishing a sales network there. In its total worldwide sales, Kia quickly reestablished itself as the number two Korean automaker, displacing Daewoo, which had risen to number two after Kia's earlier exit. In 1993, Kia began selling its Sephia subcompact car in the United States. In 1995, well ahead of Hyundai and anticipating a trend, Kia introduced a sports utility vehicle to its US product lineup.

In 1995 Kia also announced that it would participate in what proved to be an ill-fated joint venture with the fourth son of Indonesian President Suharto to build automobiles in Indonesia. The project was touted by Suharto as one that would bring huge benefits to Indonesia and hasten that nation's progress down the road to becoming an industrial power; but, in fact, the project was designed mostly to further enrich Suharto's son. The project would start by Kia's exporting assembled vehicles and, later, knocked-down kits to Indonesia. But, over time, a full-scale assembly operation was meant to come on line. The project would also use ever-increasing local content. The undertaking overtly violated a number of World Trade Organization (WTO) commitments of Indonesia; a number of disputes formally were lodged against Indonesia at the WTO, all of which went against Indonesia. The project was canceled following the 1997 financial crisis and the subsequent fall of Suharto.

As noted earlier, Daewoo Motors was originally a joint venture with the US firm General Motors. General Motors in fact had exerted a moderating influence on Daewoo, refusing to go along with the plans of its chairman, Kim Woo-chung, to expand internationally. But, like Hyundai and Kia, Daewoo also had ambitious schemes for selling cars overseas. Unlike the others, Daewoo intended to do so largely via foreign direct investment rather than export from Korea, though its overseas operations would use components exported from Korea (Lautier 2001). Thus, in 1992 Daewoo used borrowed money to buy out GM's stake in its automotive subsidiary, which subsequently went on an overseas shopping spree. In particular, Daewoo bought and subsequently enlarged a number of plants in Uzbekistan, Poland, Romania, and Ukraine. Smaller operations were also established in India and elsewhere in Asia. The overseas expansion cost Daewoo on the order of $5 billion (Kirk 1999, 6). Chairman Kim's main goal seemed to be to displace Kia as the number two car producer in Korea. In 1997 Daewoo bought Ssangyong Motors, a small entry by the financially weak Ssangyong group into sport utility vehicles that was losing money.

Also seeking to become a major international car producer was Samsung, which had received permission from the Korean government to enter the automotive sector in 1992. After investing several billion dollars to this end in a joint venture with Japan's Nissan, Samsung chairman Lee Kun-hee hoped to open his factory near Pusan in February 1998—just as Korea was plummeting into the worst recession in its postwar history, as it turned out. Samsung would soon agree to sell the operation to Daewoo, but this deal was never consummated because Daewoo went bankrupt. Eventually, in May 2000 the French firm Renault along with the Japanese firm Nissan would take over Samsung Motors, with the Samsung group retaining a less than 20 percent minority interest; by then, Nissan itself would be under the control of Renault. Samsung Electronics had helped to finance the venture into the automotive industry, and one outcome was that Samsung Electronics realized substantial losses. These losses would become the basis for major disputes between minority shareholders of Samsung—including foreign mutual funds—and Lee Kun-hee.

The third major exporter in 1993 was the shipbuilding sector.[8] Probably even more than in the other two sectors, shipbuilding—which was, as we have seen, the first of the heavy and chemical industries sectors in which Korean firms emerged as world leaders, led by Hyundai and followed by Samsung, Daewoo, and several smaller firms—benefited from the *endaka* of the early 1990s. Thus, whereas in 1992 47.9 percent of all orders worldwide (by gross tons) for new ships went to Japanese producers and 17.3

8. Data in this paragraph are from Lloyd's Register, *World Shipbuilding Statistics*, various issues.

percent to Korean producers, in 1993 the orders for new ships going to Korea exceeded those going to Japan, 37.8 to 32.3 percent. However, because Japanese producers had more capacity than Korean producers, in 1993 the volume of ships under construction still favored Japan, 45.4 to 22.3 percent. Because there was worldwide excess capacity in this sector in 1992 despite growing world demand, competition was fierce and based almost entirely on price. Furthermore, demand in this sector was notoriously cyclical. There had been a cyclical low in 1988, when 11.8 million tons of new orders were placed, but 15.9 million tons were ordered in 1990 and 16.1 million tons in 1991. Then, new orders fell to slightly more than 12 million tons in 1992 but climbed to almost 24 million tons in 1993. This high demand was creating a heyday in the sector, but many expected that demand might fall substantially in the future.

Price competition in shipbuilding was the rule even though the technological prowess of producers varied widely around the world. In 1992 Japanese-built ships embodied more advanced technology than did Korean-built ones (Kim Doo-suk 1996), and this was true in spite of efforts by Hyundai during the 1980s to upgrade the technical capabilities of its shipyards. Korea was able to compete by offering prices low enough to offset Japanese technological advantages. Those prices in turn were possible in part because Korean steel was priced much lower than Japanese steel (and the quality of steel, especially from the Pohang Iron and Steel Company, or POSCO, was high). Also, as just noted, in 1993 the *endaka* became a major factor in Korea's favor. Together, these factors lowered Korean shipyards' costs to about 73 percent those of the Japanese for ships of similar design and comparable size (Kim Doo-suk 1996, 68). Kim Doo-suk estimates that technological factors favoring Japanese producers were such that Korean prices had to be 75 to 85 percent those of Japanese prices for Korean ships to be competitive, with the high yen of 1993 giving only a slight competitive edge to Korean shipbuilders. Thus, while the *endaka* put the Koreans into a position that was favorable, it was also precarious.

The shipbuilding sector in Korea was not a large employer, but it was Korea's third-largest exporter in 1993 and a sector on which large numbers of Koreans indirectly depended on employment (e.g., those in the steel industry). Only four years earlier, the Korean industry had been in such bad shape that in 1989 the government had ordered a halt to capacity expansion and had extended special assistance to the most afflicted shipbuilders, Daewoo, Halla (which then was a sizable seller of smaller vessels but did not build large ships), and Hanjin. Hyundai and Samsung by contrast were relatively well-off. This period had been characterized by a won valued high relative to the yen. Even so, Korean shipyards operated at about 80 percent of the cost of Japanese yards, but this cost advantage was not enough to offset Japanese technological advantages. Thus, the heyday of 1993 in this sector was a welcome relief.

Given the glut that had persisted for many years in the global shipbuilding sector, Korean firms did not add much capacity during the late 1980s or early 1990s. But then, at the height of the 1993 boom, the Halla group, controlled by a nephew of Hyundai chairman Chung Ju-yung, decided to do what Hyundai had done in the early 1970s—to enter the large-ship sector by building what Halla claimed would be the most modern and efficient shipbuilding operation in Korea, if not the world. But by the time the shipyard was ready to be opened, the bloom was off the boom, and the whole group, mired in debt, would have to declare bankruptcy.

This move by Halla helped to propel an effort at the Organization for Economic Cooperation and Development (OECD) to put some sort of limits on government subsidies to shipbuilding. Thus, in 1995 the OECD concluded a shipbuilding agreement in which Korea participated along with the nations of the European Union, the United States, Japan, and the non-EU Scandinavian shipbuilding nations: it was designed to eliminate or reduce subsidies given to shipbuilders and to prohibit "injurious pricing" (or, as some countries put it, "dumping") in this industry. Given that Korea was the nation that relied the most on low costs and low prices to compete in world markets, Korea was arguably the nation most affected by the agreement. One consequence was to cause Korean producers to take steps to improve the technology used in their product.

Expansion by the chaebol during the 1990s was not limited to the enlargement of existing operations or the entry by one group into activities already undertaken by other groups. Some chaebol entered into entirely new activities, one of which was aircraft manufacture. Samsung entered this business in a licensing arrangement with Lockheed Martin to manufacture F-16 military jets for use by the Korean air force, Hyundai established a subsidiary to produce light aircraft of its own design, and Daewoo produced training aircraft for military use (Kirk 1999).

The Second Half of Kim Young-sam's Administration

The first half of Kim Young-sam's administration may have been characterized by nominal reform accompanied by considerable optimism and expansion, but the second half was marked by growing indications that rough waters lay ahead.

These danger signs grew prominent even though reforms continued. Thus, in 1995 the second phase of the 1993 "Blueprint" for interest rate deregulation was implemented one year ahead of schedule (this was, of course, the third phase of the original 1991 four-phase plan). Then, in 1996 Korea became a member of the Paris-based OECD, an international organization often termed the "rich nations' club." OECD membership required that Korea adhere to the OECD Code on Liberalization of Capital

Movements, and to meet the obligations of this code Korea implemented a number of financial reforms, mostly pertaining to external accounts (see Noland 2000). Under plans that were to be phased in over a number of years, Koreans would be allowed to hold foreign bank accounts and to purchase foreign securities. Domestic firms could freely issue warrants denominated in foreign currencies (previously they could do so only with government approval). Non-Koreans could issue securities denominated in won, and limits on foreign purchases of Korean equities would be lifted. Foreigners would be allowed to purchase short-term won-denominated bonds; restrictions on purchase of long-term bonds would also be relaxed, but in an unspecified time frame. Foreigners would also be allowed to hold won-denominated accounts at overseas branches of Korean banks.

The overall effect of these liberalizing measures was that short-term capital accounts were largely opened, but long-term ones were not. This sequencing, most experts would agree, was wrong (Dobson and Jacquet 1998; Shin and Wang 1999), because short-term money could now flow into Korea to finance long-term investment. The result would be a mismatch between the term structure of liabilities (the short-term debt owed to foreigners) and assets (the long-term investments financed by that debt, if the foreign financing was direct; or, if the foreign funds were intermediated by banks, the loans of the banks to those who made the ultimate investments). Bankers generally see this mismatch as problematic because if investors who have funded the liabilities were to withdraw their funds, there likely would be no liquid funds available to pay the investors. Thus, withdrawal of funds would create a liquidity crisis. In fact, in late 1997 exactly such a withdrawal precipitated the biggest economic crisis in Korea since the time of the Korean War. Also, the OECD liberalization created a mismatch between currency denomination of liabilities and assets of Korean banks. Assets were held mostly in local currency (won), while liabilities were often denominated in foreign currency (mostly US dollars). Under these conditions, were the won to depreciate significantly against the dollar (as happened in late 1997), the banks would suffer losses as their liabilities, when expressed in won, would grow (or, equivalently, their assets, when expressed in dollars, would shrink), implying shrinkage of the banks' capital.

After liberalizing capital accounts pursuant to joining the OECD, Korea did experience a significant increase in the rate of inflow of short-term capital. Portfolio investment in Korea (including short-term bank loans) increased from 1.2 percent of GDP in 1993 to 3.2 percent in 1994, and then jumped to 4.2 percent in 1995. These inflows rose further to 5.4 percent of GDP in 1996. Because controls on capital outflows had also been relaxed, these jumps were partially offset by increased capital outflows, mostly on direct investment accounts; but, even so, the net international indebtedness of Korea grew. Sterilized intervention was employed to prevent the capital inflows from triggering uncontrolled domestic monetary expansion and hence inflation. Nonetheless, because the nominal exchange rate was fixed, the real exchange rate appreciated, reducing the competitiveness of Korean exports (Kwack 1999; Krueger and Yoo 2001; Warr 2000). Kwack Sung-yeung (1999) argues that with international capital mobility increasingly a fixture of the economic landscape in Korea during the mid-1990s, a move from a fixed exchange rate to a floating rate (which would have increased uncertainty about future exchange rates) might have discouraged at least the more speculative of the short-term flows and hence might have averted the crisis that followed. However, Korea did not choose to float the won. Peter Warr (2000) notes that as the 1990s unfolded, the won became increasingly overvalued as signaled by declining rates of growth of exports, declining terms of trade, and rising current account deficits (especially after 1995). He also suggests that capital outflows during the second half of 1997, leading to the currency crisis late in that year, might have been the result of expectations that the won would be devalued.

As foreign borrowing increased, so did the use of debt financing, especially in the manufacturing sector, where debt continued to rise faster than assets. At the beginning of 1994, the ratio of total borrowing to total assets in the Korean manufacturing sector was an already high 45 percent. By the end of 1997, this ratio had risen to almost 60 percent (Organization for Economic Cooperation and Development, *OECD Economic Surveys: Korea 1999*).

Following his legislative victory in 1996, Kim Young-sam stepped up his anticorruption drive by seeking indictments for corruption against his two immediate predecessors, Chun Doo-hwan and Roh Tae-woo, even though he had reason to be grateful to Roh at least for having essentially given him the 1992 presidential nomination. Kim Young-sam's hand was doubtless forced by the revelation of the account nominally held by Daewoo chairman Kim Woo-chung but actually held by Roh, described earlier. Chun was also to face capital charges for the 12/12 Incident and the slaughter in Kwangju.

The anticorruption trials drew enormous public support; they revealed that both men had received a total of more than $1 billion in bribes, most of which had been used to finance political slush funds.[9] Both were convicted and sentenced to long jail terms. Chun also was convicted on capital charges and sentenced to death. This latter sentence was commuted in late 1996 by an appeals court. As noted in chapter 3, in December 1997, both men were set free by Kim Young-sam, with the concurrence of then president-elect Kim Dae-jung.

As also noted earlier, Kim Young-sam sought to press charges against the leaders of the chaebol who had paid the bribes to Chun and Roh.

9. There is no evidence that either of these men gained exceptional personal wealth as a result of the bribes.

Indictments thus were handed down in 1996 against Lee Kun-hee of Samsung and Kim Woo-chung of Daewoo as well as the heads of a number of smaller groups. Both chairmen appeared unfazed by the indictments and no one expected that they would face any serious penalties. Both were convicted, but as noted earlier, Lee received a suspended sentence while Kim Woo-chung was sentenced to a jail term that was never served.

In January 1997, Kim Young-sam announced the formation of a presidential commission consisting of 31 members drawn from the industrial and financial sectors and from academia. Its mission was to prepare a comprehensive set of further reforms for the financial sector. Later in the year, the commission duly presented two sets of recommendations, one dealing with interest rate reform (essentially, implementation of the fourth phase of the earlier four-phase plan for interest rate decontrol) and the other with the reduction of entry barriers to the financial sector in Korea and with measures to address ailing financial institutions and to improve the central banking and supervisory functions of the government (Lee S. 1998). The Ministry of Finance and Economics subsequently drew up a plan that, according to the ministry, would implement 89 percent of the commission's recommendations. But these reforms proved to be too late and too little to head off the crisis that ensued six months later, though they were mostly pointing in the right direction. In fact, many of the commission's reforms were incorporated one year later into the conditions accepted by the Korean government in exchange for assistance by the International Monetary Fund.

In 1996 it became clear that at least some of the earlier capacity augmentation had been overzealous. In that year, domestic demand slackened and, affected by the high value of the Korean won, export growth came almost to a halt. As a result, Korean economic growth fell to 7.1 percent in real terms, from 8.9 percent in 1995, with a further drop expected in 1997. This spelled difficulty because, as noted in the previous section, during the prior five years so many Korean companies had made aggressive capital investments, their decisions based on what were proving to be overly optimistic projections about future growth. Moreover, most of these firms were leveraged to the hilt, to the point that even a modest slowdown could endanger their financial health and significantly increase bankruptcy risk.

Indeed, by 1996 earlier bankruptcies following periods of excessive debt-financed capital investment had faded in memory. The last such major cataclysm had been in 1985, with the failure of the Kukje group. But in 1997, even before the financial crisis broke out, bankruptcy struck a number of chaebol, including one in the top 10 (but not in the top 5, which have been the focus of most of the discussion in this book).

The first of these raised eyebrows, to say the least. This was the failure of the Hanbo group, already mentioned in connection with land speculation during Roh's presidency. Hanbo's main business was not real estate but steel, and it was in fact one of the least diversified of the groups identified by the KFTC as the top 30 groups in Korea. Hanbo, then number 14 on the KFTC list,[10] was the second-largest steel-producing firm in Korea. But Hanbo was far behind the largest steel producer, state-owned POSCO, by any measure (e.g., assets, output, or employment). Hanbo produced specialty steels that did not compete directly with POSCO's primary steel products and also performed downstream processing of primary steel. Hanbo had interests as well in construction, pharmaceuticals, and energy, but these were small compared to the steel operation. The group was extraordinarily highly leveraged even by Korean standards, as had been Kukje 10 years earlier. In January 1997, Hanbo declared that it was unable to service its debts of close to $6 billion and filed for bankruptcy.

Subsequent investigations revealed some sordid tales. Hanbo, in attempting to get banks to "evergreen" loans so that the firm might stay in operation, had bribed a number of influential persons to pressure the banks. One of those who had accepted bribes was Kim Hyun-chol, a son of President Kim Young-sam. It was alleged that some of the funds had been used to finance the 1992 campaign. Kim Young-sam worsened his own situation by refusing to release any records of these moneys, claiming that none had been kept. Kim Hyun-chol was convicted of accepting bribes and sent to jail, as was the CEO of Hanbo. President Kim's reputation as a corruption fighter was sullied and he fell into disgrace. Over the next year, he largely withdrew from the political arena; in July 1997, the nomination as candidate for president from the Democratic Liberal Party went to Lee Hoi-chang, and Kim played no role in the process. The scandal resounded to the benefit of Kim Dae-jung, who led the movement to force Kim Young-sam to disclose his campaign finances.

Possibly because of the scandal, Hanbo's crisis was not resolved in what had become the typical Korean style. The firm did not receive massive government aid, nor was it sold to cronies of the sitting president. Rather, it came effectively under government control, and the group's management was fired. As was typical of the earlier periods, however, funds were advanced to Hanbo to allow its operations to continue.

Further bankruptcies followed. The Sammi Steel Company, a specialty steel producer and the largest subsidiary of the 26th-ranked Sammi chaebol, declared itself bankrupt in March 1997, threatening the whole group.

10. As Noland observes (2000), this ranking was based on assets, which in Hanbo's case were considerably overvalued; had these been correctly valued, the firm would have ranked lower (Noland says 17th).

Hanbo, like other private steel companies in Korea, was largely a downstream producer of steel products. As noted earlier, the production of crude (unprocessed) steel in Korea comes almost entirely from state-owned POSCO, which supplies product for further processing to downstream firms, whose capacity in Korea was largely created during the 1980s and 1990s.

This triggered massive price declines for most stocks listed on the Korean Stock Exchange. The Jinro group, a large producer of beverages, defaulted on debt in April. The government's response to both these problems was more "classic" than its response to Hanbo: on April 18, 35 Korean banks, with government backing, announced an "antibankruptcy pact" whereby funds would continue to be lent to Sammi and Jinro to enable them to continue operations (Haggard 2000). The state-owned Korea Asset Management Corporation subsequently bought these loans from the banks, thereby injecting new liquidity into the banking system as well as removing what likely would be nonperforming assets.

The antibankruptcy pact was then extended to firms other than Sammi and Jinro. It called for the banks to continue to provide credit, and to suspend debt-servicing charges, to any of the large groups that could not meet these charges for a period of 90 days, but only if it was judged that the group was fundamentally sound and able to present a credible plan to restore itself to financial health.

This pact was soon to be tested severely, as the next card to fall was an important one: the Kia group, the big producer of trucks, buses, and motorcars. On June 23, 1997, the chairman of this group, Kim Sun-hong, approached the government for assistance because Kia's banks were unwilling to roll over loans that were coming due. The firm was made subject to the antibankruptcy pact, but Kim denounced this as inadequate and attempted to organize a "Save Kia" campaign. The campaign failed, and on October 22, the Kia group was nationalized and its management ousted. It has been reported that Kia's largest single shareholder, Ford Motor Company, was never notified of the nationalization.

Further problems erupted in October and November, as the financial crisis took hold. On October 2, the Ssangbang Wool Company, a textile producer, announced that it would likely default on debt. And in November, the Newcore group announced that 9 of its 18 affiliates faced imminent bankruptcy and would file for court protection. Two smaller bankruptcies, of the Kukdong and Hanil groups, also occurred in late 1997. Each of these owned assets that had formerly been in the Kukje group, which had been liquidated in 1985.

Thus, the warning signs were proliferating in 1997 that there were major problems in Korea that stemmed from the highly indebted chaebol and falling rates of return on capital, brought on in large measure by overexpansion of these groups. Even so, in the spring of 1997, Soogil Young, then president of the Korea Institute for International Economic Policy and a former top economic advisor to Kim Young-sam, seemed to believe that although long-term problems did exist, no crisis was imminent. Speaking before an audience in Washington, DC, Young stated:

> There is, in any case, no need for serious concern in the short term for Korea's foreign debt position. . . .

To say that there is no imminent crisis is not the same thing as saying there is nothing to be concerned about. There is indeed a crisis in progress in Korea —a longer-term crisis. The structure of high cost and low efficiency has become embedded in Korea's economy since the late 1980s, if not earlier, and has since been in place, largely intact, despite various efforts to ameliorate it. The result has been a gradual, but continual, loss of international competitiveness. This threatens the medium and long-term growth prospects of the Korean economy.

This problem of the Korean economy has been manifest since the late 1980s with the emergent supply inflexibilities in the markets for labor and land, and with the consequent spiraling of the costs of these factors of production. Korea's notorious supply-side inflexibilities in the financial market had been continuing unabated. In the market for goods and services, *chaebol* had been by and large resisting the pressure for the reform of their management and governance, and in this way failing to adjust to the emerging new realities of global competition[.] (Young S. 1997)

Young's worries about the long-term problems of Korea were certainly on the mark, but his soft-pedaling of short-term concerns was not. In fact, I was able to speak privately with Young at the function where the remarks cited just above were delivered, and found that he was, off the record, actually quite worried about the state of the Korean economy in even the short run. He was soon proven right.