

**From 'East Asian Miracle' to 'Crony Capitalism':
The Role of the International Monetary Fund in the Political Economy
of the 1997-98 Financial Crisis in South Korea**

by

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ABSTRACT

The East Asian financial crisis of 1997-98 challenged the viability of the South Korean model of development both objectively, in that South Korea was brought to the brink of economic ruin by it, and also subjectively, in that strong government involvement in its industrial development and export promotion, which had been something of an embarrassment to the dominant neo-liberal orthodoxy of the International Monetary Fund (IMF) before the 1997 financial crisis, came under open attack as 'crony capitalism' at the time of crisis. My analysis of the shift in IMF's discourse about South Korea from 'East Asian miracle' to 'crony capitalism' at the time of 1997-98 financial crisis in South Korea attempts to illustrate that this shift performed what can be called a discursive demolition of South Korean model of development: the IMF created panic among foreign investors and thus made a decisive contribution to the unfolding of the financial crisis of unprecedented dimensions in the country. Having accomplished this, it was also able to impose a program of radical corporate restructuring and further capital account opening of South Korea for the ever easier access of foreign, especially US capital.

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List of Abbreviations

AMF	Asian Monetary Fund
BOK	Bank of Korea
C-20	Committee of Twenty
CSIP	Capital Structure Improvement Plans
DLF	Development Loan Fund
EPB	Economic Planning Board
FDI	Foreign Direct Investment
FKI	Federation of Korean Industries
FSC	Financial Supervisory Committee
GDP	Gross Domestic Product
GNP	Gross National Product
GTC	General Trading Companies
HCI	Heavy and Chemical Industrialization
IMF	International Monetary Fund
ISI	Import-Substitution Industrialization
KDB	Korea Development Bank
MBC	Merchant Banking Companies
MOFE	Ministry of Finance and Economy
NBFI	Nonbank Financial Institution
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
SAL	Structural Adjustment Loan
SAP	Structural Adjustment Program
SDR	Special Drawing Right
SWNCC	State-War-Navy Coordinating Committee
USAID	United States Agency for International Development
WB	World Bank

Introduction

The East Asian financial crisis of 1997-98 was remarkable in several ways. It was the sharpest financial crisis to hit the developing world since the 1982 debt crisis. It hit the most rapidly growing economies in the world and prompted the largest financial bailout in history, that of South Korea. It was also the least anticipated financial crisis in years, taking the majority of economists and experts by surprise.

More fundamentally, the crisis proved to be a turning point in the life of the much celebrated South Korean 'East Asian miracle'. For more than three decades the country's state-led and *chaebol*-centered economic system recorded stunning growth rates – higher than those of virtually any other country in the world. The crisis challenged the viability of the South Korean model of development both objectively, in that South Korea was brought to the brink of economic ruin by it, and also subjectively, in that the strong government involvement in its industrial development and export promotion, which so far had been something of an embarrassment to the dominant neo-liberal orthodoxy, now came under open attack as 'crony capitalism'. Accordingly, the search for culprits in the crisis economies focused on corrupt and mismanaged banking systems, lack of transparency in corporate governance, and the shortcomings of state-managed capitalism.

More critical and thorough analyses of the crisis demonstrated, however, that the crisis was, in fact, the ultimate testament to the shortcomings of liberalized international capital markets, a major policy objective of neo-liberalism, and their vulnerability to sudden reversals of market confidence. However, it is important to

note that this was not the diagnosis accepted by the one institution which had the biggest role to play in the unfolding of the South Korean financial crisis from late November 1997 on. The adherence of the International Monetary Fund (IMF) to the 'crony capitalism' diagnosis in its intervention was, to say the least, to be momentous for the further evolution and 'resolution' of the crisis.

For, if the consensus of critical scholarly opinion is to be believed, the fundamental cause of the East Asian crisis lay not so much in the state-led developmentalist model – which South Korea had followed beginning in the 1950s and 1960s, and for which 'crony capitalism' had appeared as a derogatory label in the course of the financial crisis, – but in its progressive abandonment under domestic and foreign pressures in the 1990s. The development of the crisis could be traced quite clearly to this progressive liberalization of the South Korean economy, particularly the progressive lifting of controls on capital transfers, including on short term capital flows. It was this which made the South Korean economy vulnerable to the panic exit of capital in the closing months of 1997. The IMF has, of course, been a partisan of capital mobility, including that of short-term capital, since its formation and has urged this course upon all countries, including South Korea. However, its role in the South Korean crisis was clearly more profound than this. For it was also clear to most critical economists that it was the intervention of the IMF itself which turned ordinary jitters into the full scale panic that constituted the opening act of the crisis.

Not surprisingly then, the IMF's active involvement in the East Asian crisis of 1997-98 attracted an unprecedented amount of attention, both positive and negative. The dominant neo-liberal view portrayed the IMF as a 'financial messiah' whose mere presence is able to resurrect exhausted economies and restore the public's confidence in the financial systems of the crisis-hit economies. Representatives of

this line of thought – scholars like Peter J. Zhang, W. Max Corden, and David C.L. Nellor – viewed the role of the IMF in the cases of crises like the one in East Asia as largely positive. This optimism about the IMF role rested on a view of the East Asian economies, and of the rapid growth they had experienced in past decades, as masking many weaknesses. The 1990s had seen unprecedented vast inflows of foreign capital into the ‘Asian tigers’ on an unprecedented scale. ‘At their height, net private capital inflows constituted as much as 13% of Thailand’s GDP and 17% of Malaysia’s,’ suggests Zhang.¹ However, in his opinion, these large private capital flows were driven to a large extent by the ‘over-zealous search for high yields without proper regard to potential pitfalls.’² Therefore, he argues, the crisis, in more concrete terms, was merely the reversal of this vast tide of capital.

Corden, on the other hand, insists that the IMF’s intervention was necessary despite the sound fundamentals of the South Korean economy: such crises can hit out of the blue, making the IMF a very necessary institution. There had not been any obvious ‘easy’ way out of the crises of 1997-98, he suggests, and certainly not one that could have done without the IMF.³ Since the crisis-hit economies of East Asia have records of conservative fiscal policies and since, as Corden sees it, the crisis that hit them was in no way connected with expansionary fiscal policies and foreign borrowing by governments, it is obvious, he says, that ‘the IMF is needed, desperately needed, in situations like the Asian crisis’⁴ to finance the current account deficits that

¹ Peter G. Zhang, *IMF and the Asian Financial Crisis* (Singapore: World Scientific Publishing Co. Pte. Ltd., 1998), 69.

² *Loc.cit.*

³ W. Max Corden, “The World Financial Crisis: Are the IMF Prescriptions Right?” in *The Political Economy of International Financial Crisis: Interest Groups, Ideologies, and Institutions*, ed. Shale Horowitz and Uk Heo (Singapore: Institute of Southeast Asian Studies, 2001), 41.

⁴ *Ibid.*, 61.

result from the drying up of private sector funds. Corden differs from Zhang in not being critical of South Korean government policies, and he is apologetic about certain mistakes by the IMF. In the cases of Malaysia, South Korea, Indonesia, and Thailand the original prescriptions of the IMF can be criticized for imposing fiscal contraction requirements, though, he adds, IMF prescriptions also changed, as the crisis evolved, recognizing the need for some fiscal ease. In the case of Indonesia, for example, by 1998 IMF programs allowed for very substantial fiscal deficits. Corden believes that if the current IMF conditions and recommendations, as well as World Bank advice, are followed, and the countries can survive the short term, they are likely to be better off than otherwise – they will be more prepared to deal with future shocks and surprises, for example, by having proper bankruptcy laws and arrangements for rescheduling debt.

Nellor's defense of the IMF's role in the crisis is even more basic: the IMF's activities in Asia amount to nothing more and nothing less than fulfilling its *Articles of Agreement*.⁵ Clearly, he admits that preventing the crisis would have been preferable, and the international community must find ways to reduce the likelihood of such occurrences. But inevitably crises will occur, and the IMF is the institutional mechanism that the international community has created to address them.⁶ With the onset of the East Asian crisis, he says, the IMF stood ready to help these countries in whatever way possible, not only responding to the reversal of capital flows but, at the

⁵ The purposes of the institution, as Article 1 of the IMF's *Articles of Agreement* spells out, are 'to promote international monetary cooperation...', 'to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income...', 'to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation'.

⁶ David C.L. Nellor, "The Role of the International Monetary Fund," in *East Asia in Crisis: From Being a Miracle to Needing One?* ed. Ross H. McLeod and Ross Garnaut (London and New York: Routledge, 1998), 263.

core, building on macroeconomic stabilization by proposing more efficient resource allocation through a new role for governments.

If the IMF's role in the South Korean financial crisis had made at least some of its defendants a little apologetic, it made its critics more vehement. Critics of the IMF had long regarded it as a Western-dominated financial club whose measures were aimed at breaking open developing economies to the penetration of metropolitan goods and investment, in particular goods and investment from the United States. They had also long criticized the effects of IMF interventions on the economies and populations of the developing world. Now, however, the criticism acquired a new dimension. The IMF's intervention in South Korea was the first in one of the most dynamic of the models of state-led development. Wade and Veneroso argued that the long-term damage of the IMF's prescriptions to the East Asian economies in crisis is likely to be enormous. The reason, Wade and Veneroso said, has to do with a neglected dimension of the crisis – the financial architecture of East and Southeast Asian economies, including that of South Korea – that differs from the kind of case the IMF usually deals with.⁷ The main difference that Wade and Veneroso lay emphasis on is in corporate debt/equity ratios which are much higher in East and Southeast Asia than, say, in the US or the UK. This is mainly due to a particular character of East and Southeast Asian financial structures, such as high ratios of bank deposits and loan intermediation to GDP. Given these East Asian differences, IMF financial liberalization policies would have higher costs and smaller benefits in Asia. The answer as to why the Fund continued to press these policies on East Asian economies, Wade and Veneroso suggest, involves the interests and the owners of international capital, or, as they put it, the Wall Street-Treasury-IMF Complex, as the

⁷ Robert Wade and Frank Veneroso, "The Asian Crisis: The High Debt Model Versus the Wall Street-Treasury-IMF Complex," *New Left Review* 228 (March/April 1998): 3-22.

reforms sought by the Fund were connected in one way or another with further opening up East Asian economies for its benefit.

The IMF's intervention in East Asia was so controversial as to draw fire from certain prominent economists at its own sister institution, the World Bank. Joseph E. Stiglitz, chief economist at the World Bank at the time of the crisis, charged that the IMF austerity measures would not revive the economies of East Asia – they would plunge them into recession or even depression.⁸ High interest rates might devastate highly indebted East Asian firms, causing more bankruptcies and defaults; reduced government expenditures would only shrink the economy further, he argued. It was the very strength of the South Korean economy which, it seemed, would ensure that the damage done by IMF policies would be greater.

The South Korean financial crisis and its unprecedented dimensions also spurred great debates about the appropriateness and effectiveness of the South Korean model of development. Since the crisis a range of arguments with respect to the South Korean model has been developed by various scholars implying that it was not any good in the first place. Su-Hoon Lee suggests that the South Korean crisis has been a long time in making.⁹ The true roots of the crisis, he suggests, lay within the very development model that provided South Korea with the miracle. The world-market dependent, state-led, *chaebol*-centered form of South Korean development did bring miraculous growth to the country, but it had done so within a very specific geopolitical and world-market context, he argues. What was happening at the time of the crisis was the unraveling of that development model. Lee argues that as

⁸ Joseph Stiglitz, "What I Learned at the World Economic Crisis: The Insider," *The New Republic*, 17 Apr. 2000.

⁹ Su-Hoon Lee, "Crisis in Korea and the IMF Control," in *The Four Asian Tigers: Economic Development and the Global Political Economy*, ed. Eun Mee Kim (London: Academic Press, 1998), 209-228.

geopolitics and the world-market situation changed drastically in the late 1980s, the model of South Korean development lost its steam, resulting eventually in the financial crisis. In the same vein, Heather Smith argues that the origins of South Korea's financial crisis predate 1997.¹⁰ The causes of the crisis were systemic, so the appropriate policy response was not simply the provision of funds to accommodate short-term liquidity constraints and the restructuring of debt: a commitment to fundamental structural and institutional reforms was also necessary as a precondition for reviving access to international capital. These reforms had to include austere fiscal and monetary measures, an opening of business operations to external scrutiny, reform of the labor market, and the removal of barriers to domestic markets.

The line of argument defying the "miraculous nature" of the South Korean rate of development is in fact nothing new. It had been occasionally voiced here and there among academics even before the crisis.¹¹ Paul Krugman, for example, had previously argued that the rapid economic growth in East Asia was nothing but a simple reflection of large-factor input. Therefore, like the rapid economic growth in the Stalinist period in Russia, he suggested, it could not be sustained in the long run without improved productivity.

Disagreements between progressive economists and the IMF with its more or less strictly neo-liberal outlook are no novelty, and many critics of the IMF have raised questions about the aims and motivations which lie behind its actions. However, the IMF's diagnosis and treatment of the South Korean crisis seemed to

¹⁰ Heather Smith, "Korea," in *East Asia in Crisis: From Being a Miracle to Needing One?* ed. Ross H. McLeod and Ross Garnaut (London and New York: Routledge, 1998), 66-84.

¹¹ See for example Paul Krugman, "The Myth of Asia's Miracle," *Foreign Affairs* 73, no. 6 (November/December 1994): 62-78. See also Alwyn Young, "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," *The Quarterly Journal of Economics* 110, no. 3 (August 1995): 641-680.

raise questions about the role of the IMF in the world financial and economic system more strongly than ever before. They had the potential to expose the IMF's true aims and motivations more clearly and damagingly than ever before. Arguably, then, the most important conceptual aspect of the East Asian financial crisis was that it raised fundamental questions about the role of the IMF – both in its inability to prevent the crisis and in its handling of the strategies it adopted to resolve it. Even against the already bleak record of the IMF in managing financial crises in the Third World, its management of the South Korean crisis seemed to expose it to accusations of deliberate political manipulation largely in the interests of the United States and its corporations.

The momentous role of US Treasury Department in the negotiations for the IMF Stand-By Arrangement for South Korea in 1997, and for the program of fundamental corporate restructuring that accompanied it, revealed an intimate relationship between IMF and the neo-liberal US government. This intimate relationship, which had existed since the founding of the Bretton Woods institutions, and had been criticized for long, became more explicit than ever during the 1997-98 crisis in South Korea. In this thesis I take the side of those looking critically at the role of the IMF in managing South Korean financial crisis of 1997-98. Not only did the IMF program for South Korea fail to generate a sustainable economic recovery, it was clearly seen to be designed to change South Korea's regulatory structure in a way that would enable US corporations to purchase South Korean corporations more easily than ever. Indeed, prominent economists in the US, including liberals like Lester Thurow, were arguing explicitly that this should be the goal of US policy in the region, US policy to be achieved through the good offices of the IMF.¹² The end of

¹² See Lester Thurow, "Asia: The Collapse and the Cure," *The New York Review*, 5 Feb. 1998.

the Cold War had diminished the importance of South Korea as a frontline state and now it would get a treatment as bad as the rest of the Third World, indeed, worse, since there was, potentially, much more that US capital could gain from South Korea. This underlines my wider argument that the IMF has been instrumental in the US's pursuit of broader geo-political interests at the time of South Korean financial crisis, and not merely any narrowly defined interests of its corporations.

I would like to approach this point by comparing the record of IMF's views on South Korean model of development during the period of its high-speed growth (1960s to 1990s) and the 1997-98 financial crisis. Indeed, most writers, including critical ones, have not registered the extent to which the IMF had, in the past, praised the very model which at the time of the crisis it was denouncing as 'crony capitalism'. Discourse has been an essential part of the way the neo-liberal governments of the United States of the 1980s and 1990s have come to promote what they saw as the unquestionable benefits of neo-liberal economics, and is important to take account of. By Richard Peet's account, 'by the mid-1980s, neoliberal economics had come to dominate a previously social democratic and Keynesian development discourse.'¹³ Most importantly, this domination has also come to extend to global governance institutions like the IMF and the World Bank. Robert Wade made this clear in his informative account of the process through which the World Bank study *The Asian Miracle* came into being and of the tussle between Japan and the US in the preparation of this landmark report.¹⁴ He showed effectively that it is virtually impossible for unorthodox development paradigms, like the state-led model of Japan, which moreover is the second largest member of the World Bank, to come through

¹³ Richard Peet, *Unholy Trinity: The IMF, World Bank and WTO* (London: Zed Books, 2003), 13.

¹⁴ See Robert Wade, "Japan, the World Bank, and the Art of Paradigm Maintenance: *The East Asian Miracle* in Political Perspective," *New Left Review* 217 (May/June 1996): 3-36.

and get accepted by the neo-liberal orthodoxy of World Bank's publications promoted by the United States.

What my analysis of the shift in IMF's discourse from 'East Asian miracle' to 'crony capitalism' at the time of 1997-98 financial crisis in South Korea will attempt to illustrate is that through it – what I call the 'discursive demolition' of South Korean model of development – the IMF first created panic among foreign investors thus decisively worsening the financial crisis, and then used the very severity of the crisis to impose a program of radical corporate restructuring and further opening of the capital account to foreign capital which was far more radical than anything imposed in the name of neo-liberalism hitherto. The thesis consists of three chapters. Chapter One will deal with the evolution of the IMF from its inception in 1944 until the East Asian financial crisis of 1997. The chapter will illustrate how starting in mid-1970s the policies of the IMF have become more ideologically grounded in neo-liberalism pushed on it by the interests of the United States capital primarily. Chapter Two will talk about the record of economic development of South Korea during the three decades of its high-speed growth (1960s-1990s). The chapter will highlight the overwhelmingly positive IMF perception of economic policies of South Korean government that produced such stunning rates of economic growth attributing them either to the crucial role of government intervention during the 1960s and most of 1970s or, although inaccurately, under the influence of neo-liberal ideology pushed through the IMF by the US, to the free market incentives provided by the South Korean government since the early 1980s. That is to say even at the height of the sway of neoliberalism in the IMF, the role of the government was seen to make a decisive contribution to the success of the South Korean economy. That is to say between the late 1970s and 1997, the real story of state-led economic development of

South Korea over the three decades was discursively distorted by neo-liberals at the IMF wishing to attribute South Korea's success story to the free market incentives. Finally, Chapter Three will deal with the 1997-98 financial crisis discussing the shift in IMF's discourse to openly attacking South Korea's state-led model as 'crony capitalism', and with this making a crucial contribution to the unfolding of the crisis, and to its ability to impose a harsh restructuring program on South Korean corporate sector arguing for the necessity to open up country's capital account to foreign capital even further than it had been in the 1990s. The underlying motives of the program were not the sustainable economic recovery of South Korea, but the ever easier access of US corporations to purchase South Korean corporations.

Chapter One

The International Monetary Fund: An Evolution

The East Asian financial crisis of 1997-98 was the first major IMF intervention in such a highly productive and competitive economy of the region as that of South Korea, although it distinguished itself for much more than just this. In order to understand the role of the IMF in South Korean financial crisis, it is important, first of all, to understand the institution. This chapter will focus on IMF's origins, structure and practices. It will trace their evolution and important changes in IMF functions since its inception in 1944 up to the East Asian financial crisis. The chapter will highlight the dominant role of the United States in life of the IMF illustrating how, starting in the late 1970s, the policies of the IMF have become more ideologically grounded in neo-liberalism pushed on it by the dominant position of the United States in international finance. Although the practices of the IMF, including the practices of conditionality accompanying its aid assistance, have been consistent with the views of US as the major shareholder since its very inception, the break-up of the original Bretton Woods system in 1971 led to the crucial change in the nature of IMF conditionality. From that point on it was to be characterized by greater intrusiveness of neo-liberal ideology dictated by the capital interests of the United States. With the introduction of the Structural Adjustment Programs (SAPs) in the 1980s the intrusiveness of IMF's neo-liberal conditionality was to be strengthened even further. It is with these programs that the IMF would acquire a new power for itself – the power of adapting domestic financial structures of Third World countries to the US-

based international system. The practice would continue into the 1990s playing a crucial part of the East Asian financial crisis in 1997-98 hitting the most fast developing region of the world. The prominent role of the US Treasury in the design and implementation of IMF aid programs for crisis-hit countries, in particular that of South Korea, would reveal the intimate relationship between the neo-liberal US government and the IMF more explicitly than before.

The Bretton Woods System: Original Functions of the IMF

It is important to note in advance that the functions under which the IMF acted at the time of South Korean financial crisis of 1997-98 differed substantially from the original functions prescribed for it at the time of the Bretton Woods conference. To understand the nature and the extent of the change in IMF's functions by the time of South Korean financial crisis let us consider first its original role as envisioned by the Bretton Woods architects. It has been said that the inception of the IMF would not have been possible but 'for the coincidence of the hour and of the men.'¹ It was clear, well before World War II, that a new global economic order had to be built from scratch. Although a number of monetary conventions attempting to resolve the economic stalemate in the inter-war period had been held during the 1920s and 1930s, none of them resulted in the establishment of a global monetary system capable of coping with crisis conditions of the time.. For example, a World Economic Conference attended by 66 nations was held in London in 1933 in an attempt at dealing with mounting problems, such as with Britain abandoning the gold standard in

¹ J. Keith Horsefield et al., *The International Monetary Fund 1945-1965: Twenty Years of International Monetary Cooperation*, vol. 1 of *The International Monetary Fund 1945-1965: Twenty Years of International Monetary Cooperation* (Washington, D.C.: IMF, 1969), 3.

1931. The main pitfall of the conference, however, was that it could not escape the classical principles that had guided economic policy in the past: ‘it called for governments to balance their budgets, remove controls on the free movements of goods and capital and return to the gold standard.’² To the usual explanation for the failure of these international conventions to establish a new global economic regime – lack of world hegemonic power capable of occupying Britain’s dominant pre-war position in international finance – Richard Peet also adds ‘the continuing divorce between economics and politics in the (nineteenth-century) liberal imagination, and the inherent tendency for international rivalry in (competitive) capitalist systems undergoing crisis.’³ The idea of political intervention in the market had been present to a limited degree in classical political economy. However, most liberal economists who dominated the pre-WWII period basically believed that there were no necessary connections between economic growth (based on markets tending naturally to equilibrium) and political developments. With the Great Depression the classical liberal approach based on self-regulating markets was put in doubt, and the necessity of a global regime to control world financial activity was becoming apparent. The emergence of this view of ‘embedded liberalism’ was to be instrumental in determining the nature of the future International Monetary Fund.

In the early 1940s, during the World War II, two concrete and viable proposals for a global regulatory regime were conceived. Both John Maynard Keynes, the well-known author of *The General Theory of Employment, Interest and Money*, and the Honorary Advisor to the British Treasury, and Harry Dexter White, director of the Division of Monetary Research, US Treasury Department, envisaged a permanent

² Peet, 31.

³ *Ibid.*, 32.

international financial institution for managing global economic and monetary matters. It is important to note, though, that the Bretton Woods conference of July 1944, at which those proposals were brought forward for public discussion, merely formalized the negotiations that had already been going on between the US and the UK for two and a half years before the conference. As Raymond F. Mikesell, economist from 1942 to 1947 in the Division of Monetary Research, US Treasury Department, observed: 'Bretton Woods was a drafting meeting, with the substance having been largely settled previously by the U.S. and U.K. delegations supported by the Canadians.'⁴ Through a succession of bilateral agreements, the United States and the United Kingdom, the emerging and the declining hegemon of the world capitalist order respectively, worked together towards forming a 'world with expanding trade and easily convertible currencies...predominantly organized by private, not government, interests,'⁵ a world that matched their own economic interests as industrially dominant powers. In order to understand what the IMF finally became it is important to note some of the specificities of the proposals which the British and the Americans discussed. For their approaches to how the new global order ought to be realized in practice turned out to be utterly different.⁶

Keynes proposed the creation of an international central bank, with which member states would be obliged to maintain an account. To protect countries from needless devaluations, their respective exchange rates were to be fixed to an

⁴ Raymond Mikesell, *The Bretton Woods Debates: A Memoir*, Essays in International Finance no. 192 (March 1994), 34.

⁵ Alfred E. Eckes, Jr., *A Search for Solvency: Bretton Woods and the International Monetary System, 1941-1971* (Austin & London: University of Texas Press, 1975), 79-80.

⁶ For a closer look at the detailed discussion of differences in the views of Keynes and White see, for example, Horsefield et al, 1: 3-54; Block, 42-50; Marcello de Cecco, "Origins of the Post-War Payments System," *Cambridge Journal of Economics* 3, no. 1 (1979): 49-61; and Friedrich A. Lutz, *International Monetary Mechanisms: The Keynes and White Proposals*, Essays in International Finance no. 1 (July 1943).

international unit of exchange called the ‘bancor’, which this bank would be able to issue, and against which currencies of the world would be measured. Keynes also envisaged a greater autonomy in economic policies for member states than did White. This was important because Britain was trying to preserve the Sterling Area and the British Empire from being taken over by the emerging dominance of the United States. Realizing the poor state of the British economy at the time, Keynes wanted to create

...a blueprint for the future in which multilateral trade and payments were to be re-established among nations in the form of a more-or-less ‘nationalised’, i.e. highly controlled system...The \$25 billion supranationally managed stabilisation fund was essential to this picture. Without it, or with only a fraction of it, Great Britain would be throwing away the well tried trading and currency system of the sterling area in exchange for nothing. The new trade and payments system would be justified, for a deficit country like Britain, only if her economy was to be helped to readjust by a large buttress of IMF loans.⁷

As De Cecco explains, ‘[t]raditionally, since before the World War I, Britain had realized a surplus in imperial markets and through colonial revenues to spend on imports from the US and Europe...But during the war British industry had been allowed to concentrate on the war effort and Britain had accumulated a large deficit with the Empire in the form of sterling balances. As a supplier of imperial markets, Britain had been replaced by the US, which had thereby transformed its pre-war deficit with the Empire into a large surplus.’⁸ By pressing the importance of greater autonomy for member nations in his vision of the post-WWII global economic order, Keynes intended to leave more freedom for Britain to pursue its post-war economic policy vis-à-vis the United States, as the major surplus country, in reconstructing its position as the centre of the Sterling Area.

⁷ De Cecco, “Origins”, 52.

⁸ *Ibid.*, 53.

White, instead, proposed that the institution's finances be provided by contributions from member countries which were to be called 'quotas' and that financial assistance to troubled economies be drawn from this. Conditionality was one of the main pillars of White's plan implying that a country receiving, or intending to receive, financial assistance had to undergo certain domestic policy adjustments, as requested by the institution, to be eligible for aid. This was implicitly stated in the paragraph 3 of the Preamble of his Plan's draft:

...The resources of this Fund would be available under adequate safeguards to maintain currency stability...the Fund would be influential in inducing countries to pursue policies making for an orderly return to equilibrium.⁹

It was intended that such a structure would give the institution a more cooperative character and at the same time secure for it a greater supervisory role over each borrowing country's economic policies in order to ensure repayment. The US Dollar, attached to gold at the rate of \$35 an ounce, would serve as the primary international reserve currency. Thus White's plan envisaged a more important role for the Dollar than did Keynes's. With the world's largest economy at the end of WWII and holding 60 per cent of the world's gold reserves, the United States acquired successful leadership of the world economy and was determined to play dominant part in the establishment of the postwar economic order.

Having replaced Britain at the centre of the global economy, the US now wanted to give its new *de facto* hegemony institutional form. As Van Dormael notes, for US Treasury Secretary Morgenthau, the establishment of an 'International Stabilization Fund' (an early version of the IMF's name) would be 'the victorious consummation of his years of struggle to move the financial centre of the world from

⁹ See "(B) Preliminary Draft Outline of a Proposal for an International Stabilization Fund of the United and Associated Nations (Revised July 10, 1943)" in Horsefield et al., *The International Monetary Fund 1945-1965: Twenty Years of International Monetary Cooperation*, vol. 3 of *The International Monetary Fund 1945-1965: Twenty Years of International Monetary Cooperation* (Washington, D.C.: IMF, 1969), 85-86.

London and Wall Street to the United States Treasury, and to create a new concept for international financial dealings.’¹⁰ In this respect, Hudson highlights the importance of the central role the US *government* played in establishing American hegemonic position in global finance since the post-WWI era:

From the outset...the role of government in U.S. overseas investments was decisive. It was government that, however circuitously, determined the growth and direction of U.S. investments abroad, not the investment of private finance capital that determined the foreign policies of the United States.¹¹

The UK’s principal concern in the negotiations leading up to the Bretton Woods conference was the maintenance of the Sterling Area as a sphere of its privileged interests and financing recovery in the post-WWII period. Britain’s position vis-à-vis the United States in this respect was, however, severely compromised by the *Atlantic Charter* of 1941 and further by the *Anglo-American Lend-Lease Agreement* of 1942. The *Atlantic Charter* spelled out the principles which were to guide the policies of the two countries after World War II. Most importantly, it produced a crucial statement of economic objectives which, according to the *Charter*’s Article IV, committed both countries ‘to further the enjoyment by all States, great or small, victor or vanquished, of access on equal terms, to the trade and to the raw materials of the world which are needed for their own economic prosperity.’¹² This implied the abolition of the use of the Imperial Preference principle Britain had been enjoying in its economic relations with the Dominions

¹⁰ Armand Van Dormael, *Bretton Woods: Birth of a Monetary System* (London and Basingstoke: The Macmillan Press Ltd., 1978), 241.

¹¹ Michael Hudson, *Super Imperialism: The Origin and Fundamentals of U.S. World Dominance*, 2nd ed. (London: Pluto Press, 2003), 56-57. This was to be distinguished from the UK hegemony which relied on largely private regulation of money with the Bank of England functioning as a commercial bank that was not nationalized until 1946. See also Lars Mjoset, “The Turn of Two Centuries: A Comparison of British and U.S. Hegemonies,” in *World Leadership and Hegemony*, ed. David P. Rapkin (Boulder and London: Lynne Rienner Publishers, 1990), 21-47 on the differences between British and US hegemonies more generally.

¹² Quoted in Richard N. Gardner, *Sterling-Dollar Diplomacy: Anglo-American Collaboration in the Reconstruction of Multilateral Trade* (Oxford: Clarendon Press, 1956), 46-47.

through the elimination of any discrimination by either the US or Britain against the importation of any product originating in the other country. The *Lend-Lease Agreement* under which the US provided wartime aid to Britain went even further than the vague language of the *Atlantic Charter*. Article VII of the *Agreement* stated:

The terms and conditions upon which the United Kingdom receives defense aid from the United States of America and the benefits to be received by the United States of America in return...shall include provision for agreed action by the United States of America and the United Kingdom...directed to the expansion, by appropriate international and domestic measures, of production, employment, and the exchange and consumption of goods, which are the material foundations of the liberty and welfare of all peoples; to the elimination of all forms of discriminatory treatment in international commerce, and to the reduction of tariffs and other trade barriers.¹³

As Gardner emphasizes, by providing for mutual undertakings of non-discrimination the Article had put the greater burden of practical implementation on the part of Great Britain, 'since no appreciable discrimination was being practised by the United States.'¹⁴ The linking of Britain's post-war policy obligations to the terms of the Lend-Lease settlement thus provided a major source of difficulty for Great Britain at the time of the Bretton Woods conference.

Conditions on membership in the Fund and on distributing aid funds had been a crucial point of divergence in the views of Keynes and White. Keynes proposed that the financial aid to the economies of countries with balance of payments deficits would be given with no conditions attached in terms of their domestic policies. The surplus countries would have to adjust by inflating their economies and by increasing their imports, while deficit countries would be largely free to pursue their own policies.¹⁵ The Union was to be based on the overdraft principle, meaning that the quotas allotted to member countries imposed a limit only on their total drawing rights,

¹³ Quoted in Gardner, 58-59.

¹⁴ Gardner, 59.

¹⁵ Fred L. Block, *The Origins of International Economic Disorder: A Study of United States International Monetary Policy from World War II to the Present* (Berkeley: University of California Press, 1977), 47-48.

not on the total liability they might be called on to bear.¹⁶ Such a plan was intended to give Britain freedom for domestic experimentation while assuring access to significant quantities of international credit.

In contrast to the inherently automatic Clearing Union of Keynes's plans, White argued that the Fund be given extensive powers to control matters that had previously been regarded as belonging to national sovereignties. According to White's plan, the resources of the Stabilization Fund were to be distributed according to the rules that the institution-to-be would impose on its members including

the abandonment, not later than one year after joining the Fund, of any restrictions and controls on foreign exchange transactions that had not been approved by the Fund. Member countries would not be allowed to alter exchange rates without the approval of the Fund. They could not accept investments and deposits from another country except with that country's consent (the participants in the debates on reform all had vivid memories of the large sums in capital flight in the 1930s). Members would also commit themselves to reduce trade barriers.¹⁷

Keynes vigorously opposed this, which he felt reflected 'the excessively discretionary American vision of the Fund's operation.'¹⁸ A provision requiring changes in the domestic policies of its members, such as changes in the exchange rate policies, might, he felt, be used as 'a basis for interference in Britain's policies of internal expansion.'¹⁹

To the standard Keynes/White story in establishing the Bretton Woods international order in the mid-1940s critical literature on the subject points to one principle which enjoyed support from both of the chief architects of the Bretton Woods order at the time – that countries need to use extensive capital controls in their international financial activities. Scholars like Eric Helleiner, for example,

¹⁶ Gardner, 87.

¹⁷ Harold James, *International Monetary Cooperation Since Bretton Woods* (Washington, D.C.: IMF, 1996), 41.

¹⁸ *Loc.cit.*.

¹⁹ Gardner, 115.

emphasized that, in light of the memory of speculative capital flows that distorted global finance in 1931, both Keynes and White 'acknowledged that capital controls...[were] seen as the necessary cost of protecting stable exchange rates and especially the welfare state from speculative and "disequilibrating" flows.'²⁰ Although both Keynes and White admitted that there are a lot of difficulties in controlling financial movements, as Helleiner pointed out, they argued there are two ways to overcome these difficulties: 'through the use of comprehensive exchange controls,' or through states' cooperation 'in enforcing each other's capital controls.'²¹ Both of the mechanisms were endorsed in the final *Articles of Agreement* of the Bretton Woods. In light of the later neo-liberal penchant for the abolition of capital controls, it is important to point out that the international monetary order that was created in 1944, in fact, explicitly restricted global financial flows as to prevent future possible disruptions in global finance similar to the one in 1931.

In the course of the negotiations it was largely White's plan which became the basis for discussion as the US was extremely reluctant to accept Keynes's plan of the overdraft principle under which it would have either to extend almost unlimited credit or to bear the main burden of balance-of-payments adjustment. Nor, now that the US saw itself as the central world power, was it willing to create much autonomy for other countries. As a result, it was to an overwhelming extent White's plan that was eventually adopted, creating the Bretton Woods system in 1944 with two main financial institutions – the International Bank for Reconstruction and Development, or the World Bank, and the International Monetary Fund – with different roles for each. The World Bank, initially intended to make loans for the reconstruction of a Europe

²⁰ Eric Helleiner, "Explaining the Globalization of Financial Markets: Bringing States Back In," *Review of International Political Economy* 2, no. 2 (Spring 1995): 318.

²¹ *Ibid.*, 319.

ravaged by war, later went on to work with Third World countries to stimulate long-term economic development through the creation of wealth. Unlike the World Bank, the IMF was not intended to be an aid agency. The role of the IMF was to ensure international monetary stability through the use of short-term loans to countries experiencing balance of payments difficulties.²² It was also authorized to impose on these countries conditions which were supposedly aimed at correcting the problems which led to the balance of payments difficulties in the first place.

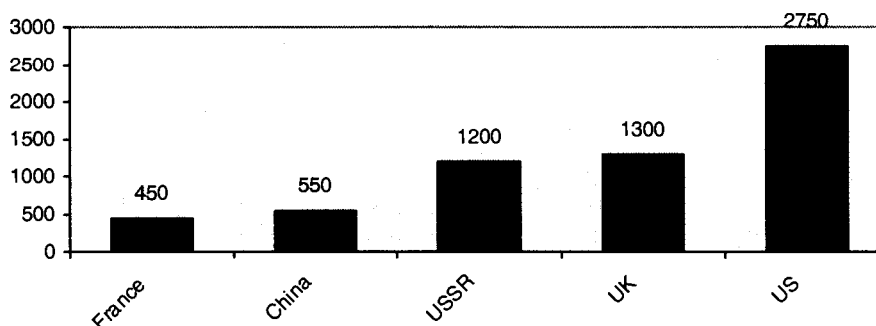
The centrality of the IMF to US strategy is clearer when we compare its structure against that of the other main Bretton Woods institution, the World Bank, which was clearly less important to US strategy and less central the institutional architecture of its hegemony. First of all, IMF membership was a pre-condition for membership in the World Bank. Each member of the World Bank was to have two hundred fifty votes plus one additional vote for each share of stock held; voting power at the IMF thus came to be determined in proportion to a country's quota. It is worth noting that although it is generally believed that the quota of each member country was determined by their relative economic importance, a different explanation was provided by Raymond F. Mikesell, an economist in the Division of Monetary Research in the US Treasury Department, and later member of the technical secretariat of the Bretton Woods conference. Mikesell, who was asked by White to develop a formula for stabilizing Fund quotas, explained that White

...gave no instructions on the weights to be used, but I was to give the United States a quota of approximately \$2.9 billion; the United Kingdom (including its colonies) about half of the US quota; the Soviet Union, an amount just under that of the United Kingdom; and China, somewhat less. He also wanted the total of quotas to be about \$10 billion...our military allies...should have the largest quotas, with a ranking on which the president and the secretary of state had agreed.²³ (See Figure 1.1)

²² See David Osterfeld, "The World Bank and the IMF: Misbegotten Sisters," in *The Collapse of Development Planning*, ed. Peter J. Boettke (New York: New York University Press, 1994), 185-209; or Zhang, 15-24.

²³ Mikesell, 22.

Figure 1.1 IMF Quotas, 1945
(in millions of United States dollars)



Source: US Department of State, "International Monetary Fund Final Act Text," in *Proceedings and Documents of the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 1-22, 1944*, vol. 2, (Washington, D.C.: US Government Printing Office, 1948), 1477.

Member countries' quotas were to be based on some sort of 'scientific formula' which gave evident weight to a country's gold and Dollar holdings, and to estimates of its foreign trade and national income. What happened in reality, though, was that American planners played around with the figures in efforts to come up with a formula that would reflect White's recommendations, thus fudging matters so as to actually base the quotas on US's political priorities. Mikesell admitted that he

...went through dozens of trials, using different weights and combinations of trade data before reaching a formula that satisfied most of White's objectives...Had there been reasonably good official national-income estimates for the major countries in 1943, it might not have been possible for me to approximate White's conditions.²⁴

Quotas were of great importance as voting power was to be based on them. With its one-third of all the quotas at the outset, the United States had tremendous leverage over the Fund. Thus was established the direct power of the United States over any IMF decision as the US was the only member state in the institution with a veto power, which it was eager to employ. In addition to its one third quota, the US also enjoyed the benefits of its leading role in the world economy, a role which would ensure that the vast majority of other countries, including in particular most of the

²⁴ *Loc.cit.*

other holders of substantial quotas among European countries, would not exercise their votes against the US.

During the first few years after its inception, the Fund made little progress toward stable, convertible currencies. Europe was still to recover from the war. During the European Recovery Program period (1948-51), the Fund often did little more than send out technical missions, collect statistics, and train financial experts from underdeveloped countries. Unrealistically high exchange rates enabled the war-torn countries to obtain imports less expensively, but they also discouraged these countries from competing on world markets. In the early years, Britain still financed 40 percent of world trade. Soon, however, the drain on Sterling reserves reached dangerous proportions which, by September 1949, led to a unilateral major devaluation on the part of Great Britain. 'London's giant devaluation upset the admittedly inappropriate network of exchange arrangements and brought a wave of competitive depreciations from thirty-one other countries who together accounted for two-thirds of world trade.'²⁵ This event revealed how ineffective the Fund was as an instrument of monetary cooperation, in particular in terms of maintaining orderly exchange arrangements for its member countries to prevent precisely that kind of problem for global finance.

The 1950s then saw a gradual passing on of the notion of conditionality from theory into the fuller practices of the IMF. As Peet underlined, '[c]onditionality was essentially a US conception for the operations of the IMF that was opposed by other member countries.'²⁶ Indeed, during the Atlantic City pre-conference discussions (June 15-28, 1944), Britain had the support of virtually all other countries in opposing

²⁵ Eckes, Jr., 230.

²⁶ Peet, 66.

the US initiative in introducing amendments to the text of the *Articles of Agreement* to make it more clear that balance of payments financing was not an unqualified right. While the opposition succeeded in preventing the American amendments from being adopted, the final wording of the Article V, Section 3 of the *Articles* read that countries seeking balance of payments assistance “shall be entitled to purchase” foreign currency, and that a country needing assistance ‘represents that it [the currency demanded] is presently needed.’²⁷ This gave the United States an opportunity to challenge several requests to draw on IMF funds in the late 1940s while continuing to press the case that members’ use of IMF resources was not automatic. As a result, little use was made even of the gold that countries had deposited. It was only after a reluctant general acceptance of the US position on conditionality after the 1952 IMF Executive Board agreement to a statement by the Managing Director that the policies proposed by any country to overcome balance of payments problems would, above all, determine the IMF’s attitude towards its loan request, that this part of the mandate of the IMF came into full use.²⁸ As Harmon observed, the US executive director simply vetoed requests that did not comply with the American position, and the practice was for countries requesting drawings of large amounts of foreign currency to approach the US directly for prior approval.²⁹ This, most of all, signified an early building of US hegemony through the IMF.

In the 1960s problems arose with using gold and the US Dollar as the main reserves backing international financial transactions. This involved the US running huge balance of payments deficits while financing its war in Vietnam, and earlier in

²⁷ Horsefield et al., 3: 191.

²⁸ *Ibid.*, 228-30.

²⁹ Mark D. Harmon, *The British Labour Government and the 1976 IMF Crisis* (London: Macmillan Press, 1997), 27.

Korea, flushing the world economy with excessive dollars, and thus putting downward pressure on the Dollar's value. As the use of the Dollar as a reserve by other countries grew, the United States faced a reserve shortage. To lessen the pressure on the Dollar – significant amounts of which were now held in foreign, primarily European, hands – the IMF established a new artificial reserve asset. Ironically, this was something similar to the 'bancor' proposed by Keynes at the time of the Bretton Woods but now not as an instrument for restricting US prerogatives within the world economy but increasing them and even, as we shall see, permitting a level of monetary indiscipline to the US that would never be allowed to any other country. In 1968 the First Amendment to the original *Articles of Agreement* was passed setting up Special Drawing Account from which participating countries could obtain Special Drawing Rights (SDRs), effectively a form of international currency. The purpose of the SDRs, as stated in Article XXIV, Section 1 (a) of the amended *Articles of Agreement*, was as follows: 'In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such a manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.'³⁰

In light of the inevitable parallels which might be drawn with Keynes's 'bancor', giving the impression that the US was now willing to submit to the sort of discipline which Keynes had advocated, a critic clarified that this measure was simply one of the 'gadgets devised to deal with the U.S. payments position, rather than the

³⁰ "Articles of Agreement of the International Monetary Fund (July 28, 1969)," in *The International Monetary Fund, 1966-1971: The System Under Stress*, vol. 2 of *The International Monetary Fund, 1966-1971: The System Under Stress*, ed. Margaret Garritsen de Vries (Washington, D.C.: IMF, 1976), 123.

beginning of a new approach to managing the international order.’³¹ The creation of the SDR was to lessen the use of the Dollar as a reserve by other countries, and thus to reduce the capacity of the US to painlessly incur more deficits, thereby avoiding the adjustment process and loss of gold. The 1971 decision of the Nixon administration to break the gold-Dollar link, however, eventually resulted in a massive increase in world dollar reserves. This, in any case, rendered any role the SDR might have played in providing adequate global liquidity surplus to requirements.

On the whole, throughout 1950s and 1960s, the IMF played little role in the regulation of world money supply in comparison with, and in relation to, ‘a select ensemble of national central banks, led by the US Federal Reserve System.’³² It was only with the crisis of US hegemony in 1970s and, above all, in the 1980s that for the first time the IMF would rise to prominence in global monetary regulation.

Collapse of the Bretton Woods System: Changing Functions of the IMF

After about two decades of expanding international trade under a regime of relatively stable exchange rates, the international monetary system established at Bretton Woods faced its first major challenge, one which introduced the first major shift in the role of the IMF in the structuring of US hegemony. The strain came in the late 1960s after US President Lyndon Johnson decided in the mid-1960s to use inflation to finance the War in Vietnam overseas and the War on Poverty at home. The US ran into huge balance of payments deficits, which it financed simply by

³¹ James, 174.

³² Giovanni Arrighi, *The Long Twentieth Century: Money, Power, and the Origins of Our Times* (London: Verso, 1994), 68.

issuing more dollars; world Dollar holdings grew as a result, flushing the world with excessive liquidity. Gold flowed out of the United States as a consequence and threatened to turn the balance of financial power away from the United States. To deal with this, as is well-known, US financial strategists decided to end the Dollar's tie to gold. What is often overlooked is that this also led to a crucial restructuring of the IMF as it was designed at Bretton Woods and amended in 1968.

In August 1971, US President Richard Nixon announced his decision to end the convertibility of the US Dollar to gold as part of his 'new economic policy,' signifying the collapse of the gold standard aspect of the Bretton Woods system, and moving the world towards a pure Dollar standard. As a result, an increasing number of countries were forced to abandon attempts to maintain fixed exchange rates between their currencies and the Dollar by limiting the excessive inflow of dollars into their domestic economies. Gowan points out that '[t]his suited the US administration because it wished to force a revaluation on other states and could now do so through its own policy for the dollar.'³³ In practical terms, he explained, this meant that 'the US government could, alone among governments, move the exchange price of the dollar against other currencies by huge amounts without suffering the economic consequences that would face other states which attempted to do the same.'³⁴ What resulted was a global regime of 'Dollar seigniorage' that gave the US financial system great advantages as the world's main source of credit. As Gowan suggests, 'if the high dollar produces a flood of imports into the United States, generating a very big, long-term deficit on the current account of its balance of

³³ Peter Gowan, *The Global Gamble: Washington's Faustian Bid for World Dominance* (New York: Verso, 1999), 20.

³⁴ *Loc.cit.*

payments, the deficit could be funded in dollars.³⁵ Thus, he then elaborates, seigniorage gave the US government ‘the ability to swing the price of the dollar this way and that, having great economic consequences for the rest of the world while the US remains cushioned from the consequences that would apply to other states.’³⁶ ‘This strategy of Nixon’s in “liberating” international financial markets,’ according to Gowan, was based on the idea that doing so ‘would *liberate the American state from succumbing to its economic weaknesses and would strengthen the political power of the American state.*’³⁷

Nixon’s decision also represented a crucial shift in American position from mainly Keynesian towards a new liberal approach with regard to international financial movements that would be intimately tied with the changing functions of the IMF at that time. To follow Helleiner, there were two main reasons for the new financial liberalism in US foreign economic policy in this period. First, ‘US officials realized that the emerging open, liberal international financial system would help preserve US policy autonomy,’³⁸ and second, ‘a more liberal international financial system would preserve the privileged global financial position of the US.’³⁹ This shift also included American big business which moved from reluctantly supporting Keynesian state regulation of the economy during much of the post-WWII period to actively supporting liberal deregulation in the mid-1970s. ‘US corporations, particularly those operating in emerging areas such as information technology, realized that they could compete in a neoliberal global space of free commodity

³⁵ *Ibid.*, 25.

³⁶ *Ibid.*, 25-26.

³⁷ *Ibid.*, 23.

³⁸ Helleiner, “Explaining the Globalization”, 323.

³⁹ *Loc.cit.*

movements and open capital markets liberated from “miles of red tape”.⁴⁰ In a way, as Helleiner underlined, ‘the basis of American hegemony was being shifted from one of direct power over other states to a more market-based or “structural” form of power.’⁴¹ The success of American liberal project for a new world order required the subjection of all states to some form of supranational authority. This requirement will have instrumental consequences for the future role of the IMF in managing international finance as the neo-liberal dominance of the United States since mid-1970s was to be promoted most importantly through the global institutions governing the development of world economy and finance, such as the World Bank and the IMF. The importance of the fact was to be realized more explicitly than ever during the South Korean financial crisis in the late 1990s.

An unsuccessful attempt by the European and the Japanese governments to establish a new, reformed system through the IMF’s Committee of Twenty (C-20)⁴² conference in 1972-74, a system in which SDRs would play a central role as the international monetary anchor or numeraire to which the Dollar would be subordinated, although officially supported by the US, in reality was no more than ‘a means of buying time while it imposed its own will on events outside the conference discussions.’⁴³ With its manipulative encouragement to the Organization of

⁴⁰ Peet, 12.

⁴¹ Helleiner, “Explaining the Globalization”, 323.

⁴² The Committee derived its name from the fact that representation was based on the 20 ‘constituencies’ that appointed or elected Executive Directors to the Fund. The official title of the Committee was the ‘Committee of the Board of Governors on Reform of the International Monetary System and Related Matters.’ See John Williamson, *The Failure of World Monetary Reform, 1971-74* (Sunbury-on-Thames: Nelson, 1977), 60-75 for a detailed discussion of the C-20 negotiations.

⁴³ Gowan, 20.

Petroleum Exporting Countries (OPEC) in quadrupling world oil prices in 1973,⁴⁴ the US managed to preserve its Dollar standard, as most non-oil-producing countries, especially in the Third World, were faced with huge balance of payments deficits in dollars as oil was denominated in US dollars. The conference participants realized at the time that collective planning of a new consensual international monetary order was virtually dead.⁴⁵ The major role of private financial operators, namely US private banks, in the subsequent recycling of petrodollars from Western banks to the Third World resulting from the oil price increase was to be understood as an expansion of private financial markets in the form of a political multiplier of the impact of the US Treasury's regulation of the Dollar which could be directed against Japanese and European economies.

Since, under the IMF's *Articles of Agreement*, the par value of the currency of each member was to be expressed in terms of gold, with the breakup of the Bretton Woods' fixed exchange rate system the original function of the IMF – which was 'to promote exchange stability, to maintain orderly exchange rates arrangements among members' by expressing the par value of the currency of each member 'in terms of gold as a common denominator' – disappeared. However, that had no impact on the organization's lending. By 1973, all the members of the IMF came to be in breach of its *Articles of Agreement* as floating the exchange rates of member countries became generally accepted as an outcome of the systemic crisis. The end of fixed parities allowed almost all countries to pursue faster monetary expansion, with the result that the world money supply grew.⁴⁶ Widespread floating thus immediately accelerated

⁴⁴ See, for example, Pierre Terzian, *OPEC: The Inside Story*, trans. Michael Pallis, (London: Zed Books, 1985).

⁴⁵ Williamson, 71-72.

⁴⁶ James, 262 (Figure 10-1).

inflation. In an effort to redefine the practice of surveillance of the international monetary system, the Second Amendment to the IMF's *Articles of Agreement* was passed in 1976.

The 1976 Amendment altered the *Articles* of the IMF first of all by legalizing the floating exchange rate system. According to the Article IV, Section 2 of the amended *Articles*,

Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.⁴⁷

Secondly, it was also decided that the IMF would watch over exchange rates agreements. According to Section 3 of the same Article,

...the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies.⁴⁸

The amended *Articles* did not include any explicit provisions for the surveillance of domestic economic policies, since, as James points out, 'exchange rates provided a guide to assessing all links of the national to international economy.'⁴⁹ Thus, the strengthening of this function increased the Fund's ability to watch over and direct the national economic policies of its members. In a sense, with this increased role of the IMF in the world financial structure, not least because the sheer number of decisions which it had to now monitor increased, the world financial

⁴⁷ "Articles of Agreement of the International Monetary Fund (April 1, 1978)," in *The International Monetary Fund, 1972-1978: Cooperation on Trial*, vol. 3 of The International Monetary Fund, 1972-1978: Cooperation on Trial, ed. Margaret Garritsen de Vries (Washington, D.C.: IMF, 1985), 382.

⁴⁸ *Loc.cit.*

⁴⁹ James, 272.

arrangements became much less automatic and thus much more politicized. This also clearly increased the power of the United States through the IMF.

The amended *Articles of Agreement* came into force in 1978 and formally provided that members could adopt the exchange arrangements of their choice. However, the 'firm surveillance' of the IMF would be exercised under the principle that 'a member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.' As Article IV, Section 3 of the amended *Articles* stated,

Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund.⁵⁰

In contrast to the Bretton Woods order, the IMF's function thereby shifted from that of policing member states' commitment to an agreed rate of exchange to that of overseeing a specific country's exchange rate policy, thus acquiring more political leverage over member states' domestic policies. The significant extension of functions in the IMF in the late 1970s to overseeing natural exchange rate policies of member countries was of crucial importance at the time. Although the IMF had always exercised policy conditionality over its borrowers, the importance of the change in late 1970s was that the nature of IMF conditionality from that point on, and in particular with the introduction of Structural Adjustment Programs in 1980s, was to be characterized by greater intrusiveness of neo-liberal ideology dictated by the dominant position of the United States in international finance. Another important aspect of the change was that in the late 1970s the IMF assumed greater powers of

⁵⁰ "Articles of Agreement" in de Vries, 382.

control over longer-term economic policies (structural adjustment rather than short-term stabilization) of its member countries. The ‘Dollar seniorage’ that had resulted from the collapse of the Bretton Woods system and the creation by the United States of the ‘Dollar-Wall Street regime’⁵¹ with private US banks taking active part in international financial relations led to the reemergence of the IMF as an international lending organization on a different, and eventually more powerful basis – something which came to be realized more fully with the Third World debt crisis of the early 1980s.

The Debt Crisis: Structural Adjustment Programs (SAPs)

While the collapse of the classic Bretton Woods system, signified by the unilateral decision of the United States to break the Dollar-gold link, entailed both an important reform of the international monetary system, and of the functions of the IMF, the second major turning point in the life of the IMF, which highlighted its intimate ties with the United States more than ever, came with the 1982 Third World debt crisis. Despite the world economic crisis of the 1970s, certain developing countries continued to grow at a relatively rapid pace even during the second half of the decade. Most states in the Third World, and some notable ones in Eastern Europe (Poland, Hungary, German Democratic Republic, and Romania), borrowed heavily from private, mostly US, financial institutions, on relatively easy terms in the 1970s and early 1980s to finance the development, in particular industrial, which they desired. US banks came to acquire an important role, one which was intimately connected to the US’s new system of ‘Dollar seigniorage’. As Gowan suggests,

⁵¹ Gowan, 19-25.

initially the US banks were 'far from happy about recycling the petrodollars to countries in the South. The US government had to lean on the banks to do so and had to provide incentives for such lending.'⁵² Among such incentives were the parallel involvement of the IMF/WB in such lending, the removal of controls on the US capital account in 1974, the decision to eliminate the limit on the amount of total lending that could go to any single borrower, and promise to bail them out in case of troubles as a result of such lending.⁵³ The loans were also made at floating interest rates, positioning the US banks to take advantage of any increases in interest rates.

It is noteworthy that the 1970s were a borrowers' decade, with real interest rates at historic lows. No wonder then, that many countries in the Second and Third Worlds were keen to avail themselves of the opportunities this created for 'debt-led growth'. By the 1980s, however, things came to a disastrous head: 'it had become clear that in many instances of such investment development had not taken place, or at least not to the extent required.'⁵⁴ The problem then was that whereas most of the funds had been borrowed by governments and private firms in the Third World at low interest rates, the arrival of neo-liberal governments in the US and the UK in the early 1980s reversed the historic trend of low interest rates. The low interest rate policies of the US government caused the Dollar to lose over a quarter of its value against the yen and the mark between 1975 and 1979. 'Worried that the Dollar's fall might slip out of control..., Federal Reserve Chairman [Paul] Volcker made his famous turn, jacking up interest rates, swinging towards a strong dollar and a drive to restore

⁵² *Ibid.*, 22.

⁵³ *Loc.cit.*

⁵⁴ Mike Mason, *Development and Disorder: A History of the Third World Since 1945* (Toronto, Ontario: Between The Lines, 1997), 426.

money's role as a stable standard of value (rather than just as an inflationary means of circulation).⁵⁵

As a result, the borrower Third World and Eastern European governments were now faced with much greater debts and debt service payments. Large-scale defaults were averted only by official intervention of the IMF. The crisis threatened a collapse in the US banking system (which was the principal lender), but the lesson learnt by the Reagan administration at the end was very significant. It learned, according to Gowan, that 'the imperial power could take advantage of a country's debt crisis to reorganize its internal social relations of production in such a way as to favour the penetration of its own capitals into that country.'⁵⁶ Ravaged by their debts and the collapse of raw-material prices, the borrowing Third World countries were forced to accept harsh conditions from the IMF. The countries most affected included Mexico, Peru, Brazil, Argentina, Zambia, among others.⁵⁷

New conditions from the IMF were established in Structural Adjustment Programs (SAPs), developed by Reagan's Treasury Secretary James A. Baker III and the US Treasury Department and proposed in October 1985 in Seoul. These represented an unprecedented broadening of the notion of conditionality that accompanied the IMF aid financing to troubled countries. With the chief components of the programs including such comprehensive macroeconomic and structural policies as reduction in government spending, cutting wages, liberalization of imports, removal restrictions on foreign investment, devaluation of the local currency, and

⁵⁵ Gowan, 40.

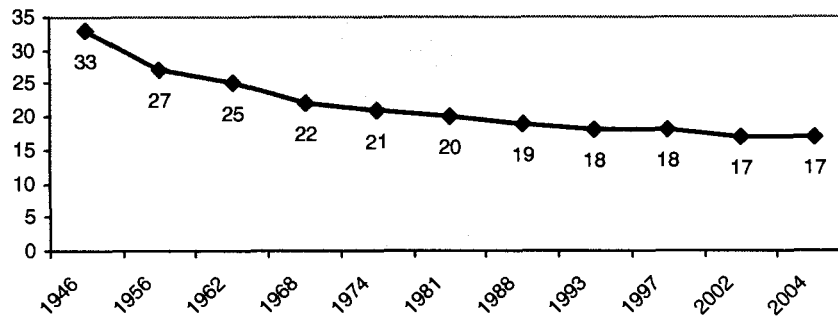
⁵⁶ *Ibid.*, 41.

⁵⁷ Mason, 427.

privatization of state enterprises, the adjustment programs constituted a vast enhancement of the sort of conditionality that was practiced previously.

The introduction of the SAPs and the key role of US Treasury in their design and implementation highlighted the chummy nature of the relationship between the neo-liberal US government and the IMF. Moreover, it also signified the changing nature of US hegemony within the IMF. As Figure 1.2 indicates, voting power of the US in the IMF, which was almost one third of total votes in 1946, diminished over the years by almost a half, given the steady decline of US's share of world GNP. This meant that the direct power enjoyed by the US in the IMF earlier declined as well.

Figure 1.2 US Voting Power in IMF, 1946-2004
(in percent of total)



Source: IMF Annual Reports, various years.

Thus the way that the neo-liberal US control of the IMF has been exercised since the early 1980s was to gain much more ideological, indirect ground than before. One example of this indirect control is the location of the IMF's headquarters in Washington, D.C. which provides American policymakers with an easier access to crucial internal processes of the IMF and its decisions. Another vivid example is the training of IMF personnel. It is the elite academia of Western Europe and North America symbolized by 'the two Cambridges, in England and New England'⁵⁸ that

⁵⁸ Peet, 19.

serves as the provider of IMF staff. The academia also serves as a source of theory and the domain of neo-liberal policy formation for the IMF. One more example of the way US neo-liberalism came to dominate IMF is through the strong endorsement of neo-liberal discourse from American neo-liberal ‘think-tanks’ into the wider IMF’s policymaking. To follow Peet, ‘the organized, systematized ideas behind an economic discourse often originate in theories or ideas “floated” in the public arena by academics in the elite institutions embedded in this [Protestant Western Europe and North America] culture region – usually the elite universities, with large endowments stemming from long-established capital accumulations, collections of the world’s finest intellects, whose density lends “truth effects” even to casual statements.’⁵⁹

It is with this ideological background that the SAPs were introduced into the policies of the IMF. While IMF and World Bank economists tried to sell the SAPs as necessary to promote efficiency and sustained growth, Third World leaders accurately perceived that the strategic target of structural adjustment was the mechanism that ‘touched the very core of the development policy process...The rate and manner of growth and societal objectives of the recipient countries are the very stuff of that elusive but important concept called sovereignty.’⁶⁰ Since SAPs covered so many dimensions of economic policy, agreeing to Structural Adjustment Loan (SAL) was virtually to turn over the control of a country’s economy to the Bretton Woods institutions. Thus Third World countries were not eager to receive SAPs initially, but as more and more of them ran into greater difficulties servicing the huge loans made by Northern banks in the 1970s, the US and the Bretton Woods institutions took

⁵⁹ *Loc.cit.*

⁶⁰ Morris Miller, *Coping Is Not Enough!: the International Debt Crisis and the Roles of the World Bank and International Monetary Fund* (Homewood, I.L.: Dow Jones Irwin, 1986), 185-186.

advantage of ‘this period of financial strain to insist that debtor countries remove the government from the economy as the price of getting credit.’⁶¹

The principal aim of IMF lending in this decade was thus not the original one of stabilizing the borrower countries but to ensure that the errant Northern banks did not suffer the consequences of their profligate lending to the Third World of the 1970s. The longer term objective, however, was to integrate developing countries further into the US-dominated world economy by incorporating specific requirements into the outlines of the aid programs. As Karin Lissakers asserts, ‘the proposed reforms on which the money was to be conditioned went much further than standard IMF nostrums on devaluation, reduction in public-sector borrowing and control over the money supply, and decontrol of wages and prices,’ and were tantamount to ‘putting the national patrimony on the block.’⁶²

The SAPs represented the expansion of conditions tied to the IMF aid loans to its member countries to enormous dimensions covering even the little details of the member country’s domestic monetary policy. But what is more important is that it is with these programs that the IMF acquired a new power for itself – the power of adapting the domestic financial structures of Third World countries to the US-based international system, thus putting US capital and business interests first.

Summing up, when the IMF was created in 1944, its well-defined purpose was to enforce the rules of a fixed-exchange system regarding altering a country’s exchange rate when fundamental adjustment was needed, as well as to provide

⁶¹ John Sheahan, “Development Dichotomies and Economic Strategy,” in *Towards a New Strategy for Latin America*, ed. Simon Teitel (Washington, D.C.: Inter-American Development Bank, 1992), 33 quoted in Walden Bello, *Dark Victory: The United States, Structural Adjustment and Global Poverty* (London: Pluto Press, 1994), 28.

⁶² Karin Lissakers, *Banks, Borrowers and the Establishment: a Revisionist Account of the International Debt Crisis* (New York: Basic Books, 1991), 229.

temporary resources to deal with a country's balance of payments problems. As we have seen, the dominant role of the United States in the construction of the Bretton Woods system allowed it to impose its own vision on how the post-WWII international monetary and economic order should be structured. Thus the foundation was laid for a close relationship between the IMF and the United States that was to have, as this chapter attempted to demonstrate, an indispensable influence on the character of the international monetary and economic order for decades to come.

With the collapse of the Bretton Woods system in 1971, the IMF lost its original purpose. The switch to floating exchange rates eliminated the Fund's exchange-rate regulatory role and changed the character of balance of payments problems. But, with the help of the Nixon administration in the early 1970s, the IMF redefined its role as the world financial system moved to a pure Dollar standard. The Second Amendment to its *Articles of Agreement* in 1978 determined that it would from that point on gain the power to oversee a particular country's exchange rate policy thus assuming greater powers of control over longer-term economic policies rather than short-term balance of payments stabilization of its member countries. Another important change at the time was that since the late 1970s the nature of IMF conditionality has become ideologically grounded in neo-liberalism pushed on it by the capital needs of the United States in international finance. With the introduction of the Structural Adjustment Programs as a solution to the Third World debt crisis in the early 1980s, the intrusiveness of neo-liberal conditionality increased dramatically. Since then the Fund has distributed its assistance only in return for a promise to carry out a series of comprehensive neo-liberal economic reforms that arguably were designed to help the country with its economic difficulties, but in fact were no more

than a method of adapting domestic financial structures of Third World countries to the US-based international system.

It was the East Asian financial crises of 1997-98 that have revealed, more than ever, the intimacy between the IMF and the US government. The erratic disruption hit the most fast developing region of the world, the region that has been unanimously described by development scholars of Right and Left as 'the engine of the world economy far into the twenty-first century,'⁶³ the Republic of Korea in particular. Even the World Bank, with which the IMF had maintained a close cooperation during the 1970s and 1980s and earlier, expressed severe criticism of its sister institution, denouncing as misguided the high interest rates and other painful austerity policies the IMF required Asian countries to pursue in exchange for international bailouts.⁶⁴ The IMF, under the close auspices of US Treasury, stepped in with a South Korean rescue package for one of the most developed countries in the world. To be able to implement the crisis aid package, the largest in IMF history, it had to invent a new kind of loan, the Supplemental Reserve Facility, which would allow it to distribute aid funds exceeding five times the recipient country's IMF quota. Before discussing the role of the IMF in the 1997-98 financial crisis in South Korea in more detail, it is necessary to have a close look at the development of that country since the division of the peninsula into North and South Korea in 1948 up until the 1990s. Particular attention should be paid to the evolution of the South Korean model of development

⁶³ Walden Bello, "East Asia: on the Eve of Great Transformation?" *Review of International Political Economy* 5, no. 3 (Autumn 1998): 425.

⁶⁴ See, for example, Paul Blustein, "World Bank Turns Up Criticism of the IMF," *Washington Post*, 3 Dec. 1998; David E. Sagner, "Decision by US and IMF Worsened Asia's Problems," *The New York Times*, 3 Dec. 1998; or Ibrahim F.I. Shihata, *The World Bank and the IMF Relationship-Quo Vadis? Essays in International Financial & Economic Law* no. 36 (London: The London Institute of International Banking, Finance and Development Law Ltd., 2002).

as well as to the IMF's role in and perception of it during the three decades of its high-speed growth.

Chapter Two

Republic of Korea: the 'East Asian Miracle'

South Korea's state-led, *chaebol*-centered economic system helped generate its impressive development from 1961 until the 1997 financial crisis. In the early 1960s, South Korea was regarded as one of the poorest countries in the world and the US, overseeing the development of its important Cold War ally, was 'extremely gloomy about the prospects of Korean development.'¹ By the 1980s, South Korea had turned from a world laggard to a leader. 'In the space of two decades the country's GNP grew from a paltry US\$100 million to US\$5,000 million.'² The economy of South Korea became the envy of the world. It had grown consistently over just two decades to become the world's eleventh largest economy. In terms of its size and the range of industrial sectors involved in its development, South Korea was the most important among the so-called 'four Asian tigers' (the others were Hong Kong, Taiwan and Singapore), all of which had experienced consistently high economic growth rates from the mid-1960s onwards, setting an example for the rest of the Third World.

This chapter will deal with the role the IMF played in, and how it perceived, the South Korean model of development during the decades of South Korea's high-speed growth. The evaluation of IMF's views will be set in the context of the economic transformation and development of South Korea since the division of the

¹ Edward S. Mason et al., *The Economic and Social Modernization of the Republic of Korea* (Cambridge, MA: Harvard University Press, 1980), 195.

² Andrew VanHulst, *The Politics and Economics of Capital Liberalization: The IMF's South Korean Rescue Package* (Melbourne, Vic.: School of Geography and Environmental Science, Monash University, 2002), 44.

Korean peninsula in 1945 up to the early 1990s. The chapter will demonstrate that throughout the period of South Korea's rapid development the IMF's views about South Korean model of development have been very positive. The IMF had been praising economic policies of the South Korean government that produced such stunning rates of economic growth attributing them either to the crucial role of government intervention during the 1960s and most of 1970s or, although inaccurately, to the free market incentives since the early 1980s. The shift in IMF's discourse to neo-liberal perception in the early 1980s appeared to correspond rather closely with the neo-liberal views and interests of the United States. However, as much as the neo-liberal orthodoxy of the IMF and the US government has tried to pass their views off as 'the truth', the real story of South Korean development increasingly suggests that South Korea's example did not represent the triumph of the free market principles. On the contrary, as this chapter will try to illustrate, it is in fact one of the few successful examples of state-led economic growth in the post-WWII era.

Import-Substitution Industrialization

Although South Korea's 'take-off' in economic development is conventionally taken to have started in the early 1960s, it is worth having a look at the period since the division of the peninsula in 1948 and into the 1950s – the period of the government of South Korea's first President Syngman Rhee – for it provides the crucial background and basis upon which the later rapid economic transformation of South Korea took place. It is also a subject which is often overlooked by neo-liberals who until 1997 had wished to portray South Korea as a model of free market and 'export-oriented' development. They also overlook the exceptional importance of

South Korea to US Cold War strategy and the exceptional treatment which South Korea received at the hands of the US as a result. Given that the main motivation behind the neo-liberals' portrayal of South Korea as a model of free market and 'export-oriented' development was to hold it up as an example for other Third World countries to emulate, the exceptional treatment it received from the US would greatly diminish its exemplary status.

According to Jung-en Woo (Meredith Woo-Cumings), a distinguished South Korean scholar, South Korea in the 1950s represented 'an archetype of import-substitution industrialization (ISI)' supported almost entirely through direct aid coming overwhelmingly from the United States.³ Notably, therefore, the role of the United States in the development of South Korea during ISI period of the late 1940s and 1950s will take up an important part of our discussion.

Not only the Cold War and US policy towards South Korea, but South Korea's very singular colonial past set it apart from the experience of other Third World countries. From 1910 to 1945 Korea found itself under the colonial rule of Japan which, as a colonial power, emphasized not only military and police forms of control but also development under strong state auspices using the "mighty trio" of state organization, central banking, and *zaibatsu* conglomerates' to industrialize Korea.⁴ It was the only colonial power to follow such a policy for its colonies.

³ "From 1946 to 1976, the United States provided \$12.6 billion in American economic and military aid to Korea (for Taiwan, it was \$5.6 billion), with Japan contributing an additional \$1 billion, and \$2 billion coming from international financial institutions...The Korean total of \$6 billion in U.S. *economic* grants and loans, 1946-1978, compares to \$6.89 billion for all of Africa, and \$14.89 billion for all of Latin America. U.S. *military deliveries* to Taiwan and Korea in 1955-1978, (i.e., excluding the Korean War) totaled \$9.05 billion, whereas all of Latin America and Africa combined received \$3.2 billion." See Jung-en Woo (Meredith Woo-Cumings), *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press, 1991), 45.

⁴ Bruce Cumings, "The Origins and Development of the Northeast Asian Political Economy: Industrial Sectors, Product Cycles, and Political Consequences," *International Organization* 38, no. 1 (Winter 1984): 10.

Starting from the mid-1930s, the policies of Japanese government towards Korea shifted from promoting mainly agricultural development during an earlier period towards encouraging investment in manufacturing and heavy industries (particularly metals and machinery). Hence, some of the essential preconditions for rapid industrialization already existed in the country well before the ISI of the 1950s or the take-off in South Korea's industrial development in the early 1960s.⁵

The Cold War also played a vital part in the nature of political and economic development of South Korea in the post-WWII era. From 1950s Korea became a 'test case of containment' for the United States, one of the chief stakes in its efforts to maintain its sphere of influence in East Asia vis-à-vis the Soviet Union.⁶ Unable to exercise control over all of Korea because of the Soviet presence in the north, the United States came to the conclusion that to secure its position of regional influence it had no choice but to create a separate South Korean state under its own control.⁷ Therefore, after Japan's surrender after World War II and the US proposal in 1945 to divide the Korean peninsula into trusteeships, the peninsula was partitioned along the 38th parallel. Syngman Rhee, who had been prominent in the anti-Japanese movement in the first decade of the century and spent the rest of the period of Japanese colonialism living in the United States and working to win US support for Korean independence, became the Republic of Korea's first president in 1948, eventually leading the country throughout the Korean War and until 1960.

⁵ See for example Martin Hart-Landsberg, *The Rush to Development: Economic Change and Political Struggle in South Korea* (New York: Monthly Review Press, 1993), 104-110.

⁶ See, for example, James I. Matray, "Korea: Test Case of Containment in Asia," in *Child of Conflict: The Korean-American Relationship, 1943-1953*, ed. Bruce Cumings (Seattle and London: University of Washington Press, 1983), 169-193.

⁷ See Bruce Cumings, "American Policy and Korean Liberation," in *Without Parallel: The American-Korean Relationship Since 1945*, ed. Frank Baldwin (New York: Pantheon Books, 1974), 39-108 for a detailed analysis of US role in the division of the Korean peninsula. See also Claude A. Buss, *The United States and the Republic of Korea: Background for Policy* (Stanford, C.A.: Hoover Institution Press, 1982), in particular ch. 3, on US strategy towards Korea in the early years of Cold War.

The exceptional role of US government in the post-WWII development of South Korea also took form of massive amounts of aid provided by the US to South Korea. One of the most obvious motives of US aid policy to South Korea during those years was the geostrategic position of Korea at the time of the Cold War. The Truman's administration's Korea policy after 1946 increasingly involved a search for a strategy that would allow the United States to withdraw militarily from South Korea without giving up the peninsula to Communist domination. With Truman's determination to reduce defense spending and balance the federal budget, the US State-War-Navy Coordinating Committee (SWNCC) concluded in 1947 that continued occupation of Korea would be impossible if the United States attempted to maintain its policy of containing Soviet expansionist ambitions in Korea through occupation alone, and proposed instead a plan for \$600 million in economic assistance over three years. The idea appeared to be, as James I. Matray noted, 'If the United States spent enough money..., Stalin would be unable to match the American commitment and would have to retreat.'⁸

On the other hand, Woo suggests, even in the 1950s South Korea itself was of little or no economic interest to the United States. Nor was the US the focus of the South Korean government: South Korean ISI, in Woo's words, was a defensive industrialization undertaken by South Korean leaders and aimed at keeping Japan at arm's length. To this end, the South Korean government routinely sabotaged the American effort to coordinate postwar reconstruction policies in the region and, instead, recycled aid resources for other purposes of its own: 'with the same dollar it makes more sense to build Korean industries than to purchase Japanese goods.'⁹ With

⁸ *Ibid.*, 172.

⁹ Woo, 54.

security and economic considerations thus inextricably mixed in the immediate post-WWII period, the United States pursued a policy of ‘work[ing] on Korea to open up to Japan.’¹⁰ These ‘differing conceptions of the East Asian order – [South] Korea as the economic appendix of the Japanese recovery in the American conception, versus [South] Korea as an independent and soon-to-be self-sufficient nation (if only enough American resources to be pumped into the economy) – significantly shaped the orientation of Syngman Rhee’s political economy.’¹¹

The authoritarian character of Rhee’s political system gave rise to widespread corruption and massive misuse of American aid. These were, ironically, very functional both to ISI and to the shaping of a native class of capitalists. Throughout the Syngman Rhee period the eventual reunification of South and North Korea was much emphasized. The Rhee government was concerned less with long-term growth, and more with immediate priorities of reconstruction and maintenance of minimum consumption standards, both of which were to be achieved by aid maximization rather than investment and production.¹² Cold War considerations dictated that the levels of foreign grant aid from the United States continued to fill South Korea’s internal and external financial gaps, which in fact rose steadily from the end of the war to the peak of \$383 million in 1957. These massive amounts of aid were largely misdirected by Rhee’s government towards generating political campaign contributions during elections and for other activities of Rhee’s Liberal party. One of the obvious ways of mobilizing internal support for Rhee’s position as the head of state was to forge a closer alliance with the new group of businessmen that had arisen in the post-WWII

¹⁰ *Ibid.*, 56.

¹¹ *Loc.cit.*

¹² David C. Cole and Princeton N. Lyman, *Korean Development: Interplay of Politics and Economics* (Cambridge, M.A.: Harvard University Press, 1971), 167.

period. This marked the development of an important element in the political system of South Korea – the close nexus between government and business – which, as we shall see, would ultimately succeed in creating a brand new bourgeoisie through patronage and clientelism. This issue deserves a deeper look as the state-business nexus would become an important actor in the rapid development of South Korea in the decades to come – the one to be praised by the neo-liberals at the IMF for three decades before the 1997 crisis and, ironically, then blamed by them as responsible for the 1997-98 financial turmoil at the time of the crisis.

The windfall gains from foreign aid provided a basis for the emergence of an altogether new entrepreneurial element. Political connections led to an uneven distribution of the spoils. Although the Americans wanted to sell off industrial properties which were left from the period of Japanese colonial rule, initially there were few qualified buyers, and many of the properties ended up in government hands.¹³ Despite the maintenance of some of state-owned enterprises, much privatization took place. Estimated, according to Woo, at 85 percent of the national wealth (including 3,551 operating plants and firms, land, infrastructure, and inventories), the Japanese-owned enterprises auctioned in the 1950s proved to be ‘the greatest bargain in history – small-time businessmen who cultivated government connections could now claim ownership of large factories.’¹⁴ She gives an account of the give-away nature of those auctions:

Take an example of one textile plant valued at 3 billion won in 1947. It was later appraised down to 700 million won, and then auctioned off at 360 million won: a mere one eighth of the original price and a half of the re-appraised price. Payments were to be in annual installments stretching fifteen years...but only fools paid debt on time: it was always rescheduled, and then finally, the intervening war was an excuse never to pay.¹⁵

¹³ *Ibid*, 58.

¹⁴ Woo, 67.

¹⁵ *Loc.cit*.

Thus, on the one hand, the massive sell-off of Japanese enterprises at below-market prices to small entrepreneurs of South Korea during the 1950s contributed to the increase in the size of industrial enterprises and, on the other hand, it led to a tentative groping toward a symbiotic relationship between the state and the progenitors of the large diversified business groups (*chaebol*) which were to characterize South Korea's subsequent spectacular development. South Korean entrepreneurs understood that 'collaboration with political authority was the essential prerequisite for business survival and expansion.'¹⁶ On the whole, however, the increase in the number of large industrial groups in 1950s was, in itself, not very significant.¹⁷ What was more important was that this growing state-business collaboration brought onto the stage of South Korean politics a category of 'political capitalists', which was to make an important contribution to the character of South Korean development as a whole.

The significance of US's inadvertent capital support for the ISI program of South Korea can hardly be overstated, however. '[US] aid financed nearly 70 percent of total imports between 1953 and 1962 and accounted for 75 percent of total fixed capital formation.'¹⁸ In return, the United States did seek various institutional reforms in an effort to gain greater leverage over South Korean economic policy-making. 'The Americans wanted higher taxes, decreased government expenditure, which would have reduced the power of the bureaucracy, and a more realistic exchange rate, which would have reduced Rhee's discretionary control over foreign

¹⁶ *Ibid.*, 66.

¹⁷ Of the top fifty *chaebol* in Korea in 1990s, only three or so had founders who accumulated wealth under the Japanese and only a few more were able to emerge and expand their activities in the 1950s. See *loc.cit.*

¹⁸ Stephan Haggard, *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries* (Ithaca and London: Cornell University Press, 1990), 55.

exchange and imports.¹⁹ The policies included, among others, the formation of a Combined (i.e., Korean-American) Economic Board, and, in 1957, the Financial Stabilization Program. However, the fate of these early American attempts to influence South Korean economic policies was telling of the balance between the US's geostrategic objectives and its economic ideology in the peninsula.

As Amsden shows, '[t]he economic policies that the United States espoused in [South] Korea showed consistency over time.'²⁰

The lesson that the United States drew from the upheavals in Korea was the need for stability before growth, and this lesson was at the heart of American short- and medium-term macroeconomic policies toward Korea. Long-term goals were perceived in terms of the law of comparative advantage, the objective being to reduce Korea's dependence on aid. For the purpose of developing a sound economy, aid was dispensed on the principle of static efficiency, that is, building infrastructure, natural resource-processing facilities, and light industry on the basis of small-scale enterprise.²¹

This policy, Amsden suggests, 'reflected little of the Keynesian revolution then sweeping American universities [as e]conomic advisors in South Korea, for the most part, were not academics; rather they were affiliated with the US military and with international aid organizations.'²² The first Korean-American pact, signed with Syngman Rhee in December 1948, outlined the *quid pro quo* of the aid relationship: 'The United States expected certain economic reforms: sound fiscal and monetary policies, the continued privatization of the Japanese properties, and the creation of a counterpart fund into which the South Korean government would deposit the local currency equivalent of all US aid.'²³ These reforms were largely aimed at

¹⁹ *Ibid.*, 55-56.

²⁰ Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (Oxford: Oxford University Press, 1989), 43.

²¹ *Loc.cit.*

²² *Loc.cit.*

²³ Haggard, *Pathways from the Periphery*, 56.

establishing monetary stability in South Korea – following the massive inflation and balance of payments deficits of the immediate post-WWII period – as it was a crucial prerequisite for the success of US capital projects in the country that were ultimately supposed to make the provision of further assistance unnecessary. The main efforts of US administration were directed toward reviving Japan, with South Korea as an ‘appendix’ for its economic revival.

By and large, however, as Amsden suggests, ‘the Rhee administration staunchly opposed the US policy package.’²⁴ Rhee’s stated position was, she explains, that a stabilization package compromising devaluation, a balanced budget, tight money, and high interest rates would make growth all but impossible. The real cause of Rhee’s attitude, however, was that the implementation of the policies demanded by US advisors would have restricted his flexibility in using aid in exchange for political campaign contributions.

Trying to end the irresponsible waste of aid funds by Rhee’s administration during the mid-1950s, the United States introduced a shift in the direction of its foreign aid to South Korea by replacing grants with conditional development loans. From that point on a series of preconditions directed at specific policy reforms would accompany each aid package. This new direction in US foreign aid, Woo suggests, presented development not as a virtue in itself but as ‘the most expedient means to the political ends of the cold war.’²⁵ This was the first time that the political ends of the Cold War were explicitly tied up to economic policy in South Korea. The shift came most profoundly with the establishment of the US Department of State Development Loan Fund (DLF) in 1957 signifying a switch ‘away from putting out brush fires

²⁴ Amsden, 43.

²⁵ Woo, 70.

toward concentration on the developing world.²⁶ It was immediately applied to South Korea with a wrenching Financial Stabilization Program (1957-1960) that same year.

Formulated and executed by the Combined Economic Board where the American voice was preponderant, it was an all-out attack on incontinent government spending, but it also retarded new investment. No net monetary expansion was allowed for 1957 and the first half of 1958, to be followed by a small increase thereafter; a ceiling was imposed on the government deficit; and commercial banks were required to receive an approval with the Monetary Board of the Bank of Korea, now under scrutiny and direction of the Combined Economic Board, for loans exceeding 10 million won.²⁷

Ironically enough, this shift in the foreign aid policies of the United States also came while the US was pushing for the necessity of conditionality to accompany aid funds distributed by the IMF. During the period of ISI in the 1950s, the IMF, which South Korea joined in 1955, played no role in stabilizing the South Korean economy, as the country was supported substantially by foreign aid from the United States. A 1969 study by S. Kanasa-Thanan, the resident representative of the IMF in South Korea in 1966-67 – the first study by the IMF of South Korea – asserted that with the massive foreign aid, considerable progress had been made during the 1953-1963 period toward rebuilding the country's infrastructure.²⁸ He admitted, however, that 'even the large inflow of foreign aid during that period could not meet the pressing demands for resources for social and economic reconstruction as well as for national defense,'²⁹ and that the South Korean government 'continuously resorted to inflationary finance.'³⁰ Given the IMF's historic emphasis on monetary stability, an

²⁶ *Ibid.*, 69.

²⁷ *Ibid.*, 71.

²⁸ S. Kanasa-Thanan, *Stabilizing an Economy – A Study of the Republic of Korea*, IMF Staff Papers, vol. 16 (Washington, D.C.: IMF, March 1969), 2.

²⁹ *Loc.cit.*

³⁰ *Loc.cit.*

emphasis which was only strengthened during the phase of renewed neo-liberalism, this uncritical stance of 1969 is noteworthy.

The drastic cut in grants-in-aid from the United States marked the start of the demise of Rhee's political system.³¹ With GNP in persistent decline from 1957, by 1959 the economy was deeply depressed.³² The growing inefficiency of the import-substitution strategy had become, as Edward S. Mason indicates, a major impediment to development by that time. Despite Syngman Rhee's autocratic political style, the state was weak during the 1950s. Industrial policy was inward-looking. Business interests established close rent-seeking relationships with political elites, and technocratic forces within the bureaucracy were marginalized. In essence the period of the First Republic (1948-1960) was trapped in problems of corruption, hyperinflation, and unending balance of payments deficits. What is important to underline, however, and what is nevertheless usually ignored, is that despite all these problems, ISI in South Korea in the 1950s did take place. More importantly, it had also laid the basis upon which the later economic transformation of the country would take place – an important basis which is overlooked by the neo-liberal accounts. Following the dramatic rioting of April 19, 1960, to protest electoral fraud and corruption, Rhee was forced to resign and accept a United States offer to go in exile in Hawaii. The soon-to-follow takeover of power by the military made a difference not only in reorienting economic policy, but also in the subsequent restructuring of

³¹ Aid dropped from the all time high of \$383 million in 1957 to \$321 million in 1958; then came to a shocking \$100 million cut in 1959, slashing the aid figure down to \$222 million. See Woo, 72.

³² The GNP growth rate peaked at 8.7 percent in 1957, then declined to 7.0 percent in 1958, 5.2 percent in 1959, and 2.3 percent in 1960.

Source: Economic Planning Board, *Statistical Yearbook 1962* (Seoul: Economic Planning Board, 1962), 69 as quoted in Haggard, *Pathways from the Periphery*, 59.

basic political and administrative institutions, political changes that were a crucial prerequisite for subsequent policy reforms.

Drive for Export-Led Growth

South Korea's economic 'take-off' in the 1960s should be understood and analyzed in terms of both international and domestic factors – a curious conjunction of 'external pressure with crucial institutional and political changes at the domestic level'³³ – that would also direct the political and economic policies of the country for years to come. The revolution that swept President Rhee from power in April 1960 also disposed of his political instrument, the Liberal Party. It was replaced by a badly divided Democratic Party which, after a few months of Interim Government, chose Chang Myon as Prime Minister. The Myon government assumed power against a backdrop of economic turmoil with no comprehensive understanding on how to solve the problems. Many of the Democratic Party politicians had for years focused their energy on opposition to Rhee, not on the development of constructive policy alternatives, and they lacked experience of administration and power. By Hart-Landsberg's estimation, '[a]pproximately two thousand street demonstrations, involving about one million people, took place during the ten months of Chang's period in power.'³⁴ The regime was ultimately overthrown on May 16, 1961 by a military coup undertaken by a small group of army officers led by Major General Park Chung Hee. This marked the establishment of the military dictatorship in South Korea which in turn laid an important basis for the soon to come rapid economic transformation of the country.

³³ Haggard, *Pathways from the Periphery*, 62.

³⁴ Hart-Landsberg, 136.

The establishment of military dictatorship in South Korea did not end the considerable influence of the United States on the country's political and economic development. In fact, Hart-Landsberg underlines that the policies of the United States, and those of Japan as well, were instrumental in shaping both the structure of South Korea's planning system and Park Chung Hee's choice of development strategy. Moreover, he suggests that 'South Korea's rapid economic growth and industrial transformation would not have been possible had it not been for United States and Japanese willingness to grant South Korea access to financial aid, technology, and markets on especially generous terms.'³⁵ As American grants-in-aid declined in the early 1960s, two things intruded to help the South Koreans get on the track with foreign investment: the rapprochement with Japan and the Vietnam War. Ironically, neither was supported by the majority of the South Korean population, and Hart-Landsberg notes that the ruling party had to rely on parliamentary tricks to ensure approval of these policies.³⁶

In late 1962, with encouragement from the United States, and amid its most contentious political battles at home, the government of South Korea reached an agreement with Japan which called for sizable Japanese financial flows to South Korea.³⁷ To the outraged public in South Korea all this looked like neocolonialism, and a sea of demonstrators vowed to oppose any attempt at restoring relations with – and moves to become economically dependent upon – Japan. According to Jounghwon Alexander Kim, a prominent South Korea scholar, apart from the widespread opposition to the normalization of relations with the former and much-

³⁵ *Ibid.*, 138.

³⁶ *Ibid.*, 144.

³⁷ Japan provided a \$300 million grant, \$200 million in government-to-government aid, and \$100 million in commercial credits. See Haggard, *Pathways from the Periphery*, 72.

hated colonial master, the primary issue throughout the political crisis in South Korea, was 'not opposition to Japan as such, but rather opposition to the Korean government, which it was feared would use financial resources from Japan to further consolidate its internal control, and in so doing would create an economic dependence on Japan in order to stay in power.'³⁸ Nevertheless, despite this opposition, the Normalization Treaty was concluded in 1965.

As part of the Treaty, Japan agreed to give South Korea \$200 million in public loans, \$300 million in grants, and at least \$300 million in commercial credits, to be paid over a ten-year period beginning in 1966. Between 1966 and 1967, South Korea received approximately \$90 million in Japanese grants and credits and over \$100 million in private commercial loans from Japanese banks. This immediate infusion of money more than replaced shrinking U.S. aid.³⁹

According to Woo's estimation, '[t]he total sum was not small for a country whose entire exports in 1964 amounted to \$200 million.'⁴⁰ Although Japanese funding was thus enormously important to South Korea, enabling it to finance its trade deficit and launch its heavy and chemical industrialization drive during the 1970s (something to be discussed further on), the South Korean people were right to be concerned, as the money was used not only to support industrial growth, but also Park's political power through financing election campaigns.

The beginning of the US war in Vietnam brought a further aid bonanza for South Korea. Just a few years before the US had sought to limit its aid commitments in South Korea given the fundamental disagreements between the US and the Rhee governments over the appropriate approach to manage aid: '[the] content [of aid was] largely dictated from the American side, while its ultimate uses and beneficiaries

³⁸ Joungwon Alexander Kim, *Divided Korea: The Politics of Development, 1945-1972* (London: Harvard University Press, 1975), 257.

³⁹ Hart-Landsberg, 145.

⁴⁰ Woo, 87.

were strongly influenced by the framework of Korean economic policies.’⁴¹ And now it had to pour even more aid into that country. Generous US financial aid to South Korea during the Vietnam War before long came to play a crucial role in the country’s economic ‘take-off’ in the 1960s. As a key to winning US financial support, Park sent South Korean troops to fight in Vietnam and was rewarded generously by the United States for doing so:

From 1965 to 1973, \$185.3 million was remitted to South Korea by South Korean military forces in Vietnam. In terms of foreign exchange earnings, US commercial support for South Korean business was even more significant, totalling almost \$540 million from 1966 to 1972...South Korea made an additional \$1.1 billion from US military activities in South Korea itself, including local spending, the provision of goods and services, and construction contracts...This total of more than \$2 billion represented approximately 19 percent of South Korea’s foreign exchange earnings over the period from 1965 to 1973.⁴²

The payments were formally agreed to as part of the Brown Memorandum which was signed by American Ambassador Winthrop Brown on March 4, 1966, but not made public in the United States until Senate hearings in 1970. The Brown Memorandum also committed the United States to further promotion of South Korean exports and modernization of both the South Korean army and US forces in South Korea, including increasing ‘technical assistance to the Republic of Korea in the general field of export promotion’ – an essential part of the Park’s economic strategy in the 1960s.

This brings us to the discussion of domestic developments in South Korea during the 1960s which illuminate an important dimension of the nature of the regime under which the storied economic development of this country would take place. Among the most important ones that contributed to the economic take-off and further development of the country – and, ironically, among the most highly debated ones

⁴¹ Mason, et al., 193.

⁴² Hart-Landsberg, 147-148.

during the course of the 1997-98 financial crisis, the ones that IMF officials in particular would attack – were centralization of economic and financial decision-making, and restructuring of state-business relations.

The military government of Park Chung Hee envisaged a much stronger role for economic development than did previous governments. As Edward S. Mason demonstrates, 'it became evident early that the promotion of economic growth was to be the primary objective of the military regime, and that economic growth was regarded as the chief factor that would legitimize the new government.'⁴³ Thus, Park moved quickly to establish his control over the economy. In July 1961 he created the Economic Planning Board (EPB) – which was to become South Korea's most powerful planning body – to direct the economic activity of the country for the decades to come.⁴⁴ The EPB came about by the joining together of the Ministry of Reconstruction, the Bureau of the Budget, and the Bureau of Statistics. It was headed by a deputy prime minister and was given not only the responsibility to direct planning, but also (by virtue of the fact that it controlled the national budget and thus government spending priorities) the ability to implement its plans. To strengthen its planning and implementation powers, the EPB was given the power to regulate both foreign borrowing, through its control over the issue of mandatory government repayment guarantees, as well as direct investment, through its control over an investment screening process.⁴⁵ Moreover, the EBP was also granted the authority to regulate the prices of a number of domestically produced goods and services deemed

⁴³ Mason, et al., 46.

⁴⁴ The following description of the powers and functions of the Economic Planning Board draws on Hart-Landsberg, 165.

⁴⁵ The power to regulate foreign loans and investment was handed over to the Ministry of Finance in 1981.

essential by the government. The creation of the Economic Planning Board thus signified combining of the centralization of political authority with the centralization of economic decision-making – something to be of tremendous significance for the rapid economic transformation that followed.

Furthermore, after a continuing debate between those who supported the autonomy of the central bank and those who believed that monetary policy should be one of several coordinated components of economic policy, the military government placed the central bank – the Bank of Korea (BOK) – under its own control by revising the Bank of Korea Act in May 1962. Commercial banks were also brought under government control by confiscating the stocks of the banks, which had previously been privately owned.⁴⁶ This was largely a manifestation of the orientation of the new government towards a centrally managed and powerful set of institutions and instruments for carrying the government policies. From this point on, South Korean state intervention was to operate in large part through discretionary and targeted credit policy as one of its principal instruments of economic development.

The link between state power and development strategy can also be seen in the restructuring of state-business relations. ‘Two weeks after the coup, thirteen prominent businessmen were arrested, and an investigation was launched into the activities of another hundred and twenty’ as part of an anti-corruption campaign.⁴⁷ Although the government seized all outstanding shares of commercial bank stocks, thus gaining control of a powerful policy instrument, they did however compromise with large manufacturing and construction firms. Revivification of the economy was

⁴⁶ Aid advisors had persuaded Syngman Rhee to denationalize the banking system in the 1950s.

⁴⁷ Stephan Haggard and Chung-in Moon, “The State, Politics, and Economic Development in Postwar South Korea,” in *State and Society in Contemporary Korea*, ed. Hagen Koo (Ithaca and London: Cornell University Press, 1993), 66.

the primary task of the military government which sought to achieve it through long-term development planning. Ironically enough, the only viable economic force for fulfilling this difficult task happened to be the target group of leading businessmen.⁴⁸ For this reason, the government decided to collaborate with rather than punish South Korea's businessmen. On their release from prison, the 'prominent businessmen' formed the Federation of Korean Industries (FKI) and submitted a plan to the Supreme Council 'identifying fourteen key industrial plants...in which they were interested in investing.'⁴⁹ This important change in the nature of business-government relations in South Korea in the 1960s occasioned the launching of a particular form of capitalist state, whose survival was to be contingent on the contentment of the business class – the so called 'Korea, Inc.' As Woo observes, 'it was...the farcical "punishment" of illicit accumulators that revealed the real steering mechanisms of Korea, Inc.: the state has its hand on the tiller but business provides the motive force.'⁵⁰

The first project of the EPB was to come up with comprehensive economic development plans, and a series of Five-Year Economic Development Plans were subsequently initiated. The First Five-Year Plan was announced in January 1962, to take effect immediately and remain in place until 1966. South Korea did not have a large domestic market or abundant natural resources. What South Korea had in abundance though was a relatively well-educated and well-trained labor force. Having chosen exports based on light manufacturing products, which were labor

⁴⁸ See Kyong-Dong Kim, "Political Factors in the Formation of the Entrepreneurial Elite in South Korea," *Asian Survey* 16, no. 5 (May 1976): 465-477.

⁴⁹ Haggard and Moon, 66.

⁵⁰ Woo, 111.

intensive but not capital- or technology-intensive, as a way out of poverty, the EPB promoted export-oriented industrialization as the main strategy of economic growth.

Maximization of exports was encouraged through a number of government initiatives, including 'currency devaluation, tax exemptions for exporters, tariff exemptions for imports used in the production of exports, subsidized interest rates for exporters, and state infrastructure support for export production.'⁵¹ Although all of those initiatives played a certain part in the export-oriented growth, the most important one, the one which contributed the most to South Korea's success, was government controls over credit allocation:

Beginning in early 1960s, the South Korean government took an active role in guiding resource allocation through the formulation of both multi-year development plans and annual overall-resource-allocation programs. With the assumption of this leading role, the government increasingly interfered with the distribution of credit and gradually took over the rationing of credit from the BOK and financial institutions.⁵²

Accordingly, the system of general credit guidelines contained in the Regulations Pertaining to the Uses of Funds in the Financial Sector, which was introduced in 1958, gave way to 'a system of government directives, ranging from general guidelines to the earmarking of funds or the assigning of bank loans for specific sectors, industries, and even individual firms and projects.'⁵³ In addition, the Park government adopted 'an increasingly complex structure of interest rates intended to give varying amounts of favored treatment to different categories of borrowers.'⁵⁴ In some cases, as with export producers, the preferential interest rates and large credit allocations went together, Cole and Park explain. In other cases, as

⁵¹ Hart-Landsberg, 170-171.

⁵² David C. Cole and Yung Chul Park, *Financial Development in Korea: 1945-1978* (Cambridge, M.A.: Harvard University Press, 1983), 173.

⁵³ *Loc.cit.*

⁵⁴ *Loc.cit.*

in much of agriculture, the interest rates were kept low, but loan amounts were limited.⁵⁵

These and several other early actions by the Park administration, Haggard suggests, 'provoked mixed reactions from the new Kennedy administration in the United States...Though impressed by the reformist zeal of the military government, the United States was troubled by the government's unwillingness to accept budgetary and monetary discipline,'⁵⁶ such as by insisting on keeping interest rates artificially low. Using aid as a weapon to force policy changes, the US government initiated a number of stabilization programs in South Korea; these included imposing ceilings on growth of the money supply, improving budget deficit, expansion of commercial bank credit and of foreign reserves.

But it was with the introduction of the high-interest-rate monetary policy in 1965 that the United States especially got its way and made an important shift in the direction of the financial development of South Korea. In September 1965, the South Korean government undertook a major financial reform, highlighted by a drastic increase in the interest rates on bank time deposits, a smaller and selective increase in the rates on bank loans, and a partial shift from direct to indirect controls over the volume of bank credit. The reform was based on the July 1965 Korean financial system study report produced by Professors John Gurley and Edward Shaw of Stanford University and by Hugh Patrick of Yale University, commissioned by the USAID program.⁵⁷ The primary objective of the arrangement suggested by the three American advisers was to attract into the banking institutions private savings that had

⁵⁵ *Loc.cit.*

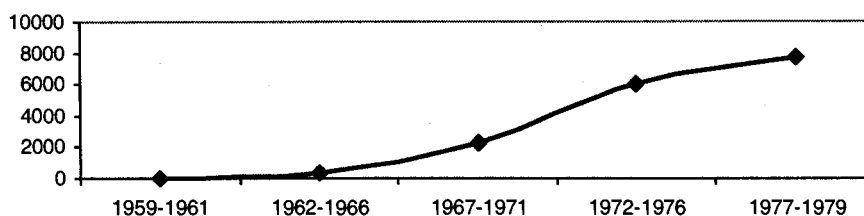
⁵⁶ Haggard, *Pathways from the Periphery*, 68.

⁵⁷ See John G. Gurley, Hugh T. Patrick, and Edward S. Shaw, "The Financial Structure of Korea," United States Operations Mission to Korea, July 1965.

hitherto been directed to the accumulation of inventories and other assets as a hedge against inflation. To this end, the interest rates on one-year time deposits were doubled from 15 to 30 percent per year. Bank lending rates were also adjusted upward, but less sharply.⁵⁸

New interest rates proved to be a powerful attraction for new deposits and resulted, as Cole and Lyman put it, in 'bringing the public into the development process.'⁵⁹ Indeed, according to them, the flow of private savings into the banks 'more than tripled in the first year of the reform.'⁶⁰ Another important effect of the interest rate reform, according to Amsden, was that the cost differentials between domestic and foreign interest rates encouraged South Korean borrowers to borrow abroad. This resulted in a massive inflow of foreign financing (See Figure 2.1). 'Because the real private cost of borrowing abroad was typically negative, investment as a share of GNP rose from 15% in 1965 to 30% in 1969.'⁶¹

Figure 2.1 Foreign Borrowing, 1959-1979
(in millions US dollars)



Source: Economic Planning Board, *Handbook of Korean Economy*, 1983 as quoted in Amsden, 92.

One more reason why the reform was of such significance is that it was also supported by the first of South Korea's Stand-By Arrangements with the International

⁵⁸ For a closer look at the background, elements and effects of the reform see Chapter 7 in Cole and Park.

⁵⁹ Cole and Lyman, 89.

⁶⁰ *Loc.cit.*

⁶¹ Amsden, 94.

Monetary Fund. In support of the program promoted by US advisors, the interest rate measures of 1965 were implemented in conjunction with the IMF Stand-By Arrangement of \$9.3 million. According to the IMF *Articles of Agreement* established at Bretton Woods, the institution's role was to provide the necessary liquidity to a country experiencing balance of payments crisis. The Fund's involvement is thus interesting in itself as South Korea suffered no major balance of payments crisis at that time, and therefore, strictly speaking, the IMF involvement in advancing the interest rate reform of 1965 was unnecessary. One of the important dimensions of this IMF's intervention that illuminates the early IMF-South Korea relationship is that Park's decision to turn to the IMF was largely dictated by the necessity to have someone to blame if the outcome of the reform would turn out to be to the detriment of South Korean economy. The government could then blame the outcome on, as Cole and Park put it, the 'unexpected developments in the economy but [it] would seldom acknowledge that it could or should have taken corrective action to offset those developments.'⁶²

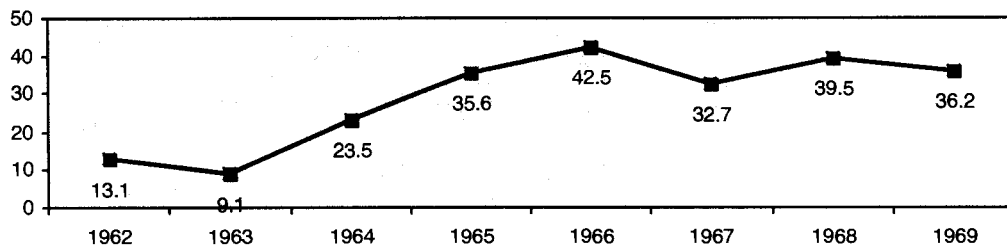
The policies of government control over credit allocation toward specific industries, and sometimes toward specific business groups, as well as the provision of export credit at preferential rates for the purposes of export maximization as pursued by the South Korean government during the 1960s was highly praised by the IMF. The 1971 account by Hyong Chun Kim, an economist in the Far Eastern Division of the Asian Department of the IMF, characterized the export-oriented growth policy of the South Korean government as extremely successful.⁶³ He stressed, in particular, the importance of government financial measures designed to provide a range of

⁶² Cole and Park, 258.

⁶³ Hyong Chun Kim, "Korea's Export Success, 1960-69," *Finance & Development* 8, no. 1 (March 1971): 14-21.

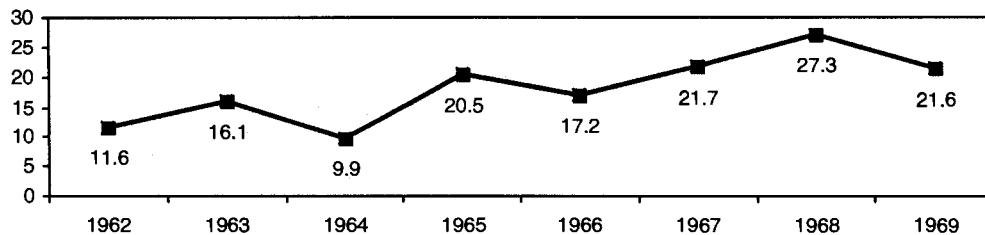
export incentives, including reduction in, or exemption from, various taxes and custom duties, export credit at preferential rates, accelerated depreciation on facilities used for the production of exports, and discounts on power and transportation rates. Bank credits to exporters at an annual rate of 6 percent and grants to exporters of one-year monopoly export rights for the introduction of new products or the opening of new foreign markets were also highlighted as of crucial importance for South Korea's growth and export success during the 1960s. The irony is, however, that having praised the government's central role in exercising discretionary control over credit allocation toward specific industries during the decades of high-speed growth in 1971, IMF officials would widely discredit this very policy as one of the South Korean economy's inherent structural weaknesses during the financial crisis of 1997 when it was blamed as one of the main causes of the crisis.

Figure 2.2 Real Growth in Exports, 1962-1969
(in percent)



Source: International Monetary Fund.

Figure 2.3 Real Growth in Manufacturing, 1962-1969
(in percent)



Source: International Monetary Fund.

Taken together, the state's highly focused and integrated policies during the 1960s were a powerful force for economic growth. The result, as Figures 2.2 and 2.3 demonstrate, was a rapid increase in manufacturing production and exports, as 'annual real growth between 1966 and 1969 averaged over 10 percent.'⁶⁴ As Woo observes, 'by the end of the 1960s, the three indispensable conditions could be found in Korea: a global economic structure that accommodated and welcomed an upstart, a developmental state that could exploit its external conditions and harness its grip on domestic sectors, and finally a hardworking and increasingly confident bourgeoisie.'⁶⁵

Notwithstanding dramatic rates of growth, South Korea's drive for export maximization in the 1960s was also accompanied by a rapidly growing foreign debt. As Hart-Landsberg indicates, 'Park's export promotion policies had created a dual economy: a dynamic import-dependent export sector fueled by cheap funds and imported capital goods and a stagnant domestic economy weakened by a depressed agricultural sector, lack of capital, and a poorly paid working class.'⁶⁶ By the end of 1960s, it was becoming apparent to the Park administration that South Korea's import-dependent export strategy was fast becoming unworkable. With foreign aid, credits, and export markets shrinking, it was becoming increasingly difficult for South Korean firms to service their international debt. As Hart-Landsberg indicates, '[m]ore than 2,000 firms were forced into bankruptcy by 1971.'⁶⁷ And, with South Korea's export products heavily weighted toward such standardized, labor intensive

⁶⁴ Haggard and Moon, 73.

⁶⁵ Woo, 116.

⁶⁶ Hart-Landsberg, 174.

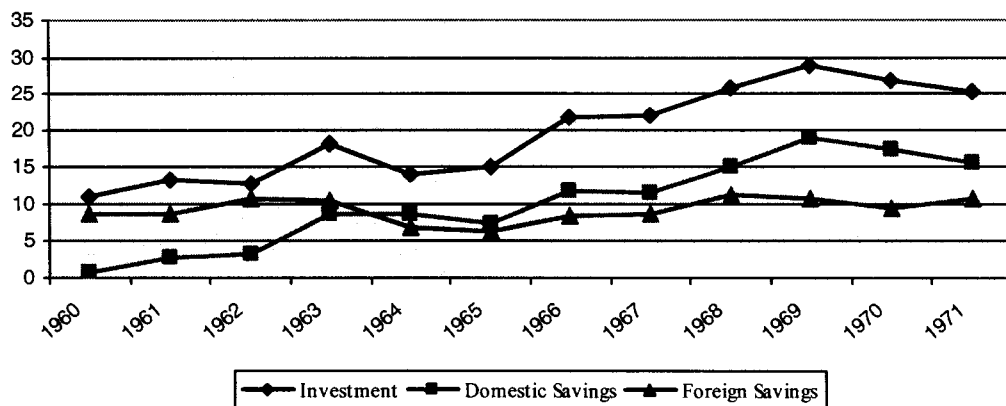
⁶⁷ *Ibid.*, 175.

products as textiles, apparel, plywood, and wigs, existing export markets could hardly be considered safe at a time when several other low-wage Third World countries were also attempting to increase export of such manufactures. These, and other considerations to be discussed in the next section, contributed to the shift of South Korea's economic planning toward heavy industrialization during the 1970s.

'Late' Industrialization

South Korea's competitiveness internationally in labor-intensive industries, together with devaluation, and the Vietnam boom, all contributed to the country's rapid growth and export expansion. However, by the end of the 1960s, the South Korean economy encountered new difficulties. As Haggard and Moon indicate, '[t]he GNP growth rate declined from 15 percent in 1969 to 7.9 percent in 1970, and inflation accelerated. Despite rapid export growth, the current account deficit increased from \$103 million in 1965 to \$847 million in 1971, reflecting consistently high levels of investment relative to savings'⁶⁸ (See Figure 2.4 below).

Figure 2.4 Investment and Savings as Percent of GNP, 1960-1971



Source: BOK, *National Income in Korea*, 1978.

⁶⁸ Haggard and Moon, 73.

At the same time, workers, especially women workers, were beginning to engage in workplace struggles to improve their earnings and working conditions:

Two...critical strikes took place in 1968 at U.S.-owned electronics firms, Oak Electronics and Signetics...In 1969, there was a large-scale strike by textile workers at sixteen cotton textile firms as well as a strike by metal workers at Chosun Shipbuilding Company...[In 1970] came a hunger strike by chemical workers at Korea Pfizer Company, a subsidiary of American Pfizer, followed by an auto workers strike against Shaehan Motor Company, a joint venture with General Motors.⁶⁹

These acts of resistance, especially strikes at firms with foreign investments, were raising fears among South Korean planners that foreign businesses would no longer see South Korea as an attractive production location. Facing a serious balance of payments deficit by the early 1970s, Park hoped to lessen it by encouraging greater foreign direct investment. As labor struggles such as the ones mentioned above threatened to undermine this strategy, the government introduced new labor legislation in January 1970 thus making labor organizing in the newly established free trade zones almost impossible and strikes illegal. All disputes had to be settled through a compulsory arbitration procedure under the control of the government and foreign corporations. Following a fraudulent presidential election of April 1971 during which Park successfully used voter intimidation to defeat his opponent, he had the National Assembly pass the Law Concerning Special Measures for Safeguarding National Security under which he was granted the authority to ban public demonstrations, freeze wages, rents and prices, and 'mobilize any material or human resources for national purposes.'⁷⁰ A year later Park announced the intention of rewriting the constitution in order to institutionalize his newly acquired powers.

⁶⁹ Hart-Landsberg, 182-183.

⁷⁰ Gerhard Breidenstein, "Capitalism in South Korea," in *Without Parallel: The American-Korean Relationship Since 1945*, ed. Frank Baldwin (New York: Pantheon Books, 1974), 257.

The new constitution, which was called the Yushin Constitution, came into effect in November 1972. The new constitution in effect left the President's continuation in office at his own discretion. It also gave Park sweeping new powers to rule by emergency decree. According to Mason et al., 'it [the Constitution] gave him the authority to dissolve the National Assembly, and the power to prepare a slate of representatives making up one-third of the Assembly's membership. The Constitution also declared that neither court actions nor objections could be raised against the special declarations issued by the President and the extraordinary measures taken thereunder.'⁷¹ The Yushin Constitution of 1972 thus made a momentous contribution towards the further strengthening of the executive, and of Park's personal authority in particular, by technically making him a dictator for life. This, as we will see, had a crucial significance for the industrial development of South Korea during the 1970s.

Apart from the need to revive the domestic economy from the standstill at the turn of the decade, there were several external factors impelling the South Korean government to put a strong policy emphasis on exports and Heavy and Chemical Industrialization (HCI) in the 1970s. Woo lists the Nixon Doctrine, the textile wars with the United States and the 1973 oil price shock as having been the most important.⁷²

In 1969, the newly elected president of the United States Richard Nixon, trying to cope with the deterioration in the country's balance of payments position due to massive expenditures during the Vietnam War, announced the US foreign policy design for the next decade: under the slogan of 'Asian hands must shape the

⁷¹ Mason, et al., 52-53.

⁷² Woo, 120.

Asian future,' the administration of Richard Nixon decided to withdraw an entire combat division with a force of twenty-four thousand from South Korea, thus marking end of an epoch of rank clientelism whereby South Korea was, from 1950 to 1972, one of the world's largest recipients of American military assistance. According to the Nixon Doctrine, at the heart of which lay the normalization of diplomatic relations with China, 'the United States would no longer take primary military responsibility for defending Asian countries from "communist-led or inspired aggression."'⁷³ This implied to South Korean officials that the US was keeping its troops in South Korea out of its own strategic and security considerations in the area rather than because South Korea was pleading for the US do so. This realization in turn implied that South Korea should start achieving self-reliance strengthening its military capability and should begin producing its own military hardware. This also led to South Korea's own normalization of diplomatic relations with China, although it was not until the beginning of China's open-door policy in 1978 that the economic relationship between the two countries started to expand.

The impact of declining US aid on the South Korean import-dependent export strategy was further aggravated by US economic protectionism from the turn of the decade. In 1971, the US forced South Korea to sign a bilateral trade-restraint agreement on textiles. This action, Hart-Landsberg suggests, represented a serious threat not just to the textile industry but to the entire South Korean economy as textiles were South Korea's leading export item, with planners projecting a continued increase in sales. In 1970, textiles accounted for 33 percent of total manufacturing output, 32 percent of manufacturing employment, and 38 percent of all South Korean

⁷³ Hart-Landsberg, 175.

exports.⁷⁴ Considering that of all South Korean exports in 1970, 47.3 percent went to the US, a quota on Korean textile imports into the US had a devastating effect on Korea.⁷⁵ This factor, among others, had a major impact on the further inclination to re-orient South Korean production toward heavy and chemical industries.

Last, but not least, was the 1973 oil price shock. The quadrupling of petroleum prices by OPEC countries in the mid-1970s was a disaster for all energy-short nations, including South Korea. While the North possessed great hydroelectric and fossil fuel reserves, South Korea depended on imported oil for 60 percent of all its energy consumption. The South Korean response to the crisis, as Woo puts it, was fully to absorb oil price increases (accounting for a 62 percent rise in the value of imports in 1974), and then finance the current account deficit by depleting foreign reserve holdings and borrowing abroad. As a result, from 1973 to 1974 South Korea's total foreign debt shot up by 42 percent, 'investment climbed to a historical high of 32 percent of the GNP, from 26 percent in 1973, expansion in domestic credit hit over the 40 percent level, and Seoul's Wholesale Price Index went above 42 percent.'⁷⁶

To cope with the situation, rather than curtailing investments in basic and defense-related industries, South Korea simply pushed forward on its course of expansion promoted by the Yushin system, which was already in place at that time. The Heavy and Chemical Industrialization Declaration by President Park in 1973 set as the government's top priority the development of the following six industries:

⁷⁴ Woo, 126.

⁷⁵ For a discussion of US-Korean trade frictions in the 1970s see Chung-in Moon, "Irony of Interdependence: Emerging Trade Frictions between South Korea and the U.S.," in *Alliance Under Tension: The Evolution of South Korean-US Relations*, Manwoo Lee, Ronald D. McLaurin, and Chung-in Moon (Seoul: Kyungman University Press, 1988), 47-79.

⁷⁶ Woo, 128.

steel, petrochemicals, shipbuilding, industrial machinery, nonferrous metals, and electrical industries. Measures for the steady build-up of heavy industries were in the same vein as those proven effective in building light industries in the 1960s: to build a few large-scale industrial complexes for heavy and chemical industries and designate a number of firms to build plants with government-arranged foreign capital and domestic financing.⁷⁷ The vast foreign debt repayment problems at the start of the decade posed serious challenge to state policies – because of its system of loan guarantees, the government was ultimately responsible for the foreign debt. Under pressure to restore lender confidence, in 1971 the government of South Korea turned to the IMF for help. The stabilization program advanced by the IMF called upon South Korea “to limit new private borrowing, devalue its currency, reduce fiscal deficits, slow monetary growth, and end export subsidies and import restrictions.”⁷⁸ The United States gave full support for the program. It is noteworthy that the breakup of the Bretton Woods system in 1972 and the subsequent crucial shift in the IMF’s functions from policing member states’ commitment to an agreed rate of exchange to overseeing a specific country’s exchange rate policy – thus assuming greater powers of control over longer-term economic policies rather than short-term balance of payments stabilization – meant also that the 1970s saw a resurgence in the IMF’s activities as it became both ‘the good cop (the lender of last resort) and the bad cop (imposing stabilization) of international finance that created some stability and order in the global money bazaar.’⁷⁹ For South Korea, Woo underlines, ‘this meant that the IMF, and not the US State Department, was now the new watchdog of South

⁷⁷ See *ibid.*, 128-147 for a detailed discussion of the Heavy and Chemical Industrialization Plan.

⁷⁸ Hart-Landsberg, 176.

⁷⁹ Woo, 151.

Korea's political economy'⁸⁰ to oversee its long-term financial policies. The first priority for the US in the East Asian region in the 1970s was a strong and prosperous South Korea, together with a strong Japan, to serve as a solid buffer against communist states. The export-led kick-off had given South Korea a sound start, and American aid to support South Korean economic policies gradually declined, so by this time South Korea was not so closely monitored economically by US State Department. Thus the IMF supervision of South Korea during most of the 1970s was of 'normal' character, not yet influenced by the neo-liberal aspirations of the United States.

The South Korean institutions to suffer most from the IMF stabilization program in 1971 were the *chaebol* as they relied on relatively cheap funds to sustain their operations. Now, as a result of IMF agreement, they were denied access to new foreign loans at the same time that domestic credit markets were being tightened by government policy. To save businesses suffering under deteriorating financial conditions due to foreign loans and massive domestic debts, in August 1972 the government announced the Emergency Decree on Economic Stabilization and Growth, popularly known as the 'August 3rd Measure'. The decree effectively 'froze all curb loans to businesses and converted them into either long-term debt with very favorable terms (including a three-year's moratorium) or into capital investment in firms, and it lowered official interest rates on both deposits and loans.'⁸¹ This set of measures was among the first crucial policies of the Yushin regime, as it purported in effect to write off existing domestic debts of the beleaguered firms, thus giving the firms a breathing spell of relief. The 'August 3rd Measure' most of all highlighted the

⁸⁰ *Loc.cit.*

⁸¹ Cho Soon, *The Dynamics of Korean Economic Development* (Washington, D.C.: Institute for International Economics, 1994), 43.

close relationship between the Yushin regime and the South Korean capitalist class as it was considered a moving engine of the economy by the government which was determined to provide the necessary incentives for its further development.

The 'August 3rd Measure' was commended by the IMF. The Fund's Asian Department complimented the South Korean government's efforts to improve its balance of payments by mobilizing resources for the private sector from both domestic and foreign sources, thus enabling Korea to improve and expand and diversify its manufacturing production in support of its drive for greater exports.⁸² While noting that, 'triggered by a cyclical downturn of domestic investments, the slowdown in growth was further aggravated in late 1971 by uncertainties in international monetary developments and restrictions abroad on Korea's exports,' the IMF spoke highly of the government's August 1972 economic measures under which 'business enterprises were to be provided with larger credit facilities and greater access to resources for increasing investment and improving productivity.'⁸³ The IMF thus expressed confidence that the successful implementation of the August 1972 measures would 'pave the way for sound and sustainable growth of the Korean economy.'⁸⁴

As noted above, the August 1972 measures signified the strengthening of the special relationship between the government and big business in South Korea – something which had characterized the Korean economy since the 1960s. In fact, the relationship seemed now to be entering a new phase – one in which the role and power of the *chaebol* in the economic life of the country would acquire

⁸² "Experience of Korea Shows Cause and Effect: Policy Helps Curb Prices, and Growth Follows," *IMF Survey*, 12 Feb. 1973, 40.

⁸³ *Ibid.*, 41.

⁸⁴ *Loc.cit.*

unprecedented dimensions (although the most important decisions of firms investing in priority industries would still be supervised by the government):

In 1982 out of a total of 35,971 firms registered in the manufacturing sector, firms belonging to the top 30 conglomerates numbered only 271, or less than one percent. Yet these 271 firms accounted for 40.7 percent of sales; 33.2 percent of the value added production; 37.2 percent of fixed assets; and nearly 20 percent of employment.⁸⁵

Around late 1970s-early 1980s, a notable shift appears in IMF discourse with regard to the nature of South Korea's tremendous economic achievements. The emergence of neo-liberalism as the dominant ideology within the institution came largely as a response to the US neo-liberal government's initiatives in promoting free-market economy principles, most importantly through international aid institutions like the IMF. Impressed by the outstanding rates of growth of South Korean economy for the two decades, naturally the mainstream economists from the US government and the IMF wished to attribute South Korea's success to the free market ideas and hold it up as an example for the other Third World countries to follow the lead. A 1982 IMF account by Larry E. Westphal, for example, suggests that in its export promotion program the South Korean government had primarily

relied on market incentive policies to ensure that firms earn adequate profits on their exports. These incentives are applied across the board and generally operate through the taxes and measures that affect market prices; they apply to all firms automatically.⁸⁶

Westphal's account of South Korean development is extremely important from the perspective of the evolution of IMF's view on the nature of South Korean economic development. Unlike IMF accounts from the 1960s and most of the 1970s, which gave credit to government intervention in the economy as a highly effective method to sustain economic growth, views from the late 1970s and the 1980s, like

⁸⁵ Walden Bello and Stephanie Rosenfeld, *Dragons in Distress: Asia's Miracle Economies in Crisis* (San Francisco, C.A.: Institute for Food and Development, 1990), 63.

⁸⁶ Larry E. Westphal, "The Private Sector As 'Principal Engine' of Development: Korea," *Finance & Development* 19, no. 2 (June 1982), 36.

those of Westphal, downplayed the role of state intervention in successes of South Korean economy and suggested that

by no means are all new entries into export markets the result of selective intervention by the Government. Indeed, exports from selectively promoted infant industries have never accounted for more than a quarter of Korea's manufactured exports. For most exports, targets have worked together with the market incentives to promote rapid expansion.⁸⁷

This shift in IMF emphasis on the market incentives, rather than government intervention, as the guiding force in the South Korean economy all the way since 1960s illustrates an important point in the evolution of the international monetary system at large, and the role of the IMF within it. As Hart-Landsberg suggests, not only did these economists, like Westphal, understate the economic role of the state, they have also seriously overstated the importance of free-market competitive entrepreneurship. For 'South Korea's economic rise and industrial transformation was in fact powered by a few, large business groups whose growth can be best explained with reference to state directives and initiatives, the most important being financial.'⁸⁸ Indeed, at first, the *chaebol* were not enthusiastic about HCI. Less than a decade of growth based on light industries had not prepared them to plunge into an unpredictable future in heavy and chemical industries. However, with the state's promise for generous support, several *chaebol* – most notably Hyundai, Daewoo, and Ssangyoung – joined hands with the state for HCI.⁸⁹

Essentially, the approach the government took for building up the heavy and chemical industries was no different from the one it took in the 1960s when light industries were established. It involved attractin foreign capital and using preferential

⁸⁷ *Ibid.*, 37.

⁸⁸ Hart-Landsberg, 69.

⁸⁹ See Eun Mee Kim, *Big Business, Strong State: Collusion and Conflict in South Korean Development, 1960-1990* (Albany, N.Y.: State University of New York Press, 1997), ch. 5 on the discussion of the state-*chaebol* alliance for development during the 1970s.

credit instrument for supporting plan goals. Numerous funds were thus developed over the 1970s to advance particular industrial purposes. 'During the Fourth Five-Year Plan (1972-1976), 70 percent of financing of government identified projects such as petrochemical facilities, steel mill expansion, and oil refineries, was to come from foreign loans, while 60 percent of total heavy and chemical investment was to be financed by foreign loans and direct investment in joint ventures.'⁹⁰ A credit-based financial system, mediated by an interventionist authoritarian state, thus became the basis of Korea Inc. – a fact that became increasingly apparent during the 1970s. Through its mediation of enormous amounts of finance capital, the state achieved its autonomy and its capacity to shape the market, firms, and society at large.

The results of the 1970s 'big push' were remarkable. Korea's GNP grew by 11 percent on average each year from 1973 to 1978 – an outstanding achievement even in the annals of the twentieth century's remarkable economic performances. By 1978 South Korea became the number one Third World exporter of manufacturers to the developed capitalist countries. Its efficient steel industry, its modern shipyards, its production of advanced electronics, all bespoke a successful economic transformation. A 1979 report in the *IMF Survey* by Albert C. Cizauskas describes South Korea's export insurance and financing program – the first one of its kind to be implemented in a developing country.⁹¹ While export credit insurance and financing programs had been rapidly evolving into an increasingly complex structure of government-supported facilities to promote exports in most industrial countries, South Korea became the first one in the ranks of rapidly industrializing countries to

⁹⁰ Haggard and Moon, 77.

⁹¹ Albert C. Cizauskas, "Korea's Eximbank Provides Incentives to Diversify Export Mix, Destination," *IMF Survey*, 26 Nov. 1979, 366-370.

set up an export-import banking institution. To most observers, including the IMF, it was thus obvious that South Korea had become a major industrial power and a model of Third World development. As Cizauskas stresses,

[t]he establishment of the Korean Eximbank...marks an important point in the evolution of developing countries. The growth of capital goods exports from middle-income developing countries such as Korea, their sharpened competition in this area with traditional exporters in the developed countries, and their dual role as substantial borrowers as well as lenders to finance expanding exports of capital goods have been some of the less-noted but potentially most far-reaching developments of this decade.⁹²

The growth did not come without a price, however. The big push for HCI was accompanied by a rapid increase in external debt from \$3.5 billion in 1972 to \$20 billion in 1979 and \$40 billion in 1983.⁹³ Moreover, this debt was increasingly short-term in nature, thereby requiring frequent rollovers. The situation was worsened by the second round of oil price increases in July 1979, which accelerated inflation and balance of payments deficits. As Hart-Landsberg suggests, 'by the end of 1980, South Korea's industrialization policy left it the world's third-largest debtor, trailing only Brazil and Mexico.'⁹⁴ Park's response to the situation, a reduction in government spending and money creation, triggered a recession. 'GNP growth slowed to 6.5 percent in 1979 and then fell by more than 5 percent in 1980.'⁹⁵ With Park's assassination in October 1979, the Yushin regime came to a swift and sudden end, as the country moved, after a brief period of political opening, to the next period of dictatorship, this time under President Chun Doo Hwan. Under both domestic pressure from the *chaebol* and external pressure from the United States, he was to introduce the agenda of market liberalization onto the course of South Korea's

⁹² *Ibid.*, 367.

⁹³ Amsden, 95 (Table 4.7).

⁹⁴ Hart-Landsberg, 195.

⁹⁵ *Loc.cit.*

economic development, that was to continue in the 1980s and early 1990s and would make South Korea's state-led development model much more dependent on foreign capital – a factor which would play a crucial role in the subsequent 1997-98 financial crisis.

Market Liberalization

During the HCI drive of the 1970s endorsed by the South Korean government the *chaebol* had grown enormously – in particular those that had invested in the heavy and chemical industries. The state's HCI strategy helped produce a small group of super-wealthy *chaebol*. As a result of state's support for continued growth and expansion, by the 1980s these *chaebol* had become competitors to the state in the provision of certain services, including financial services and research and development. Thus in the 1980s the tight alliance between the state and the *chaebol* came under growing tension as the *chaebol* 'became an important voice demanding that the state reduce its control in the economy...The capitalists wanted the state to become a *protectionist government*: one that continued to provide protection to, but ceases the heavy-handed control of, the private sector.'⁹⁶

Labor movements, which were severely repressed during the 1960s and 1970s, became also played an important part in pressing the state for liberalization during the 1980s. The HCI of the 1970s brought relatively well-educated workers into large factories, providing fertile ground for labor union mobilization.⁹⁷ After years of repressive labor policies and relatively dormant labor activities, the number of labor strikes reached a record high of more than 3,600 cases in 1987.

⁹⁶ Kim, Eun Mee, 171.

⁹⁷ See Hart-Landsberg, 270-280 for a detailed discussion of the labor mobilization during the 1980s.

The push to restructure the South Korean economy in the 1980s also came from without the South Korean state:

The United States increased its pressure toward Japan and other NICs in East Asia, prompted primarily by the continued trade deficit with Japan. One of the United States's demands toward South Korea was that it open the economy to U.S. investment, products, and services. Although the United States did not pressure South Korea to restructure its economy, as it did Japan, the pressure to open the South Korean economy had indirectly implied that the South Korean state should reduce the protection of domestic business.⁹⁸

Incentives to change the economic policies also derived from the political climate in South Korea in the early 1980s. Chun Doo Hwan assumed presidency without a popular election. In an effort to distance himself from Park, with whom he was closely identified, and to make a clear departure from Park's authoritarian legacy, Chun introduced his liberalization agenda by pursuing both extensive structural reform of the national economy and a more market-oriented style of economic management that would bring many changes into the South Korean development picture.

Liberalization of the financial sector and privatization of the banking system constituted a crucial part of Chun's liberalization reforms. The economic stabilization program launched by the government in 1981 included 'privatization and deregulation of the five existing national commercial banks, the ten local or provisional banks, and all nonbank financial institutions (NBFIs). All five national banks were privatized by 1983. Moreover, the government allowed the establishment of two new privately owned national banks, one each in 1982 and 1983.'⁹⁹

The economic stabilization program of the Chun government to help South Korea cope with the economic recession of the late 1970s was supported in 1981 by an IMF Stand-By Arrangement authorizing purchases up to the equivalent of SDR576

⁹⁸ Kim, Eun Mee, 168.

⁹⁹ Hart-Landsberg, 233.

million, which was equivalent to 225 percent of South Korea's Fund quota of SDR255.6 million over the next 12 months. The relevant IMF Press Release outlined the aims of the Stand-By Arrangement as being 'to ensure a return to economic growth, maintain price stability, and limit the current account balance of payments deficit to a manageable size.'¹⁰⁰ The policies designed to achieve these objectives included measures to improve the efficiency of the tax system as well as, more importantly, to relax government controls on the financial system. This approach of the IMF further differed from the policies it had prescribed to South Korea earlier. The IMF blamed the recession on the 'ambitious investment program in heavy and chemical industries' of the South Korean government "through the provision of subsidized credit and other measures.'¹⁰¹

Along the lines of the liberal restructuring, the Chun government also sought to liberalize and internationalize the capital market:

The major features of the plan included allowing investment in the secondary market; allowing corporations to raise funds directly through issues in foreign markets; the mutual listing of stocks on South Korean and overseas markets; and a greater volume of dealings between domestic and foreign securities companies.¹⁰²

Thus through a series of policy reforms the South Korean market was groomed to be gradually opened to the operation of foreign banks. This was increasingly due to strong pressure on the part of the United States, which played a vital role in this turnaround of the direction of South Korea's development for political and ideological, as well as economic reasons.

The world economic slowdown in the late 1970s led South Korea's major trading partners, in particular the United States, to restrict imports further, adding to

¹⁰⁰ International Monetary Fund, *Press Release* no. 81/8, 13 Feb. 1981.

¹⁰¹ "Fund Support Helps Korea Achieve Success In Program of Adjustment, Economic Growth," *IMF Survey*, 21 Sept. 1981, 294.

¹⁰² Haggard and Moon, 85.

South Korea's foreign debt problems. As a result, South Korean exports subject to import restrictions in industrialized countries increased from 32.3 percent of South Korea's total exports in 1981 to 42.9 percent in 1982. South Korean exports subject to antidumping measures, a specific form of protectionism, rose from 8.2 percent of total exports in 1981 to 12.4 percent in 1983 and 17.9 percent in 1984.¹⁰³ Due to Chun's vast unpopularity among South Korea's population for his harsh authoritarian rule, he was desperate for new financial aid and for guarantees to US markets, as well as for active US political support to solidify his own rule. The Reagan administration was willing to offer Chun the assistance he needed, but, in exchange, it wanted the further liberalization of the South Korean economy. Given that some liberalization was in fact welcomed by Chun as a way to reduce inflation and discipline the *chaebol*, he approved an increase in imports of selected consumer goods and agricultural products. As a result, the number of import goods on the 'automatic approval list' jumped from 68.6 percent of imported goods categories in 1980, to 74.5 percent in 1981, and 87.7 percent in 1985.¹⁰⁴ Chun, in return, received what he wanted from the United States: significant political, economic, and military support.

The concession on import liberalization, however, was not as problematic as that on finance, nor would it have as profound an impact on the state, the economy, and society of South Korea. Meredith Woo-Cumings explains the colossal implications of the changes for the South Korean state:

It [financial liberalization] meant that Korea's financial market would be *internationalized* and not protected: foreigners would enter into banking, insurance, and capital markets in competition with domestic institutions, granted as a quid pro quo for Korea's entry into foreign financial markets. To compete at the world level, Korean financial firms had to behave like capitalists and not bureaucrats, think profit

¹⁰³ Meredith Woo-Cumings, "Slouching toward the Market: The Politics of Financial Liberalization in South Korea," in *Capital Ungoverned: Liberalizing Finance in Interventionist States*, ed. Michael Loriaux et al. (Ithaca and London: Cornell University Press, 1997), 75.

¹⁰⁴ *Ibid.*, 76.

and not control; and this meant the *privatization* of banks. But since banks cannot thrive in situations of financial repression, finance would have to be *deregulated*, ceilings on interest rates lifted, the practice of policy loans abolished, and returns on financial assets allowed to increase so that saving and lending would be profitable. The high cost of capital thus issued would lead the chaebol to find other sources of financing, and this...would result in the blossoming of the capital market.¹⁰⁵

For foreigners with capital, she notes, financial liberalization meant internationalization, especially desirable since ‘the US banks in Seoul were making money hand over fist.’¹⁰⁶ In 1984 foreign banks saw a 26.6 percent increase in net profits from the year before. Their profits were almost equal to those of South Korean banks. And they kept rising since operating in South Korea was ‘virtually risk free’ for foreign banks:

In addition to the guarantee on a given margin, exchange risk was eliminated by the swap facility, and default risk was reduced by a payment guarantee, either from domestic bank or from the principal firm of the chaebol group, and by freedom, denied to domestic banks, to lend to credit-worthy firms only.¹⁰⁷

No wonder then, she implies, that ‘more and more American and European banks therefore clamored to get into the South Korean market, and the existing ones demanded more freedom to expand their operations.’¹⁰⁸ The Reagan and Bush Sr.’s administrations put considerable pressure on South Korean government on behalf of these banks. ‘By the end of 1993, the number of foreign banks in South Korea nearly doubled, from forty branches in 1981 to seventy-three.’¹⁰⁹

The deregulation of the financial system and privatization was the heart of Chun’s liberalization program. According to Hart-Landsberg, ‘Chun supported this marked departure from past policy in the hopes that privatization of the banking

¹⁰⁵ *Ibid.*, 80.

¹⁰⁶ In 1980 the Bank of America, Citibank, Chase Manhattan, Manufacturers’ Hanover, and Lloyd Bank recorded returns on capital that were as high as 359 percent. See *New York Times*, 14 Apr. 1980.

¹⁰⁷ Woo-Cumings, “Slouching toward the Market”, 81.

¹⁰⁸ *Loc.cit.*

¹⁰⁹ *Loc.cit.*

system...[and]...deregulation would make it harder for the chaebol to dominate the allocation of credit.’¹¹⁰ In fact, however, the reforms had a profoundly different impact on the state-*chaebol* relationship than that which Chun had intended. Liberalization produced significant changes in both the ownership and operation of the country’s NBFIs. Under the terms of the liberalization program, the state was committed to privatize and deregulate this sector. Government shares were sold off, barriers to foreign entry were reduced, and the various NBFIs were allowed greater freedom to set interest rates and offer new services. The *chaebol* were best placed to take advantage of this privatization:

By the end of 1983, eleven of twenty-six existing insurance companies were under the ownership of a single *chaebol*. Several *chaebol* in combination dominated the remaining companies. As for the six life insurance companies, all except one were owned by a single *chaebol*.¹¹¹

The low interest rate policy that was kept throughout the 1970s and the early part of the 1980s when policy loans were extensively used to promote heavy and chemical industries, was also adjusted under the government’s financial liberalization efforts. The commercial banks were given the freedom to set interest rates on regular deposits and loans and on corporate bonds, commercial papers, and transferable certificate of deposit. NBFIs were also given more freedom in setting interest rates. The Chun government took a number of steps trying to limit the ability of the *chaebol* to gain control over these newly privatized national commercial banks: ‘an 8 percent ceiling was placed on the percentage of shares that a single shareholder was allowed to own.’¹¹² At the same time, the South Korean state continued to restrict the activities of foreign financial institutions, and the government still retained much of

¹¹⁰ Hart-Landsberg, 233.

¹¹¹ Christian Institute for the Study of Justice and Development, *Social Justice Indicators in Korea*, 21-22 quoted in *ibid.*, 234.

¹¹² Hart-Landsberg, 233.

its influence over credit allocation. As Hart-Landsberg underlines, ‘because the government’s financial strategy was more a tactical move designed to weaken the chaebol and win US support than an embrace of free market ideology, the liberalization was far from complete market opening either the chaebol of the US government had hoped for.’¹¹³ It is important to stress therefore is that the liberalization steps that the Chun government pursued in the 1980s were quite limited compared to what was being instituted elsewhere.

The result of deregulation was thus, ironically, that the *chaebol* came to secure a stronger foothold in the country’s financial system. Decentralized economic decision-making increased the role of market forces as the determinant of economic activity and resource allocation, and favored nondiscretionary interventions. As a result, Haggard and Moon note, ‘the state was deprived of political resources and instruments to control and coordinate the private sector.’¹¹⁴ Because discretionary credit control was the key instrument for controlling the private sector, the decreased dependence of big business on the state shifted power toward the conglomerates.

The IMF, for its part, praised the private sector as playing a critical role in the economic modernization of South Korea actually highlighting the *importance* of the ‘flexible and pragmatic relationship between business and government’ as one of the most important expressions of a ‘legacy of social, political, and economic structures that were favorable to economic development’¹¹⁵ – the very type of relationship that it would later blame as the underlying cause of the 1997 crisis. In 1983 an IMF

¹¹³ *Loc.cit.*

¹¹⁴ Haggard and Moon, 88.

¹¹⁵ Westphal, 34.

Resident Representative in South Korea, characterized the developments in South Korea in the early 1980s as far better than had been expected:

The current account deficit was limited to \$2.5 billion, or 3.8 percent of GNP; inflation was held well below 10 percent; and real growth was maintained at about 6 percent, despite the slump in exports. In response to policies to stimulate private investment, real fixed investment rose by 14 percent, after declining in 1980 and 1981. Because of liberalization measures adopted earlier in the year, foreign direct investment rose by 28 percent, after no growth in 1981. Although interest rates were reduced, real interest rates remained positive, and domestic savings increased to 23 percent of GNP in 1982, from an average of 20 percent in 1980-81. The average annual rate of consumer price inflation was brought down to the level that prevailed in major trading partners. Domestic cost pressures abated as wage increases were held below those granted in previous years as interest rate cuts lowered the operating expenses of the productive sector.¹¹⁶

Similarly, a comprehensive IMF's Asian Department's study *A Case of Successful Adjustment: Korea's Experience During 1980-84* reported the South Korean government's efforts during 1980-84 to be successful in overcoming the country's economic crisis at the turn of the decade.¹¹⁷ While recognizing the South Korean 'economic miracle' of the 1960s and 1970s, the authors also pointed out the economic problems that South Korea faced at the beginning of the 1980s and the magnitude of the economic adjustment that took place during the subsequent years. The South Korean authorities, the study held, were able to cope with the adverse domestic and external shocks of the crisis. The authors of the study, however, warned that 'the specter of protectionism casts a shadow over Korea's prospects for meeting its growth potential and its debt-servicing obligations'¹¹⁸ thus pushing for the necessity of further liberalization of South Korean economy. The emphasis on protectionist policies of South Korean government and the need to liberalize further exemplified a shift toward neo-liberalism in IMF's prescriptions. Important to note at

¹¹⁶ Delano Villanueva, "Korea Maintains Growth, External Adjustment Despite Depressed Condition of World Trade," *IMF Survey*, 18 Apr. 1983, 118.

¹¹⁷ Bijan Aghevli, and Jorge Marques-Ruarte, *A Case of Successful Adjustment: Korea's Experience During 1980-84*, Occasional Paper no. 39, (Washington, D.C.: IMF, August 1985), 1.

¹¹⁸ *Ibid.*, 20.

the time that while the issue of protectionism was raised, the issue of business-government relationship was not. This pattern of praise and criticism reveals the influence of US interests: Cold War considerations compel the United States not to treat South Korea like any other developing country.

The Roh Tae Woo government that assumed power in 1988 brought along a wave of democratization – his presidential period was marked most importantly with increase in ‘the strong, democratic opposition of Korea’s newly mobilized masses.’¹¹⁹ Moreover, as in early years of Chun’s presidency, at the beginning of Roh government there appeared much discussion about the government breaking the *chaebol* into pieces and supporting small- and medium-size instead. But, as Bello and Rosenfeld indicate, ‘[i]n both cases, however, plans were subverted by chaebol power and by the technocrats’ realization that they ultimately needed the chaebol as much as they needed them. Thus, dismantling the chaebol would greatly depend on a new coalition of political and social forces coming to political power.’¹²⁰ Whether the 1997-98 financial crisis would succeed in bringing about such a coalition is something to be discussed in the last chapter.

Summing up, South Korea’s phenomenal economic development since the 1960s had brought tremendous achievements to the country by 1990. After two decades of rapid growth based on exports, South Korea continued to grow at an impressive rate of 8.7 percent between 1980 and 1991 in terms of the average annual growth rate of GNP per capita – arguably the fastest growth rate in the world – setting an example for the rest of the Third World.

¹¹⁹ Bello and Rosenfeld, 75.

¹²⁰ *Ibid.*, 171.

What the discussion in this chapter has tried to demonstrate is that despite slight variations over time, the highly centralized state-led approach to economic development constituted the essence of the South Korean model, with clear cut development plans committed to advance economic growth expressed in export maximization in the light industries during the 1960s, heavy and chemical industrialization during the 1970s, and limited market liberalization of the 1980s. The chapter emphasized the importance of South Korea to the Cold War strategy of the United States often overlooked by neo-liberal accounts. It was the geo-strategic location of South Korea as a frontline state that largely allowed it to avoid excessive direct coercion of US for imposing its capital interests to the detriment of South Korean economy up to the 1990s, something that other countries of the Third World were not able to do.

South Korea's geo-strategic importance was also mirrored in the perception of the IMF which since the early 1980s sought to reflect the neo-liberal views of its major shareholder. Whereas before the onset of the so called 'Washington consensus' in the early 1980s the IMF had been happy to attribute the outstanding rates of growth of South Korean economy for the two decades to government-directed policies, since the early 1980s mainstream economists from the neo-liberal US government and the IMF wished to attribute South Korea's success to free market ideas and set it as an example for the other Third World countries to follow. South Korea, and the diagnosis of its economic success, was to become a battlefield of development policies in which the IMF and the US were clearly on one side. The South Korean financial crisis of 1997-98, as we will see in the next chapter, shows this even more strikingly.

Chapter Three

Financial Crisis of 1997-98: 'Crony Capitalism'?

The IMF has done more to promote America's trade and investment agenda in Korea than 30 years of bilateral talks.

Lawrence H. Summers¹

As we have seen in the previous chapter, by the 1990s, South Korea had developed from one of the poorest agrarian societies in the world to a near-developed country. Nothing testified to this development more than the 1993 proposal that South Korea join the Organization for Economic Cooperation and Development (OECD), the advanced industrial nations' club. South Korea thus dramatically shortened the usual phases of industrial transformation which most of today's developed nations experienced over a span of over a century. From 1964 to 1994, the GNP of South Korea grew at an average of 8 percent a year in real terms. Income per capita at current prices was recorded at a meager \$87 in 1962, but increased to \$10,163 by 1995. South Korea's economic growth rate per annum put it among the fastest growing economies in the world over that period. The share of industry including utilities and construction to total GDP, only 20.1 percent in 1960, had swelled to 45 percent in 1991.

As can be also seen from the previous chapter, the IMF views regarding the state-led development strategy of South Korea during the decades of its high-speed growth and the nature of its remarkable achievements had not been very consistent. While the importance of government intervention was stressed during the 1960s and

¹ Quoted in Linda Weiss, "State Power and the Asian Crisis," *New Political Economy* 4, no. 3 (1999): 333.

1970s as responsible for economic growth, during the 1980s a shift in IMF views occurred towards a neo-liberal explanation of South Korea's success which stressed the centrality of free market incentives, albeit still in government policies. The IMF commended close government/business cooperation and selective government interventions across a wide range of activities as the major element in sustaining South Korea's export-led development during those decades. The IMF in fact emphasized the importance of the 'flexible and pragmatic relationship between business and government'² as responsible for the phenomenal rate of development in South Korea. The IMF also praised the policy of direct allocation of credit that South Korean government had employed by underlining that 'credit policies were effective in lowering the cost of funds and enhancing access to funds in priority sectors.'³ This emphasis, the IMF said, contributed to the rapid expansion of South Korean industry and the growth of manufactured exports.

Although up to the 1997 financial crisis the IMF had been praising the model's impressive effectiveness in sustaining high economic growth, attributing it either to the crucial role of government intervention during the 1960s and most of 1970s or, albeit inaccurately, to free market incentives since the early 1980s, during South Korean financial crisis of 1997-98 the IMF's perception of South Korea turned around and openly attacked South Korea's economic structure. The IMF now emphasized the putatively inherent structural weaknesses of the South Korean economy which led to the crisis. Following this diagnosis, the IMF imposed a program of radical corporate restructuring and capital account opening on the country. My argument is that it was through this turn to what may be called a 'discursive

² Westphal, 34.

³ Dimitri Vittas and Yoon Je Cho, "The Role of Credit Policies in Japan and Korea," *Finance & Development* 31, no. 1 (March 1994): 11.

demolition' of the previously celebrated characteristics of South Korea's model of export-led development, that the IMF and the US government were able to impose a series of radical restructuring reforms aimed mainly at opening up South Korea's capital account even more widely to foreign capital.

Uneven Financial Liberalization of the Early 1990s

The Roh Tae Woo (1988-1993) government and, much more so, the successor government of Kim Young Sam (1993-1998), continued to promote the gradual process of liberalization of South Korea that had started in the early 1980s. As discussed in the previous chapter, South Korea since the 1960s had maintained highly regulated and repressed financial markets, emphasizing state-directed finance through a highly centralized banking system, and using capital controls to delink domestic financial markets from the global market. However, pressures for liberalization developed in the 1980s both from domestic firms disadvantaged in international competition by high domestic interest rates and limited options for corporate finance and from foreign governments promoting the interests of their own financial institutions. By the early-1990s, both the internal and external environment had changed significantly. South Korea had become the eleventh largest economy in the world and could no longer resist joining the trend of globalization in finance. It was with this recognition that the South Korean authorities initiated financial liberalization in the 1990s.

The push for financial liberalization in the 1990s was, to an overwhelming extent, influenced by the interests of the most powerful economic interest group in South Korea – the *chaebol* – which by that time had become an independent political

force, exerting a powerful influence on government policies.⁴ While the government continued relying on the *chaebol* to keep the national economy going, by the 1980s, and even more so in the early 1990s, the *chaebol* had become less dependent on it for their meeting their financial needs, as was discussed in the previous chapter. Specifically, in the 1980s, the South Korean government allowed various non-bank financial institutions (NBFIs) to grow in a relatively free environment, and it was the *chaebol* that became the owners of some of these new financial institutions.⁵ The trend continued in the 1990s, as the government carried out further reforms that allowed banks, including merchant banks, and the *chaebol* to borrow abroad. As Chung H. Lee, Keun Lee and Kangkoo Lee observe, ‘although it was liberal market ideas that influenced the government to carry out financial reforms, *chaebol*’s own interest in securing alternative financing channels was an important factor in determining the agenda and process of financial liberalization in South Korea.’⁶

There were various other agents, including politicians and bankers, pushing for liberalization as well. They all, however, had different scenarios in mind when they argued for financial liberalization:

To many industrial firms, financial liberalization meant unlimited access to credit, i.e., they could borrow as much as they wanted, but at low interest rates. At the same time it meant to them, that they could establish their own financial institutions as entry barriers would be dismantled. To the bankers, it meant they could be freed from any government regulations, including those for economic as well as prudential goals. Politicians viewed financial liberalization as something consistent with democratization and which could get the support from every quarter of the society (perhaps excluding the bureaucrats), and foreign governments.

⁴ See in particular Chung H. Lee, Keun Lee and Kangkoo Lee, *Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea*, Working Paper Series, Institute of Economic Research, Seoul National University (March 2000). <http://econpapers.hhs.se/paper/snuioerwp/no31.htm> (accessed 6 Nov. 2003).

⁵ “As of 1988, the top 30 *chaebol* owned 12 security companies (out of a total of 25), 18 insurance companies (out of a total of 35), and 18 investment trust companies (out of a total of 38).” *Ibid.*, 8.

⁶ *Ibid.*, 4.

⁷ Yoon Je Cho, *The Political Economy of the Financial Liberalization and Crisis in Korea*, Working Paper no. 99-06, Institute of International and Area Studies, Sogang University, Seoul, Korea (October 1999), 4.

The outcome of these widely dispersed approaches and expectations of different actors in South Korean society with regard to financial deregulation was a political compromise in a gradual, uneven, and ultimately problematic liberalization process.

The Roh government had announced a comprehensive interest rate deregulation plan in 1991, and the incoming Kim Young Sam administration accelerated the deregulation process with its *Blueprint for Financial Liberalization and Market Opening* in July 1993. It was designed to ‘overcome inefficiencies introduced by the non-price allocation of credit in the economy, by opening the financial sector to foreign participation and gradually removing controls on long-term, and later short-term, international capital movements’⁸ and was to be implemented over a five-year period. The Kim Young Sam administration also dismantled the Economic Planning Board by merging it with the Ministry of Finance and forming a Ministry of Finance and Economy (MOFE); it likewise abolished the Five-Year Development Plans. The *Foreign Exchange Reform Plan* introduced by the government in December 1994 laid out a detailed schedule for the deregulation of current account transactions, the liberalization of capital account transactions, and the reform of the foreign exchange market. As a result of these reforms, many restrictions on the financial markets and foreign exchange transactions were relaxed or abolished in order to accelerate the ‘globalization’ of South Korean economy.

As part of its liberalization strategy, in 1993 South Korea also announced its application for membership in the OECD. Anxious to meet this goal, the Kim government often speeded up the pace of financial reforms, so that the actual implementation of liberalization deviated substantially from the officially announced

⁸ Smith, 73.

plan. This, as Cho points out, resulted in an ‘uneven, poorly phased approach to financial liberalization.’⁹ In 1993, the government expanded the scope for short-term foreign currency borrowing by allowing firms to borrow abroad, either directly or through South Korean banks, to finance the importation of capital goods. With interest rates relatively high in South Korea, and continued restrictions on firms’ ability to issue long-term bonds or secure long-term loans in foreign markets, firms were encouraged to increase their reliance on short-term foreign borrowing, and South Korean banks were encouraged to step up their Won-lending activities. ‘Against a background of poor credit risk assessment and supervision of the institutions active in the short-term securities market, short-term financing was quickly made available on a large scale to firms engaged in high-risk expansion of long-term investment in steel, automobiles, petrochemicals, and so on,’ Cho observes.¹⁰ Thus, short-term bank borrowing was liberalized while long-term borrowing remained regulated.

For nonfinancial borrowers too it was the short-term trade credits and other credits that were liberalized, while long-term suppliers’ credit and foreign access to bond markets remained restricted. Furthermore, the government allowed the entry of many new merchant banking companies (MBCs) during 1994-96. These new MBCs borrowed heavily in the short term, but invested in long-term assets. This increasing mismatch in maturity between foreign liabilities and assets in MBCs, along with the fact that the country’s financial institutions were not properly monitored or supervised by the authorities, made South Korean system very vulnerable to a foreign exchange crisis.¹¹

In February 1996, South Korea said good-bye to the developing world and proudly announced its accession to the OECD. South Korea’s accession to the OECD was contingent upon its acceptance of the obligations of the OECD Codes of Liberalisation of Capital Movements and Current Invisibles Operations. The codes

⁹ Yoon Je Cho, “The Role of Poorly Phased Liberalization in Korea’s Financial Crisis,” in *Financial Liberalization: How Far, How Fast?* ed. Gerard Caprio, Patrick Honohan, and Joseph E. Stiglitz (Cambridge: Cambridge University Press, 2001), 159.

¹⁰ *Ibid.*, 160.

¹¹ *Loc.cit.*

are binding on OECD member countries and require them to remove specific restrictions on the movement of capital and invisible operations. Foreign direct investment in financial services and foreign portfolio investment are addressed in the capital movements code, and cross-border trade in financial services is covered in the code on invisible operations. Reservations to both codes and exceptions to the National Treatment principles are permitted, and South Korea availed itself of the opportunity to exercise this option, particularly with respect to the financial services sector. The average acceptance rate among the OECD member countries of the codes on financial liberalization is 89 percent; South Korea accepted only 65 percent of the codes, but the plan was that the liberalization process would continue on a variety of issues, to make sure that many of its reservations and exceptions would be phased out by 2000.

Restrictions on both inward and outbound direct investment would also eventually be eased...[F]oreign banks and securities firms would be allowed to establish more branches and offices, respectively. Foreign insurance companies would be permitted to hold own-currency-denominated cash or securities as well as won-denominated assets. Foreign equity participation in investment trusts and asset management companies would be introduced in a controlled manner, with all restrictions to be removed in 1998.¹²

It is also crucial to emphasize that the South Korean economy, largely to conform to the growing pressure from the United States, had gone a long way toward liberalization by the mid-1990s. This was in sharp contrast to the 1970s, the most interventionist phase of South Korean development, or even to the 1980s, the limited market liberalization phase.

Nevertheless, as some neo-liberal views see it, despite considerable liberalization achievements, by the time of the East Asian crisis, many impediments to freer market operations and foreign participation remained in place. In particular,

¹² Marcus Noland, *Avoiding the Apocalypse: The Future of the Two Koreas* (Washington, D.C.: Institute for International Economics, 2000), 57.

[p]articipation in South Korean capital markets by foreign firms was limited. Foreign securities firms were permitted to own only up to 10 percent of the paid-in capital of South Korean securities firms...the government still regulated the portfolios of commercial banks. It still owned a large number of financial institutions (of which the Korea Development Bank was the largest), and state-owned financial institutions still dominated other markets, such as mortgage lending...Despite the decline of policy loans, the central bank still acted as a source of subsidized lending to preferred borrowers.¹³

According to Yoon Je Cho, a former Senior Financial economist at the World Bank, the financial liberalization was limited for several reasons:

First, the high debt ratio, reaching above 300-400 percent for most large corporate firms, made themselves highly vulnerable to external shocks and required continued government intervention in the credit market. Without substantial reductions in the corporate debt ratio, full financial liberalization could prompt severe financial instability any time in an economic down turn. Second, the government still wanted to use the banking system as a vehicle for economic policy goals, including support of small-medium firm financing, securing cheap financing to the highly leveraged corporate sector, etc. Restrictions on the interest rates and credit allocation stayed in place for this purpose. Third, government officials did not have much confidence in the market's capacity to adjust to the new economic environment and to absorb the shock. Since the financial market had been governed with a web of explicit and implicit administrative guidance, they tended to believe that the withdrawal of guidance would lead to the instability of the market. In addition, they were reluctant to surrender their power of controlling the market. Fourth, chaebols became very dominant in the South Korean economy by the 1980s. They acquired substantial control over the financial system, by owning most of the nonbanking financial institutions. Liberalization of the financial market and of entry restriction could result in further enhancing the dominance of the chaebols in the financial market and the economy. Many worried that financial liberalization and economic deregulation would simply shift the dominant power of the South Korean economy from the government to chaebols.¹⁴

Thus, the government, despite its appreciation of the positive aspects, remained unconvinced of the net effect of full financial liberalization. This coincided with the bureaucrats' reluctance to lose their power as well. Foreign participation in South Korean financial markets therefore continued to be circumscribed, and access by South Korean residents to international capital markets was still restricted. Under this plan, according to Noland, 'the South Korean financial system still remained

¹³ *Ibid.*, 56-57.

¹⁴ Cho, "The Political Economy", 19-20.

among the most repressed in Asia.’¹⁵ Many of the concerns, expressed by the neo-liberals, were addressed by the subsequent IMF package.

Capital Flight: Financial Crisis of 1997-98

To most observers the magnitude of the 1997-98 crisis was entirely unexpected. By one account, ‘[t]he real economy of South Korea grew strongly in the first half of the 1990s, with annual growth averaging 7.7 percent between 1990 and 1996 – close to the average of over 8 percent sustained for more than 30 years. The driving force was the growth of exports of goods and non-factor services, which averaged growth of 15.3 percent per year in US dollar terms between 1992 and 1996. This, in turn, was made possible by growth in facilities (fixed) investment, with the share of gross fixed capital formation in GDP averaging nearly 37 percent in the five years to 1996.’¹⁶ Even in mid-July 1997, Korea’s broad macroeconomic indicators appeared favorable. Unlike in the strong growth period of the late 1980s, inflationary pressures were largely absorbed in producer margins, although inflation remained above OECD levels.

The crisis began when a decline in Thailand’s exports caused investors (domestic and foreign) to lose confidence in early 1997 that the Thai government could maintain the pegged exchange rate between the Baht and the US Dollar.¹⁷ The result was a severe devaluation of the Thai Baht and, although the Thai government initially attempted to preserve the value of the baht by intervening in foreign

¹⁵ Noland, 57.

¹⁶ Smith, 66.

¹⁷ Thailand’s exports had grown in dollar terms by 22 percent in 1994 and 25 percent in 1995; in 1996, however, they declined by 2 percent. See Nidhiprabha Bhanupong, “Economic Crises and Debt-Inflation Episode in Thailand,” *ASEAN Economic Bulletin* 15, no. 3 (1998): 311.

exchange markets, Thailand's foreign exchange reserves were soon exhausted. The government consequently decided to allow the market to determine the currency's value in July 1997, and to seek emergency assistance from the IMF.

Following the devaluation of the Thai Baht, the financial contagion spread through Southeast Asia, and investor concerns about South Korea escalated as the Korean Won came under pressure the following month. In response, to calm investors, the South Korean government announced on August 25, 1997 that 'it was committed to providing financial support to commercial and merchant banks and that it would ensure repayment of debt liabilities of South Korean financial institutions.'¹⁸ This was probably not a very wise move on the part of Bank of Korea officials since it could be interpreted by foreign investors to mean that the South Korean economy was indeed in serious trouble. The government also announced that 'all financial institutions would be required to submit restructuring plans to be implemented over a period of three to five years.'¹⁹ Conditions, however, continued to deteriorate. The Korean won dropped from 850 to the US dollar in October 1997 to 1,995 in December that same year. The stock market in Seoul also collapsed to below 400 on the South Korean stock index that had been over 1000 at the end of 1994.

This panic was largely caused by the shortage of foreign currency. 'The Bank of Korea reserves declined from \$30 billion to less than \$20 billion in one month, from the end of October to the end of November. Even this official announcement of \$20 billion was probably an overestimation, because the foreign currency reserve of

¹⁸ Stijn Claessens, Swati Ghosh, and David Scott, "Korea's Financial Sector Reforms," in *The Asian Financial Crisis: Origins, Implications, and Solutions*, ed. William C. Hunter et al. (Boston: Kluwer Academic Press, 1999), 169.

¹⁹ *Loc.cit.*

the Bank of Korea at the end of December 1997 was only \$8.87 billion.²⁰ Compared to its foreign currency reserve, Korea's foreign debt at the end of November 1997 was \$116.1 billion. Almost 60 percent of the debt being short-term, South Korea faced a financial crisis.

The causes of the crisis, according to neo-liberal analysts, included, among other things, an accumulation of non-performing loans and a rapid buildup in foreign debt – something which curiously enough had been an essential characteristic of the South Korean 'high-debt' development for decades. A deeper look by some scholars, however, suggests a different interpretation of the immediate events leading to the crisis of the South Korean economy at the end of 1997. Haggard and MacIntyre are among those who hold this view. According to them, South Korea had experienced a substantial terms-of-trade shock in 1996: this amounted to a worsening of its current account position caused by a slowing of export growth across a range of sectors. 'The current account deficit increased from 2 percent of GDP in 1995 to 4.9 percent in 1996. With the increased deficit naturally came an increase in foreign indebtedness, which stood at \$78.4 billion at the end of 1995, \$104.7 billion at the end of 1996 and \$116.1 billion in November 1997, when the crisis broke out.'²¹ However, Haggard and MacIntyre note, 'these problems appeared to turn around *before* the crisis broke. The current account deficit began to lessen in the first half of 1997, and in June the country recorded a surplus.'²² Moreover, it is important to underline that the country's overall foreign debt burden was very modest – 25 percent of its GDP,

²⁰ Tamio Hattori, "Economic Development and Technology Accumulation: Experience of Korea," *Economic and Political Weekly*, 29 May 1999, M-78.

²¹ Stephan Haggard and Andrew MacIntyre, "The Political Economy of the Asian Financial Crisis: Korea and Thailand Compared," in *The Asian Financial Crisis and the Architecture of Global Finance*, ed. Gregory W. Noble and John Ravenhill (Cambridge: Cambridge University Press, 2000), 69.

²² *Loc.cit.* (emphasis added).

compared with 47 percent of GDP in Indonesia and 46 percent in Thailand at the end of 1996.²³ Consequently, they say, ‘there were few reasons, to believe *ex ante* that South Korea’s debt burden was unsustainable or that debt would not be rolled over.’²⁴ Haggard and MacIntyre’s position is supported by Chang Ha-Joon who also suggests that ‘while certainly large and fast-growing during the last few years, South Korea’s foreign debt was *not* at an obviously unsustainable level.’²⁵ The World Bank defines a country as ‘less indebted’ when its debt/GNP ratio is under 48 percent.²⁶ In 1996, as Chang indicates, ‘South Korea was well below this threshold at 22 percent, and on the eve of the crisis, it could not have been much more than 25 percent.’²⁷

In contrast, the corresponding figures at the end of 1995 were 57 percent for Indonesia and 35 percent for Thailand...Moreover, the main debt buildup was between 1994 and 1996, when growth in South Korea’s foreign debt averaged 33.5 percent per annum. By 1997, the growth of South Korea’s foreign debt was already slowing down. Its foreign debt increased from \$105 billion at the end of 1996 to \$120 billion in September 1997...and...actually decreased to \$116 billion by the end of November 1997.²⁸

As for the accumulation of non-performing loans in the domestic banking system, which many East Asian crisis analysts argued was the inevitable outcome of state direction of credits, the picture is not that simple.

Indeed, according to the information from the Bank of Korea, the share of non-performing loans to total loans increased from 4.1 percent at the end of 1996 to 6.8 percent in September 1997, at the eve of the crisis. While this may sound high, it is not particularly high by South Korean historical standards. It was only marginally higher than the average for the 1990-95 period (6.4 percent), and lower than in 1990

²³ *Loc.cit.*

²⁴ *Loc.cit.*

²⁵ Chang Ha-Joon, “South Korea: The Misunderstood Crisis,” in *Tigers in Trouble: Financial Governance, Liberalisation and Crises in East Asia*, ed. Jomo K.S. (London and New York: Zed Books Ltd., 1998), 223.

²⁶ A country is ‘moderately indebted’ when this ratio is between 45 and 80 percent, and ‘severely indebted’ when it is over 80 percent. See World Bank, *Global Development Finance*, vol. 1 (Washington, D.C.: World Bank, 1998), 65-66.

²⁷ Chang, 223.

²⁸ *Ibid.*, 224.

(7.5 percent) and 1993 (7 percent). Therefore, the accumulation of non-performing loans in the domestic banking system alone cannot explain the crisis.²⁹

Thus, the foreign debt situation in South Korea was almost as bad at the end of 1996 as it was on the eve of the crisis. It is difficult to say that the worsening of the debt situation sparked off a crisis of such unprecedented dimensions. The IMF Managing Director Michel Camdessus himself remarked confidently on the soundness of macroeconomic policies of South Korean government in early 1997. To a question during the Press Conference on April 24 as to whether he sees anywhere in the world the potential threat of a new financial crisis similar to the one in 1994 in Mexico, and with particular request to comment on South Korea, he replied:

We see with satisfaction the way in which South Korea has managed the difficult coexistence of several tensions recently. And we are confident that the authorities will continue to keep the economy growing and will reduce the current account deficit, which they see as too high and which we see, also, as a little bit on the high side. The measures they are taking should bring it down to more reasonable levels soon.³⁰

He was supported by then Director of the IMF Asia and Pacific Department Hubert Neiss who, in light of the currency crisis already in swing in Thailand, made a similar comment in an interview to *IMF Survey* on September 17, 1997. He praised South Korea's 'fundamentally sound economic policies' (including its 'conservative monetary and fiscal policies combined with high private savings, deregulation of economic activity, external liberalization, and investment in human capital') as being responsible for the last two decades of dramatic growth in the region. He also emphasized on the eve of the crisis that was about to hit South Korea that 'these

²⁹ *Ibid.*, 223.

³⁰ Michel Camdessus, Press Conference, IMF Meeting Hall A, Washington, D.C., 24 Apr. 1997. <http://www.imf.org/external/np/tr/1997/tr970424.htm> (accessed 20 May 2004).

policies remain in place; therefore, the region still has considerable potential for rapid development.³¹ As Neiss asserted,

Important challenges remain for the period ahead. Economies of the region will need more robust financial systems that can make efficient use of large, and potentially volatile, capital flows. They will also need to manage a transition to higher-technology production, which, for many countries, will require even greater investments in education. But I am confident that the region will soon return to strong, sustained growth, once the current market turbulence has been surmounted.³²

Given the relative stability of South Korea's macroeconomic base in the months immediately preceding the crisis, a stability which the IMF observers acknowledged, the level and the speed of the crisis that unraveled in November-December 1997 turned out to be shocking to most economic analysts around the world. The underlying cause, however, as we shall see, appears to be more political than economic:

In January 1997, Hanbo Steel, a major [South Korean] steel company went bankrupt. It was subsequently revealed that a web of high-level corruption – involving some very close associates and the second son of then President Kim Young Sam – surrounded Hanbo's entry into the steel industry and the continued extension of loans to it despite its known problems.³³

The collapse of Hanbo, the first major *chaebol* to go bankrupt since Kukje more than decade earlier, was to have repercussions beyond its debts: a subsequent series of bribery arrests, culminating in the arrest and conviction of President Kim Young Sam's son and political confidante, Kim Hyun Chol, shook the political establishment and significantly damaged the elder Kim:

Since the biggest chaebol, Hyundai, had been consistently denied entry into the steel market in the preceding years for a minor chaebol, securing the license and continued financing for a minor conglomerate with a dubious record manufacturing of manufacturing capability could not be explained by anything other than by corrupt political practices of South Korean government.³⁴

³¹ Hubert Neiss, "Asian Experience Underscores Need for Swift, Corrective Policy Action," *IMF Survey*, 17 Sept. 1997, 288.

³² *Loc.cit.*

³³ Chang, 224.

³⁴ *Loc.cit.*

As noteworthy as the Hanbo case may have been, foreign confidence in the South Korean economy was significantly damaged by the further story surrounding the fate of Kia, the eighth largest chaebol in the country:

When Kia first showed signs of trouble in June 1997, then Finance Minister Kang Kyung Shik argued that the Korean economy needed more market discipline and therefore, he did not mind showing that 'even the chaebols can fail'. Given Kang's well-known connection with Samsung, the second biggest conglomerate, many observers interpreted this as a coded message that he would let Kia be taken over by Samsung. At the time, Samsung's new automobile venture was looking increasingly doubtful without the acquisition of an existing firm with solid manufacturing capability, as Samsung had already spent an inordinate amount of money buying and strengthening expensive, but unsuitable reclaimed land in then Korean President Kim Young Sam's hometown of Pusan. When the Kim Young Sam government found out that a takeover of Kia by Samsung was not going to go well with public opinion, it changed its policy stance about Kia's fate many times, undermining international confidence in the economy.³⁵

Notwithstanding the popular perception that developed largely as a result of the East Asian crisis, Chang observes, 'corruption involved in the Hanbo and Kia cases was *not* typical of what was going on in South Korea under its state-led model of development.'³⁶

Admittedly, large sums of money had flowed from big business to powerful politicians and top bureaucrats. Such flows were often tied to particular projects in areas like urban planning and government procurement, but they were rarely directly related to specific projects *in the main manufacturing sectors*. Moreover, under the Kim Young Sam government, for the first time in Korean history since the 1960s, the names of particular chaebols, such as Samsung, were talked of as being particularly 'close to the regime'. Previously, the *chaebols* as a group were treated preferentially, but rarely was any one or a few of them regarded as being closer to the government than the others. The Hanbo scandal thus reflected an important transformation in the state-business relationship in South Korea under Kim Young Sam, which meant that the major manufacturing sectors were no longer as insulated from corrupt political practices as before.³⁷

The 1997 *chaebol* scandals, like those involving Hanbo and Kia, to some extent reflected the South Korean government's desire to show the wider community that South Korea was actually on the road to liberalization and a market-oriented

³⁵ *Ibid.*, 225. For an insightful description of the Kia politicized battle story see also Haggard and MacIntyre, 72-74.

³⁶ *Ibid.*, 224.

³⁷ *Ibid.*, 224-225.

restructuring of the economy by announcing that ‘even the chaebols can fail’. The scandals, however, were also effectively picked up by the Western community, and most importantly by the IMF, as examples of ‘crony capitalism’ thus emphasizing perception of the corruption and favoritism of the East Asian model of development in general, and the South Korean in particular. This move, as we will see further, was to have much more profound implications for the South Korean economic ‘miracle’ than appeared at first.

The IMF steps in

The disposition of the Hanbo and especially the Kia case, as well as the bankruptcies of two other top thirty *chaebol*, Sammi Steel and Jinro, in March and April 1997 respectively, sent mixed signals about the government’s intentions toward failing enterprises and exacerbated uncertainty about the health of the banking system among foreign investors. As a result, the markets declined, and net capital outflow was manifested in reduced rollover rates of short-term debt. These rollovers, which allow borrowers to renew loans as they come due, ‘fell from about 80 percent in October 1997 to 50 percent in November to about 30 percent in December.’³⁸ ‘Net foreign lending to South Korean banks fell from \$18 billion in 1996 to -\$6 billion in 1997.’³⁹ The possibility of default thus dramatically emerged.

The unfolding crisis in South East Asia exacerbated Seoul’s already deteriorating current account deficit and created speculative pressure on the Won.

³⁸ Sung-hee Jwa and Chan-guk Huh, *Risk and Returns of Financial-Industrial Interactions: The Korean Experience*, KERI Working Paper 9801 (Seoul: Korea Economic Research Institute, 1998) quoted in Noland, 210.

³⁹ In-Seok Shin and Yun-Jong Wang, *How to Sequence Capital Market Liberalization: Lessons from Korean Experience*, Working Paper 99-30 (Seoul: Korea Institute for International Economic Policy, 1999) quoted in Noland, 210.

Throughout October and November, the BOK pumped over \$21 billion into ailing banks to ensure that their short-term liabilities could be met while equally large amounts were spent defending the won against mounting speculative pressure. Meanwhile, from the end of October, spooked foreign investors began selling stocks, causing market indices to plummet and creating extra downward pressure on the won. In early November, with foreign reserves nearly depleted, the BOK allowed the won to float...Concurrently, the total amount of debt due mushroomed as international banks called in short-term debts that in better times simply would have been rolled over.⁴⁰

On November 21, 1997, South Korea went to the IMF for assistance. About a week and a half later, South Korea entered into a three-year Stand-By Arrangement with the IMF. Michel Camdessus, the Managing Director of the IMF, welcomed the South Korean decision to turn to the IMF and assured Korean authorities of full support.⁴¹ He also welcomed the announcement of financial market stabilization measures by the South Korean authorities 'to overcome the financial crisis, which has arisen *despite* sound macroeconomic trends.' According to Camdessus, these measures 'provide a good basis to begin the needed restructuring of the financial system.' This restructuring, he said, together with 'further structural measures as well as an appropriate strengthening of monetary and fiscal policies would provide a sound basis for a comprehensive package that could be supported by the IMF and the international community.' In his address at the Institute of Advanced Business Studies of the University of Navarra at Barcelona, Spain on November 28, 1997 he singled out two factors, as being largely responsible for the crisis. They gave the first official indication of the nature and orientation of the restructuring envisaged by the IMF:

Two...factors undermined market confidence. One was the lack of transparency about government and central bank operations, about the true state of financial sectors, and about the links between banks, industry, and government and their possible impact on economic policy, a problem that is particularly serious in Korea. In the absence of sufficient information, markets are entitled to fear the worst and to

⁴⁰ VanHulsten, 55-56.

⁴¹ "Camdessus Welcomes Korea's Request for IMF Assistance," *News Brief* no. 97/25, 21 Nov. 1997. <http://www.imf.org/external/np/sec/nb/1997/nb9725.htm> (accessed 28 May 2004). The quotes that follow are from this source.

doubt the capacity of governments to take corrective action. The other factor was the controls – and threat of controls – on market activity, which not only made investments riskier, but tended to reinforce the view that governments were addressing the symptoms, rather than the causes, of their problems, and accelerated investors' run for cover and set back other efforts to restore confidence.⁴²

In fact, both these factors had been more pronounced in the economic policy regime during South Korean rapid export-led development in the 1960s and 1970s than during the immediate pre-crisis period in the mid-1990s. A regime which had been highly praised by the IMF previously was now dismissed in the course of the crisis as evincing 'crony capitalism'.

Thus was launched an ideological campaign by the 'messiah' of global finance – a campaign supported, as we shall see, by the US Treasury and by Kim Dae Jung who was elected President in the midst of the crisis. This offensive aimed at undermining the earlier South Korean model of development by dismissing its essential characteristics as being largely responsible for the crisis. The broader aim, however, was to push for the further restructuring of South Korea's financial and economic system of towards an Anglo-Saxon form of free market capitalism. Ironically enough, the campaign was launched at a time when the reality of the situation had forced the US and the global development agencies to accept at least a basic recognition of the success of the East Asian model of development.⁴³ This shift, in turn, highlights the overall inconsistency of the IMF views on developments in global finance, or, to put it in other words, demonstrates the consistency of IMF views

⁴² Michel Camdessus, "The Asian Crisis and the International Response," Address to the Institute of Advanced Business Studies, Barcelona, Spain, 28 Nov. 1997. <http://imf.org/external/np/speeches/1997/mds9717.htm> (accessed 25 Feb. 2004).

⁴³ See, for example, World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (Washington, D.C.: World Bank, 1993). The nature and extent of intellectual resistance can be gauged from Robert Wade's informative account of the tussle between Japan and the US in the preparation of this landmark report see his "Japan, the World Bank, and the Art of Paradigm Maintenance: The East Asian Miracle in Political Perspective," *New Left Review* 217 (May/June 1996): 3-36.

with the views and capital interests of its major shareholders, particularly the United States.

The agreement that South Korea concluded with the IMF on December 3, 1997 included financing for a total of \$57 billion – the largest rescue package in the history of the IMF, nearly 20 times South Korea’s quota.⁴⁴ In terms of macroeconomic objectives, the goals of the Stand-By arrangement, in the IMF’s words, were ‘to narrow the external current account deficit to below 1 percent of GDP in 1998 and 1999, contain inflation at or below 5 percent, and – hoping for an early return of confidence – limit the deceleration in real GDP growth to about 3 percent in 1998, followed by a recovery toward potential in 1999.’⁴⁵

IMF help came with the usual stringent conditionality. South Korea had to agree with the IMF about its macroeconomic policies as well as about the Fund’s unusually detailed financial and corporate restructuring demands during the three years of the program. This was the first time that the IMF had imposed such detailed conditions in return for its assistance, even more so than the conditionality that accompanied SAPs introduced in the 1980s. The IMF recommended to the government of South Korea a short-term macroeconomic policy focused on high interest rates to restore the plummeting confidence of overseas investors during the early months of the crisis.⁴⁶ It also recommended that the government implement

⁴⁴ Of this, \$21 billion came from the IMF. In addition, the World Bank pledged \$10 billion for what amounted to balance of payments support to an OECD member. The Asian Development Bank provided \$4 billion in support of policy and institutional reforms, and about \$20 billion came from the bilateral support from the members of the international community, of which Japan and the United States provided \$10 billion and \$5 billion respectively. The IMF nimbly invented a new kind of loan in December 1997, the Supplemental Reserve Facility, to enable it to bypass its normal ruling that financial packages are not allowed to exceed five times the recipient country’s quota.

⁴⁵ See “Republic of Korea. IMF Stand-By Arrangement.” <http://www.imf.org/external/np/oth/korea.htm> (accessed 19 Sept. 2003).

⁴⁶ Interest rates were raised from 12.5 percent to 21 percent to reign in liquidity; interest rates rose to 32 percent in December.

various policies to restructure and reform the heavily indebted corporate sector dominated by the *chaebol* and a financial sector burdened with non-performing loans. In addition, it insisted that South Korea *rapidly* open its capital account and lift foreign ownership restrictions. During the December 5, 1997 press conference on the IMF package for South Korea, First Deputy Managing Director of the IMF Stanley Fischer specifically stressed that the program required a quantum leap in policies that the authorities had been planning to implement gradually over a number of years. 'Their [South Korean] decision to join the OECD obviously implied that their capital markets would be opened and that a lot of the other structural measures now in the program would be implemented in due course, but they have had to be implemented much more rapidly.'⁴⁷ But in fact, despite the singularity of detailed conditionality accompanying IMF assistance, as Mr. Fischer emphasized, the IMF program essentially asked South Korea

to take measures to maintain a balanced budget or budget with a small fiscal surplus, taking into account the cost of financial sector restructuring...We don't have any desire or intent to do things which would reduce growth beyond the levels to which they will be reduced...[W]e see this program as having very little fiscal adjustment, just the necessary amount, and an upfront monetary policy adjustment to stop the rot of confidence, restore it, and then take it away. And I don't see any excesses in that regard in this program.⁴⁸

The IMF also demanded that foreign investors be allowed to acquire South Korean businesses by purchasing their shares, to own majority stakes in South Korean businesses, and to open South Korea's domestic financial markets to foreign banks and insurance companies. Fifty percent ownership by a single foreign entity, Mr. Fischer announced, was to be permitted already by the end of 1997 so that the market discipline on the *chaebol* and on other South Korean companies would be enhanced in

⁴⁷ Stanley Fischer, Press Conference, IMF Meeting Hall B, Washington, D.C., 5 Dec. 1997. <http://imf.org/external/np/tr/1997/tr971205.htm> (accessed 25 Feb. 2004).

⁴⁸ *Loc.cit.*

the coming year or years.⁴⁹ To the question as to what the IMF program would do to the *chaebol* system in South Korea – the very system that produced such spectacular results – he stated there was no particular guarantee as to whether the *chaebol* would survive. ‘Whether they survive as they are restructured is something that the market will decide.’⁵⁰ In Mr. Fischer’s words,

When this crisis began, there was a great emphasis on the question about the wisdom of opening capital markets. I believe it’s significant that the country which was best known for not opening its capital markets has suffered as big a crisis if not bigger than those who had opened their capital markets, and this reinforces our general view that capital market liberalization is a necessary part of economic development.⁵¹

As part of the program, efforts were also undertaken by the IMF to secure national treatment to foreign banks under a combined supervisory and regulatory framework. Foreign banks were to be allowed to purchase equity in South Korea’s domestic banks without restrictions.⁵² Troubled financial institutions were to be closed or, if deemed viable, restructured and/or recapitalized. A credible and clearly-defined exit strategy was to include closures as well as mergers and acquisitions by domestic and foreign institutions, provided the new groupings were viable; and clear principles on the sharing of losses among equity holders and creditors were to be established. Any support to financial institutions, including through foreign exchange loans, would be given on strict conditions, and all support to financial institutions

⁴⁹ The ceiling on foreign ownership was set at 10 percent in 1992 and subsequently raised to 12 percent by the end of 1994, 15 percent in July 1995, and 18 percent in April 1996. The government announced a further gradual opening that would increase the ceiling to 20 percent in 1996, and three additional percentage points annually thereafter to 29 percent. The ceiling was raised on schedule to 20 percent in October 1996 and to 23 percent in May 1997, but the plan was subsequently overtaken by the crisis events and the ceiling was raised to 26 percent in November 1997, to 55 percent in December 1997, and finally to 100 percent in May 1998. See Noland, 55.

⁵⁰ Fischer, “Press Conference,” 5 Dec. 1997.

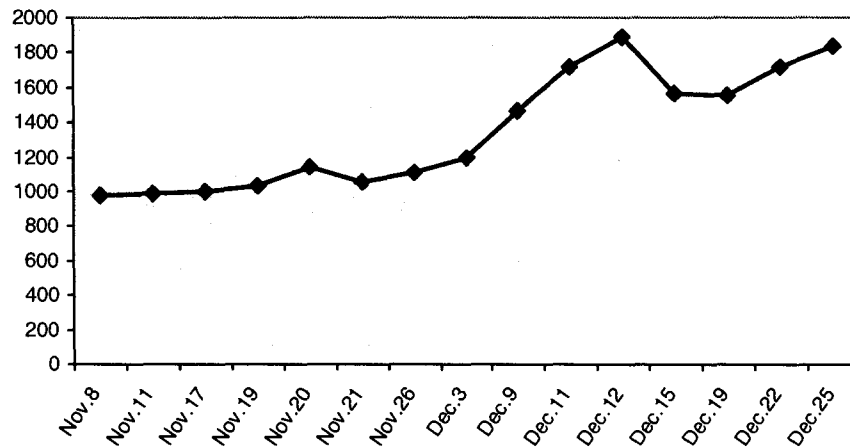
⁵¹ *Loc.cit.*

⁵² VanHulten, 62 (Table 4.4).

other than BOK liquidity credits would be provided according to preestablished rules and transparently recorded.

Remarkably, the IMF economic program requiring a fundamental restructuring of South Korean financial sector largely denounced the earlier South Korean government-led model of development as inefficient to operate in the world of industrialized free-market economies, presenting the financial crisis of 1997 as an obvious proof. This assessment came in sharp contrast to the admiration of the impressive growth track expressed by the IMF during more than three decades of its high-speed growth. Unsurprisingly, such a denunciation created a panic among foreign investors and resulted in a spectacular fall of the South Korean Won since December 4th when the IMF program was announced (see Figure 3.1 below).

Figure 3.1 Won Value against the Dollar, Nov.-Dec. 1997



Source: "Chronology of the Asian Currency Crisis and its Global Contagion," The Nouriel Roubini's Global Macroeconomic and Financial Policy website.
<http://www.stern.nyu.edu/globalmacro/AsiaChronology1.html> (accessed 30 Aug. 2003).

A respected Harvard economist, Jeffery Sachs noted in early 1998, 'There is no "fundamental" reason for Asia's financial calamity except financial panic itself. Asia's need for significant financial sector reform is real, but not a sufficient cause for

the panic, and not a justification for harsh macroeconomic policy adjustments.⁵³ Not only did Sachs consider such an approach unfair, he made a strong case that it was counterproductive. In his view, the policies imposed by the IMF on South Korea only intensified the panic, to the point where South Korean banks found themselves to be on the verge of default. 'Just one day after the [IMF] measures were unveiled, the eleventh largest conglomerate declared bankruptcy when Korean banks abruptly refused to roll over its short-term debts.'⁵⁴

Sachs was not alone in his observations. A Nobel-prize winner, Joseph Stiglitz, from 1997 to 2000 senior vice-president and chief economist at the World Bank, the IMF's sister institution and its partner in Structural Adjustment, was also openly critical of the IMF approach to dealing with the crisis in Asia:

Many of the fundamental explanations of the crisis have done a poor job in explaining the scope or depth of the East Asian turmoil. Further evidence for the role of "animal spirits" comes from the timing of the crisis. Although conditions were deteriorating in some countries prior to the crisis, in other countries there was very little "news" that explains the onset of the crisis. The general facts of high debt-equity ratios, lack of transparency, and weak financial systems were well known to investors during the periods when they were lending relatively cheaply to the East Asian countries. Much of the macroeconomic data, the "news," was actually turning more favorable in the run-up to the crisis. This is especially striking in Korea. Korean inflation rose to 5.5 percent in mid-1996, but in the months before the crisis it had fallen to just over 4 percent. Its trade deficit, one of the "culprits" in many explanations of the crisis because its counterpart was aggregate net borrowing from abroad, had fallen steadily throughout 1997, essentially reaching balance in the months before the crisis and moving into a small surplus in November.⁵⁵

Martin Feldstein, in the same line, was extremely sceptical about the appropriateness of the IMF measures for handling the crisis:

When the foreign exchange crisis hit Korea, the primary need was to persuade foreign creditors to continue to lend by rolling over existing loans as they came due. The key for achieving such credit without an IMF guarantee of outstanding loans was to persuade lenders that Korea's lack of adequate foreign exchange reserves

⁵³ Quoted in *Toronto Star*, editorial, 12 Jan. 1998.

⁵⁴ *Loc.cit.*

⁵⁵ Joseph Stiglitz, "The Role of International Financial Institutions in the Current Global Economy," Address to the Chicago Council on Foreign Relations, 27 Feb. 1998. http://www.tier.org.tw/apec/hotnews/Discussion_Papers/Stiglitz%202.html (accessed 30 May 2004).

was a temporary shortage, not permanent insolvency. By emphasizing the structural and institutional problems of the Korean economy, the Fund's program and rhetoric gave the opposite impression. Lenders who listened to the IMF could not be blamed for concluding that Korea would be unable to service its debts unless its economy had a total overhaul...Unsurprisingly, after the program was announced, the bond rating agencies downgraded Korean debt to junk bond status.⁵⁶

The IMF was impinging on national choices that worked in the past and could be expected to work again. In Miles Kahler's words, 'The entrapment of those [East Asian] countries in currency and financial crises no more proved that their underlying political and economic arrangements had failed than the Scandinavian banking crises of the early 1990s confirmed the failure of the welfare state.'⁵⁷ To understand why the IMF behaved the way it did, it is necessary to put the financial crisis in South Korea in a broader international perspective of the 1990s, in particular with respect to the policies of the United States – the major shareholder of the IMF and an actor that was to play a notable role in determining the fate of the troubled East Asian economies, the one of South Korea in particular, during the 1997-98 financial crisis.

How the US Treasury Restructured Korea's Economy through the IMF

Following the end of the Cold War and George Bush Sr.'s announcement of the establishment of the New World Order, the 1990s were marked by the US reinforcing its free-market ideology. This influence also extended to the subsequent Clinton administration (1993-2001). In addition to traditional national security concerns, the Clinton Doctrine emphasized the importance of US economic interests in US foreign policy. According to an address by Anthony Lake, Assistant to the President for National Security Affairs, at the School of Advanced International

⁵⁶ Martin Feldstein, "Refocusing the IMF," *Foreign Affairs* 77, no. 2 (March/April 1998): 31.

⁵⁷ Miles Kahler, "The New International Financial Architecture and its Limits," in *The Asian Financial Crisis and the Architecture of Global Finance*, ed. Gregory W. Noble and John Ravenhill (Cambridge: Cambridge University Press, 2000), 255.

Studies of Johns Hopkins University on September 1993, the successor to containment had to 'be a strategy of enlargement...of the world's free community of market democracies.'⁵⁸ Lake listed four components of the strategy of enlargement as he envisioned it: 1) to 'strengthen the community of market democracies'; 2) to 'foster and consolidate new democracies and market economies where possible'; 3) to 'counter the aggression and support the liberalization of states hostile to democracy'; and 4) to 'help democracy and market economies take root in regions of greatest humanitarian concern.' In practice, this meant that, as Clinton put it in 1994, 'We have put our economic competitiveness at the heart of our foreign policy.'⁵⁹ US domestic growth was thus tied to a foreign policy that would promote US exports and global free trade by making sure the United States remained the world's largest exporter. Thus, in Brinkley's words, 'Unlike many of its critics, Clinton was quick to understand that in the post-Cold War era good trade policy was the sine qua non of sound foreign policy, as the presence of market-based democracies would render the world a safer, richer place. If the Cold War enemy was communism, the post-Cold War villain was protectionism.'⁶⁰

During the 1980s, the US had benefited from having crisis-hit countries open their financial markets to free flows of international funds and to US financial operators, and from inducing them to open their asset markets for buy-out by US corporations and so on. But these, according to Gowan, were 'piecemeal gains

⁵⁸ Anthony Lake, "From Containment to Enlargement," Address at the School of Advanced International Studies, Johns Hopkins University, Washington, D.C., 21 Sept. 1993. <http://www.uiowa.edu/~c030162/Common/Handouts/Other/Lake.htm> (accessed 1 June 2004).

⁵⁹ Quoted in Douglas Brinkley, "Democratic Enlargement: The Clinton Doctrine," *Foreign Policy* 106 (Spring 1997): 117. See also Graham Evans, "The Vision Thing: in Search of the Clinton Doctrine," *The World Today* 53 (August/September 1997): 213-216; and Charles William Maynes, "A Workable Clinton Doctrine," *Foreign Policy* 93 (Winter '93/94): 3-20 on the discussion of the Clinton Doctrine.

⁶⁰ Brinkley, 117-118.

associated with particular countries and crises.⁶¹ Significantly, East and South-East Asian countries had largely escaped the crisis treatment because these states had largely avoided financial crises. Still, the Clinton administration sought to break into the region, famous for its practices of state-led industrial development and financial protectionism. David Rothkopf, Clinton's Deputy Under Secretary of Commerce for International Trade Policy, who played a central role in developing the Clinton administration's ground breaking Big Emerging Markets Initiative, emphasized the importance of the East Asian region if the United States 'was to maintain its economic leadership.'⁶²

For the United States, with its neo-liberal outlook, South Korea represented the most noticeable example of economic and financial protectionism in the 1990s, as discussed earlier in the chapter. Although its trade barriers were lower than those of most developing countries and those of other newly industrialized countries such as Brazil, they were still greater than those of the major industrialized nations. Because of this, the major industrialized countries, most notably the US, pressed South Korea to liberalize trade. 'Tariff rates on many goods exported by the US remained high, worth the average tariff on agricultural goods at 16.6 percent and tariffs on products such as potatoes, nuts, fresh fruit, and fruit juices remaining even higher, at between 30 and 50 percent.'⁶³ In addition to the barriers that limited US exports of goods, South Korea also had a number of barriers that restricted US exports of financial

⁶¹ Gowan, 84. The countries most affected included Mexico, Argentina, Zambia, Peru, among others.

⁶² See David J. Rothkopf, "Beyond Manic Mercantilism," in *Riding the Tigers: American Commercial Diplomacy in Asia*, ed. James J. Shin (Council on Foreign Relations, 1998). http://www.cfr.org/pub136/james_j_shinn/riding_the_tigers_american_commercial_diplomacy_in_asia.php (accessed 1 June 2004).

⁶³ James M. Devault, "The Republic of Korea and the US: Trade and Trade Policy Issues," in *The US-Korea Economic Partnership: Policy Directions for Trade and Economic Co-operation*, ed. Youn-Suk Kim and Kap-Soo Oh (Brookfield, V.T.: Ashgate Publishing Company, 1995), 106.

services. Two areas of particular importance were insurance and banking. Liberalization of the South Korean insurance market became an important goal of US insurers because South Korea had the sixth largest insurance market in the world. Not only was the market large, but, according to some estimates, 'it also was expected to grow at an annual rate of 15 to 20 percent in the near future.'⁶⁴ Insurance had been a point of dispute between South Korea and the US for more than a decade, with US insurance firms complaining that they were discriminated against by regulations that benefited the major South Korean insurers and helped limit foreign competition. Banking was another crucial service sector in which US and foreign participation remained limited. The major problem was the dominance of credit markets by the South Korean government. Although gradual liberalization had been under way since the 1980s, the government still controlled interest rates and continued to be very influential in the allocation of credit, thus giving rise to complaints from US and other foreign banks about discrimination and to demands for more immediate access to the service sector of South Korea.

The aim of these kinds of attack, however, as Gowan notes, was not just a quantitative one. If they had been, he says, by 1997 the US should have been well satisfied as South Korea had become the US's fifth largest market. The aim, he suggests, was 'a radical restructuring of the social relations of production within Korea in order to engineer an economic *Gleichschaltung* of Korean capitalism and of others in the region with the interests of American capitalism.'⁶⁵ Stiglitz strengthens the point:

in response [to the recognition that continued growth and integration in the global markets would require some liberalization, or deregulation, in the way its financial

⁶⁴ *Loc.cit.*

⁶⁵ Gowan, 89.

and capital markets were run], South Korea had carefully charted out a path of liberalization. This path was too slow for Wall Street, which saw profitable opportunities and did not want to wait. While Wall Streeters defended the principles of free markets and a limited role for governments, they were not above asking help from government to push their agenda for them.⁶⁶

This is where the crucial role of the US Treasury-Wall Street-IMF complex, to use Wade and Veneroso's term, entered the picture.⁶⁷

The US Treasury Department's depictions of the sources of the 1997 financial crisis in South Korea evolved as the crisis unfolded, though it is remarkable that this evolving, overwhelmingly neo-liberal, discourse remained targeted rather single-mindedly at capital account opening of the troubled economies. As the crisis in East Asia evolved, US Treasury officials consistently drew upon established themes of neo-liberal discourse (the so called 'Washington Consensus') in favour of a global capital mobility regime in developing their diagnosis of the causes of the crisis.⁶⁸ For example, in his remarks to the National Center for APEC in Seattle on September 18, 1997, Secretary of US Treasury Department Robert E. Rubin asserted that a 'broad-based agreement on strong market fundamentals such as open markets, privatization, reduced deficits and the rule of law' was the key to recovery in the region.⁶⁹ He also emphasized increasing 'transparency' as a means to correct the shortcomings of 'crony capitalism'. He argued that the affected governments must 'strengthen the disclosure requirements' and 'achieve greater transparency in central bank balance sheets' and 'strengthen...domestic financial systems.'

⁶⁶ Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: W.W.Norton&Company, 2002), 102.

⁶⁷ See Wade and Veneroso, "The Asian Crisis". The term, although with a variation, was originally taken by the authors from Jagdish Bhagwati's "The Capital Myth: The Difference between Trade in Widgets and Dollars," *Foreign Affairs* 77, no. 3 (May/June 1998): 7-12.

⁶⁸ See, for example, Moises Naim, "Washington Consensus or Washington Confusion?" *Foreign Policy* 118 (Spring 2000): 87-102.

⁶⁹ Robert E. Rubin, Remarks to the National Center for APEC, Seattle, WA, 18 Sept. 1997. <http://www.ustreas.gov/press/releases/rr1937.htm> (accessed 2 June 2004).

Rubin's comments supported earlier remarks by then Deputy Treasury Secretary Lawrence H. Summers, who in his "Building a Global Financial System for the 21st Century" Address to the Congressional Economic Leadership Council on August 12, 1997 largely blamed the Thai crisis on 'the unsustainable macroeconomic policy mix, combined with highly inefficient domestic intermediation and a poorly equipped regulatory regime' as well as a 'lack of transparent and timely balance sheet.' In this way, Summers avoided holding the 'openness of the Thai financial markets' to foreign capital flows responsible for the crisis.⁷⁰ As the financial crisis spread further in the region, Summers subsequently deepened Treasury's view of the mix of policy errors and domestic structural institutional incapacities common to affected East Asian nations in similar ways. He presented the causes of the crisis in terms of an 'unsustainable mix of monetary and exchange rate policies' on the part of East Asian governments and 'large short-term foreign currency exposure...backed by unproductive assets' in the private sector, compounded by a 'reluctance to reveal the full extent of losses.'⁷¹

This narrative representation of East Asian misdeeds by the US Treasury took a much stronger form in a February 1998 speech. Summers there presented the 'systemic roots' of the East Asian financial crisis in terms of a discursive attack on the core features of the developmental state. The attack then morphed into a description of the evils of national industrial policies and crony capitalism. Summers asserted that this development model

favoured centralized coordination of activity over decentralized market incentives. Governments targeted particular industries, promoted selected exports, and

⁷⁰ Lawrence H. Summers, "Building a Global Financial System for the 21st Century," Address to the Congressional Economic Leadership Council, 12 Aug. 1997. <http://www.ustreas.gov/press/releases/rr1879.htm> (accessed 2 June 2004).

⁷¹ Lawrence H. Summers, Testimony Before the House Committee on Banking and Financial Services, 13 Nov. 1997. <http://www.ustreas.gov/press/releases/rr2062.htm> (accessed 2 June 2004).

protected domestic industry...[relied]...on debt rather than equity, relationship driven finance not capital markets, and informal rather than formal enforcement mechanisms.⁷²

The discursive demolition of the South Korean development model by this prominent spokesman of the US Treasury Department entailed an implicit rebuke to the South Korean government for subsidizing highly leveraged *chaebol* in South Korea through government-directed lending by ‘inadequately independent’ domestic commercial banks. This approach had been quite successful due to the large debt-to-equity ratios, by Western standards, of South Korean conglomerates and their pre-crisis penchant for financing their operating expenses with short-term foreign borrowings. And it had remained successful with the *chaebol* experiencing no acute debt-servicing difficulties, until the international currency markets, led by the Wall Street financial firms, bid the Won down by about 80 percent over roughly three months at the end of 1997, setting the stage for IMF-imposed interest rate increases.

The US Treasury’s discursive demolition of the South Korean model of development, mirrored closely by the IMF discourse during the crisis, was quite successful in forcing reforms that were connected in one way or another with further opening of the South Korean economy to international capital. As Linda Weiss asserts, ‘while the IMF is no mere instrument of US interests, seeking to maintain its independent role, it nevertheless depends on US support and is inescapably drawn into a close relationship with the world’s leading nation-state and “its” finance capital.’⁷³ The United States exerts a considerable degree of control over the IMF by virtue of its voting power and its right to veto all decisions put before the Board of Executive Directors. The US is the largest contributor to Fund resources, and at the

⁷² Lawrence H. Summers, “Emerging From Crisis: the Beginnings of a New Asia,” Remarks Before the Economic Strategy Institute, 11 Feb. 1998. <http://www.ustreas.gov/press/releases/rr2217.htm> (accessed 2 June 2004).

⁷³ Weiss, “State Power and the Asian Crisis”, 335.

time of the 1997 financial turmoil it exercised control over roughly 18 percent of the Executive Board votes. As only 15 percent of the vote is required to veto any IMF funding proposal, the US effectively can prevent the passing of any funding proposal not to its liking. Moreover, after the IMF acquired a new role, and a new neo-liberal discourse, for itself in the 1970s, its role has become much more ideological in nature with the discursive attacks of the US playing as much role as its veto power.

Jagdish Bhagwati of Columbia University takes the argument even further:

...Wall Street has exceptional clout with Washington for the simple reason that there is a definite networking of like-minded luminaries among the powerful institutions – Wall Street, the Treasury Department, the State Department, the IMF, and the World Bank most prominent among them. Secretary Rubin comes from Wall Street...Nicholas Brady, President Bush's Secretary of the Treasury, is back in finance as well; Ernest Stern, who has served as acting president of the World Bank, is now managing director of J.P. Morgan; James Wolfensohn, an investment banker, is now president of the World Bank...This powerful network...is unable to look much beyond the interest of Wall Street, which it equates with the good of the world. Thus the IMF has been relentlessly propelled toward embracing the goal of capital account convertibility.⁷⁴

In search of the ultimate dismantling of controls on capital account worldwide, on a US initiative, the Interim Committee of the IMF issued the Hong Kong Statement on capital account liberalization, thus placing liberalization at the centre of the IMF agenda at the October 1997 annual meetings of the IMF and the World Bank, just as the Asian financial crisis was speeding up. In this vein, the Interim Committee proposed an amendment to the IMF *Articles of Agreement* that would make liberalization of capital movements 'one of the purposes of the IMF, and extend, as needed, the IMF's jurisdiction through the establishment of carefully defined and consistently applied obligations regarding the liberalization of such movements.'⁷⁵ Thus, as Wade and Veneroso characterize it, the proposed revision of the IMF's *Articles of Agreement* was 'an expression of a Big Push from international

⁷⁴ Bhagwati, "The Capital Myth", 11-12.

⁷⁵ "Capital Account Liberalization Essential to an Efficient Monetary System," *IMF Survey*, 6 Oct. 1997, 302.

organizations, backed by governments and corporations in the rich countries, to institute a world-wide regime of capital mobility that allows easy entry and exit everywhere.⁷⁶

Another clear expression of the Big Push for easier worldwide capital mobility at the 1997 IMF/WB annual meeting, was the successful effort by the IMF and US Treasury Department in preventing any other power, namely Japan, from standing in their way of liberalizing the world capital. When the Thai crisis was at its height in July 1997, and the IMF was belatedly being approached for assistance, Japan sought to exercise its regional leadership by proposing an Asian Monetary Fund (AMF) that was supposed to function like the IMF, but in a more forceful and rapid manner, and without the IMF-type conditionality clauses. This proposed fund was to be a multilateral revolving facility, involving other Asian countries, notably China, Hong Kong, Taiwan and Singapore as well as Japan. It was to be backed by funds of \$100 billion, drawn from the combined reserves of the major Asian countries. As Mathews and Weiss observed,

the proposal quietly made the Asian diplomatic rounds in August and September of 1997, but it came out into open at the meetings of the IMF and World Bank...At these meetings, the IMF and the US Treasury Department fought strenuously to prevent the alternative AMF from being established. The public arguments used (in addition to the private pressures brought to bear) were that the AMF would duplicate the functions of the IMF and that the relative absence of conditionality would enhance the 'moral hazards' associated with countries drawing from the Fund.⁷⁷

Japan backed down on its proposal, and by the time of the G-7 meeting in Ottawa in November, its Ministry of Finance spokespersons were stating that any Asian fund would work in cooperation with the IMF, and as a supplement to it. By

⁷⁶ Wade and Veneroso, "The Asian Crisis", 19.

⁷⁷ John A. Mathews and Linda Weiss, "The Case for an Asian Monetary Fund," JPRI Working Paper no. 55 (March 1999).

the start of 1998, nothing more was being heard in public about the AMF. As Bhagwati noted,

there [was] no assurance that Sakakibara [Japan's Vice Minister of Finance for International Affairs] would have managed to get even \$10 billion approved by the Japanese government. But the point is that the United States and the IMF acted together to kill the plan outright instead of even exploring it.⁷⁸

As we have seen above, the United States, or, to be more specific, the US Treasury Department, in concert with the IMF, played a key role in promoting its own foreign economic agenda of liberalizing capital controls around the world by advancing its policies at the IMF during the 1997 financial crisis in East Asia. US Treasury Secretary Rubin and Deputy Secretary Summers were, to quote Bruce Cumings, the 'horsemen of Clintonomics...[that]...rode the herd on the Asian crisis.'⁷⁹ The US Treasury Department along with the IMF officials discursively targeted the industrial policies of South Korea – successfully employed over several decades to achieve its status as the eleventh largest economy – blaming its 'corrupt' practices as the 'root' cause of the financial crisis. As Summers proclaimed in February 1998, 'The IMF has done more to promote America's trade and investment agenda in Korea than 30 years of bilateral talks.'⁸⁰ But as it seems unlikely that any of this would have happened without domestic South Korean support for the reforms that the IMF and the US had been pressing, let us turn to the domestic developments in South Korea at the time of the IMF Stand-By Arrangement negotiations in November/December 1997 as well as during the period of the arrangement mandate up until 2000.

⁷⁸ Jagdish Bhagwati, "The Asian Economic Crisis: What Do We Know Now?" chap. 5 in *The Wind of the Hundred Days: How Washington Mismanaged Globalization* (Cambridge, M.A.: The MIT Press, 2000), 60.

⁷⁹ Bruce Cumings, "The Korean Crisis and the End of 'Late' Development," *New Left Review* 231 (September/October 1998): 52.

⁸⁰ Quoted in Weiss, "State Power and the Asian Crisis", 333.

How Kim Dae Jung Helped the IMF Restructure the Korean Economy

The crisis in South Korea broke amidst a presidential election in which the ruling Grand National Party of Kim Young Sam lost power to the National Congress for New Politics led by Kim Dae Jung. Kim Dae Jung had spent most of his life arguing that a repressive state heavy regulation of the financial sector, and an inefficient and corrupt corporate sector went hand in hand. Because of his long history as an opposition figure and his identification with the poor, Kim Dae Jung, who lacked close personal connections to the *chaebol*, appeared to be a populist. As the presidential campaign was still under way the three candidates predictably denounced the IMF program as labor unions vigorously opposed the IMF package that was clearly aimed at dismantling the *chaebol* and would subsequently make thousands of workers unemployed. The front-runner Kim Dae Jung even announced that he might renegotiate the pact if elected. Hence, both the international financial institutions and the United States viewed his election with some concern, particularly following Kim Dae Jung's remarks about the need to reexamine the IMF program. But, as Haggard points out, 'the international community had an extremely poor understanding of Kim Dae Jung.'⁸¹ Indeed, according to Bruce Cumings, 'no other conceivable political leader was better positioned than Kim to truly change Korean system – he had called for reforms analogous to those of the IMF throughout his long

⁸¹ Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (Washington, D.C.: Institute for International Economics, 2000), 100.

career.⁸² Five days later it was revealed that the IMF had all candidates for the upcoming election to sign a written pledge of support for the IMF package.⁸³

Kim's diagnosis of South Korea's problems emphasized both the failures of state intervention and the need for political checks on government. In his analysis of the crisis, *DJnomics: A New Foundation for the Korean Economy*, he notes the short-term problems of mismanaged liberalization and loss of confidence by foreign investors, but gives greater weight to the state's failing to develop 'the rules and principles of a market economy [and] failing to implement structural reform policies consistent with changes in the international environment.'⁸⁴ The solution to the problem was to be found in more effective democracy. Problems of corruption and collusive ties between the government and businesses required regulation, but would also be addressed by making the economy more market-oriented. In Kim's often-used phrase, 'democracy and the market economy are like two sides of the same coin.'⁸⁵

Although Kim Dae Jung did not formally take office until February 25, 1998, he and his team had been the main negotiators with the IMF since his election on December 18, 1997. While he appears, as we shall see, to have gone along with the IMF package, initially he expressed caution about the reforms demanded by the IMF. His caution reflected a strong popular reaction to the IMF deal, based on anger at the government and the *chaebol* for reckless expansion which had emptied the banks and

⁸² Cumings, "The Korean Crisis", 60.

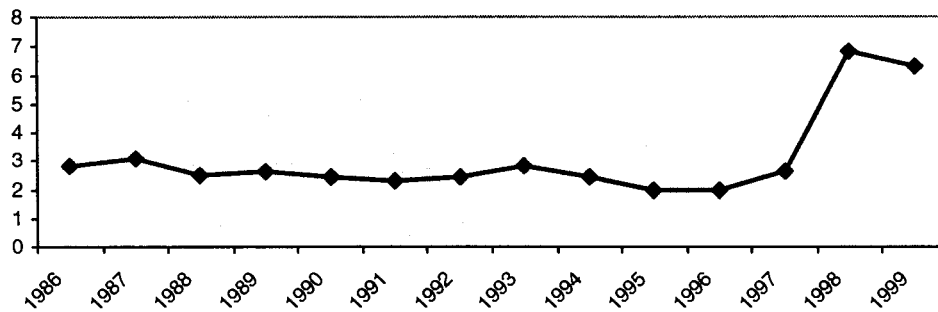
⁸³ Nicola Bullard, Walden Bello, and Kamal Malhotra, "Taming the Tigers: The IMF and the Asian Crisis," in *Tigers in Trouble: Financial Governance, Liberalisation and Crises in East Asia*, ed. Jomo K.S. (London and New York: Zed Books Ltd., 1998), 108.

⁸⁴ Kim Dae Jung, *DJnomics: A New Foundation for the Korean Economy* (Seoul: Korean Development Institute for the Ministry of Finance and Economy, Republic of Korea, 1999), 10.

⁸⁵ *Ibid.*, 35.

created a dependency on foreign capital. Although, by Cumings's account, 'Korea has had one of the strongest labor movements in the world,' South Korea had virtually no social security or unemployment compensation system as 'a puny unemployment law passed in 1995 allows 50 percent of wages for 30 to 210 days, depending on how long a worker has been employed – measures that are well below ILO standards.'⁸⁶ As the institutional changes – such as thorough restructuring of its corporate and financial sectors – that the IMF program suggested were necessary for solving Korea's 'problems' would have created unprecedented levels of corporate bankruptcy and unemployment, the trade unions reacted in huge strikes.⁸⁷ However, Kim Dae Jung persuaded the labor movement to back down and agree to massive layoffs in return for the right to exist legally and to participate in politics and field candidates for elections.⁸⁸

Figure 3.2 Unemployment Rates, 1986-1999
(in percent)



Source: Korea Ministry of Labor (various years), *Yearbook on Labor Statistics*.

⁸⁶ Cumings, "The Korean Crisis", 62.

⁸⁷ As can be clearly seen from Figure 3.1, the unions had every right to be worried about the scale of worker layoffs that were to follow the corporate restructuring demanded by the IMF.

⁸⁸ Of two large labor unions, KFTU and KCTU, KCTU has been illegal until early 1998. Moreover, from 1970 to 1987 the state controlled the recognition of all unions at foreign-invested companies, banning strikes and all unapproved union organizers. See Cumings, "The Korean Crisis", 62.

What followed was a close realization of IMF program requirements for the economic restructuring of South Korea by the Kim Dae Jung government. With his rhetoric strikingly close to that of the IMF and the US Treasury, Kim argued that democratization and economic development had to emerge simultaneously, and that transparency in political and economic relations would develop as a matter of course when these goals were pursued simultaneously. In accordance with the IMF conditions, the Kim Dae Jung government thus carried out deregulation in the financial and corporate sectors.

The key early reform was to establish the Financial Supervisory Commission (FSC) through the consolidation of the office of the financial inspector of the MOFE, the Office of Bank Supervision under the Bank of Korea, Securities Supervisory Board, insurance Supervisory Board, and Credit Management Fund Agency. The FSC consolidated financial supervision across all financial entities and markets and played a role in developing a new regulatory and supervisory framework. This Commission was to play a central role in restructuring the *chaebol* – the key reform of the Kim government.

As the major part of the corporate reform – due to be completed in the fall of 1998 – the government devised a complete corporate restructuring scheme, known as the ‘Big Deals’. Under the program, the Big Five (Hyundai, Samsung, LG, Daewoo, and SK) would swap major lines of business among themselves to consolidate excessive and duplicative investments while simultaneously achieving greater economies of scale. Kim argued that excessive investment, and the debts amassed to complete the projects, were the key causes of the debt crisis. The Kim Dae Jung administration therefore pushed the *chaebol* into mergers and asset swaps to try to increase specialization and reap the benefits of consolidation and economies of scale.

In an effort to reduce the level of overall debt, early in 1998, the FSC urged the top 30 chaebol to lower their debt-equity ratios from an average of 519 percent at the end of 1997 to 200 percent by the end of 1999. For the Big Five, this commitment was embodied in Capital Structure Improvement Plans (CSIP), agreements with their banks on a variety of restructuring measures – asset sales, including to foreigners; issuance of new equity; debt-equity swaps; and operational restructuring. The goal was ultimately to improve the country's industrial efficiency and international competitiveness. Kim even came to press for the restructuring of the Federation of Korean Industries (FKI) itself, the peak organization that had long represented *chaebol* interests and that under the leadership of Daewoo's Kim Woo-Chang, had actively opposed the government's corporate restructuring plans. According to Haggard, the Big Deals became a 'litmus test of corporate commitment to the restructuring process,' and were indicative of the government's directive approach to corporate restructuring.⁸⁹

What was the outcome of the corporate restructuring process? In 1999 and 2000, South Korea's economy recovered faster than anyone expected. In early 2000 the IMF touted South Korea's 'dramatic turnaround' after the crisis. Not only had South Korea's output surpassed its pre-crisis value, but, according to the IMF, 'over the past two years bold policies and a commitment to reform have made Korea a more open, competitive, and market driven economy.'⁹⁰ South Korea's real GDP grew by almost 11% in 1999, and near 9% in 2000. The unemployment rate, which peaked at over 8% in early 1999, temporarily dipped below 4% in 2000. Continued trade

⁸⁹ Haggard, *The Political Economy*, 153.

⁹⁰ *IMF Survey*, 6 Mar. 2001, 78-80.

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

A closer look at the data, however, suggests that the recent South Korean recovery was not as impressive as the IMF claims. All in all, some argue that post-crisis restructuring imposed by the IMF has failed to generate a sustainable economic recovery. High growth in 1999 and 2000, with its large trade surpluses and the rebound of investment from its collapse in 1998, was associated with a dramatic shift from contractionary to expansionary macroeconomic policy after mid-1998 which did not, however, continue thereafter. The recovery soon petered out. The financial restructuring imposed by the IMF and supported by the Kim Dae Jung government has not restored prosperity to South Korea – rather, it has brought a serious and prolonged credit crunches and continued corporate profitability problems, leading to a large slowdown in the rate of capital accumulation.⁹¹ Four plus years of reforms have created neither a healthy financial sector nor a profitable industrial sector. Instead, they triggered a vicious circle in which ongoing problems in real-sector firms keep financial institutions perpetually weak. Ominously, the rate of capital accumulation in South Korea may well be experiencing a pronounced secular decline. ‘Real fixed investment in 2000 and 2001 was still 7 percent lower than in 1997, and real equipment investment in 2000 by large manufacturing firms (the core of South Korea's export economy) was still 38 percent below its 1997 level.’⁹² The IMF reforms have failed to restore Korea to a sustainable high-growth path. The economic condition of the majority of the population has deteriorated. Inequality has risen significantly, as it does in every country that falls under IMF control. ‘The ratio of

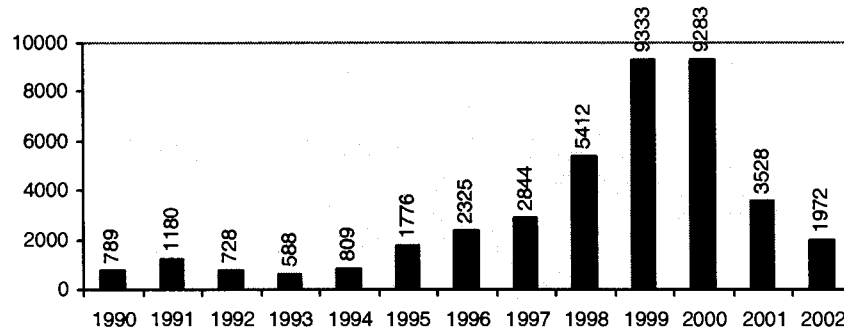
⁹¹ James Crotty and Kang-Kook Lee, “Is Financial Liberalization Good for Developing Nations? The Case of South Korea in the 1990s,” *Review of Radical Political Economics* 34 (2002): 327-334.

⁹² *Ibid.*, 330.

the income of the top 20 percent of households to the bottom 20 percent rose from 4.7 to 6.8 over the same period.”⁹³ It seemed like the Korean ‘miracle’ has ended in 1997, with the help of the IMF.

What the restructuring imposed by the IMF did achieve, though, was the elimination of the ceiling on foreign share ownership of South Korean companies. The result, as can be seen from Figure 3.3 below, was a multiple increase in foreign direct investment inflows in the three years following the IMF Stand-By Arrangement.

Figure 3.3 FDI Inflows, 1990-2002
(in millions US Dollars)



Source: United Nations Conference on Trade and Development.

Although this would seem to indicate that the IMF intervention has helped to effectively dismantle the developmental state in South Korea, a sharp decrease in FDI in years 2001 and 2002 (no statistics are available for 2003) implies this was hardly the case. As Linda Weiss has shown quite well, in fact, the process of corporate restructuring during the years of IMF Arrangement has been driven ‘by the state, not

⁹³ *Loc.cit.*

the market.⁹⁴ The same can be said about the deregulation of South Korea's financial sector:

...while the [Kim Dae Jung] administration lays claim on being strongly committed to a liberalised economy and to foreign investment in every sector, it has not interpreted this to mean an unregulated environment or one that leaves outcomes entirely to the survival of the fittest foreigners. On the contrary, its new focus on 'prudential regulations' aims to reverse earlier damage caused by deregulatory haste. Thus, the state has stepped up regulatory measures to control foreign bank operations.⁹⁵

In a World Bank study, *Which Firms Do Foreigners Buy? Evidence from Korea*, Caroline Freund and Simeon Djankov explore the patterns of foreign acquisitions that took place shortly after the IMF.⁹⁶ They identify which sectors and firms attracted foreign investment after the liberalization of investment activity at the end of 1997. It is worth noting, they say, that some industries, such as chemicals and machinery, tended to attract somewhat more FDI, while others, such as primary metals and petroleum, tended to attract less. One other major difference between international transactions and domestic transactions is their size. 'Of the 73 domestic transactions...the median transaction value was \$35 million. Of the 109 foreign acquisitions...the median value was \$58 million.'⁹⁷

Thus, while, as a result of IMF-imposed restructuring of South Korean financial and corporate sectors, foreign competitors have received an easier access to South Korean financial markets – something which was the foundation of the policy of the US in particular towards countries of East Asia ever since 1980s, the eventual foreign uptake was not very high or long-term. The restructuring of the economic

⁹⁴ Linda Weiss, "Guiding Globalisation in East Asia: New Roles for Old Developmental States," in *States in the Global Economy: Bringing Domestic Institutions Back In*, ed. Linda Weiss (Cambridge: Cambridge University Press, 2003), 249.

⁹⁵ *Ibid.*, 255.

⁹⁶ See Caroline Freund and Simeon Djankov, *What Firms Do Foreigners Buy? Evidence from Korea*, Country Economics Department Paper Series no. 2450 (Washington, D.C.: The World Bank, July 2000).

⁹⁷ *Ibid.*, 11.

bases of South Korea towards an Anglo-Saxon form of capitalism imposed by the IMF has tried to make a leap towards speeding up this process, with foreign firms acquiring control of the companies in such industries as chemicals and machinery, which had been fundamental to South Korean development for its decades of 'miraculous' growth.

In other words, the 1980s and early 1990s saw a rapid increase in the size of South Korea's major *chaebol*, which was already becoming evident by the start of the 1980s. Chun's government's policies of limited liberalization during the 1980s resulted in the massive ownership of NBFIs by the major business groups. This significantly increased the autonomy of the *chaebol* as South Korean business groups became less dependent on government-controlled commercial banks; the era thereby marked a crucial shift in the *chaebol*-state relationship. Growing influence of the top *chaebol* had been a crucial factor in the 1990s in pushing for further liberalization, which they saw as an opportunity for getting access to unlimited foreign credit at low interest rates. The decision of the Kim Young Sam government to seek membership in the OECD added an external push for further liberalization and capital account opening and significantly speeded up the overall process of liberalization. In the end this process turned out to be quite uneven and distorted, as the South Korean government placed more emphasis on deregulating access to short-term capital, while leaving long-term capital controlled.

The result was an escalating rate of corporate debt/equity ratios, which in itself was an essential characteristic of the South Korean rapid development of the last three decades. Eventually, the discursive demolition of the South Korean model of development as a whole advanced by the US Treasury officials, and even more so by the IMF officials, resulted in creating panic among foreign investors and contributed

to the unfolding of a financial crisis of massive dimensions. Moreover, this dismissal of South Korea's model as 'crony capitalism' by the IMF made it possible for it to impose, with the help of the US Treasury and the Kim Dae Jung administration, a program of radical corporate restructuring and capital account opening of South Korea. While it may be argued that the eventual uptake was not as high as was hoped, it is not as important as once again emphasizing that the aim of US policy was to create an *option* for US corporations. The end of the Cold War diminished the significance of South Korea as a frontline state, and now the US policy could be less tolerant toward the economic nationalisms of its former allies. South Korea would get the same treatment as the rest of the Third World, or indeed, worse, since there was much more that the US capital could gain in South Korea. This shows that the role of the IMF has been tailored as much to the *political* needs of US hegemony as to the economic needs of US capital. This in turn underlines my argument in this thesis that the role of the IMF at the time of 1997-98 financial crisis in South Korea has been instrumental in pursuit of political interests of the United States.

Conclusion

My argument in this thesis is that the role of the International Monetary Fund at the time of the 1997-98 financial crisis in South Korea has been instrumental in the pursuit of political interests of the United States. I approach this argument by comparing the record of IMF's views on South Korean model of development during the period of its high-speed growth from 1960s to 1990s and during the 1997-98 financial crisis. Although IMF's active involvement in South Korean financial crisis attracted an unprecedented amount of critical attention, most critical writers have not registered the extent to which the IMF had, in the past, praised the very model which at the time of the crisis it was denouncing as 'crony capitalism'.

The IMF's discourse has been an essential part of the way the government of the United States has promoted what it sees as its interests and goals in the world. In this thesis, the discourse of the IMF about South Korea is an example of the close relationship between the IMF's discourse and practices and the goals and interests which the US government has perceived and pursued in the world. In addition, this thesis makes another argument: that the discourse of the IMF has not only passively reflected US government goals, it has actively promoted them, and in the case of South Korea, with shocking effectiveness. My analysis of the shift in IMF's discourse about South Korea from 'East Asian miracle' to 'crony capitalism' at the time of 1997-98 financial crisis attempts to illustrate that this shift performed a discursive demolition of South Korean model of development: the IMF created panic among foreign investors and thus made a decisive contribution to the unfolding of the

financial crisis of unprecedented dimensions in the country. Having accomplished this, it was also able to impose a program of radical corporate restructuring and further capital account opening of South Korea for the ever easier access of foreign, especially US capital.

The critical analyses of the crisis showed that its fundamental cause lay not so much in the state-led developmental model – which South Korea had followed beginning in the 1950s and 1960s but in its progressive abandonment under domestic and foreign pressures in the 1990s – marked in particular by the progressive lifting of controls on capital transfers, including on short term capital. It was this which lay the South Korean economy vulnerable to the panic exit of capital in the closing months of 1997. The IMF has, of course, been a partisan of capital mobility and has urged this course upon all countries, including South Korea. However, its role in the South Korean crisis is clearly more profound than this. For it was also clear to most critical economists that it was the intervention of the IMF itself – and in particular its neo-liberal interpretation of the causes of the crisis – which turned ordinary jitters into the full scale panic that constituted the opening act of the crisis.

The momentous role of US Treasury Department in the negotiations for the IMF Stand-By Arrangement for South Korea in 1997, and for the program of fundamental corporate restructuring that accompanied it, revealed an intimate relationship between IMF and the neo-liberal US government. This intimate relationship had existed since the founding of the Bretton Woods institutions, and had been criticized for long, but became more explicit than ever during the 1997-98 crisis in South Korea. Not only did that IMF program for South Korea fail to generate a sustainable economic recovery, it was also clearly seen to be designed to change South Korea's regulatory structure in a way that would enable US corporations to

purchase South Korean corporations more easily than ever. The end of the Cold War had diminished the importance of South Korea as a frontline state and now it would get a treatment as bad as the rest of the Third World, indeed, worse, since there was, potentially, much more that US capital could gain from South Korea. This underlines the argument that the IMF has been instrumental in the promotion of broader geopolitical interests of the United States at the time of South Korean financial crisis.

This point is further underlined when we review the record of the IMF's views on South Korea during the Cold War. During the 1960s and most of the 1970s, the IMF's assessment of South Korea's tremendous economic achievements in export promotion emphasized the role of the government's interventionist policies as indispensable for the country's rapid growth. The arrival of neo-liberal governments in the US and the UK in the late 1970s and early 1980s marked a defining moment in the future role of the institutions like the IMF, the role in which the promotion of neo-liberal ideology onto the international monetary order would play an important part. Whereas before the onset of the 'Washington consensus' the IMF had been happy to attribute the outstanding rates of growth of South Korean economy to government-directed policies, now mainstream economists from the neo-liberal US government and the IMF wished to attribute South Korea's success to free market ideas and set it as an example for the other Third World countries to follow.

A more careful analysis of the real story of South Korean development disproves the validity of the IMF's new neo-liberal view of the nature and sources of South Korean economic 'miracle'. First of all, neo-liberal accounts overlook the exceptional importance of South Korea to US Cold War strategy and the exceptional treatment which South Korea received at the hands of the US. The *quid pro quo* of the Korean-American aid relationship was based on geostrategic rather than economic

interests of the US in the East Asian region. In return for massive amounts of aid supplied to South Korea by the US during 1950s and early 1960s, it demanded certain economic reforms from South Korean government that would allow it to create a strong state to resist the influence of Communist from the north. While US policy advice was not always followed, and was sometimes openly flouted by the Rhee government during the 1950s, the US goal was, paradoxically, achieved. Massive misuse of American aid by the Rhee administration helped create the basis for industrialization and the all-important capitalist class through import-substitution industrialization and was followed by the creation of more clearly developmental state by the Park government in the 1960s strongly committed to expansion of exports.

Business-state connections played a crucial role in the South Korean model with the government successfully exercising a low-interest-rate policy of discretionary credit allocation to specific business groups in return for economic achievements as well as political support of the government during the 1960s and 1970s. Being the core composite agencies of South Korean development model, the *chaebol* grew rapidly, in particular during the Heavy and Chemical Industrialization of the 1970s. As a result of this continued growth and expansion with the state's protection and support, by the 1980s the *chaebol* started to challenge the state in provision of certain, including financial, services.

In response to the *chaebol's* pressure, and to the continued insistence of the United States, the Chun government of the early 1980s pursued limited liberalization reforms of the financial sector and privatization of the banking system. The banks and non-bank financial institutions were given freedom to set interest rates, and as a result domestic interest rates mounted. The result of Chun's deregulation, however, was that the *chaebol* came to secure an even stronger foothold in the country's

financial system. Attracted by lower interest rates of foreign credit, by the 1990s the *chaebol* started to exercise hard pressure on the government for liberalization. The state, on the other hand, was not ready to give up its control at once and, instead, with Kim Young Sam's announcement of decision to join OECD by 1996, developed a plan of gradual liberalization. The actual liberalization that took place in the early 1990s, however, was uneven and distorted as South Korean government made more emphasis on deregulating access to short-term capital, while leaving long-term capital controlled. The result was an escalating corporate debt/equity ratios which, although in itself being an essential characteristic of South Korean rapid development for the previous three decades, came under open attack by the IMF discourse during the financial crisis of 1997-98 emphasizing the structural insolvency of South Korean economy and dismissing it as 'crony capitalism'.

This was the crucial shift in IMF's discourse towards South Korea. Until that time the IMF had been praising economic policies of the South Korean government that produced such stunning rates of economic growth attributing them either to the crucial role of government intervention during the 1960s and most of 1970s or, although inaccurately, to the free market incentives since the early 1980s. But it was during South Korean financial crisis of 1997-98 that the IMF's perception of South Korea turned around and openly attacked South Korea's economic structure imposing a program of radical corporate restructuring and capital account opening of the country. It was this discursive demolition of the South Korean model of development which ultimately created panic among foreign investors and contributed to the unfolding of the financial crisis of unprecedented dimensions in the country. While the main objective of any IMF program for a country in crisis is to restore confidence in country's currency, as Figure 3.1 indicates, after the IMF program for South Korea

was announced on December 4, 1997 the value of the Won in fact fell sharply to an ever-low 1,995 Won to US Dollar, or 100 percent, in a matter of days.

Thus, instead of restoring confidence, the IMF's neo-liberal program and rhetoric gave the impression that South Korean economy was structurally insolvent, when, in fact, according to more thorough analyses, South Korea experienced nothing more than a liquidity crisis. US Treasury officials took an active part in designing and negotiating of the IMF radical corporate restructuring and capital account opening program for South Korea revealing an intimate relationship between the IMF and neo-liberal US government. While this relationship has been present throughout IMF's life, it became more explicit than ever at the time of South Korean financial crisis in 1997-98. The IMF's economic program not only failed to generate sustainable economic recovery in South Korea, but it was clearly designed as to allow US corporations to buy up South Korean corporations more easily than ever before. As Lawrence Summers, then Deputy Treasury Secretary, proclaimed, 'The IMF has done more to promote America's trade and investment agenda in Korea than 30 years of bilateral talks.'¹ While it may be argued that the eventual uptake was not as high as was hoped, it is not as important as emphasizing that the aim of US policy was to create an *option* for US corporations. The end of the Cold War diminished the significance of South Korea as a frontline state, and now the US policy could be less tolerant toward the economic nationalisms of its former allies. South Korea would get the same treatment as the rest of the Third World, or indeed, worse, since there was much more that the US capital could gain in South Korea. This shows that the role of the IMF has been tailored as much to the *political* needs of US hegemony as to the economic needs of US capital. This underlines my argument in this thesis that the

¹ Quoted in Linda Weiss, "State Power and the Asian Crisis," *New Political Economy* 4, no. 3 (1999): 333.

role of the IMF at the time of 1997-98 financial crisis in South Korea has been instrumental in pursuit of political interests of the United States.

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