Cambridge Journal of Economics 2002, **26,** 667–678

COMMENTARY

This section is designed for the discussion and debate of current economic problems. Contributions which raise new issues or comment on issues already raised are welcome.

A political-economic analysis of the failure of neo-liberal restructuring in post-crisis Korea

James Crotty and Kang-Kook Lee*

This paper evaluates IMF-led neo-liberal restructuring in post-crisis Korea. The main conclusions are that: the economic rebound in 1999–2000 was both incomplete and unsustainable; restructuring created a ongoing credit crunch that continues to constrain investment spending; Korea may have been pushed onto a long-term low-investment, low-growth trajectory; insecurity and inequality have risen substantially; and the influence of foreign capital has dramatically increased. The paper concludes by suggesting that Koreans should reject radical neo-liberal restructuring and consider instead reforms to democratise and modernise their traditional state-guided growth model.

Key words: Globalisation, Korean crisis, Neo-liberalism, IMF restructuring
JEL classifications: E61, G18, O53

1. Introduction

From 1961 to 1996, Korea's version of the East Asian state-led growth model achieved what some believe to be the greatest development success in history. Real GDP growth averaged 8% a year, while real wages rose at annual rate of 7%. Many Western economists admired the efficiency of the Korean model. For example, Stanley Fischer, until recently First Deputy Managing Director of the International Monetary Fund (IMF), wrote in 1996 that 'there really has been a miracle in East Asia', adding that the view that government action was central to this success is 'widely shared' (1996, pp. 345, 347). However, in the decade preceding 1997, under external pressure from G7 governments

Manuscript received 19 November 2001; final version received 8 March 2002.

Address for correspondence: James Crotty, Economics Department, University of Massachusetts, Amherst, MA 01003, USA; email crotty@econs.umass.edu
*University of Massachusetts, Amherst. We are grateful to Jim Boyce, Ha-Joon Chang, Gary Dymski, Bob Pollin and Mohan Rao for helpful comments on an earlier draft. James Crotty would like to thank the Ford Foundation and the Political Economy Research Institute at the University of Massachusetts Economics Department for research support.

References for data cited here can be found in Crotty and Lee (2001), a longer version of this paper, available on the Internet.

© Cambridge Political Economy Society 2002

and foreign firms and banks who wanted to share in the Korean 'miracle', and internal pressure from the large family-owned conglomerates known as *chaebol* and wealthy individuals who wanted freedom from government restraint, the state ended its traditional control of *chaebol* investment decisions, substantially reduced its regulation of domestic financial markets, and, critically, liberalised short-term capital flows. Chang and Evans argue that 'the dismantling of the development state was effectively finished by . . . 1995' (1999, p. 29).

This ill-advised liberalisation led to a rapid inflow of short-term foreign bank loans. Foreign short-term credit, which stood at $12bn in 1993, rose to $32bn in 1994, $47bn in 1995 and $67bn in 1996. These funds helped fuel an over-heated investment-led boom and created serious financial stress in the economy. In 1997, after the beginning of the Asian financial crisis, foreign banks demanded immediate repayment of their loans. Illiquid Korean banks and highly leveraged Korean firms were unable to comply. Pushed to the verge of default, the Korean government accepted an IMF loan to repay the foreign debt incurred by its banks and non-financial corporations. In return, the IMF took control of the Korean economy.

Though the external crisis that brought the IMF to Korea was caused by the deconstruction of the traditional model, not its inherent flaws, the model was suddenly declared to be non-reformable in principle.[1] The IMF therefore began the process of replacing it with the only economic model said to be viable in the new era—a lightly regulated, globally integrated, free market economy. The IMF had an enthusiastic partner in President-elect Kim Dae Jung. In a 1985 book titled *Mass-Participatory Economy: a Democratic Alternative for Korea*, he stated that 'maximum reliance on the market is the operating principle of my program' and that 'world integration is our historic mission' (1985, pp. 78, 34). 'I believe that the crisis will be remembered as a blessing,' Kim announced in 1999, 'because it is forcing essential economic changes' (*New York Times*, 18 February 1999).

Neo-liberal restructuring would have failed to restore security and prosperity to the majority of Koreans, no matter how it was implemented. In the post-World War II era, no developing country has ever experienced long-term, widely shared growth based on the adoption of a neo-liberal model. *But the mode of implementation of neo-liberalism in Korea was exceptionally destructive*. To minimise transition cost, the shift to a neo-liberal model should have been gradual, and it should have taken place under conditions of reasonable economic growth. A rapid replacement of existing institutions with a radically different set can fracture existing economic relations before new ones can be established, destroying an economy's coherence. And it is impossible in a depressed and financially fragile economy to identify and eliminate inefficient firms and banks when almost every firm and bank faces insolvency, and when the entire price–profit system is in chaos. The appropriate macro policy response to the crisis should have been expansionary budgets, low interest rates and the maintenance of a supply of credit adequate to support moderate demand growth. This is the typical policy response of developed country governments in times of financial crises, as well as the approach taken by Korean governments in earlier crises. However, the first thing the IMF did when it took power in December 1997 was to order a compliant President-elect Kim to impose austerity macro policy. Interest rates were boosted to 30%, and fiscal policy was sharply tightened in the first half of 1998.

The imposition of austerity macro policy in the wake of the financial crisis was certain to trigger an economic collapse. The rate of decline of the won accelerated as soon as these

[1] See the analysis of the causes of the Korean crisis in Chang *et al.* (1998) and Crotty and Dymski (1998).

policies were announced, real GDP growth plummeted, and the rate of unemployment quadrupled—from 2·1% in October 1997 to 8·6% in February 1999. *The IMF and Kim Dae Jung must have known that their macro policy would have disastrous economic consequences, because everyone else knew*. Criticism of IMF policy was widespread. The 17 December 1997 issue of the *Korea Herald* reported that the Minister of Labour predicted a doubling of unemployment from its already high level, and quoted a consensus forecast by private-sector economists that unemployment would triple to over two million. The 17 January 1998 edition of the *New York Times* predicted that Korean unemployment would reach 10%. Jeffrey Sachs called the IMF programme 'folly' and an 'indiscriminate punishment' of Korea (*New York Times*, 8 January 1998). Paul Krugman suggested that default would have been better than the IMF programme (*New York Times*, 18 December 1997).

The IMF–Kim team immediately proceeded to restructure radically Korea's industrial and financial institutions in the midst of the economic and financial collapse, a decision that cannot be justified on economic efficiency grounds. Unless we are willing to believe that the IMF–Kim team was astoundingly incompetent, we must assume that its motivation for this bizarre policy decision was political. Keep in mind that they faced a serious dilemma upon taking control of the Korean economy. An attempt to impose their free-market revolution in a non-crisis environment would have met with determined resistance from labour, large segments of the Korean people, and even some sectors of the business community. *The creation of an economic collapse that weakened the labour movement and disoriented much of the Korean public was thus a necessary political precondition for the implementation of radical neo-liberal restructuring.* Austerity macro policy generated the sudden appearance of a large 'reserve army of unemployed' which debilitated the labour movement, while the crisis and collapse frightened much of the middle class, making it politically feasible to proceed with restructuring. Many middle class Koreans were in favour of a continuation of the pre-crisis liberalisation process from which they had personally profited, but they did not support economic collapse or a radical neo-liberal revolution. Since the new policies had to be implemented while economic conditions kept political resistance weak, Korea ended up with a 'big-bang' rather than a gradual version of neo-liberal restructuring.

The Korean economy rebounded from its 1998 collapse faster than expected. In mid-2000, supporters of neo-liberalism declared Korea's recovery a new 'miracle'. However, as we demonstrate below, four years of restructuring have created an economic disaster. The extent of this disaster was magnified by the economically dysfunctional but politically expedient mode of implementation of neo-liberal reforms.

2. A brief macro economic overview of Korea under restructuring

The combination of financial crisis and austerity macro policy followed by radical restructuring caused a precipitous drop in economic activity in 1998. Real fixed investment fell by 22%, real consumption by 12%, and real GDP by 6·7%. With domestic demand and the exchange value of the won in free fall, the balance of trade improved dramatically. Merchandise imports fell by $50bn, creating a trade surplus of $41· 6bn for the year—a record 13% of GDP. This was the only thing that kept Korean aggregate demand from total collapse; real final domestic demand fell by 13·8%.

Then came the rebound. Real GDP grew by almost 11% in 1999, and nearly 9% in 2000. The unemployment rate dipped below 4% in 2000. Continued trade surpluses

($28bn in 1999 and $17bn in 2000) helped restore the country's production and employment levels.

However, the recovery was incomplete. In 2000, consumption was only 6% above its pre-crisis level. Real fixed capital investment in 2000 was still 9% lower than in 1997 largely owing to the prolonged collapse of the construction industry, and real equipment investment by large manufacturing firms—the core of Korea's export-led economy—was still 37% below its 1995–97 level.

The recovery was also unsustainable. High growth in 1999 and 2000 is attributable to large trade surpluses, the rebound of investment and consumption from their collapse in 1998, and a dramatic shift from contractionary to expansionary macro policy after mid-1998. The huge trade surplus was central to the recovery, yet it shrunk by over $8bn in 2001 as exports fell by 13%. Liberalisation raised export dependence by over 50% from 1993 to 2000, but with both the US and the global economy now growing at a very low pace, prospects for renewed export-led growth are dim indeed. Since the terms of trade have fallen by 35% since 1995, it would make no economic sense for Korea to try to continue to export its way to acceptable growth rates, even if that were possible.

Significant fiscal stimulus is also not likely to continue. Though public debt as a percentage of GDP roughly doubled since the crisis, it remains at the low end of OECD countries. Nevertheless, external agencies such as the IMF and the OECD are pushing very hard for a return to fiscal and monetary conservatism. In 2000, the Korean government actually ran a budget surplus in excess of 1% of GDP, though it shifted into deficit again in early 2001 in response to the slowdown that began in late 2000.

Finally, neither investment nor consumption is likely to continue the rapid growth shown in 1999 and 2000. Investment growth is constrained by low profits, a credit crunch and sluggish exports. Consumption spending has recently been rising more rapidly than disposable income, but only because of an explosion of household debt (discussed below). There are obvious limits to, and potential financial dangers associated with, sustained debt-fuelled consumption spending.

These underlying problems became evident in late 2000. Real GDP growth slowed dramatically in the fourth quarter of 2000 and has been sluggish since. Total fixed investment in the third quarter of 2001 was 3% below its year-ago level. A government survey of the largest 2,828 non-financial firms conducted in October forecast a decline in real equipment investment spending of 14% for 2001, putting it 45% below the 1995–97 average. These data heighten concern about a possible permanent decline in the rate of capital accumulation. Even with the recent rise in household debt, household consumption for the first three quarters of 2001 was only 2·3% above the same period in 2000. Total employment fell by almost 4% between November 2001 and January 2002. The IMF estimates real GDP growth for 2001 at 2·6%, which is the lowest growth rate in near two decades, 1998 excepted. Though the economic slowdown appears to have ended, at least temporarily, in the first two months of 2002, intermediate growth prospects are modest at best.

Meanwhile, Korea, a country proud of its tradition of social solidarity, is discovering that there are no exceptions to the iron rule that neo-liberalism generates rising inequality everywhere. Not only was median real household income in mid-2000 still below its 1997 value, but the Gini coefficient, which equalled 0·28 in 1997, reached 0·32 four years later, and the ratio of the income of the highest quintile of households to that of the lowest quintile rose by 19% from 1997 to 2001. The household poverty rate more than tripled from 1996 to 1999.

3. Neo-liberal restructuring in labour, finance and the corporate sector

The objective of the IMF–Kim team was to accelerate dramatically the liberalisation process that began in the late 1980s. Their concrete goals were to increase the efficiency of the Korean economy by: creating a fully 'flexible' labour market; ending government interference with the free-market allocation of finance (through conversion from a state-guided, bank-based to a globally open, capital-market-based financial system); breaking up the *chaebol* conglomerates; substituting stock market for founding-family control of *chaebol* firms; and fully opening all Korea's markets to foreign banks and firms. 'What we need now, more than anything else, are foreign investors,' Kim stated in an address to the US Congress in 1998.

3.1 Restructuring labour

President-elect Kim was determined to erode the domestic market power of large *chaebol* firms through massive foreign investment, which would not take place unless Korea's militant unions were tamed. Breaking the strength of the labour movement thus became a central policy goal. Capital–labour conflict over the flexibility issue was at a temporary standstill after the successful general strike of January 1997. This changed dramatically in early 1998 as austerity policy quickly created rapidly rising unemployment. With labour badly weakened, the IMF demanded that the government immediately repeal the traditional labour laws protecting job security, as its agreement with Korea specified. New capital-friendly labour laws were enacted in February 1998. For the first time in modern Korean history, firms were allowed to fire as many workers as they pleased in cases declared to be of 'urgent managerial need' (which included foreign take-overs) and temporary help agencies were legalised.

Prior to the crisis, Korea was the only OECD country with over 40% of those who worked for a non-family member in the insecure and poorly treated status called non-regular or non-permanent. From 1992 to 1996, about 58% of Korean workers had permanent job status. But in the context of collapsing sales, the *chaebol* were able to take advantage of the new labour laws by firing large numbers of permanent workers in 1998 and early 1999, then hiring mostly cheaper, non-union, temporary workers when demand improved in 1999 and 2000. Their actions pushed the percentage of permanent workers down to just above 48% in 1999 and just below 48% in 2000. Seventy per cent of female employees had irregular status in 2000, compared with 57% in 1995. Moreover, Koreans traditionally worked very long hours. In 1999, the Korean manufacturing work year totalled 2,760 hours, second in the OECD only to Turkey. The collapse in 1998 brought no reduction in hours, and in 1999 and 2000 hours worked met or exceeded their decade highs.

Knowing that restructuring would lead to high unemployment and rising poverty, President Kim expanded Korea's weak social welfare system. Unfortunately, the level of income protection for most workers remains woefully inadequate. A 2000 OECD report on Korean labour and welfare policies reported that only one in nine unemployed receive unemployment benefits, such benefits amount to but 50% of the previous wage, and the maximum duration of benefits is three to eight months. Moreover, only a quarter of those of retirement age receive a pension of any kind, while the average pension is about two to three US dollars per day.

Large *chaebol* firms have cut employment, substituted non-regular, non-union workers for permanent workers, and raised labour productivity. After hesitating in 1998 in order

to see whether the Kim government and the *chaebol* would make good on their promise to tame Korea's unions, foreign capital poured into Korea in 1999 and 2000. None of these results sought by the IMF–Kim team would have been possible in the absence of the deliberately created mass unemployment of 1998–99 and brutal attacks on labour unions by the Kim government. More than 650 labour activists have been arrested since 1997. An OECD report on Korea observed that 'arresting and imprisoning workers for what might be considered legitimate trade union practices is back in vogue, a matter of considerable concern both at the OECD and the International Labour Organisation'. The union movement has now been badly weakened, though it is not yet broken.

3.2 Restructuring financial markets

The government's objectives were to drive weak financial institutions from the market, clean up the large volume of non-performing loans (NPLs) generated primarily by its own macro policies in early 1998, recapitalise viable financial institutions, apply stronger prudential regulation to avoid excessive risk, assign one or two main creditor banks to monitor and control the credit allocated to each important *chaebol* group, and induce foreign banks to take control of much of Korea's banking system in order to modernise its management techniques and raise its profitability.

After the severe economic collapse in 1998, all institutions involved in corporate lending were in desperate shape. The government was thus required to inject huge amounts of public money into the banking system. Public funds spent on financial restructuring through September 2001 totalled over 150 trillion won—an astounding 29% of 2000 GDP. This huge infusion of public capital gave the government control over almost all important Korean banks. The *de facto* nationalisation of the banking system meant that the Kim government now had immense power over the debt-ridden *chaebol*: the avowedly neo-liberal state had put itself in control of the core of the private economy.

Strict prudential regulations were implemented immediately, in the midst of the economic collapse in 1998. Badly weakened commercial banks and non-bank financial intermediaries (NBFIs) were required for the first time to meet the Bank for International Settlements (BIS) capital adequacy standards, which required that capital must be at least 8% of the full value of total loans. As rising NPLs and the collapse of asset prices shrank the value of capital, and the criteria for classifying loans as non-performing were tightened significantly, banks were forced to reduce the supply of loans sharply. Banks and NBFIs had no choice but to refuse to renew expiring loans and stop new lending. The ill-timed application of the BIS standard and the closing of a large number of banks and NBFIs drastically cut credit flows to the business sector. To implement such radical change in a short period was itself extremely irresponsible. But to do it in the midst of a severe economic and financial collapse, when most important financial institutions were already insolvent, was clearly malevolent.

IMF macro policy had already created a contraction of the credit supply. Financial restructuring policy turned this into a severe credit crisis. The dramatic drop in bank credit to the corporate sector caused firms to slash investment, wages and employment further, thereby aggravating the ongoing deficiency in aggregate demand. Falling demand pushed more firms into bankruptcy, which increased the volume of NPLs in the banking system. This forced banks to lower credit even further in an attempt to raise capital adequacy to mandated levels. The disastrous results of these policies were inevitable and thus foreseeable. As World Bank Chief Economist Joseph Stiglitz put it: 'If, in the midst of

a downturn, we push banks too quickly toward "prudent" capital adequacy ratios, we risk shutting down the flow of credit entirely' (quoted in Kumar and Debroy, 1999, p. 16).

In the four years since the outbreak of crisis, non-financial firms in Korea have experienced an ongoing credit crunch with two phases. Total funds made available to highly levered real-sector firms dropped from 117 trillion won in 1997 to just 28 trillion won in 1998. This evaporation of credit was a major cause of the collapse of investment spending and the rapid deterioration in the financial health of real sector firms—phase one of the credit crunch. The first half of 1999 saw a significant improvement. The total flow of money to industrial and commercial firms rose to an annual rate of 73 trillion won. Many Koreans now believed that their worst economic problems were behind them. But in July 1999, the government decided to force the huge, debt-ridden Daewoo *chaebol* into bankruptcy. Daewoo had been universally believed to be too big for the government to allow it to fail: its collapse triggered panic in the commercial paper and bond markets. Korea thus entered a second phase of the credit crunch. Hampered by new capital adequacy standards and stricter prudential regulation, banks chose to increase their holdings of government bonds and to increase lending to the more secure household sector rather than continue lending to industrial firms. The flow of funds to non-financial enterprise collapsed to a 33 trillion won annual rate in the second half of 1999, a mere 29% of the 1997 figure. Firms were once again starved of funds. The year 2000 was similar to 1999 in that corporate access to finance improved significantly in the first six months, only to collapse again in the second half of the year.

By the end of 2000, it was clear that neither the industrial nor the financial sector had been restored to health. Industrial production peaked in October (falling by 10% through July 2001). Real machinery and equipment investment fell in both the third and fourth quarters. *Chaebol* profit rates fell substantially in the second half of the year. When Hyundai, the largest *chaebol*, experienced a serious liquidity crisis in mid-year, lending by banks and NBFIs dropped precipitously. Total funds to non-financial corporations in the second half of 2000 dropped to an annual rate of just 45 trillion won.

In December 2000, the government intervened yet again to try and stop the bond market collapse from pulling the entire financial sector down with it. By midyear, the *Wall Street Journal* warned that 'crunch time is approaching for South Korea, threatening a liquidity shortage similar to the one that nearly brought the country's economy to a standstill late last year' (4 June 2001, A17). The state-owned Korea Development Bank was authorised to use 20 trillion won to facilitate the rollover of shaky corporate bonds. The injection of these government funds led to a positive net flow of funds from the bond market to the corporate sector after a year and a half of net bond repayments.

Government interventions such as these contradict the logic of radical restructuring, because they vitiate the process through which the 'strong'—primarily foreign firms—are able to take over the 'weak'. But the perilous condition of both financial and industrial sectors made non-intervention too dangerous a policy stance for President Kim to adopt, especially in view of the massive deterioration in his popular support. *The Economist* recently reported that only 20% of Koreans now support Kim, 'down from a high not long ago of 80%' (1 September 2001, p. 38).

Commercial banks began to operate in the black in 2001 for the first time in many years, because the massive infusion of public funds had finally reduced the stock of NPLs to manageable levels and banks had rapidly shifted out of shaky commercial and industrial loans into high margin household loans. The stock of household debt rose by almost 50% from 1999 to September 2001. From the third quarter of 2000 to the third quarter of

2001, the flow of household loans rose by an incredible 63%. In 2001, 91% of new bank loans were made to households (*Chosun Ilbo*, 31 January 2002). The rate of growth of household debt and of the default rate on credit cards have been so rapid that concerns about the danger of an outbreak of financial distress in the household sector are being raised. Worse, the flight by banks from commercial and industrial loans has reinforced the credit crunch facing non-financial firms. Total financial flows to non-financial firms fell by 39% in 2001, and were only about one-third their 1997 value (IMF, 2002, p. 59).

3.3 Restructuring non-financial corporations

The Kim government announced five principles of corporate restructuring whose stated purpose was to break the traditional dominance of the large *chaebol* conglomerates, introduce more competitive pressure on *chaebol* firms, and raise productive efficiency and profitability. They were: a drastic and immediate reduction of corporate leverage; improved transparency; the end of cross-debt guarantees by conglomerate firms; *chaebol* concentration on core businesses; and, in an attempt to weaken founding-family control, greater managerial accountability to minority shareholders. The *chaebol* founding families had supported the brutal military dictatorship that ruled Korea for three decades and were virulently anti-labour. Thus, President Kim's attack on the *chaebol* was extremely popular. By virtue of the public monies it injected into the financial system after 1997, the government controlled the main creditor banks for each large *chaebol* and was thus in position to attempt to force structural change on them.

Government policy had only modest success in reducing corporate debt burdens. The highly leveraged top 30 *chaebol* did reduce their average debt–equity ratio. However, most of the decline came about because the denominator rose, through new stock issues, asset sales and asset revaluations. Whereas debt fell by 26% in the two years following the onset of crisis in December 1997, the value of equity rose by 125%. In 2000, the top 30 *chaebol* had debts of 265 trillion won, significantly less than in 1997, but more in nominal terms than in 1995 and only slightly less than in 1996. An examination of the broad non-financial corporate sector shows that total debt in 2000 was 23% higher than in 1996, and less than 4% lower than in the peak year of 1997. An IMF study of a sample of 452 large firms showed even worse debt-reduction results, found no improvement in the maturity structure of corporate debt, and reported a deterioration in corporate liquidity since the crisis (IMF 2002, pp. 87–8).

The drive to raise corporate profitability had no success at all. Net profit (after interest and tax payments) as a percentage of sales for the top 30 *chaebol* traditionally measured 2–4%. It collapsed to minus 4·5% in 1998 before rebounding to 2·5% in 1999. In 2000, it fell again to 0·5% as the economy soured late in the year. Ordinary profit (net of interest payments) as a percentage of sales in manufacturing fell to minus 1· 8% in 1998. 1999 saw a slight rebound to 1· 7%. Deteriorating economic conditions late in 2000 lowered it to 1· 3% for the year. Performance in 2001 was even worse. For firms listed on Korea's main stock market, net profit fell by 40% in 2001, while ordinary income fell by 27% (*Korea Herald*, 10 January 2002). The IMF reported that as of 2001, 'overall profitability remained weak'; ordinary income 'showed almost no improvement over the period' (IMF, 2002, pp. 85, 89). Clearly, restructuring has yet to restore even pre-crisis profit levels, never mind create a new high-profit regime.

Worst of all, *restructuring may have created a substantial long-term decline in the rate of capital accumulation leading to a sharp secular decline in Korea's long-run growth prospects*. Real fixed investment in Korea was 21%, 18% and 9% lower in 1998, 1999 and 2000 than

the average level in 1995–97, and it declined substantially in 2001. A recent survey of large manufacturing firms by the government-owned Korean Development Bank showed that real equipment investment was 57%, 53% and 37% below the 1995–97 average in these same years, and estimated that the level of investment would fall by 14% in 2001. Data for large firms in other industrial sectors exhibited a similar trend. The ongoing credit crunch contributed significantly to this investment collapse. Profit flows are weak, and credit has been cut off on the supply side by financial market restructuring and blocked on the demand side by the government's mandate that *chaebol* firms slash their debt–equity ratios.

Though economists have debated the extent of the contribution made by technical progress to Korea's development 'miracle', everyone agrees that the cornerstone of its success was three decades of fast-paced capital accumulation. A secular collapse in the rate of capital accumulation would thus be expected to signal the onset of an era of disappointingly slow trend GDP growth. Supporters of the IMF–Kim regime have argued that neo-liberal restructuring will eventually raise the efficiency and productivity of investment sufficiently to sustain high growth even with a lower rate of accumulation, but there are three reasons for scepticism. First, there are no examples of developing countries that have achieved high growth as a result of increased investment efficiency brought about by radical neo-liberal restructuring. Second, the fall in the rate of capital accumulation is, to date at least, so large that no foreseeable rise in efficiency could possibly offset it. Third, data from the Bank of Korea show that the gross profitability of Korean firms (before interest payments) was not inferior to that of large firms in other countries prior to the crisis. A substantial rise in efficiency will, therefore, not be that easy to achieve.

The Kim government promised to reduce dramatically the degree of founding-family control over the large *chaebol*. Though some *chaebol* owners have been removed from power through bankruptcy or equity dilution, most knowledgeable observers believe that insiders remain in control of most of the larger *chaebol*, a development that has contributed significantly to the collapse in public support for President Kim. Since the conglomerates have been severely weakened by post-crisis government policy, insiders have few if any attractive options to choose among. Nevertheless, it would appear that the same insiders are doing the choosing. The deterioration of Korea's economic performance so weakened the *chaebol* that government threats to drive them into bankruptcy if they do not alter their governance structures have become increasingly hollow. After mid-2000, the economy was so fragile that efforts at governance reform took a back seat for fear of a second crisis. The severity of this problem led the government to relax many important anti-*chaebol* policies. The *New York Times* recently reported that Korea's 'economic-reform programme has stalled this year' (9 November 2001). Since the *chaebol* still dominate Korea's economy, efforts to force their owner-managers from power by starving them of needed credit is more likely to destroy the economy than it is to dislodge *chaebol* insiders.

3.4 Restructuring and the rising influence of foreign capital

Kim Dae Jung believed that the key to successful corporate and financial restructuring in Korea was a massive infusion of foreign capital. This would solve Korea's foreign exchange problem, infuse Korean industry with modern managerial methods, and provide the kind of vigorous competition needed to break the *chaebol* stranglehold on the Korean economy once and for all. The restructuring policies chosen by the IMF–Kim

team made rising foreign ownership inevitable. President Kim used state control of the banks to pressure the heavily indebted *chaebol* into slashing leverage by 60% within just two years. Given the depressed state of domestic demand and the havoc caused by radical restructuring, Korean enterprises could meet this demand only through the extensive sale of real assets and the large-scale issuance of new stock. Since domestic firms were broke, foreign firms and banks were the only possible large-scale buyers. This forced Korean economic assets to be put up for an international auction in which all bargaining power lay with the buyers. The collapse of the won also made Korean firms very inexpensive. The remaining restrictions on capital inflows, which were still substantial at the beginning of 1997, were quickly disposed of by the IMF and President Kim. Whereas pre-crisis liberalisation had raised foreign investment to $8bn in 1997, an astounding total of $62bn in foreign portfolio and direct investment (FDI) entered Korea from 1998 to 2000.

From the late 1980s to the end of 1994, inward FDI averaged about $1bn a year. It rose to $3bn in 1996. Post-crisis liberalisation opened the door to outsiders, but the uncertainty caused by the collapse of late 1997 and 1998 and the tense tenor of labour relations caused potential buyers to bide their time. By 1999, conditions were ripe for foreign take-overs. FDI totalled a cumulative $31bn in 1999 and 2000—a nominal sum 25% greater than all inward FDI from 1962 to 1997. FDI as a percentage of total fixed investment had been no more than 1% until the mid-1990s, but it jumped to 13% in 1999 and 2000. One tragic aspect of this great 'fire sale' is that the overwhelming majority of FDI expenditures involved foreign acquisitions of domestic firms, rather than new or 'greenfield' investment.

Meanwhile, net portfolio inflow, which varied between one and 5bn dollars annually from 1992 to 1999, leapt to almost 12bn dollars in 2000. Gross flows were much larger and very erratic, helping create severe instability in the Korean stock market. The value of Korea's main stock price index was 350 in late 1997, rose to near 1000 in mid-1999, dropped to 500 at the end of 2000, and hit 800 in early 2002. Stock market 'turnover' in Korea is now the highest by far in the developing world, an indication that stock price movements are driven by short-term speculators, not long-term investors. Moreover, Korean stock price variability seems to reflect movements in the US stock market rather than changes in Korea's economic prospects. President Kim's plan to let stock and bond markets determine the size and distribution of capital investment in Korea is a reckless and irresponsible gamble with the future well-being of the Korean people.

The IMF–Kim strategy of increasing foreign ownership of Korean industry and finance dramatically has succeeded beautifully. The percentage of Korean market capitalisation owned by foreigners rose from a minuscule 2·7% in 1992 to 12·3% in 1997, then leapt to 36·2% in January 2002. Foreign firms have gained major influence over such important Korean industries as semiconductors, cars, electronics, telecommunications, petrochemicals and finance. The 1990s liberalisation raised foreign ownership of the top seven Korean firms (as measured by stock market capitalisation) to an average 20·6% just before the crisis broke out, but after three years of restructuring it had more than doubled to 47%. In mid-2001, foreigners owned 56% of the listed shares in Samsung Electronics, the number one firm, 63% of POSCO, the great steel producer, and 57% of the listed stock of Hyundai Motors.

The dramatic rise in foreign ownership of the listed stocks of many of the most important Korean firms raises again the question of whether insider control of the large *chaebol* has been broken. The issue of *chaebol* ownership and control is complex because the large *chaebol* have both publicly traded and privately held companies as well as

substantial cross-holdings among sister companies. According to government sources, total insider holdings rose from about 44% of total shares in 1996–98 to 51% in 1999. In 2000, insider control fell back to 43%. Latest estimates put insider ownership at 45% and rising. At this point, insiders appear to retain effective control over *chaebol* policy. But the pace of foreign investment suggests that this could change in the foreseeable future.

President Kim had a clear popular mandate to end *chaebol* founding-family dominance of Korea's economy and its political process; he did not have a mandate to replace it with foreign domination. A trade of foreign control for *chaebol* founding-family control of Korea's most important economic assets would be no bargain for the Korean people. Foreign owners are likely to be as anti-labour as the *chaebol*, and they are even less likely to cooperate with government economic policies they do not like.

Foreign interests now control six of the nine largest commercial banks. This is especially dangerous because Korea had a bank-based system of corporate finance for four decades, with all major commercial and industrial firms dependent on bank loans for their investment capital. Since Korea's businesses are still heavily in debt, foreign control over key financial institutions gives foreign interests a stranglehold on Korea's future economic development. The current drive to shift bank credit flows from industry to high-income households (starving the business sector of badly needed investment funds in the process) has been led by foreign-owned banks. This is only one example of the economic damage they can do.

4. Conclusions

That neo-liberal restructuring failed to improve economic prospects for the Korean people is hardly a surprise. It has failed to deliver a better life for the majority of citizens wherever it has been imposed, though it often enriches economic élites. What is surprising perhaps is the shocking extent of the damage done to Korea's economy by the IMF and President Kim in such a short period of time. Korea was not some 'basket case' economy seeking help from the IMF in 1997 because of a miserable long-term economic record. Prior to the crisis it was one of the strongest economies in the world, admired even by mainstream US economists. We believe that the extraordinary damage done by IMF policy in Korea resulted from the political problems confronting the IMF and President Kim as they took control in December 1997. Not the labour movement or the general public or much of the business community would willingly accept radical neo-liberal restructuring. Thus, an economic collapse strong enough to weaken opposition became a political precondition for the implementation of the desired 'reforms'. Austerity macro policy in the first half of 1998 operating on an already vulnerable economy got the job done. However, the window of opportunity could not be kept open too long if a complete economic breakdown was to be avoided. Big-bang neo-liberal restructuring was the result, but it took place under economic conditions likely to maximise its destructiveness.

The damage done to the economy by liberalisation prior to the crisis and the failure of IMF policy since the crisis naturally raise the crucial question as to whether the Korean people would have been better off if their traditional model had been replaced not by neo-liberalism, but with a reformed state-led growth model, one adapted to current economic and financial conditions and thoroughly democratised. We believe the answer is yes. Space constraints do not allow a discussion of this issue here; interested readers can find our views on this matter in the last section of Crotty and Lee (2001). Until the late 1980s, control of state economic policy remained in the hands of a repressive military regime and,

even after the 'revolution' of 1987, the extent of genuine democracy was quite limited. The Korean people need to remove the remaining vestiges of its authoritarian shell from the rational core of the state economic regulatory apparatus that produced such high real output and wage growth for 35 years. History instructs us that state economic guidance and socially embedded markets are necessary, though certainly not sufficient, conditions for sustained development.

Pre-crisis liberalisation plus radical post-crisis neo-liberal restructuring have dismantled or badly weakened many of the policy tools the government traditionally used to impose social control over the Korean economy. If Korea completes its transition to: 'flexible' labour markets and weak unions; free cross-border capital flows; investment guided by speculative, volatile stock and bond markets; corporations and banks dedicated only to the pursuit of private profit and guided only by shareholder whim, and foreign domination of finance and industry—what policy instruments will be available to any future progressive government to guide Korean economic development so that it meets the needs of all the country's people? *This may be the most serious long-term problem facing the Korean people*.

The battle for a progressive future for Korea has not yet been lost. At the present time, progressive political forces are undoubtedly weak. But the current situation is extremely fluid. The public has already deserted President Kim's political coalition, and continued economic instability is likely to alienate voters from the arch-conservative major opposition party as well. The Kim government continues to face a difficult dilemma: the more it tries to withdraw from the economy in the name of neo-liberalism, the worse economic conditions become, and the greater the need for and demand for strong government economic action. If a progressive government took office in the not too distant future, it could take advantage of this situation to reassert social control over Korea's economy. But time is running short. The further down the neo-liberal path the economy is dragged, the greater the costs of transition to a reformed state-led model. To have a reasonable chance of success, a national offensive to defeat neo-liberalism must begin soon.

Bibliography

Chang, H.-J. and Evans, P. 1999. 'The Role of Institutions in Economic Change', University of Cambridge, Faculty of Economics, mimeo.

Chang, H-J., Park, H-J. and You, C-G. 1998. Interpreting the Korean crisis: financial liberalisation, industrial policy, and corporate governance, *Cambridge Journal of Economics*, vol. 22, no. 6

Crotty, J. and Dymski, G. 1998. Can the neoliberal economic regime survive victory in East Asia? The political economy of the Asian Crisis. *International Papers in Political Economy*, vol. 5, no. 2. (A revised and updated version of this paper appeared as a chapter in Arestis, P. and Sawyer, M. (eds), *Money, Finance and Capitalist Development*, Edward Elgar, 2001)

Crotty, J. and Lee, K-K. 2001. Economic performance in post crisis Korea: a critical perspective on neoliberal restructuring, Political Economy Research Institute of the Economics Department of the University of Massachusetts web site: http://www.umass.edu/peri/research.html.

Fischer, S. 1996. Lessons from East Asia and the Pacific Rim. *Brookings Papers* 1996, 2.

International Monetary Fund 2002. Republic of Korea: selected issues, *Country Report* no. 02/20

Kim, D-J. 1985. *Mass Participatory Economy*, Cambridge, MA, Harvard University Press

Kumar, R. and Bibek, D. 1999. The Asian crisis: an alternative view, Asian Development Bank, *Economic Staff Paper*, no. 59