HOW SUCCESSFUL WERE THE IMF AND KOREAN GOVERNMENT IN MITIGATING THE 1997 ASIAN FINANCIAL CRISIS?

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Extended Project Qualification

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September 2020

CONTENTS

LIST OF ABBREVIATIONS AND ACRONYMS

$ United States Dollar

BOK Bank of Korea

BIS Bank of International Settlements

FDI foreign direct investment

GDP gross domestic product

HCI heavy and chemical industries

IMF International Monetary Fund

KIST Korean Institute of Science and Technology

M&A mergers and acquisitions

MOFE Ministry of Finance and Economy

OECD Organisation for Economic Co-operation and Development

R&D research and development

TFP total factor productivity

W won (Korean currency unit)

ABSTRACT

After years of being heralded as the poster child for globalization during the 90s; Korea's economy entered a profound financial crisis in 1997. The Korean economy was derided for its distorted capitalism - riddled with insider dealing, corruption, and weak corporate governance. In order to avoid total economic collapse, the Korean government opted for the International Monetary Fund's Structural Adjustment Loan[i]. The conditions attached to these loans were draconian and took the nation a decade to recover from. Today, Korean policymakers look to act independently of international financial institutions, as a consequence of their poor rapport with them two decades prior.

The IMF managing director, Michel Camdessus, placed the majority of the blame squarely on the Korean government. Unsurprisingly, the Korean people saw the IMF as imperialists encroaching on their otherwise successful economic policy - the very same policy that elevated their economy from an agrarian basket-case to the world's 12th largest (common slogans amongst demonstrators included "IMFired").

This research will aim to understand the degrees of success achieved by both the IMF and Korean government in mitigating the financial crisis that ensued by the end of the 1990s and make sense of the shortcomings in policymaking.

In Chapter 1, we shall begin to explore the socioeconomic history of Korea and the IMF in order to inform the context in which these agents had to act in 1997. In Chapter 2, we shall consider the determinants of the crisis and highlight red flags missed. In Chapter 3, the unfolding of the crisis will be explored alongside the Korean government's immediate mitigation. In Chapter 4, we will consider the Korean government's response in more detail, considering the central government, Bank of Korea (BOK), and the National Assembly. In Chapter 5, we will consider the IMF's response and how this complimented that of the Korean government. In Chapter 6, we shall look to determine the efficacy of the aforementioned measures and attempt to quantify the lasting impacts. Finally, in Chapter 7, we shall summarise the paper and attempt to ascertain the degrees of success achieved by the IMF and the Korean government.

1. INTRODUCTION

1.1 The Korean Economy: History and Context

After Japanese independence in 1945, South Korea was an agrarian economy. The country was one of the poorest in the world, having lost the majority of their electricity, manufacturing, and mining industries to the North (who had been occupied and consequently influenced by the Soviet Union). The South would only achieve its pre-independence level of output by 1956 and exceed the per capita income of the North by 1973[1].

The government under Rhee Syngman undertook significant land reform in the 1940s, redistributing land from the Japanese. The government also devoted 8% of spending on education, and thus elementary school enrolment reached almost 100%.

In 1965, Korea had educational enrolment similar to that of Chile, where per capita income was seven times higher. The investment ratio was also very high, at around 30-35%. What was lagging was technological development, which would not take off until the 1980s.

The Korean War left 3 million dead and had an estimated cost of two-thirds of GNP. In the 50s, Korea mostly depended on foreign aid – which accounted for 22% of Korean GDP. This helped to balance the government budget, which was invested in infrastructure.

Through the 1950s, Korea employed import substitution industrialization policies which Japan had employed in the late 1800s, the so-called "*flying geese hypothesis*". This industrial policy involved restricting imports, lowering interest rates, promoting monopolistic competition, and overvaluing the Korean Won. Initially, this policy targeted specific industries: the so-called "3-white" sugar, flour, and cotton. However, by the late 1950s, Korean companies began to produce industrial products – such as radios and electric fans.

[1] YOUNG, NAMKOONG. "A COMPARATIVE STUDY ON NORTH AND SOUTH KOREAN ECONOMIC CAPABILITY." *The Journal of East Asian Affairs* 9, no. 1 (1995): 1-43. Accessed May 3, 2020. www.jstor.org/stable/23254150.

Aid began to dry up in light of the Nixon Doctrine in the 1960s; US President Richard Nixon declared that the US would no longer "undertake all the defence of the free nations of the world," particularly due to the concentration of military resources towards the deteriorating Vietnam Campaign. Korea thus moved towards an export promotion policy thereby reducing tariffs for intermediate goods, creating export-import linkage systems, and offering low-interest rate loans to the export industry. Major institutional reform also ensued, with the creation of the Economy Planning Board (EPB) in order to streamline planning responsibility, budgeting, and statistical analysis. The government also set up the Korean Institute of Science and Technology (KIST) in 1960, which led to growth in technological progress measured in TFP. Consequently, the gap between imports and exports decreased from about tenfold to just twofold. Korea's comparative advantage lied in labour intensive industry, namely textiles.

The government needed to mobilize capital externally, as the savings ratio (11.8) was still much lower than the investment ratio (21.6). This was achieved through normalizing relations with Japan, who offered an $800M loan as compensation for colonial rule. This funded infrastructure projects such as the construction of a highway between Seoul and Pusan.

The Korean government also sent miners and nurses to West Germany, and soldiers to Vietnam. The remittance flows, in the form of wages, could then be pledged as collateral – and would enable the Korean government to secure large loans from international organisations.

By the 1970s, the Koreans began to promote heavy and chemical industries (HCI) – such as steel, electronics, chemicals, machinery, and shipbuilding. HCI promotion was much more aggressive than the export-promotion of the 60s, and by the 80s, HCI accounted for 50% of total exports. However, capital imports led to the rapid accumulation of foreign debt – at around 50% of GNP by the 1980s. Moreover, it was around this time that the *chaebols* (Korea's super-conglomerates) began to emerge, as the Korean government promoted large companies to specialize in target industries. The economies of scale achieved, they hoped, would allow Korean chaebols to compete on an international scale.

Inflation was also a major problem facing policymakers following the oil shocks of the 1970s. Consequently, as shipping prices rose, exports began to decline. Many Asian countries accepted slow growth, however, Korea moved forward with investment into HCI, echoing the

Big-Push model (Rosenstein-Rodan, 1943). This intensified inflation in Korea, as the government had increased lending to assist HCI industries.

By the early 1980s, the Korea economy was on the brink of crisis. Interest rates had been raised globally to control inflation after the oil crisis, and the American Dollar was appreciating – making it more difficult to finance foreign debt. Monetary and fiscal policy was tightened, and a “rationalization policy” ensued, encouraging M&A in the HCI. This was a resounding success, with the savings ratio finally exceeding the investment ratio by 1984.

Korean exports began to take off in the late 80s. Trade was liberalized with the tariff rate on passenger cars falling from 200% to just 20%. In addition, Japan was forced to revalue the yen following the Plaza Accord, making Korean exports more price competitive.

From 1986 to 1989, Korea experienced a current account surplus. Some records say this was the biggest economic expansion since Korea’s mythological founding father *Dangun* was born 5,000 years ago. Korea gradually lost international competitiveness in the early 90s, as they had installed democracy in 1987. This led to the increasing bargaining power of labour unions which led to rising wages and unit labour costs.

In fact, as more and more capital accumulated, marginal productivity decreased. However, in the 90s, policymakers continued to inject investment into the construction industry – which was often inefficient. The Korean government also refused to let the Won float, in order to promote stability and attract foreign investment into capital markets ahead of their entry into the OECD in 1996.

By the late 1990s, labour costs were high, real estate was expensive, unit labour costs were rising, and the incremental capital-output ratio was rising very quickly. Moreover, as the population was aging, the so-called “demographic dividend” was about to end. This all led to decreasing profitability. From 1996, many *chaebols* began to collapse.

1.2 Origins and Vested Interest of the IMF

In the weeks following D-Day in 1944, 44 nations convened in Bretton Woods, New Hampshire to discuss the future of the international monetary system.

Whilst it was generally agreed upon that there ought to be a supranational financial body in order to avoid the exchange rate instability of the interwar years; the regulation of this body and the mechanisms it would employ were more contentiously debated.

The delegates of the conference comprised (among others) John Maynard Keynes, the representative of the United Kingdom, and Harry Dexter White, the representative of the United States. The former proposed loans to be devoid of conditionality and issued in a new universal currency. Equally, trade balances would be stringently regulated. Nations with a surplus would be required to revalue their currency and export their capital. This applied vice versa to those with a deficit. Those that exceeded their allocated surplus/deficit would be charged interest, and have the excess confiscated.

This concept, unsurprisingly, was vetoed by Dexter White. The United States' position in the post-war geopolitical landscape gave it unprecedented bargaining power. As the world's largest creditor, White believed Keynes' proposal would undermine the apparatus of the US government. The resulting institution, the IMF, attached strict conditionality to loans, allowed surpluses to be maintained unfettered. This gave the Americans unilateral veto power, and would always be headed by an American delegate. Loans would be issued in the United States dollar (with the ulterior motive of toppling the so-called "Sterling Area"), which was tied to the gold standard. This gold standard system ended in 1971, and as did the IMF's role of upholding fixed exchange rate regimes. Today, the IMF is in charge of short-term loans.

The IMF has been implicated in its fair share of controversy. From the 1960s to the 1990s, it was implicated in Nicaragua - initially to promote the Cuban Campaign through Nicaraguan territory and uphold the rule of the totalitarian Somoza clan. It also recklessly lent to Romania in the 1980s in an effort to draw it away from the Soviet bloc, in spite of the humanitarian abuse at the hands of Nicolae Ceaușescu, and the lack of concrete macroeconomic data.

Today, some perceive the IMF to be of dwindling importance given the sudden rise of private capital markets. Many remain frustrated over the IMF's unwillingness to deal with regional development banks, and the under-representation of developing countries in voting power[2].

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[2] Vestergaard, Jakob, and Robert H. Wade. Report. Danish Institute for International Studies, 2014. Accessed May 3, 2020. www.jstor.org/stable/resrep13283.

1.3 Success Criteria

Korea faced four broad challenges to rebound from the crisis:

i) Containing the crisis and cushioning its impact
ii) Putting together crisis-prevention measures
iii) Carrying out postcrisis revitalization measures
iv) Organizing institutional arrangements to carry out the aforementioned

The success of both the IMF and the Korean government will be assessed against these objectives. It is important to recognize that these success criteria are not all-encompassing. Indeed, there exist several objectives that must be assessed qualitatively – such as the psychological impacts of the crisis on investors and consumers.

Having outlined the success criteria – one must now consider how these criteria will be assessed:

i) Foreign exchange liquidity, corporate insolvency, financial sector restructuring, unemployment
ii) Macroeconomic targets, minimizing of government intervention, effective prudential control, minimizing information asymmetry, minimizing the moral hazard of foreign lenders
iii) Advanced technological innovation (in line with the *Zeitgeist*), educational reform, R&D markets, venture capital, expansion of tourism and cultural markets
iv) Enforcement of intellectual property rights, upward mobility and equity for citizens, preventing abuses of power by those in advantageous positions, social welfare

Both the IMF and the Korean government will not see all objectives as of equal priority. The IMF has historically focused on objectives i) and ii), whereas the Korean government focused on iii) and iv).

2. THE ONSET OF THE CRISIS

Summary

The literature is currently divided between two schools of thought regarding the causes of the crisis.

The prevailing argument is that of endogenous factors being of foremost importance. This argument is supported by Korea’s high levels of external debt, high costs, and currency overvaluation perpetuated by a fixed rate currency regime. The prevailing endogenous factor is that of the distorted Asian financial system – which was plagued by the lack of incentives for effective risk management created by implicit government guarantees against failure (creating a moral hazard).

The alternative argument is that exogenous factors were at play. This is supported by Korea’s strong macroeconomic fundamentals, and the deterioration of economies abroad (of which, Korea had no part to play in). However, the prevailing exogenous factor is the surge in capital inflows that made Korea vulnerable to a financial panic. Consequently, the economic disruption was caused by panic and inadequate policy response.

In reality, these two arguments are not mutually exclusive.

2.1 Endogenous

2.1.1 Underreported External Debt

In 1996, the nominal GDP growth rate of 6.25% trailed the 6.29% interest rate on external borrowing. Consequently, external debt was growing.

Initially, Korea’s external debt was underreported as the World Bank standards defined external debt as the balance of the unpaid debt amongst domestic borrowers. Following IMF consultations and pressure from foreign lenders, the government decided to include the borrowing by overseas branches as well as offshore borrowing by domestic financial companies. In 1996, this change in accounting standards resulted in a 45% increase in reported debt levels – from $112.6B under the World Bank’s measure, to $163.5B under the gross external liabilities measure. This amounted to about 31% of GDP.

2.1.2 High Costs

The Korean economy had been plagued by high costs - principally through high interest rates (8.1%), high wages (16.2% annual growth - which had persisted following Korea's 1987 democratization, and the strengthening of labour unions), high real estate prices ($226.8 per square metre), and high logistics costs (14.3% ratio of logistics costs to sales). In response, most companies adopted a "wait-and-see" attitude.

2.1.3 Capital Liberalization and Currency Overvaluation

Following the end of the Uruguay Round in 1993, Korea was preparing to make its capital market liberalization debut by joining the OECD in 1996. However, this was accompanied by lacklustre financial regulation – principally due to the division between the BOK and the MOFE. Commercial banks were under the former's supervision, whereas merchant banks and specialized banks were under the supervision of the latter. The insurance and securities sectors were regulated by their own supervisory bodies[3].

Korea was quickly inundated with unmonitored credit. In response, the government created new merchant banks - whose number increased from six to thirty from 1994 to 1996. These institutions procured foreign currency funds on a short-term basis and used them for long-term investments in Southeast Asian countries. By borrowing indirectly from domestic merchant banks, that in return borrowed from abroad, the chaebols acquired more than $30 billion of foreign assets from 1996. These institutions were not backed up by improvements in the supervisory and disclosure framework and had little experience in the global capital market. Financial institutions, which consisted predominantly of domestic merchant banks, accounted for more than 70% of external debt by November of 1997. On November 18 1997, when the Korean National Assembly failed to legislate the Bank Reform bill, investor confidence collapsed[4].

Partly in order to attract foreign direct investment from the OECD, Korea had overvalued the won for several years. While the Japanese yen had fallen 13.9% against the dollar, the won had depreciated just 6.6%. Initially, this would widen the trade deficit by encouraging

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[3] O. Yul Kwon (1998) The Korean financial crisis: Diagnosis, remedies and prospects, Journal of the Asia Pacific Economy, 3:3, 331-357, DOI: 10.1080/13547869808724656

[4] https://kellogg.nd.edu/sites/default/files/old_files/documents/272.pdf

imports and discouraging exports. However, unlike the Thai baht, Korea had controls in place that barred short selling of the won besides legitimate transactions in the forward market. Consequently, it was difficult for speculators to attack the Won – and this was not the root cause of the crisis in Korea.

2.1.3 Domestic Moral Hazard

Banks frequently made loans on a political rather than commercially prudent basis – operating on the premise that if they made loans in accordance with the government's wishes, then they would receive guarantees against failure. This became self-fulfilling and remains one of the most pre-eminent causes of the crisis.

As aforementioned, the chaebols that had been birthed from the Korean government's HCI movement in the 1970s received political favours from the government which resulted in preferential treatment from the banks[5]. The absence of salient commercial analysis resulted in these conglomerates being plagued in bad loans (most notably, Hanbo, Sammi, and Jinro – as we shall begin to discuss in the next chapter). Had the government not been involved with businesses, then the chaebols would only incur loans if they were convinced that the cash flows from the resulting investments would be sufficient to repay the debt. By 1997, the average debt-equity ratio for the top 30 chaebols exceeded 500%. The proliferation of risky lending drove up the prices of risky assets[6].

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[5] https://www.cis.org.au/app/uploads/2015/04/images/stories/policy-magazine/1999-autumn/1999-15-1-terry-black-susan-black.pdf

[6] http://web.mit.edu/krugman/www/FIRESALE.htm

Table 5.1 Top 30 chaebol in Korea, June 1997

Rank	Name	Debt-to-equity ratio[a]	Number of subsidiaries	Bankrupt in December 1998
1	Hyundai	5.8	57	
2	Samsung	3.7	80	
3	LG	5.1	49	
4	Daewoo	4.7	30	
5	SK	4.7	46	
6	Ssangyong	4.0	25	
7	Hanjin	9.1	24	
8	Kia	n.a.	26	X
9	Hanwha	12.1	31	X
10	Lotte	2.2	30	
11	Kumbo	9.4	26	
12	Halla	20.7	18	X
13	Dongha	3.6	19	X
14	Doosan	5.9	25	
15	Daelim	5.1	21	
16	Hansol	4.0	23	
17	Hyosung	4.7	18	
18	Dongkuk	3.2	17	
19	Jinro	37.6	24	X
20	Kolon	3.2	24	
21	Kohap	4.7	13	X
22	Dongbu	3.4	34	
23	Tongyang	4.0	24	
24	Haitai	15.0	15	X
25	Newcore	17.1	18	X
26	Anam	15.0	21	
27	Hanil	5.8	7	X
28	Keopyung	n.a.	22	X
29	Kiwon	n.a.	25	
30	Shinho	6.8	25	X

n.a. = not available
a. Nonfinancial subsidiaries only; last year available for bankrupt firms.

Note: This table excludes Hanbo, in the process of being liquidated in July 1997.

Source: Korea Fair Trade Commission; debt-to-equity ratios from OECD, *OECD Economic Surveys: Korea 1999.* [7]

During the crisis, those economies with the most vulnerable financial sectors experienced the most severe crises (Indonesia, Thailand, South Korea) – whereas nations with robust financial institutions, like Singapore, were equally exposed by did not experience similar disruptions.

2.2 Exogenous

2.2.1 Strong Macroeconomic Fundamentals

Macroeconomic indicators in 1996 suggested that the endogenous economy was sound. Real growth was at 6.8%, just shy of the government's 7% target. Inflation had reached 4.9%, and unemployment had peaked at 2% in that year. Both President Kim Young-Sam and the IMF shared the view that the soundness of macroeconomic fundamentals would protect Korea

[7] https://www.piie.com/publications/chapters_preview/341/5iie3373.pdf

from the contagion that had begun in Thailand[8]. The IMF themselves projected growth of the Korean economy at around 6% in 1997 and 1998 – and considering the trajectory of the Korean economy, this was not too absurd of a prediction. Even the most capable of investment banks, including Goldman Sachs, had not predicted such a dramatic slowdown in export growth.

Table 2.1 Macroeconomic Indicators, 1993–96
percent

Indicator	*1993*	*1994*	*1995*	*1996*
GDP growth rate	5.5	8.3	8.9	6.8
Growth rate of gross national income	5.7	8.4	8.1	4.8
Unemployment rate	2.8	2.4	2.0	2.0
Growth rate of consumer prices	4.8	6.2	4.5	4.9
Current account, US$, millions	989.5	–3,866.9	–8,507.7	–23,004.7
Ratio of current account to GDP	0.3	–1.0	–1.7	–4.4
Ratio of gross savings to GDP	36.2	35.5	35.5	33.8
Ratio of government budget balance to GDP	0.3	0.4	0.3	0.3

Source: Bank of Korea (BOK) 1999a.
Note: GDP = gross domestic product.

[9]

However, the current account deficit in the balance of payments had jumped up to $23 billion – principally due to the 13.4% fall in unit export price, accompanied by a mere 1.2% fall in unit import price. This stood as one of the largest current account deficits in Korea's history. However, it was still below 5% of GDP – and was regarded with little alarm, as Korea had shown current account deficits for most of her 50-year history. The IMF forecast this deficit to fall to $14 billion by 1997 (2.9% of GDP), and $11.5 billion by 1998 (2.3% of GDP).

2.2.2 International Architecture

The prices of semiconductors, steel, and petrochemicals (HCI) were falling due to global oversupply. The price of the 16M D-RAM chip fell from about $50 in 1995 to just $9 in 1996, causing alarm for the semiconductor industry (which itself was highly cyclical). The

[8] Bullard, Nicola, Walden Bello, and Kamal Malhotra. "Taming the Tigers: The IMF and the Asian Crisis." *Third World Quarterly* 19, no. 3 (1998): 505-55. Accessed May 3, 2020. www.jstor.org/stable/3993136.
[9] Lee, K., 2011. The Korean Financial Crisis of 1997: Onset, Turnaround, and Thereafter. 1st ed. Washington: The World Bank.

Japanese yen had also weakened against the American dollar, depreciating from ¥94.06 in 1995 to ¥108.78 in 1996 – giving competitive price advantages to Japanese exports (due to the reversal of the 1985 Plaza Accord, which had spurred growth in Korea). The Chinese renminbi was also concurrently devalued[10].

Around this time, Alan Greenspan of the Federal Reserve began to raise U.S. interest rates to head off inflation – as the U.S. began its recovery from a recession in the early 1990s. This directed hot money flows to the United States and away from Southeast Asia, consequently leading to an appreciation in the U.S. Dollar. Nonetheless, Southeast Asian nations that had pegged their currencies to USD found that their exports were less competitive in global markets.

2.2.3 Surge in Capital Inflows

Many Southeast Asian banks participated in maturity transformation[11], a common practice where banks accept deposits with short maturities to finance loans with longer maturities – making more funds available to productive long-term investors. Radelet and Sachs (1998)[12] highlight that many East Asian financial institutions had incurred a "significant amount of external liquid liabilities that were not entirely backed by liquid assets," consequently making them vulnerable to panics.

In the case of Korea, Japanese banks were critical actors. As the yen weakened, the value of dollar-denominated assets held by Japanese banks become larger in yen terms. Consequently, the BIS ratios of Japanese banks fell. In order to avoid losses and to protect their capital base in advance of the adoption of the BIS-mandated capital adequacy requirement in Japan, many Japanese commercials banks quickly reduced their exposure to Asia. Consequently, this led to an increasing frequency of refusal on the behalf of banks in Japan to roll over their loans to

[10] https://www.frbsf.org/economic-research/publications/economic-letter/1998/august/what-caused-east-asia-financial-crisis/

[11] https://www.frbsf.org/economic-research/publications/economic-letter/1998/august/what-caused-east-asia-financial-crisis/

[12] https://www.nber.org/papers/w6680.pdf

foreign clients in Korea – whilst simultaneously putting a strain on the foreign exchange reserves of other countries[13].

2.3 Summary

There is no unanimous agreement on the cause of the crisis. Instead, as we have explored, it can be attributed to several reasons.

The consensus arrived at by the existing literature is that one of the primary causes of the crisis is thought to have been the rapid liberalisation of capital accounts. As Grozdev (2010) explains, it was in fact institutions like the IMF that had encouraged East Asian countries to open their markets to foreign capital – as this would purportedly diversify funding sources, as well as speed up economic growth through allocating funds to their most productive use. In reality, Korea had already invested in various productions to supplement its export-oriented industries well before the IMF prescription, and consequently, much of the capital inflow was inefficient.

Another preponderant cause of the crisis was that of the large current account deficit. As Korea had fixed the won to the rapidly appreciating US dollar, they found the won considerably over-valued. This was coupled with a depreciating Japanese yen and rising costs of production, leading to a collapse in Korean competitiveness. Consequently, this led to a loss in investor confidence.

The crisis was also caused by currency mismatches, initiated by borrowing between private banks and large nonfinancial companies – as well as domestic companies borrowing from domestic banks. This left banks and corporations vulnerable to devaluations in exchange rates. Sudden outflows of capital ultimately resulted in a balance sheet crisis.

[13] https://www.imf.org/external/np/seminars/eng/2006/cpem/pdf/kihwan.pdf

3. UNFOLDING OF THE CRISIS

As aforementioned, Korean economic growth during the start of 1997 was robust. Consequently, international lenders were confident that Korean firms would encounter no barriers to repaying the short-term loans that had been incessantly flowing to them.

However, in July of 1997, Thailand was forced to ask the IMF for assistance to meet international obligations, having already spent billions of dollars in foreign reserves to protect the Thai baht from speculation. By August, the IMF announced a $17 billion rescue package. A few days later, Indonesia began to float their rupiah, which consequently plummeted in value – signalling that they, too, were having difficulties in meeting international obligations. Korean banks had lent significant sums to Indonesian banks, and consequently, the Korean won began to depreciate to record lows[14].

The situation in Asia continued to deteriorate. By October, Indonesia also began to seek IMF assistance. The central bank of Taiwan then chose to devalue its currency, and the Hong Kong Currency Board raised interest rates to fend off a speculative attack on the Hong Kong dollar. Hong Kong stocks collapsed 10.4%, wiping out $29.3 billion of market capitalization. In spite of massive intervention on behalf of the BOK, the won depreciated rapidly. By November 17, the won had depreciated to 1,000 won to the dollar – and the BOK recommended to the MOFE that Korea seek an IMF bailout. By November 19th, the finance minister Kang Kyong-shik resigned, and the BOK announced it would stop defending the won.

In November, Sanyo Securities (one of Japan's top 10 brokerage firms) and Hokkaido Bank (one of Japan's top 10 banks) collapsed under a pile of bad loans. These represented the first Japanese securities houses to go bust since World War II. By December, Japanese banks were refusing to turn over short-term loans. Only a few months prior, 80% of loans coming due

[14] https://www.nber.org/papers/w7483.pdf

were refinanced, but this fell to just 30% by December. On December 3rd, the IMF and Korean government announced a $57 billion package – of which $21 billion would come from the IMF, $10 billion from the World Bank, $4 billion from the Asian Development Bank, and $5 billion from the US government. The remainder was contributed by various countries. South Korean nationalists criticized the loan as humiliating, with president Kim Young Sam apologizing to the nation on television for the economic malaise.

Regardless, the won continued to depreciate – reaching 1790 to the dollar by December 12. On December 15th, the BOK raised interest rates and announced that the won would float freely as per the IMF agreement. The won quickly appreciated but plummeted due to worries in the market over statements made by presidential candidate Kim Dae-Jung to reject the agreements with the IMF. However, when Kim won the election, he indicated that he would abide by the agreements. The US Treasury helped broker an agreement between foreign banks and the Korean government where the former agreed to postpone drawing funds from Korea. Indeed, $24 billion of short-term debt was converted into claims with maturities between 1 and 3 years. But by then, the won had depreciated about 40% to 2,000 won to the dollar. The interest rates were then held high for the next three months and consequently allowed to fall slowly.

The IMF admitted that it was erroneous to hold interest rates at such a high level for so long, as the prolonged high interest rates would almost surely induce a major recession. The IMF had forecast that the recommended contractionary monetary and fiscal policy would allow the Korean government to turn the public deficit into a surplus. They claimed that, even under these policies, growth would contract to a moderate 3%. However, the actual growth rate in 1998 amounted to -6.7%. In January of 1998, Joseph Stiglitz, chief economist of the World Bank, questioned the assumptions and effects of the “Washington Consensus” – a so-called “one-size-fits-all” solution to crisis-wracked developing countries. A month later, Stiglitz was fired for his dissent.

A key condition insisted upon by the IMF in exchange for the $57 billion package involved layoffs (as we shall discuss in the next chapter). In January of 1998, labour unions in South Korea agreed to discuss layoffs with businesses. By February, they reached a landmark agreement to legalize layoffs. However, by May, a nation-wide strike was held by union workers to protest the growing wave of unemployment. 10,000 workers were being laid off every day. By July of 1998, the IMF announced it would ease conditions on the aid package to South Korea – which had been blamed for rising unemployment and overburdened welfare programs. In October of 1998, Japan announced a $30 billion aid package for Southeast Asia.

By the end of 1998, 11 of Korea's largest 30 groups had declared bankruptcy. However, some smaller groups were kept running by means of syndicate loans under the antibankruptcy pact.

4. KOREAN GOVERNMENT RESPONSE

4.1 Industrial Reform

4.1.1 Productivity in the Industrial Sectors

Goldman Sachs issued a report in Spring 1998 that declared only 2 of Korea's top 10 chaebols as "financially healthy" (that is, their interest coverage ratio – cash flow divided by interest rates on long- and short-term debt – was greater than 3.0). Some chaebols had an interest coverage ratio below 1.0, including the Shinho and Ssangyong group – which had prospered under HCI, but were now technically insolvent. The Goldman Sachs report was soon after followed by one prepared by management consultancy firm McKinsey & Company – which found that in most manufacturing sectors, productivities of both capital and labour were shown to be only about half of the levels found at the leading firms in the US. As we explored earlier, Korea's lagging productivity was not, by and large, due to its technology or its human capital (in 1995, the amount of capital per worker in Korea was about 80% that of the US). According to McKinsey, the low productivities were due to poor governance of industrial and financial institutions. However, this varied between industries. Korea's labour productivity in steelmaking, for instance, was 108% that of the US, and capital productivity was at 115%. This was in spite of the sector being dominated by the state-owned Pohang Iron and Steel Company (POSCO). Regardless, IMF reforms called for the privatization of POSCO.

McKinsey found that Korea's inefficiency lied in the automobile industry. They found that the labour productivity of Hyundai in 1996 was similar to that of Toyota, the international leader, in 1974. On average, the productivity of both labour and capital was 48% that of US firms. McKinsey blamed this on the sheltering of imports; by 1996 – Korea had become the world's fifth-largest auto-producing nation. Consequently, the argument for infant-industry protection was no longer relevant. Such "sheltering" and "coddling" from the government had a counterproductive effect on efficiency, and it appeared that most automobile manufacturers had excessive labour. Consequently, McKinsey recommended that the Korean government take measures to ensure the automotive firms would be able to lay off workers.

4.1.2 Structural Reforms

In early 1998, the Korean National Assembly passed several laws creating the Korea Asset Management Corporation (KAMCO) to facilitate the liquidation of hundreds of financial institutions. However, the creditor banks led the reform of the corporate sector. The top five chaebols and their creditors agreed to:

1) Adopt consolidated financial statements
2) Comply with international accounting standards
3) Strengthen the voting rights of minority shareholders
4) Appoint at least one outsider director
5) Establish an external auditors committee
6) Prohibit cross-subsidiary debt guarantees
7) Resolve all existing cross-debt guarantees by March of 2000

Alongside this measure, the government spearheaded the "Big Deal" between the top five chaebols – involving business swaps that streamlined each company into key industries such as semiconductors, petrochemicals, aerospace, and oil refining.

Moreover, the government streamlined legal proceedings for bankruptcy filings to facilitate the market exit of failing firms and ensure the representation of creditor banks in the process. There was also great progress made with labour market reforms – following the revision of the Labour Standard Act (LSA), which legalised layoffs for "managerial reasons." As we discussed in the previous section, this allowed many firms to become more efficient – as firms could now lay off workers whose wages exceeded their marginal revenue product. In addition to the LSA, legislation established "manpower dispatching businesses" – providing employment-outsourcing services for 26 occupations and thereby enhancing labour market flexibility.

Notably, the National Assembly signed the Tripartite Social Accord in February of 1998[15] – establishing the Tripartite Commission. The Commission was composed of labour, management, and government - and was intended to deal with industrial relations, freedom of association, management transparency, labour market policy, reform of the social security system, wage stabilisation, improvement of labour-management cooperation, and the

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[15] https://www.ilo.org/wcmsp5/groups/public/---dgreports/---inst/documents/publication/wcms_194172.pdf

enhancement of labour market flexibility. Scholars have considered the Accord to represent a turning point in Korean corporate culture, however, some labour representatives have not considered it beneficial for workers. In 1999, the Republic of Korean Confederation of Trade Unions (KCTU) decided to quit the Tripartite Commission, and pursue negotiations directly with the government.

The government appreciated that the new LSA would increase unemployment. Therefore, alongside the manpower dispatching businesses, they introduced the Comprehensive Unemployment Programme in March 1998 intended to protect livelihoods and fund public work projects (for instance, government-sponsored internship programmes for fresh graduates out of high school and university). The government devoted 2-3% of the national budget on this programme between 1998 and 2000, and by 1999 – almost 6 million benefited from the scheme. Unemployment benefits coverage was also expanded from establishments with 10 or more employees, to establishments with 5 or more employees. Equally, the eligibility requirements were eased. By 2000, the Korean government introduced the Basic Livelihood Security System – aimed at supporting households facing difficulties due to unemployment. This system integrated social safety schemes, homeless protection, public work programmes, and temporary livelihood security systems. This measure made some loans more accessible, such as the living expense loans – whose beneficiaries increased from 540,000 in 1999 to almost 1.5 million in 2000. Monthly payments to 4 person households also increased to 1,222,000 Won by 2002 (adjusting for inflation, this is approximately $1,500 per month today).

The government also initiated major upheaval in the public sector. In 1998, 20 of the 109 state-owned enterprises (SOEs) were privatised – while the remaining SOEs were targeted for managerial reform. The government aimed to reduce their employment by 11% by the end of 2000, in addition to streamlining its organisational structure and the quasi-government sector. However, as aforementioned, this was largely indiscriminate and did not consider SOEs that had already shown productive potential, such as POSCO.

5. IMF RESPONSE

5.1 Immediate Reform

In line with the IMF Stand-By Arrangement (SBA), the Korean government was required to tighten monetary policy and immediately close insolvent financial institutions. The sharp raising of interest rates was expected to curb the outflow of funds and the steep depreciation of the won. The call rate was raised from 12.3% to 30.1% in December of 1997, leading yields on corporate bonds to soar from 14% to over 30%. Equally, broad money growth was reduced to 13.9% from 16.3% the month prior[16]. The IMF also asked Korea to employ contractionary fiscal measures, in order to generate a budget surplus equivalent to 1% of GDP by 1998. Only when the downward economic spiral continued did the IMF succumb and ease the budget requirements, allowing the Korean government to run a budget deficit up to 0.8% of GDP (in comparison, during 1991-95, most Western European nations racked up a deficit between 3-8% in order to curb the economic downturn).

5.2 Structural Reform

The IMF financial sector reforms fell broadly under 3 categories[17]:

1. Reform of the central bank and financial supervisory system
2. Opening up the financial sector
3. Restructuring the financial sector

5.2.1 Reform of the Central Bank and Financial Supervisory System

The IMF wanted to carry out fully those reforms that had been called for by the Presidential Commission, as aforementioned, but were only partially implemented. Under the IMF reforms, supervisory functions were transferred to the Financial Supervisory Board (FSB) – which would report directly to the Prime Minister and not the MOFE. Under this

[16] http://press-files.anu.edu.au/downloads/press/p95511/pdf/article05.pdf

[17] https://www.piie.com/publications/chapters_preview/341/5iie3373.pdf

arrangement, either the BOK or the FSB could request bank inspections, which would then be carried out concurrently by both bodies. However, the FSB had the final authority on corrective actions.

IMF research suggested that financial stability tended to be enhanced when different types of financial institutions were allowed to compete with one another. Consequently, IMF conditionality called for the passage of legislation to enable banks, insurance companies, and other non-bank financial entities to enter each other's lines of business. Existing securities and insurance supervisory agencies were merged into the FSB under the FSC – the Financial Supervisory Commission.

5.2.2 Opening up the Financial Sector

IMF reforms with regards to the liberalization of the financial sector also largely followed the earlier Presidential Commission. The main objective was to liberalize long-term capital accounts – as short-term accounts had already been liberalized following OECD membership. Under IMF reforms, restrictions on foreign ownership of stock in Korean firms were gradually eliminated – allowing foreign takeovers of Korean firms. This led to a fire sale in Korean companies and a massive surge in brownfield FDI:

1. General Motors bought a stake in Korean manufacturers of automobiles and parts, and Ford increased its stake in Kia
2. Procter & Gamble purchased a majority share of Ssangyong Paper, which producer napkins, diapers, and kitchen towels
3. Royal Dutch Shell negotiated a purchase of Hanwha Group's oil refining company, which had already sold part of its joint venture in chemicals to the German BASF
4. A humorous anecdote from Krugman (1998)[18]: "Michael Jackson is getting into the action, negotiating to acquire a ski resort from its owner, a bankrupt Korean underwear maker."

The bond market was also opened to foreigners, for both private and corporate bonds. However, until the end of 1998, foreign investors were restricted to holding no more than 30% of the total of any one type of bond. Nonetheless, FDI increased dramatically from

[18] http://web.mit.edu/krugman/www/FIRESALE.htm

$6.97 billion in 1997 to $8.85 billion in 1998 – in spite of the substantial contraction in GDP. However, Korea's FDI: GDP ratio was still among the lowest in both Asia and the OECD. Equally, the growth in FDI from 1997-1998 represented a slowing trend that had almost doubled year-on-year since 1995.

5.2.3 Restructuring the Financial Sector

Financial sector restructuring constituted the most pervasive reforms. It called for 3 sets of reforms:

i) Identifying banks and financial institutions that were unviable
ii) Providing exit strategies for these institutions, and restructuring plans for those deemed salvageable
iii) Establishing a timeline under which all Korean banks would meet the Basel capital adequacy standards as established by the BIS

The FSC introduced the prompt corrective action (PCA) system – which would measure banks against specific quantitative risk indicators (which were based on best practices as defined by international organizations), and to take according corrective action. This delivered a clear message to investors that regulatory forbearance would no longer be tolerated. The FSC made clear that they would distance themselves from internal operating decisions, and no longer micromanage banks.

To help initiate restructuring measures for institutions that failed to meet the thresholds demanded by the indicators, the Korea Deposit Insurance Corporation (KDIC) was created. It provided bank depositors with some deposit insurance that was paid by the banks themselves. This would come in to effect after 2001 when the government's emergency measures (that guaranteed all deposits in the banking system) would end. The premiums on this insurance were levied on the soundness of the bank as per FSB standards.

The Korean government had already created KAMCO in late 1997 to purchase nonperforming loans from financial institutions – as a recommendation of the Presidential Commission. Under IMF reforms, the role of KAMCO was supplemented by the creation of Haneurum Merchant Bank (a so-called "bridge merchant bank") which would specifically resolve the insolvencies of the merchant banks. Together, KAMCO and KDIC financed a total of W64 trillion for financial sector restructuring.

6. CONSEQUENCES OF INTERVENTION

6.1 Macroeconomic Fundamentals

Table 1: Macroeconomic Indicators of South Korea: 1995–2000

		1995	1996	1997	1998	1999	2000
National Account	GNI (billion $)	488.1	518.3	474.0	313.0	402.1	455.2
	Annual GDP growth rate	8.9	6.8	5.0	−6.7	10.7	8.9
Trade	Exports (billion $)	125,058	129,715	136,164	132,313	143,686	172,268
	Imports (billion $)	135,119	150,339	144,616	93,282	119,752	160,481
	Trade Balance (million $)	−10,061	−20,624	−8,452	39,031	23,933	11,786
Foreign Debt	Foreign Debt (million $)	127,500	163,500	159,200	148,700	137,100	136,300
	Foreign Reserve (million $)	29,390	29,420	8,870	48,510	74,050	96,200
Public Finance	Balance (million $)	1,242	1,099	−6,959	−18,757	−13,120	5,577
	Debt (million $)	22,518	25,644	28,542	41,572	61,168	71,226
Corporate Finance*	Equity to Total Assets (%)	27.2	24.9	20.4	25.3	31.4	35.6
	Debt Ratio (%)	347.5	386.5	512.8	379.8	218.7	171.2
Employment	Unemployed (thousands)	420	426	556	1,461	1,353	889
	Unemployment Rate (%)	2	2	2.6	6.8	6.3	4.0

* The top 30 *chaebol* groups

Sources: National Statistical Office (2001), *KOSIS Database*; IMF (1999) *International Financial Statistics*; Bank of Korea (2001), *Economic Statistics Database*; Korea Development Institute (2001) *KDI Economic Outlook*

By 1999, South Korea ranked top among the 29 members of the OECD in terms of economic growth, with an annual growth rate of 10.7%. It had also become the 13th largest trading country in the world, with a total volume of imports and exports valued at $332.7 billion. Foreign reserves exceeded $90 billion, up from $4 billion at the height of the crisis. Foreign debt had also eased to $136.3 billion by 2000, down from $148.7 billion in 1997. However, public debt had ballooned – increasing from $41.6 billion in 1998 to $71.2 billion in 2000. Including loans guaranteed by the government, this figure was closer to $154.5 billion.

The debt/equity ratios of the top 30 chaebols fell to just 171.2% at the end of 2000, down from 378.8% in 1998. Whilst this looked to be below the IMF's 200% threshold, the number could have been as high as 300% if the overlapping investments among subsidiaries were counted. Even into the early 2000s, the chaebol groups continued to subsidise their sister companies with cross-loan payments.

While the debts of the top 30 chaebols had eased, their assets had also increased. The big four (Samsung, Hyundai, LG, and SK) now accounted for 50.9% of the top 30 chaebol's total assets, and 65% of their total sales. Consequently, there was a widespread consensus that the government's "big deal" program had assisted the expansion of the big four – however, they had not yet succeeded in removing malignant bank loans for the other chaebol groups.

South Korea's trade balance recovered to a surplus of $39 billion by 1998, however, this eased to $11.8 billion by 2000. This was partially because the initial surge in exports was accounted for by $2.13 billion of gold exports collected through the "gold-collecting campaign," a national sacrificial movement undertaken by 3.5 million Koreans nationwide in order to ease the IMF debt burden. However, the initial trade surplus was principally due to a demand-deficient decrease in imports rather than an increase in exports. In the longer run, very little credit was made available to bridge financing between import and export financing. As Korean exports relied heavily on intermediate and capital imports, the short-term cutbacks damaged long-term export capabilities.

The inflation rate increased precipitously after the IMF bailout, from 4.4% in 1997 to 7.5% in 1998. This was due to increases in import prices, albeit they were not directly attributable to the IMF program. Once the tight monetary and fiscal policy came into action by 1998, inflation eased to just 0.8% in 1999.

6.2 Government Labour Market Reforms

Before the crisis, most organisations had patterns of recruitment and advancement that incorporated the principles of promotion on seniority, whilst promising lifetime employment. As a result of the restructuring, the corporate sector's promise of job security (as aforementioned) was replaced by periodic layoffs, high job turnover, outsourcing, internships, and meritocratic advancement. This was observed in both the public and private sectors. By 2001, 16% of central government officials were displaced (about 26,000 employees).

The consensus of the existing literature is that this trend may eventually increase labour market flexibility. However, many were disdainful – as only the pains of the transition were immediately evident. Consequently, most blamed the government and political circles for their unemployment, as opposed to their own inability or deskilling. Large demonstrations were held constantly by labour groups and students following the crisis, who expressed discontent with the Tripartite Commission (only 3.3% believed that the Commission reflected the interests of the workers). 83.9% of the unemployed felt the need to mobilise as an independent social force.

It appears as though the unemployment policy of the government fell short of satisfying the desires of the unemployed, and its spending on social welfare as a percentage of GDP remained far behind that of developing countries. Whilst, on this surface, this may appear to be the fault of the Korean government – it is important to recognise that IMF conditionality prohibited a large budget deficit, and thus eliminated the possibility of Keynesian fiscal stimuli.

6.3 Monetary Policy

The IMF stabilisation package required the raising of interest rates from 12% to 27% by the end of 1997 and up to 30% by early 1998. The objective of this policy was to induce investors to save in domestic currency and attract foreign investment in order to stabilise the value of the Korean won. Moreover, high interest rates would dampen aggregate demand – which ought to have improved Korea's trade balance.

The policy succeeded in stabilising the currency market, as the high deposit rates offered by domestic banks suppressed the outflow of capital. However, this resulted in a widening income gap between the rich and poor, as the high interest policy had enriched those with large savings, but had adversely affected the rest of the working population (the lowest income quintile saw a decline in the total income share from 8.5% to 7.5%, whereas the highest income quintile saw an increase from 37.5% to 40.1% between 1995 and 2000).

Indeed, subsequent literature has suggested that the increase in Korea's foreign exchange reserves can be largely attributed to drastic reductions in domestic demand – and in this respect, the IMF prescription for high interest rates was excessive. The policy had ignored the pre-existing healthy macroeconomic conditions and had failed to achieve its primary objective of inducing capital inflows. Moreover, it had diminished investor confidence – as they were concerned that excessively high rates would bankrupt the Korean corporate sector.

However, Korea's trade balance quickly began to show some improvements – however these improvements were only short-term, as it was due to recession-induced reductions in imports.

As Korean industry depended heavily on raw material imports, the depreciated domestic currency hindered export growth. Consequently, this rendered recession-induced improvements in the trade balance unsustainable in the longer run.

The high rate policy also exacerbated the financial instability at a corporate level. Indebted chaebols, as aforementioned, already had a high debt-equity ratio, and the high rates resulted in excessively high debt-servicing costs. Smaller firms were even more adversely impacted, as their big business customers had been cutting back on production and investment. Consequently, small subsidiary firms were left with plummeting sales and forced to declare insolvency. During the first five months of 1998, all but 18 of the 5,239 corporations that went bankrupt were small firms (those with fewer than 300 employees). These small and medium-sized firms contributed disproportionately to the rising unemployment rate, which rose from 2% in November of 1997 to 7.6% in July 1998 (as government statistics did not distinguish part-time workers from full-timers, the actual jobless rate could have been much higher). Indeed, this also shattered the Korean tradition of lifetime employment, which generations of Korean workers had become accustomed to. Those that were not laid off were forced to succumb to pay cuts or freezes. The average jobless worker in Korea had three additional family members to support, so some 8 million people (a fifth of the population) had extreme difficulties making ends meet.

By January 1999, unemployment reached a record level of 8.5%. 25% of the total unemployment consisted of middle and high school graduates seeking unskilled jobs, followed by 12.3% for the 20s age group. Farm employment increased by 4.1% in July 1998, indicating a reverse migration from urban to rural areas. Paul Krugman argued that growth in the Asian tigers was driven by overinvestment as opposed to gains in productivity and that the government ought to support R&D efforts, development of world-class clusters to create knowledge networks, join ventures for technology transfer, and human capital development through educational reform.

6.4 IMF Financial Sector Restructuring

Rajan and Zingales from the University of Chicago[19] argue that the IMF financial sector reform package fundamentally changed the Korean model of capitalism from relationship-based (bank-based) to arms-length (Anglo-Saxon).

These terms are not widely recognised in academic circles, and thus I will go about defining them.

Relationship-based (bank-based) systems do not have an active liquid stock market where corporate securities are traded. Consequently, companies rely on bank loans to finance their investment. Before the crisis, most chaebol conglomerates were backed up by banks. If companies in a relationship-based system face turmoil, they are not threatened with takeover or liquidation, rather they are offered funds and professional guidance. As managers do not need to worry about takeover activities, they do not have the incentives to produce high profit margins (Korea had a tradition based on promotion by seniority as opposed to performance). This results in a misallocation of resources, and allocative and productive inefficiencies. Relationship-based systems are typically opaque, as information only flows between corporations and banks, without the knowledge of the general public. Consequently, there is very little transparency and accountability of corporations – which lends itself to balance sheet vulnerabilities. Relationship-based systems also lend themselves to collusive practices such as cronyism and nepotism.

Arms-length (Anglo Saxon) capitalism is very popular in the Western world and exists where the government promotes competition. Banks only play a small part in financing companies, so corporations need to issue securities to the public via financial markets. Consequently, they are obliged to submit relevant information to the public – and if the company faces financial trouble, they are under the threat of a takeover. This allows for efficient allocation of capital from less efficient hands to more efficient ones. In general, managers have the incentive to maximise profits and increase the value of the company's equity – as if the company performs badly, the shareholders will change managers.

[19] https://pdfs.semanticscholar.org/9552/91668690ed1946f87d24d64640e7e38cfaeb.pdf

Relationship-based systems have some benefits over Anglo-Saxon systems in the early stages of economic development. Relationship-based systems are more able to carry out long-term projects, as companies who are expected to constantly produce high profit margins for shareholders are not usually able to carry out long-term riskier projects. They are also particularly effective when contracts are poorly enforced, price signals are ineffective, and capital is scarce in the short-run.

However, as aforementioned, relationship-based systems suppress the price system and the signals it provides – and it can thus misallocate capital when presented with very large external capital inflows. Since the external capital comes from investors in an arm's length system, who have little contractual rights or power in a relationship-based system, and these investors are aware of the potential for misallocation, they typically keep their claims short term. This system is excessively prone to shocks.

The IMF reforms allowed for a freer, more transparent financial market that allowed for arms-length capitalism to flourish. This addressed the allocative inefficiencies that had been plaguing the economy, improved the crude balance-sheet practices, limited the extent of collusive practices, and improved incentives for senior management. This indeed stands as one of the IMF's greatest achievements during the crisis.

6.5 Social and Psychological Impact

As aforementioned, the high interest rate policy benefited a few rich who could live off their bank deposits with higher income. Indeed, the relative income of poor Koreans with respect to the richest Koreans fell to 28.5% in 1998 down from 31.4%, and that of middle-income Koreans fell to 68% down from 75%. The Korean government's Comprehensive Unemployment Program was not sufficient in order to keep inequality at bay.

Alongside growing inequality came growing social disturbance and violence. As the joblessness numbers increased precipitously, there was an explosion in the number of homeless people. Moreover, there was an increase in property-related crime rates, as well as the frequency of suicide. Robberies rose by 60% in the first half of 1998, with the incarcerated population growing by 20% in the same time period.

The crisis also threatened to undermine the foundations of Korean family structure. 45.6% of the unemployed were heads of the household, and of those households of at least one unemployed person, 40.7% had no income earner at all. Korean families had traditionally been highly dependent on the father and husband for the predominant share of economic resources, and thus the huge increase in unemployment had the potential to uproot such patriarchy. 23.9% of unemployed households said they had experienced a serious marital crisis due to the crisis. 6.6% reported increased juvenile delinquency by their children, and 8.3% were forced to split up their family since the start of the crisis. Traditional Korean values placed high emphasis on the integrity of the family, yet after the crisis, the National Police Office reported a 46% increase in domestic crime, and a 34.5% increase in divorce (however, this was partly caused by businessmen who took advantage of divorce in order to protect their properties by transferring them to their wife, having declared bankruptcy).

Children were also detrimentally impacted by the crisis. The Ministry of Health and Welfare reported a 38% increase in the number of children who needed the protection of either the government or social charity corporations from 1997 to 1998. Especially, the number of handicapped and illegitimate children seeking protection increased by 80% between 1997 and 1998. Subsequent literature has attributed this increase due to the high cost of abortion in the situation of salary cuts and unemployment. Economic difficulties also saw the number of Korean children being adopted from abroad increase for the first time since 1987 (which had previously been disparaged by the government as a dishonourable “orphan export”).

Mental health concerns were also considerable in the wake of the crisis. A joint research project conducted by the Korea Institute for Health and Social Affairs and the Korea Labour Institute found that 36.7% of the unemployed surveyed had experienced psychological instability. The average duration of frictional unemployment was around 4.71 months, and studies have shown that the longer the unemployment period – the greater the incidence of psychological instability. Consequently, with the increase in unemployment during the crisis, such mental effects would have intensified.

7. SUMMARY AND CONCLUSION

Before the crisis, South Korea was a robust economy. Per capita incomes were as high as Spain, savings rates were high, inflation was low, and the budget was balanced. However, it faced issues regarding external debt, which had been allowed to perpetuate with weak financial regulation and inadequate systems of corporate governance. Ultimately, as the contagion began to spread from neighbouring Indonesia and Thailand, Korea found its economy rapidly weakening as it faced preponderance levels of capital flight. Economic activity collapsed and 5 million people fell into poverty.

The IMF offered South Korea a loan of over $57 billion, the largest loan out of all the East Asian countries. The conditions, whilst broad, were typical. They involved financial sector reforms, such as fiscal tightening, trade, and capital account liberalisation – as well as facilitating some labour market reforms. An independent central bank was formed, which focused on inflation control, and a separate supervisory institution was created to oversee all corporate and financial operations.

The reforms offered alongside the bailout package fundamentally transformed the economic model of South Korea from relationship-based to Anglo-Saxon. Existing financial institutions facing trouble were shut down or recapitalised, restrictions on overseas borrowing were removed, and banks were forced to adhere to the Western standards of credit evaluation. The chaebol monopolies collapsed as the IMF lowered import tariffs, allowing for sectors such as the automobile industry to be exposed to international competition.

Controversially, the IMF reform package also stipulated the raising of interest rates to 27% by the end of 1997. This was intended to stabilise the value of the won by attracting foreign investment, whilst also inducing Korean investors to keep their savings in domestic currency. However, these measures almost certainly prolonged the recession and resulted in a prolonged period of stagflation.

The IMF’s high interest rate policy succeeded in stabilising the currency market by restraining the outflow of domestic capital, but this was at the cost of significant intensification of income inequality between the rich and poor population. The interest policy also did not achieve its intended purpose of increasing foreign investment – rather it reduced investor confidence in the economy as there was a general level of concern that high interest rates would bankrupt the Korean corporate sector.

The IMF policies also had a considerable social impact, an area not yet explored by the existing literature.

The Korean economic model had been in existence for half a century and had lifted tens of millions out of poverty. For the Korean government, it was difficult to abandon a macroeconomic model that had brought so much success, yet many eventually resigned themselves to the notion that the IMF bailout conditionality was the only path to recovery. Shin and Hayo’s 2002 study of Korean reactions to the IMF intervention suggests that many people were critical of the reforms, but ultimately agreed that this had helped to facilitate long-term recovery. However, opinions were highly polarised, as some groups were more badly affected than others. For instance, those paying a mortgage towards a property were more critical of the IMF’s fiscal austerity policies, as it had raised interest rates on floating rate mortgages.

The IMF has faced many criticisms with regard to its approach to the crisis. Economists have labelled the bailout package conditionality as a “golden straitjacket” that reflected very little consideration of the intricacies of the Korean situation.

Whilst Korea recovered fairly quickly compared to the other Asian tigers, it came at the expense of mass unemployment and deep-seated structural reforms. The IMF’s monetary and fiscal policies were based on the Anglo-Saxon premise that only free markets were able to provide efficient economies, and government intervention would not be necessary. The Fund held the view that the crisis was caused principally by flaws in Korea’s macroeconomic fundamentals.

However, as we have explored, studies have shown that the macroeconomic fundamentals were adequate before the crisis began. Indeed, it is important to remember that it was the IMF itself that had pushed the Asian tiger countries towards opening their markets – and as has been highlighted, this rapid capital liberalisation was inappropriate for economic growth. Moreover, the Korean government had a budget surplus and foreign exchange reserves which could have been used to stimulate demand in the economy, however, the IMF opposed government intervention.

This discussion concludes that whilst the IMF's recovery package provided several benefits for the Korean economy, their high interest rate policy came at a substantial social cost including the loss of income and unemployment. Moreover, the IMF fundamentally failed in its forecasting role, as they did not foresee the detrimental impacts of the capital market liberalisation they had been relentlessly promoting.

Whilst a shift to Anglo-Saxon capitalism was appropriate for Korea, the IMF policies were unnecessarily stringent, and prolonged the period of recession. Whilst the labour market reforms partaken by the Korean government may not have been as extensive as they ought to have been; IMF conditionality limited the extent of interventionist policies on behalf of the government – and consequently largely kept the democratically elected governing body on a leash. Even if the Korean government had wanted to implement Keynesian fiscal stimuli, the conditions of the IMF bailout would have prohibited them from doing so.

In 2013, the IMF acknowledged its failings in the Asian Financial Crisis – and indicated that it was aiming to improve its functioning as an international financial institution in order to better reach its goal. Whilst they have offered few specifics, it appears obvious that IMF policy prescriptions ought to include guidelines for implementing social safety nets.

Whatever reform measures the IMF may take, it is unlikely that the continent will ever put their trust blindly in the hands of an international financial institution ever again.

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[i] The structural adjustment loan (SAL) is issued by the IMF, and carry strict financial and budgetary obligations, or required reforms intended to open recipient countries to private investment and increase the recipient's competitiveness in the global economy. These typically include liberalisation, privatisation, and reduction in government expenditure.