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Abstract

In December 1997 the IMF offered Korea loans to help alleviate its financial crisis. These loans were accompanied by what the IMF called "extreme structural conditionality." Korea was required to replace its traditional East Asian economic system with a neoliberal model. We review economic performance in the neoliberal era. Growth has slowed, poverty and inequality have risen, and investment spending has stagnated, while foreign ownership of Korean firms and banks has skyrocketed. We argue that foreign investment has not helped Korea. For example, by leading a shift from corporate to consumer lending, foreign control of Korea's financial markets has constrained capital accumulation and helped create an excessively indebted household sector, while making it harder for the government to adopt progressive economic policies. We conclude that the eight year experiment with radical neoliberal restructuring has turned out well for foreign capital and wealthy Koreans, but has been a failure for the majority of Korea's people.

JEL codes. O19; F34; F36

I. Introduction

Prior to late 1997, Korea's state-guided East Asian economic model was widely admired by Western economists, the IMF and the World Bank for its exceptional long-term development record. For example, Stanley Fischer, later to become chief economist for the IMF, wrote in 1996 that "there really has been a miracle in East Asia" and that the view that government action was central to this success is "widely shared" (1996, pp. 345 and 347).

In the decade preceding 1997, under external pressure from G7 governments, foreign firms and banks who wanted to share in the Korean 'miracle,' and internal pressure from the large family-owned conglomerates known as chaebol and wealthy individuals who wanted freedom from government restraint, the structures of Korea's state-guided economy were dismantled. The state ended its traditional control of chaebol investment decisions, substantially reduced its regulation of domestic financial markets, and loosened control of cross-border money flows, with short-term capital flows most aggressively deregulated. Chang and Evans argue that "the dismantling of the development state was effectively finished by … 1995" (2005, p. 115). Foreign short-term credit, which stood at $12 billion in 1993, rose to $32 billion in 1994, $47 billion in 1995, and $67 billion in 1996. These funds helped create an over-heated, investment-led boom and created serious financial fragility in the economy. In 1997, after the outbreak of the Asian financial crisis, foreign banks refused to renew short-term loans, demanding payment. Illiquid Korean banks and highly leveraged firms were unable to comply. With key banks and nonfinancial corporations on the verge of default, the Korean government accepted an IMF loan to help repay their foreign debt. In return, the IMF took effective control of the Korean economy.

The post-crisis conventional wisdom asserts that the structure of Korea's economy prior to the crisis was fatally flawed. Mainstream economists acknowledge that the liberalization of short-term capital flows created the dramatic rise in short-term foreign debt that triggered the crisis. However, they insist that liberalization was not the fundamental cause of the crisis; it merely exposed the underlying rot within. (See MOFE 1999, Greenspan 1999, Brittain 1997, Hahm and Mishkin 2000, Borensztein and Lee 1999, and Krueger and Yoo 2001.)

There is an alternative interpretation of recent events in Korea, whose adherents include numerous heterodox scholars (Chang 1998, Singh 1999, Wade and Veneroso 1998, Crotty and Dymski 2001, Crotty and Lee 2001) along with a few prestigious mainstream economists such as Joseph Stiglitz, former Chief Economist for the World Bank, and Harvard's Dani Rodrik. They argue that the major cause of the crisis was not *inherent* inefficiencies in the structure of the Korean development model, but rather *contingent* inefficiencies primarily created by a liberalization process that disastrously weakened the structural integrity and coherence of the traditional Korean economic system.[1] In this view, the problem in the 1990s was not too much state intervention, but the elimination of government functions essential to efficiency within the Korean model. (This thesis is defended theoretically and empirically in Crotty and Lee 2004.) In particular, absent the deregulation of short-term capital inflows in the 1990s, there would

[1] We do not deny that the Korean 'model' had developed serious problems prior to the crisis and was therefore in need of substantial reform.

have been no system-shaking financial crisis, no IMF takeover, and no radical neoliberal restructuring.

The IMF acknowledged in statements made both just before the crisis and several years after it that Korea faced a liquidity crisis in late 1997, not a systemic failure. The October 1997 IMF report on Korea, called attention to the "absence of deeper solvency concerns." At that time, the IMF's worst-case scenario for Korea in light of the Asian crisis was a modest drop in the growth rate to 4.5% in 1998 (IMF 2003, pp. 162-63). Yet in December 1997, just two month later, the IMF declared that the Korean economy was in a state of profound structural dysfunction, requiring radical emergency surgery. This was the reason it imposed what it called "extreme structural conditionality" on Korea, along with tight monetary and fiscal policy to restore foreign investor confidence (IMF 2003, p. 179). The IMF's post-crisis evaluation report of 2003 says that if the IMF and World Bank had announced that they would provide Korea with as much foreign exchange as it needed, there would not have been a financial crisis at all.

The IMF's long-term objective was the destruction of the traditional Korean model. In its explanation of its response to the Asian crisis offered in January 1999, the IMF emphasized that "forceful, far-reaching *structural reforms* are at the heart of all [our] programs, marking an evolution in emphasis from many of the programs that the IMF has supported in the past" (emphasis in original). The structural reforms included the need to "break the close links between government and business" that define the East Asian model, "ensure the integration of the national economy with international financial markets," increase the "potential for foreign participation in domestic financial systems," and "remove impediments to growth such as monopolies [i.e., the chaebol system], and trade barriers…" (IMF 1999). We are especially concerned here with IMF demands for full integration with international financial markets and open access for foreign financial firms. The IMF acknowledged the existence of strong outside pressure on the policies it imposed on Korea. "The IMF's major shareholder governments made no secret of their view that IMF assistance should be accompanied by strong reforms. The U.S. authorities in particular insisted that strong reforms should be a condition of IMF support" (IMF 2003, p. 185**).**

The IMF had an enthusiastic partner in President-elect Kim Dae Jung. In a 1985 book titled *Mass-Participatory Economy: a Democratic Alternative for Korea*, he stated that "maximum reliance on the market is the operating principle of my program" and that "world integration is our historic mission" (1985, pp. 78 and 34). "I believe that the crisis will be remembered as a blessing," Kim announced in 1999, "because it is forcing essential economic changes" (*New York Times*, Feb. 18, 1999).

The goals of the IMF-Kim team were as follows. First, to create a fully 'flexible' labor market. President-elect Kim was determined to erode the domestic market power of large chaebol firms and raise their efficiency through massive foreign investment, which would not take place unless Korea's militant unions were tamed. Breaking the labor movement thus became a central policy goal. For the first time in modern Korean history, firms were allowed to fire as many workers as they pleased in cases declared to be of "urgent managerial need" (which included foreign takeovers), and temporary help agencies were legalized. Second, to end government interference with the free-market allocation of finance through conversion from a state-guided, bank-based to a globally-open capital-market based financial system. The government's objectives here were to drastically reduce credit flows to the chaebol groups and induce foreign banks to take control of much of Korea's banking system in order to improve its allocative efficiency. The stock market was to replace owning families as the controlling power of chaebol firms. Third, to move toward "world integration" and help break the power of chaebol by fully opening all Korea's markets to foreign firms. *"What we need now, more than anything else, are foreign investors,"* Kim stated in an address to the U.S. Congress in 1998. These goals were accepted by current President Roh, much to the regret of the trade unions and progressive activists who made his election possible.

In the next section, we briefly review economic performance in post-crisis Korea and discuss the impact of capital market opening on Korea's economy. Section III analyses the results of financial market liberalization and foreign ownership of Korean banks, while the last section draws conclusions and discusses policy options.

II. Neoliberal restructuring: slow growth, high inequality, and the rising influence of foreign capital

Post-crisis Economic Performance

Though many Korean firms had become very financially fragile, the IMF raised the short term interest rate from 13% in early December 1997 to 34% just one month later, holding it above 20% through mid 1998. It imposed restrictive fiscal policy as well. Real GDP growth fell by 6.9% and domestic demand by 13.8% in 1998. Thus, the cause of the near-depression conditions of 1998 and early 1999 was the perverse policy response to the Korean crisis put in place by the IMF-Kim team.

As can be seen in Table 1, the economy rebounded in 1999 and 2000 due to a radical shift in macro policy, a record trade surplus, a sharp rebound in consumer spending and a huge injection of public funds into the financial sector. It experienced a mild recession in 2001 as investment slumped and the trade surplus declined. Rapid growth returned in 2002 as consumer spending rose by an impressive 7.6% and investment increased. The economy slumped again in 2003 as consumption spending actually fell – its growth rate declined by 7.9 percentage points from a year earlier, and capital formation slowed. The 3.1% GDP growth rate in 2003 was the lowest in the past two decades, 1998 excepted. Strong growth in net exports raised economic growth modestly in 2004 even in the face of stagnant consumption and investment spending. Most projections for GDP growth in 2005 are below 4%. Post-crisis performance is thus far inferior to pre-crisis achievements: the average rate of GDP growth from 1998-2004, at 4.2%, is much lower than the 8% averaged in the entire pre-crisis regime and the 7.1% in 1993-97.

Table 1. Economic performance after the crisis in Korea (%, $ billion)

	1993-1997	1997	1998	1999	2000	2001	2002	2003	2004
Real GDP growth	7.1	4.7	-6.9	9.5	8.5	3.8	7.0	3.1	4.6
Consumption growth	6.5	3.2	-10.6	9.7	7.1	4.9	7.6	-0.3	0.2

Fixed investment growth	12.3	-2.3	-22.9	8.3	12.2	-0.2	6.6	4.0	1.9
Net export/GDP	-1.1	-0.6	12.9	6.7	3.2	2.3	1.4	2.4	4.4
Government deficit/GDP	-0.0	-1.4	-3.9	-2.5	1.1	1.2	3.3	1.1	0.7
Household debt/GDP	40.5*	46.6	41.3	44.3	51.1	62.0	73.6	--**	
Foreign reserves ($ billion)	21.7	8.9	48.5	74.1	96.2	102.8	121.4	155.4	199.1
Debt ratio in manufacturing	319.5	396.3	303.0	214.7	210.6	182.2	135.4	123.4	104.2
Ordinary profit/Sales in manufacturing	1.7	-0.3	-1.8	1.7	1.3	0.4	4.7	4.7	7.8

Source: BOK, National Accounts, based on 2000 prices

* Household debt is average from 1994 to 1997

** Due to the change of GDP statistics, direct calculation is impossible.

In 1999 the government decided to strengthen domestic demand and reduce Korea's excessive dependence on export growth. The only way to achieve this admirable goal on a long-term basis would be to increase jobs and real wages, while stimulating domestic investment. The government chose instead to deregulate consumer lending and provide tax incentives for consumer credit. This policy was a short-term success; the average growth in consumer spending was a spectacular 7.4% from 1999-2002. A residential real estate boom took place at the same time that added to household indebtedness. This government policy left a crushing household debt problem in its wake. Household debt as a share of GDP rose spectacularly -- from 41% in 1998 to 74% in 2002. This share is now as high as in the low-saving US, but the situation is more precarious because the ratio of financial assets to debts is only about half the US value. An outbreak of defaults that devastated the credit card industry combined with an end to government borrowing incentives brought consumption spending to a stop in 2003 and 2004. On average, consumption, which grew at annual rate of 6.5% in 1993-97, inched ahead at 2.3% a year from 1997-2004.

Most important, post-crisis investment spending stagnated. Gross investment ranged from 35% to 40% of GDP from 1990-97, but has been between 25% to 31% since then. A BOK survey shows that private sector equipment investment, a key foundation for productivity growth and the future competitiveness of Korean firms, which collapsed in the crisis of 1998 and rebounded in 1999 and 2000, has failed to grow since then (BOK 2004). Equipment investment was lower in 2004 than in 1996. Investment problems are most serious in small and medium companies.[2] Investment stagnation poses a serious threat to future prosperity.

Investment has been constrained by several forces. Domestic demand growth has slowed significantly while volatility and uncertainty have risen. Profits were low through

[2] According to a survey by the Korea Industrial Bank, large firms' equipment investment started to increase in 2004 while that of small and medium firms shrank by 34%. These companies have lower profitability than most giant firms and cannot get adequate bank funding.

2001, hindering investment. Starting in 2002, corporate profitability improved due to a fall in interest payments (as debt declined and interest rates fell) as well as a drop in labor's share of income, but investment did not respond.[3] In the new Korean economy, profits are increasingly used to raise dividends, buy back shares, and create a cash stockpile, rather than finance investment. Foreign-controlled banks have led a strategic shift in banking away from corporate to consumer lending, drying up a major source of investment finance. An increase in outward FDI that began in the mid-1990s also contributed to the investment malaise. While inward FDI was about $13 billion in 2004, outward FDI hit $8 billion, almost half of which went to China. 63% of outward FDI was by manufacturing firms, raising fear of a 'hollowing out' of Korean manufacturing (*Korea Herald*, "Korea's overseas investment jumped in 2004," January 26, 2005). In the first half of 2005, outward FDI exceeded inward FDI.

Thus, the only buoyant demand category in the past two years was net exports. How ironic! Government policy tried to shift demand from exports to domestic spending, yet domestic demand is sluggish while export dependence grows. Export plus imports as a percent of GDP rose from 65% in 1997 to 84% in 2004 -- when the ratio of net exports to GDP hit 4.4%. However, the export boom is itself unsustainable: the won has appreciated recently, imported energy prices are rising, firms continue to rely on imported intermediate goods, and export growth increasingly depends on a super-heated Chinese economy. Moreover, such heavy export dependence is irrational because the terms of trade have collapsed since the crisis.

Neoliberalism exacerbated the fragmentation of Korea's economy and society. The gap between large chaebol firms in the export sector and small and medium firms in the domestic sector has been increasing; many of the former are doing well while the latter suffer. The link between the export and domestic sectors appears to be weakening; fast growing export oriented ICT industries such as semiconductors and mobile phones rely heavily on imported intermediate goods. Thus, export growth does not trigger as much domestic spending as before (Lee et. al. 2004).

Social fragmentation also increased. The share of workers with 'irregular' jobs, including workers with temporary contracts and part-time jobs, is, at 56%, the highest in the OECD. Wages and working conditions for irregular workers are much worse than for those with permanent jobs. "Nonregular workers are paid lower wages [about half], are entitled to fewer benefits and are not well covered by the safety net… less than 8% of nonregular workers are covered by unemployment insurance, medical insurance or the national pension"(IMF 2004, p. 36). Labor's share of income fell significantly, from 62.3% in 1997 to 58.8% in 2004. Since the share of employed persons categorized as 'workers' increased from 61.7% in 1998 to 66% in 2004, the erosion of labor's economic share is serious. Meanwhile, the percent of workers who belong to unions is declining steadily.

Indices of inequality increased substantially in the aftermath of the crisis and remained high since then. The Gini coefficient for urban workers' families is about 10% higher now than in 1997, while the ratio of the income of the top 20% of working

[3] Operating profits/sales have been lower than in the pre-crisis era, which suggests that allocative efficiency has not improved. (Operating profits are measured before the deduction of interest payments and certain other expenses.) However, a dramatic reduction in financial expenses/sales substantially raised ordinary profits/sales after 2001.

families to the bottom 20% rose from 4.5 in 1997 to 5.9 in the first quarter of 2005 – a record high for Korea.[4] The rise in the ratio of the top to the bottom 10% rose by a third. Government policy does little to ameliorate rising inequality. In contrast to developed countries, Gini coefficients calculated with and without the inclusion of government transfers and taxes are not significantly different. The poverty rate more than doubled since the crisis, but the welfare system, while improved, remains inadequate to deal with the social problems created by neoliberal policies. Social welfare spending is just 10% of total government spending. Unemployment compensation is technically available to more workers in the new Korea, but in 2003 only 19% of the unemployed actually received benefits (IMF 2004, p. 39). Even the research institute of the conservative Bank of Korea recently published a report calling for efforts to establish a virtuous cycle between the export and domestic sectors and reduce income inequality (Lee et al. 2004).

Economic opening and capital inflows

Capital account liberalization was the proximate cause of the crisis, yet in response, the Kim government, under pressure from the IMF and the G8, dramatically accelerated the pace of financial opening. In May 1998 the government abolished limits on the percent of corporate stock that foreigners could own. Regulations on foreign investment in most corporate bonds, in the forward market and in commercial paper were eased or abolished. The government permitted hostile M&As by foreign investors after 1997 and made a concerted effort to sell important financial institutions to foreign buyers (MOFE 1999, pp. 137-151). Restrictions on foreign borrowing by domestic firms were further liberalized in 1998. In April 1999 the government permitted nonresidents to hold long-term deposits in domestic financial institutions, further deregulated firms' short-term foreign borrowing, accelerated deregulation of real estate investment abroad, and permitted all Korean financial institutions and individuals to engage in foreign currency transactions. In 2001 regulations on individuals' purchases of foreign currency and spending abroad were repealed, and domestic deposits by foreign financial institutions and the purchase of foreign bonds by Koreans were deregulated (*Korea Economic Daily*, April 23, 2000; MOFE 2000). Regulations on nonresidents' bond issuance and borrowing in domestic currency were repealed in 2002, as were foreign exchange transactions of financial institutions, including derivatives trading. By 2006, remaining restrictions on foreign capital transactions will be lifted (MOFE 2002).

Capital flows increased rapidly in response. As can be seen in Table 2, though net portfolio inflows have been modest, both inflows and outflows have grown rapidly, and are now very large (both exceeded $100 billion in 2004) and extremely unstable. In 2004 portfolio inflows were almost nine times as large as in 1998. Large and volatile short-term capital flows have created substantial instability in stock prices and the exchange rate. Korean stock prices now respond primarily to changes in US investor sentiment: the correlation between US and Korean stock prices is high (BOK, 1999). The Korean stock market has become a gambling casino for foreigners. In just three weeks in May of 2004 "massive withdrawals of investment funds by foreign investors" caused the KOSPI stock market index to fall by 22% (*Korea Herald*, "Foreign funds outflow from bourse easing"

[4] This survey covers workers' families living in cities. For all families in cities, the top 20%/bottom 20% ratio is 8.2.

June 10, 2004).

Table 2. Foreign capital flows in Korea after the crisis ($ billion)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
FDI inflows	3.2	6.9	8.8	15.5	15.2	11.3	9.1	6.5	12.8
Portfolio									
Inflows	12.6	13.2	16.5	41.7	60.1	43.9	65.4	81.6	116.2
Outflows	8.0	12.1	11.7	36.2	48.8	36.4	66.2	68.1	106.8
Net inflows	4.6	1.1	4.8	5.5	11.3	7.5	-0.8	13.5	9.4
Total (portfolio inflows + outflows)	20.6	25.3	28.2	78.0	108.9	80.4	131.6	149.6	222.9

Source: Bank of Korea and Ministry of Commerce, Industry and Energy.

In recent years the Bank of Korea has been forced to ‘sterilize’ the inflow of foreign funds (created by capital inflows and huge trade surpluses) by issuing ‘Monetary Stability Bonds’ (MSB) to ensure that the trade surplus is not destroyed by a rapidly appreciating won. The BOK sold large quantities of won in exchange for foreign currencies, creating a $200 billion pool of foreign reserves in the process, and simultaneously issued won denominated bonds to limit the supply of won in public hands. The supply of MSB increased from 23.4 trillion won in 1997 to 105.5 trillion in 2003 and 142.8 trillion won in 2004. The increasing interest burden associated with this aggressive sterilization policy recently pushed the BOK into deficit for the first time in a decade. The ever-rising foreign reserve hoard comforts those who remember Korea’s vulnerability in the 1997-98 crisis, but excessive exchange reserves are a costly form of protection, and they could not prevent financial instability in the event of another bout of exceptionally rapid capital outflows. It would be far more effective to reinstitute effective controls over short-term capital flows (a thesis defended in Rodrik 1999).

Korea’s capital market opening also led to a surge of inward FDI. President Kim forced Korea’s highly indebted chaebol conglomerates to put key assets on the market after 1997 by demanding that they cut their debt-to-equity ratios in half -- in just two year. Thus, only foreign firms could afford to bid for the assets they disgorged. (See Crotty and Lee 2001 for a detailed description of this process.) Moreover, capital flight in late 1997 and early 1998 caused the value of the won to collapse – from 844 won per dollar in 1996 to 1415 in at the end of 1997. Korean assets were thus offered to foreign capital in a fire sale not open to domestic bidders. Encouraged by deregulation, fallen asset prices and a collapse in the value of the won, cumulative FDI inflows from 1998-2000 were two-thirds larger then total inward FDI from 1962 to 1997. Korea got little in return. The lion’s share of asset sales were in the form of M&As. New capital assets were not created, existing assets merely changed ownership.[5] There is no convincing evidence

[5] Foreign takeovers were “Purchase and Assumption” deals in which foreign investors bought only the good assets of the firms while bad assets and debts were shifted onto newly created public institutions. When this was accomplished, foreign owners established a new firm and bought its stock. Thus, M&A-type FDI is greater than the total acquisition of outstanding stock. In 2000, the share of greenfield investment was reported to be less than 10% of total FDI (*Hankook Kyoungje Shinmun*. Apr. 12. 2000). According to a UN report, M&As were the dominant form FDI in East Asia since the crisis, a finding confirmed by Mody and Negeshi (2001).

that FDI inflows were helpful to the recovery process in Korea or in East Asia (Mody and Negishi 2001).

Is foreign capital helping Korea's economy?

Foreign stock ownership, especially of important chaebol firms, increased dramatically post-crisis. The share of foreign ownership of Korea's publicly held stock increased from 15% in 1997 to 22% in 1999, 37% in 2001 and 43% in early 2004. Foreigners have gained strong influence in important industries such as semiconductors, autos, petrochemicals, and finance. The foreign ownership share of the ten firms with the largest market capitalization has risen to an astounding 54% (*Korea Herald*, "Foreign investors flock to Korean stock market," January 19, 2005). Control of most chaebol conglomerates by their domestic owners has been sustained in the face of rising foreign ownership through interlocking ownership among chaebol firms and controlling-family ownership of unlisted shares.[6] However, foreigner owners have recently tried to control the investment policy and corporate governance structures of the firms they hold stock in. A foreign equity fund tried on several occasions to take control of the SK group, the third largest chaebol in Korea. Even Samsung, Korea's largest and most profitable company, appears vulnerable to a foreign takeover. The corporations precariously controlled by domestic insiders have begun to incorporate fear of foreign takeover into their strategic decision making. This reinforced the investment constraining behavior mentioned above. These firms hold more cash, pay more dividends (dividend payments to foreigners rose from $ 0.4 billion in 1998 to $ 3.1 billion in 2003), and make more stock buybacks than they did previously. "This trend has spurred the largest shareholders of Korea's listed companies to increase ownership in their companies to defend managerial control against what they perceive as increasing takeover threats, raising concerns about already sagging corporate investment" (*Korea Herald*, "Foreign investors increase stakes to gain more input," June 21, 2005).

It is not clear that the transfer of advanced technology by foreign firms sought by President Kim has taken place. Foreign ICT companies repatriated 98% of profit in 2002 with almost no domestic investment or R&D spending (*Seoul Kyoungje Sinmun*, November 23, 2003). Worse yet, Korea's top chaebol firms never did require a technology transfer from abroad to remain competitive in their domestic and global markets, as the success of Samsung, Hyundai, POSCO and LG demonstrate.

Curiously, as the costs of foreign portfolio and FDI inflows and outflows become clearer and the benefits less certain, the government has increased its efforts to attract foreign capital. Given Korea's experience with foreign capital since the crisis, this continued hunt for yet more FDI is astonishing, and demonstrates the utter futility of economic policy-making since 1997.[7]

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[6] Listed firms account for about 61% of the 30 top chaebols' capital. Insiders, such as owner-families and affiliate firms, controlled 65% of unlisted firms and 32% of listed firms in 2001, suggesting an insiders' total share of 45% in 2001. In 2004, the total insiders' share of the top 15 private chaebol (excluding public firms) was 46.4%.

[7] The fact that total investment was a higher share of GDP than domestic saving provided a superficial defense of the need for foreign investment before the crisis. However, saving has exceeded investment in the post-crisis years; in 2004 gross saving exceeded domestic investment by 4.6% of GDP.

The most troubling problems created by rising foreign ownership have taken place in the financial sector. They are analyzed in the next section.

III. Financial Liberalization and the Effects of Foreign Bank Ownership

Global shareholder capitalism

The neoliberal model that has guided Korean restructuring envisions a world in which efficient capital markets decide how much is invested in each country and what the allocation of finance across competing uses will be. Those who own financial capital are free to send it to whatever country offers the best expected returns. Supporters of neoliberalism argued that financial capital would flow from the capital rich advanced countries to the capital poor but opportunity rich developing world, accelerating poor country growth. To benefit fully from the new system, it was argued, Korea would have to open its financial markets to foreign firms. World-class foreign banks would bring state of the art technology and managerial systems to Korea's dysfunctional financial system. This is *global shareholder capitalism*, a system in which efficient stock and bond markets are supposed to shift financial capital from poorly run firms to those most efficiently managed. A vigorous market for corporate control is essential to its operation: stock markets must punish inefficient companies by slashing their market value, making them attractive takeover targets for more capable domestic or foreign management teams.

We believe this guiding vision is fatally flawed; adopting its policies is a recipe for instability, economic stagnation, and rising inequality. No country that trusted lightly regulated financial markets to make its saving and investment decisions has ever had a successful development experience (Chang 2002, Amsden 2001). To take one example of its shortcomings, in recent years capital has moved from developing countries, especially in Asia, to the US – not the other way around. America currently receives about three quarters of all the capital that crosses national borders. Most of the money that does go to developing nations is concentrated in a few countries, with the state-guided Chinese economy getting the lion's share. Because capital flows have become so volatile in the neoliberal era, many countries have been hit by devastating currency and banking crises.[8] In response to such crises, countries in Asia have built absurdly large stocks of dollar reserves to protect against runs on their currencies. It has been estimated that the cost of holding excessive reserves in East Asia is between one and two percent of GDP (Baker and Walentin 2001).

As noted, managements are under increasing pressure to keep stock prices high even in the shortest of runs to avoid hostile foreign takeover. Managers also seek rising short-term stock prices in order to maximize the value of management stock options, a form of compensation that dominates the top echelons of US companies and has begun to penetrate Korea. Samsung executives made almost one trillion won in capital gains on

[8] Advanced countries are not immune to these dangers. In the early 1990s, several Scandinavian countries experienced financial crises following financial liberalization. In the late 1990s, rising US stock prices, inflated by massive accounting fraud in such companies as Enron and World Com made possible by excessive deregulation, led to over-investment in ICT industries. An ICT spending collapse ensued, leaving three-quarters of a million workers idle.

their stock options last year (*Korea Herald*, "Samsung execs stock-option gains put at W1 tril," September 24, 2004). Using stock price as the main index of managerial competence might be reasonable if stock prices reflected long-term enterprise 'fundamentals' – as in efficient markets theory. But as Keynes stressed decades ago, lightly regulated financial markets are prone to bubbles and herd behavior. The stock turnover ratio in Korea is among the world's highest. In 1999 the 'average' Korean stock was sold about 3.5 times, convincing evidence that stock prices cannot possibly reflect long-term "fundamentals" (*The Economist*, June. 24, 2000, p. 122) It would be irrational for the average investor -- who will own a stock for less than four months -- to be concerned with long-term prospects. Moreover, pressure to use the firm's internal funds to raise dividends and buy-back stock reduces the internally generated funds available to finance investment spending, as it has done in the US (Crotty 2002). Shareholder capitalism thus imposes a short-term planning horizon on managements that, in concert with increased uncertainty and decreased internal and external sources of finance, constrains and distorts long-term investment.[9]

No country is in practice willing to put its economic future completely in the hands of domestic and foreign stock and bond speculators -- no matter how deep its ideological commitment to neoliberalism. Rapid stock price declines, which in neoliberal theory are rational signals to cut investment, have triggered government efforts to push prices up again. In late 2004, for example, the government announced a "plan to mobilize public funds, including the national pension fund, to prop up the stock market (*Korea Herald*, "Plan to mobilize pension funds faces criticism," November 20, 2004.) Such policies clearly indicate that the government believes it is a better judge of the optimal rate of capital investment than financial markets – an implicit rejection of shareholder capitalism.

The foreign takeover of Korea's banking system

Opening Korea's financial markets was a central component of the strategy to move rapidly from a highly regulated and "repressed" financial system to a lightly regulated and globally open one. President Kim and the IMF believed that domestic banks were too backward to lead the financial revolution. Designed for a radically different purpose, domestic banks had neither the managerial skills, the experience, the technology, the organizational structure, the strategic orientation nor the access to capital required to replicate sophisticated financial markets in North America and Europe. As President Kim put it: "Under the strategy of government-led economic development, the government used the financial industry as a tool to implement its industrial policies… Consequently, Korean financial institutions have been significantly less sound and profitable than their foreign counterparts" (MOFE 1999, p. 87.) Foreign institutions were thought to be required to change the structure and efficiency of Korea's financial markets quickly. Domestic banks would be forced to compete with them -- on their terms -- or fade into oblivion. Since the government had effectively nationalized many Korean financial institutions in the process of absorbing their bad debts -- at an enormous cost of

[9] The *Wall Street Journal* explains the problem in the US as follows. "Even companies enjoying strong profits and cash flow are building cash hoards, reducing debt and buying back their own shares – instead of making investment bets" ("Global Economy Depends on Investment," July 21, 2005).

some $140 billion, it was in position to sell these firms to whoever it wanted. Kim wanted foreign buyers. There was a subsidiary advantage: foreign firms had no commitment to existing stakeholders, whereas domestic firms had implicit contracts with their workers as well as with the domestic firms that were their long-standing customers. Thus, outsiders could be counted on to immediately slash both labor costs (employment in finance dropped by 40% from 1997 to 2002) and corporate lending, which would help achieve the rapid reduction of chaebol indebtedness demanded by President Kim.

The initial buyers were private equity firms. Their strategy was to buy troubled firms cheaply, then sell them quickly for substantial capital gain. The process started with the sale of Korea First Bank to Newbridge Capital in 1999, followed quickly by Lone Star's takeover of the Korea Exchange Bank. The Korean government gave Newbridge a sweetheart deal. After spending 12.6 trillion won to clean up the bank's bad debts, it sold the bank to Newbridge for one-half trillion won. But it also agreed to buy any assets that turned sour in the next three years, which cost the government an additional 5.1 trillion won – ten times the sale value! Newbridge sold Korea First to London-based Standard Chartered Bank for 3.4 trillion won in early 2005 – almost seven times its purchase price. Carlyle's sale of the Korean-American bank generated a 250% return on investment, while Lone Star made 1.5 trillion won on the sale of Korea Exchange Bank. None of these banks paid any capital gains tax, which infuriated the public.

Under these conditions, any foreign private equity firm that could hold on to its newly acquired Korean bank until financial markets were restored to some degree of health was bound to make a substantial profit at resale, whether it improved efficiency or not. Instead of investing large sums to modernize their banks, foreign owners extracted capital through dividends and a reduction in the bank's capital base. BOK researchers concluded in a recent study that "foreign private-equity firms… focused on stabilizing the banks, rather than improving efficiency, with the goal of quickly selling their holdings" (*Wall Street Journal*, "Foreign Investors Induce Anxiety in South Korea," May 11, 2005).

Foreign ownership of Korea's large commercial banks has skyrocketed since the crisis, and giant multinational banks have begun to purchase banks initially taken by private equity funds. The foreign ownership share of the eight large urban banks grew from 12% in 1998 to 39% in late 2003 and 64% in late 2004. Foreign firms own more than half the shares of seven of the eight large commercial banks, totally dominating commercial banking in an economy in which corporate investment funding depends heavily on commercial bank loans. By mid-2005, the share of foreign ownership in major Korean banks included: Korea Exchange Bank 74%, Korea-America 100% (owned by Citibank); Korea First 100% (owned by Standard Chartered), Hana 76%, Kookmin, 84%; and Shinhan 63%. Publicly owned Woori Bank is the only major bank not owned primarily by foreigners, and it is soon to be privatized. Foreign owned banks are thus in position to strongly influence the pace of capital accumulation. A World Bank study (based on the share of assets held by banks in which foreigners owned more than half the stock) showed that as early as 2001 Korea had much higher foreign bank ownership than most Asian countries: while Korea's share was then 30%, Malaysia had19%, Thailand 7%, Japan 7% and China 2% (World Bank 2003). By mid-2005, Korea had higher foreign bank ownership than almost all Latin American countries.[10]

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[10] Combining Financial Supervisory Service data on bank assets as of late 2004 with foreign ownership data from mid 2005, the foreign share of all bank assets, including public banks, is about 60%. However,

The most important question is: what are the likely long-term effects of letting large foreign banks gain substantial control over Korea's banking system? To answer, we need to consider the strategies that guide giant financial firms such as Citigroup and Standard Chartered. These banks are likely to concentrate on three major market segments. First, they will service Korea's and Asia's growing wealthy elites – a strategy Gary Dymski calls "upscale retail" banking. Second, they will operate in the residential mortgage and household loan markets. *The Economist* recently noted that across Asia: "There has been a sea change in the attitude of banks [after the Asian crisis] which moved away from their beloved corporations toward consumers ("Asia's banks have been shored up after the crisis – but business is still precarious," May 2, 2005). Third, they will specialize in fee-generating services for large corporations, especially those that are foreign owned, and trading on their own account.

By creating rising inequality, neoliberal restructuring is enlarging the "upscale retail" market that foreign banks see as their most important profit center. Korea already has $215 billion of wealthy household assets under private management, while all of Asia has $6.2 trillion.

> "Asia is the new battleground for the world's private banks…Rapid economic expansion across the region is creating wealth at an astonishing pace. And more of that money is coming into the orbit of professional managers as Asia's rich diversify from property and gold into bonds, equities and hedge funds…. Rich Asians generally demand a global service because the region's financial crisis in 1997-98 taught them to spread their risks." (*The Economist*, "Private Banking in Asia: Striking it Rich," June 12, 2004.)

Banks like Citi, which has 200 million customers in 100 countries, can offer every financial asset and service imaginable anywhere in the world – including investment options in off-shore tax havens, access to private equity funds and exclusive hedge funds -- and have vast experience catering to the rich in the advanced countries. It is hard to imagine domestically owned banks offering Citi serious competition. "Citibank seems particularly intent on going after the wealthy individual segment… With its array of services and strong reputation, the US company could provide unmatched one-stop shopping services. They have expertise in private banking service and can use their global franchise… to provide more products and services to clients" (*Korea Herald*, "US financial giant Citigroup seen targeting wealth consumer segment," Feb 23, 2004.) Still, having suffered large losses in credit card lending, local firms will have to try to compete for elite money: "Handicapped by millions of unprofitable customers, credit card companies are chasing the moneyed elite, who are immune to the nation's economic malaise" (*Korea Herald* "Credit card companies chase the rich," August 11, 2004)

Dominant foreign banks have huge investments in the software and hardware needed to efficiently assess the risk-return characteristics of mortgage and consumer credit applications as well as experience with securitization operations that provide the capital needed to operate in these markets. It will take time to create the credit information base required to maximize returns in this market, but eventually giant foreign banks will dominate, leaving only the bad risk applicants for domestic banks. "A bank with the systems and expertise of Citi will be able to pick and choose the best customers

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the share for private commercial banks is about 80% in 2005, which is as high as in Mexico, and higher than in most other developing countries.

in Korea, leaving domestic banks with lower-grade ones." (*Financial Times* "Asia's banks have been shored up after the crisis – but business is still precarious" May 2, 2005, 13.)

Foreign banks and brokerage houses are also likely to dominate such fee generating income sources as derivatives trading and hedge fund operations. They are the firms that are helping turn Korea's financial markets into casinos for the global rich, financial institutions, and large corporations operating in Korea. They are responsible for the explosion in international gambling on Korea's stock market. In 2003, there were more futures and options contracts written on the KOSPI stock price index than on any other financial asset in the world (Dodd 2004). How can this possibly be "efficient"? Moreover, "the local currency market is turning into one of the most popular playgrounds for hedge funds, with the won becoming the main target by the international speculative funds aimed at short-term gains (*Korea Times*, "Won Under Attach from Hedge Funds, Feb 24, 2005). It would also be reasonable to assume that foreign banks, who have important long-term relations with many of the multinationals that have taken over large Korean firms, will favor these firms in any conflicts they may have with domestic competitors.

Foreign banks are likely to help large domestic and foreign corporations in Korea fool regulators and tax collectors, and defraud investors, as they did for Enron, World Com and other large US corporations in the late 1990s. Citi was forced to pay $2 billion to Enron investors and $2.7 billion to WorldCom shareholders for helping these firms conduct colossal fraud. It was also punished for serious regulatory violations in Japan, China and Europe. According to Japanese regulators, Citi "failed to prevent transactions linked to money laundering, extended loans to manipulate publicly traded stocks, routinely misled customers about the risk involved in financial products and tied loans to the purchase of specific securities" (*Wall Street Journal*, "Japan Orders Citibank to Halt Private Banking," September 20, 2004). Citi was fined by Britain's financial regulatory agency for trying to game the European government bond market using a strategy its traders called "Dr. Evil." It executed a $13.5 billion dollar sale on its own account in August 2, 2004 in just 18 seconds. This volume, equal to an average day's trading, overwhelmed the electronic trading platform, causing a steep drop in prices. Less than an hour later, Cite purchased bonds at a large capital gain. (It also bought bond futures in anticipation of these trades). Korea's Financial Supervisory Service announced it was going to investigate Citi "for possible links to money laundering and [illegal] domestic funds outflows through the US bank (*Financial Times*, "Seoul to investigate Citigroup operations," October 5, 2004). The Korean government also initiated an investigation of foreign private equity funds for tax evasion, and is considering suspending derivatives trading by Deutsche Bank because it failed to inform several government-run companies of the risks involved in the derivatives it sold them (Financial Times, "S Korea set to suspend Deutsche," June 25/26, 2005).

Giant financial conglomerates have helped companies and wealthy families around the world evade financial and tax regulations for decades. As vividly described by James Henry in a recent book, leading international banks have created and fueled high-growth global markets for: recycling foreign aid money stolen by third world politicians, illegal capital flight, money laundering, tax evasion, and illicit weapons traffic (Henry, 2005). William Grieder, one of America's most astute economic observers, recently commented that "Citi's criminal behavior is so far flung and ambidextrous it seems to be [an integral] part of the profit structure" (Greider 2005.)

The Effects of Foreign Financial Firms on Korea's Economy

One thing foreign banks will not do is fund long-term investment by Korea's nonfinancial enterprises. Financial market funding for corporate investment in Korea is evaporating in the new foreign dominated regime. According to a 2003 BOK study, between 1998 and late 2003, foreign banks slashed corporate loans as a percent of total loans by 33 percentage points, while domestic banks, following their lead, cut such loans by 25 percentage points. Foreign banks also cut loans to small and medium enterprises more deeply than did domestic banks. The share of corporate lending in total bank lending decreased from about 75% in 1996 to 43.5 % in 2004. External funds provided by all financial institutions to the corporate sector decreased from about 118 trillion won in 1997 to an average of 65 trillion from 1999 to 2004 – *a drop of 45%*. Foreign banks also shifted bond holdings from corporate to government bonds, weakening a secure long-term source of finance for private investment. The share of government bonds in all securities held by foreign banks increased from 50% in 1998 to 68% in late 2003. The BOK report concludes that foreign banks have a powerful and growing influence in banking and that foreign control has reduced Korea's growth potential by leading the shift away from corporate lending toward consumer loans and the purchase of government bonds (BOK 2003, p. 18)

Whenever foreign firms take control of a developing country's banking market, investment funding suffers, with small and medium businesses, which employ most workers, hit hardest. Consider the case of Mexico. Large foreign banks, including Citi, own 85% of local banking assets, the highest rate in Latin America. As was the case in Korea, foreign banks gained their stranglehold on Mexican banking by acquiring banks that were devastated by a crisis. They got them cheap, but only after bad assets had been cleaned up by the government at a cost of $105 billion – about 14% of GDP **("**Mexico's banking sector is bouncing back" Knowledge@Wharton, March 10, 2004**)**. Foreign banks have starved Mexican companies of needed credit. "These banks are turning gigantic profits," because "instead of providing credit to companies that could become engines for economic growth, banks have profited by charging expensive commissions for services such as credit card use and by filling loan portfolios with government bonds. The lack of available credit is a key obstacle to economic growth" (*Wall Street Journal*, "Mexico's Foreign Banks Grow Uneasy," March 17, 2004). Recently, credit card lending has increased, but, as in the case of Korea, the rise in consumer spending it generated is unsustainable: unless there is faster growth in jobs and real wages, debt burdens will constrain future consumption spending.

Given that foreign banks are not likely to contribute to wide-spread prosperity in Korea over the long-run, it is important that domestic banks win the competition created by large-scale foreign entry because, if leaned on aggressively by the government, they might be induced to do so. However, domestic banks have yet to formulate a viable long-term defensive strategy. According to Dymski, Korea's banks "are simultaneously engaged in a strategic shift away from long-term lending relationships with large firms (especially *chaebol*), while moving toward alternative financial products and relationships. The problem is that Korean banks…have just been burned in their efforts to move toward one alternative; that is, consumer lending. They do not yet have a well-defined strategic option" (Dymski 2004, p. 22).

Post-crisis data fail to provide evidence that foreign controlled financial institutions have been more efficient than domestic ones. Domestic banks had higher return on asset and return on equity performance in each year from 2001 to 2003. However, over the longer run, it seems likely that foreign banks will dominate the most profitable segments of Korea's financial markets. Domestic firms may be left to compete with each other in marginally profitable segments. Dymski is pessimistic about the future of domestic banks: "If Citibank and other potential foreign competitors are permitted to enter the Korean market on their own terms and in pursuit of their own banking strategies, maintaining a competitive domestic banking system will be difficult or impossible" (2004, p. 24).

Another problem is that the success of foreign banks is not closely tied to the general health of the Korean economy. Since their highest priority is catering to Korea's wealthy elite, as long as income distribution remains highly unequal and the economy stumbles forward, however slowly, foreign banks will make money. Moreover, we should expect to see an increasing proportion of the financial assets of Korean elites moved offshore, which will further erode the link between foreign bank profits and Korean economic growth.

Foreign banks are also more insulated from pressure to cooperate with government economic policies than are domestic institutions. Korea Exchange Bank and KorAm, both foreign owned, were the only creditor banks that refused the government's request to participate in its $4.2 billion bailout of LC Card, the nation's largest credit card issuer, when it faced bankruptcy in 2003. As one major newspaper put it: the arrival of "Citigroup may also signal a defining loss of influence by the government in banking decisions, with foreign institutions seen as less willing to succumb to government pressures" (*Korea Herald*, "US financial giant Citigroup seen targeting wealth consumer segment," Feb 23, 2004) In 2001, Kim Jung Tae, president of the foreign-owned Kookmin bank, famously declared his unwillingness to be guided by government policy: "I want to make my way even if the government doesn't like the idea" (*Far Eastern Economic Review*, "Punching above his weight,"August 23, 2001).

As a result of these problems, the Korean people have become increasingly resistant to further encroachment by foreign economic interests, especially in financial markets. A recent article in the *Financial Times* noted the rising resentment against foreign investment: "Far from being welcomed for helping to rehabilitate its shattered economy, foreign investors are being demonized in the local press" ("If Korea is so cool, why is Seoul in a lather?, September 14, 2005). A public opinion poll done in May 2005 showed that 94% of Koreans support the government's tax investigation of private equity funds, while 70% believe that foreign capital seeks short-term speculative profit rather than long-term growth. A majority believe the government should more tightly regulate foreign capital, should limit foreign entry in industries important to national security, and expel foreign firms that "distort the economic order" (*Jose Ilbo*, May. 17, 2005) "Foreign investors are becoming increasingly concerned that financial authorities, fuelled by popular outrage at the profits foreign funds are making, are trying to make life harder for foreign investors… The spotlight has been on foreign takeovers of banks in particular"

(*Financial Times*, "S Korea feels draught as doors open to foreigners," April 11, 2005). The government has threatened to eliminate the ability of foreign private equity funds to evade Korean taxes, and to impose residency requirements on non-Korean directors. A bill requiring that half of all directors of Korean banks be Korean has been submitted to the legislature. The government also passed a law legalizing domestic private equity funds in Korea, and has pledged to invest $3 billion in public money to such funds. Its purpose is "to keep foreigners at bay, amid growing unease over the profit foreign private equity investors have been making" (*Financial Times*, "South Korea to foreign funds at bay" Feb 10, 2005, 19). Korea's central bank recently issued a report (Jeon et al. 2004) "calling on regulators to encourage domestic investment in local banks and other Korean financial institutions, underscoring a growing wariness in the country about the role of foreign investors…The recommendations appear as the government prepares to divest its 78% stake in Woori Finance Holdings," one of the three largest banks in Korea. (*Wall Street Journal*, "Foreign Investors Induce Anxiety in South Korea," May 11, 2005)

There is nothing that prevents government restriction of foreign ownership of key banks. France and Germany made it quite clear that they will not tolerate foreign takeovers of 'national champion' companies. For example, the German government recently announced it will not allow Deutsche Bank to be sold to foreigners. The French government warned Pepsi in mid 2005 not to launch a hostile takeover bid for Danone, the publicly owned French food company. In September 2005 the Prime Minister "urged his compatriots to rally behind his concept of "economic patriotism"; meanwhile "the government is drawing up a list of 10 strategic industries to be shielded from foreign ownership" (*Financial Times*, "French PM firm on calls for 'economic patriotism,'" September 23, 2005). China tightly controls its financial markets. Nevertheless, Korea's current government remains determined to pursue its plan to make Korea the 'Northeast Asian Financial Hub,' which will require even greater efforts to woo foreign financial firms. Thus, at the moment, there is no effective road block to further foreign domination of Korea's banking system even as the public backlash against it intensifies.

IV. Conclusions

After rising rapidly in the three and one-half decades leading up to the crisis, corporate investment has not grown at all in the post-crisis period. Real GDP growth substantially slowed, and may well decline further since the debt-fueled consumption bubble of 1999-2003 has run its course, and the rapid increase in net exports in 2003 and 2004 cannot be sustained. A 2005 World Bank research paper on Korea concluded that "the national economy is now suffering from weak investment, slow growth and slow job creation and rising unemployment" and suggests that the neoliberal or "Anglo-Saxon" model may have been the wrong "blueprint" for post-crisis Korea (Lee et. al. 2005, p. 38).

Inequality and poverty have increased substantially, and labor's condition is deteriorating. The radical deregulation of cross border capital flows brought very large costs and negligible benefits. The rising power of foreign financial firms contributed to investment stagnation, a dramatic increase in household indebtedness, and the conversion of Korea's stock and foreign exchange markets into global gambling casinos. Giant global banks are poised to complete their conquest of Korea's banking market, which means continued problems for investment finance, an increasing disconnect between banking profits and economic prosperity, and tightening constraints on more effective or more progressive government policies. The US, the IMF, global corporations and Korea's rich imposed radical neoliberalism on a Korean people who did not want it, not because of its development success record – it doesn't have one, but because it was in their own self-interest to do so. The eight year experiment has worked well for them, but is a dismal failure for the majority of Korea's people.

A radical rethinking of economic institutions and policies is thus in order, based on a careful analysis of relevant history, not on neoliberal fairy tales. At a bare minimum, the government should reestablish effective regulation of domestic financial markets, re-impose adequate control of short-term capital flows and FDI, and create a structure of incentives, penalties and controls that will shift financial flows away from speculation and excessive consumer credit, toward capital accumulation and productive pubic investment. Social welfare spending must be increased substantially and the tax system reformed to help reverse the rise in inequality, a goal that also requires a cease fire in the one-sided war waged by domestic and foreign capital and the government against the labor movement. Faster growth in employment and real wages is an essential component of healthy growth in domestic demand, and history suggests that this normally requires strong unions. What is needed now are the policies that should have been implemented in 1998, designed to modernize the state-guided system that achieved the thirty five year Korean economic "miracle" and thoroughly democratize the economic planning process to eliminate its non-representative, anti-labor character.

Unfortunately, these are not the lessons drawn by the current Roh government. Faced with stagnant domestic demand, the government has turned outward, banking on its ambitious plan to make Korea the 'hub' for economic activity in East Asia. "President Roh has made turning the country into the financial, manufacturing and logistics hub of the region a key component of his long-term economic plan" (*Financial Times*, "Aiming to create a regional hub," December 1, 2004). There are a number of serious flaws in this plan, not least of which is the hubris involved in trying to make Korea the key economic force in an area with far stronger economic powers. The financial component of the plan could not possibly succeed without a qualitative increase in the power of foreign capital in Korea. To seriously enter the competition to become Asia's dominant financial center would necessitate giving global financial institutions control of virtually all of Korea's financial markets and the dismantling of most regulatory controls. The hub plan will not succeed; the growing political backlash against foreign financial institutions in Korea as well as competition from more developed Asian financial centers will prevent that. Our purpose in mentioning this plan is to demonstrate again the bankruptcy of economic policy making in post-crisis Korea, and to point out that the Korea government is not yet ready to learn the appropriate lessons from its failed experiment with neoliberalism.

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