The Dangers of Letting Money Float

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Abstract

The emergence of South Korea as one of four Asian tigers in the early 1990s was a facade of success based on an unsustainable and premature financial structure. The government's imposition of the financial liberalization policy induced an environment where domestic conglomerates could borrow loans and manipulate capital without extensive government scrutiny. This paper examines the ways in which the rapid liberalization of the financial market in Korea set the climate of collapse in the Korean economy in 1998. Then, this research observes how the large conglomerates took advantage of this sudden shift and eventually brought about the financial crisis of 1998.

1 Contextual Background

Following the ceasefire of the Korean War in the mid-1960s, South Korea suffered high levels of unemployment and severe destitution (Yoo & Moon 269). However, with the advent of a more influential presidential leadership under Park and Jeon, the government of Korea sought to adopt a more export-oriented economic strategy to reduce its deficit terms of trade and generate national revenue by implementing the seven five-year economic plans in 1962 (Yoo et al., 272). The provision of this governmental policy include the deregulation of interest rates offered by domestic and foreign banks, the removal of restrictions on offering loans to domestic companies, consolidation of a more

managerial autonomy to wholesale banks, the reduction of entry barriers to financial activities and most importantly, the liberalization of cross-border capital account (Kwon, 331).

Many scholars assert that the hasty financial liberalization and dismantling of the traditional financial system in Korea had brought an imbalance in the country's current account and instigated a culture that lacks transparency within the financial market, eventually paving opportunities for overinvestment (Kim). But some emphasize that although financial liberalization in 1989 increased the firm's vulnerability in amassing more nonperforming debt, the corporate governance under the *chaebols* stands out as one of the primary factors in deteriorating the Korean economy by 1998, as *chaebols* themselves had handled the capital through unsuccessful ventures and investments (Yoo & Chul, 271). This paper shall assess the arguments that examine the two primary factors that plunged the South Korean economy into a financial crisis in 1998. Understanding these two arguments would allow economist and policy makers to determine the ways in which these main factors - financial liberalization and conglomerate business practices - have instigated the financial crisis in Korea.

To synthesize the myriad of views on this topic, this paper uses a set of sources that focus on either of the two disparate arguments. Amess, Demetriades, Kim and Kwon, who represent the views of IMF, World Bank or Korean Economic Research Institution respectively, approached this issue on a more macroeconomic perspective, viewing the issue at a more financial aspect. The title of Amess's work, for example, "Financial Liberalization and South Korean Financial Crisis" already lends itself into discussing financial liberalization as the prime focus. Since Amess and Demetriades both represent IMF and their works are highly focused on financial liberalization, their works provide us with the ways in which the international community perceived the causes of the Korean financial crisis. On the other hand, Powers, Chang, Noland, Yoo and Moon approached this issue at a more microeconomic perspective. Especially with Powers's research, her work was published in the Journal of East Asian Affairs, rendering her work to focus more on the internal affairs of Korea. Chang, Yoo and Moon, who are academic scholars in Korea's Business and Enterprise Association, have tailored their research on the business models and tactics which these conglomerates have used prior to the financial crisis. Due to their profession, Chang and Yoo, in particular, focus on

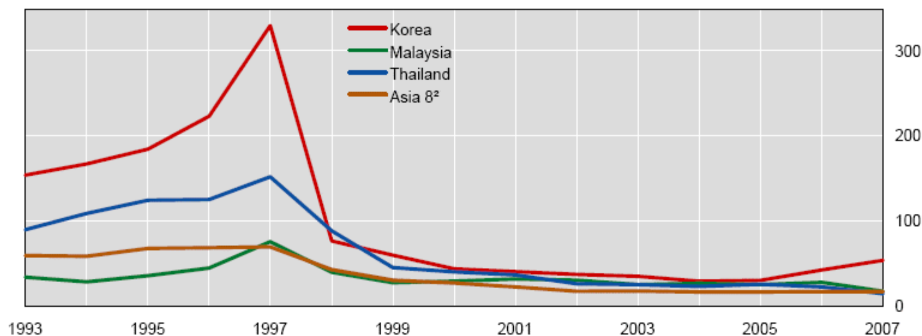
the business strategy that contributed to the collapse of Korea's financial structure. In a similar vein, the economic professor Noland shall provide us with the ways in which the Korea's business structure contributed to the collapse of Korea's economy. By blending both internal and external perspective to this issue, this paper addresses the question: How did *chaebols* and the liberalization of the financial market contribute to the South Korean financial crisis in 1998?

2 Hasty Imposition of the Financial Liberalization and Deregulation

Since 1960s, the government has had a tight control on the banks and financial flows. But the government sought the need to liberalize the financial market to supply the capital needs of the *chaebols* in a more systematic and efficient manner (Kim, 2006). Though the Korean government in 1962 had imposed the seven "five-year economic plan" to liberalize the financial activity in the country, Kim Young Sam government hastened the "five-year economic plan" to "100-day economic plan" by removing government jurisdiction over private banks and establishing a number of 'merchant banks' or wholesale banks to cater short-term debts to the conglomerates in 1989 (Chang et al., 265). During the first half of the decade, the market has responded positively to this policy, marking a stable 2% increase per annum (Chang et al., 266). Liberalization of the financial market has far quickly attracted many foreign investors, generating an increase in capital inflow from $20 billion dollars in 1990 to $100 billion dollars by 1997 (Chang, et al. 738). Similarly, the policy induced growth, increasing the country's GDP per capita from $67 in 1960s to $8,500 worth of GNP in 1997 (Yoo et al., 271). Through financial liberalization, South Korea therefore demonstrated an optimistic projection of its economic discourse.

Total short-term debt to foreign exchange reserves[1]

In per cent



[1] Short-term debt is the sum of such debt in the consolidated banking statistics (Table 9A, column B) and short-term securities (Table 17B); there may be double-counting, but see text regarding short-term debt not included. [2] China, India, Indonesia, Korea, Malaysia, the Philippines, Thailand and Taiwan (China).

Sources: IMF; BIS; authors' calculations.

While Korea initially reaped economic growth through financial liberalization, Kwon proposes that this real GDP increase only created a faade of success, hiding the underlying flaw of the entire financial system in South Korea. He criticizes the government's lack of patience and assessment in evaluating the misleading World Bank statistical data of South Korea's overall debt/Gross National Product ratio by the eve of the crisis, which was at a low 22% as to the accepted benchmark of a low-risk debt/GNP ratio which is any figure below 48% (Kwon, 333). Offering an explanation to this misrepresentation of the data, Noland explains that the debt/Gross National Product ratio does not reflect the short-term debt ratio which has comprised more than 60.1% of Korea's total debt (See figure 1). Being unaware of this underlying high short-term debt ratio is problematic because the acquisition of large amount of short-term debt, which was financed excessively following the liberalization of the capital market, does not require the firms to submit their investment proposals to the Ministry of Finance and Economy (Kwon, 335). Following up on Kwon's and Noland's argument on high levels of debt, Chang and his team argue that liberalizing the financial market has not only paved way but also encouraged private firms to seek short-term loans to minimize their overhead costs of transactions and to take advantage of the deregulated market (Chang et.al, 736). With the absence of governmental regulation, total debt stock surged from $7.27 billion to $18.62 billion over the last 5 years and the real GDP growth that accompanied with those results have blinded the government from taking precautionary measures and assessing the mismatched

maturity of the loan structures (Chang et. al, 736-737). Thus, Chang concludes that, as private firms had undergone a perpetual cycle of satisfying debt-servicing charges with more short-term debt, the Korean economy has lost credit credibility by the time firms exhausted much of its capital in 1998 (Chang et. Al, 737).

3 Downfall of Korea's Credit-Rating

The excessive borrowing of capital from the international market, which was permissible under the liberalized financial market, exposed the vulnerability of the Korean economy. In order to raise more capital of production for its conglomerates, the government aimed to ameliorate the nation's poor credit-rating by liberalizing its financial market (Chang et al., 738). Chang states that the influx of capital rose from $78.4 billion dollars in 1990 to more than $600 billion dollars by 1995, putting pressure on the domestic firms to enlarge and raise as much assets as possible (Chang et al., 738). Explaining the consequences of this policy, Kwon claims that this mounting pressure of debt has motivated the government to artificially appreciate the currency's value to generate more revenue when its products were exported (Kwon, 340). Thus, liberalized financial market accompanied by a high appreciated currency was a strategy to optimize export revenue (Kwon, 340).

However, as debt accumulated due to the firm's ability to unconditionally borrow capital without stringent government review, many Korean conglomerates were left insolvent, pulling down Korea's Standard and Poor's credit rating from an A+ to A- whereas the US treasury bill, for example, would receive an A+++ (Kwon, 351). Attesting to Kwon's observations of the decrease in Korea's credit-rating, Adelman and Nak both claim that this change had an unintended repercussion of the financial liberalization which has spurred the downfall of the Korean economy. Agreeing with Adelman and Nak's proposition, Amess and Demetriades also add that Moody's credit rating of Korea has likewise simultaneously dropped from A1 to A3 in 1997 (Amess & Demetriades, 226). Compiling all these statistical information together, Adelman and her colleague Nak make sense of these plunges in credit-rating as a pivotal event in casting a sense of insecurity in the international

market, making foreign investors withdraw money and create a net outflow of $978 billion dollars by November 1997 (Adelman & Nak, 2). Such drastic withdrawal of capital, Adelman states, was also made possible due to the liberalization of the financial market as the government no longer imposed strict regulation in cross-border financial activities. This made the Korean won uncompetitive by depreciating its value from 87 in 1994 to 140 against the dollar (Adelman & Nak, 3). The price of Korean exports dropped as well as the firms' revenue and eventually, many firms were left bankrupt and requested a bailout from the government (Adelman & Nak, 3). Therefore, Adelman and Naks concur with Amess and Demetriades on the proposition that financial liberalization has exposed the fragility of Korea's economy to the international investors and let them withdraw the capital which they have initially invested.

3.1 *Chaebol's* Overdependence on the Government

Though financial liberalization had provided the opportunities for exploitation of investment to take place, the conglomerate's overdependence of the government encouraged the excessive deficit and adoption of a poor investment strategy which led to the downfall of the Korean economy. The emergence of the *chaebols* has been a plan to gear the country into adopting a more export-oriented structure. Hence, in order to protect these exporting firms, the government cast numerous safety nets and set high barriers to entry as a mean to reduce competition (Powers, 106). Therefore, the proliferation of the *chaebols* are the repercussions of the highly regulated industrial market (Kim). Continuing onto Kwon's discussion on the origins of chaebol, Powers contends that the government's protection of the *chaebols* has spawned a culture of dependency. One of the most prevailing views about the *chaebols* was that they were considered to be the pillars of the Korean economy and that they were "too big to fail" forced the government to regard the *chaebols* with much respect (Powers, 106). This prevalent Moral-Hazard "too big to fail" argument paved way for a pathological corporate governance, rendering the assumption that *chaebols* as fragile as they must be protected at all cost. Kwon reaffirms Powers's observation by claiming that as part of the financial liberalization process, the Korean government imposed the "Foreign Capital Inducement Promotion Act" and "Law for Payment Guarantee of Foreign Borrowing" which ensured the eradication of foreign investment tax

on domestic firms and provided almost unconditional agreement to bailout the *chaebols* in times of bankruptcy (Kwon, 357).

Though Kwon emphasizes the accumulation of debt as the primary factor in the demise of the Korea economy, Yoo, Moon and to some extent Powers recognize that the primary factor which gave blind courage to the conglomerates to raise their debt-to-equity ratio to 338% was not merely due to the liberalization of financial market but also chaebol's bold over-reliance on government protection (Yoo & Moon 266). The government's approval to allow electronic manufacturer Samsung enter the highly-protected automobile industry in 1992 was one example of many risky ventures (Amess & Demetriades, 215). Chang also cites two examples that exposes the absurdity of the risky ventures: Hanbo entered the steel industry while the car manufacturing company Kia was granted permission to prospect mining sites around Korea in 1993. Hanbo, Samsung and Kia went bankrupt in 1998 (Chang, et al. 742), proving that much of its investments turned out to be too expansive and inefficient to compete against. Therefore, the faade of government protection has encouraged the increase in risky debt capital, which in turn imploded the nation's current account in 1998 (Yoo & Moon, 267).

3.2 *Chaebols's* Flawed Investment Strategy

As *chaebols* worked under the impression that the government would always protect them, their investment strategies remained flawed and risky. Noland has championed the argument that the *chaebols's* primary goal to expand their business rather than maximizing profit, which placed businesses at a low profitability ratio of 2.8%, led them to bankruptcy and eventually the economic collapse of the country (Noland, 500). Powers evidences Noland's claim by discussing that *chaebols* blindly merged with many unrelated small-medium enterprises (SME) to diversify their investment portfolios (Powers, 112). The Halla Shipbuilding company for example owned clothing productions and pharmaceutical firms while Samsung electronics owned car manufacturing and insurance companies (Powers, 112). Though these vertical integrations may have contributed to minimizing transaction costs, Chang and his team clarify that the management of this wide array of firms is often ineffective (Chang et al., 743). Yoo, who is also part of KBEA but represents the financial

market side, likewise agrees with Chang's claim on *chaebols*' ineffective business strategy by asserting that outsourcing resources and components from other small-medium sized enterprise is less risky and more efficient (Yoo, 339). Therefore, the need to diversify their portfolios at the expense of minimizing profit dividend and pile up their debt displays signs of ostentatious ambitions (Yoo, 340). Both the financial department and the industrial department of KBEA) attribute the flaw in investment strategy as the main factor in the Korean financial crisis.

The *chaebols*' ambitions not only to diversify their investment but also to radically expand their homogenous businesses and increase their market share had placed the Korean economy at risk by 1998. The chemical and heavy industries have comprised many of the industrial sectors that the government had chosen to develop in 1960 (Chang et al., 735). These securities assets are homogenous and often brought back low returns (Change et al., 736). Yoo, Park and Chang claim that the supply of these export goods increased with the absence of any increased demand in the international market (Yoo et al., 265). Powers notices that the repercussion of having increased production with no increase in real demand was the decrease in export-revenue by a stiff 45% margin by the end of 1998 (Powers, 112). Therefore, Noland wraps up the discussion on the causes of Korean economy downturn in 1998 by noting that though financial liberalization had exposed the opportunities with which private firms can exploit the financial market, it was the actual mismanagement of these debt capitals that deprived the nation of its financial capital and credibility (Noland, 506). As *chaebols* had already expanded so much of their market exposure in the domestic market, the six chaebol bankruptcy by November 1997 has caused a negative rippling effect upon the economy greatly (Noland, 507).

4 Conclusion

The liberalization of the financial sectors, the mismanagement and the overconfidence of the chaebols have respectively played a significant role in bringing about the Korean financial crisis in 1998. This case study brings a range of sources dangers of hastily bringing about the liberalization of the economy which the western world or any other capitalist nation presume it to be as the most effi-

cient. One group of sources contend that President Kim's decision to liberalize the financial market and dismantle the managed economic system 10 years earlier to its intended date of implementation has brought about unforeseen consequences. Hastening the process raised unemployment rates, paralyzed the market structure and deteriorated the real GDP growth. While the other set of sources discusses the actual corporate malfeasance as the primary causal factor in Korea's financial crisis. Therefore, the financial crisis of 1998 demonstrates an example where hasty implementation of a new financial system could ultimately bring down a country's economy if the nation is unprepared to embrace the change.

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