THE factory visit is over; the beer is sinking in the glasses; after two hours of questioning, the visiting journalist can think of nothing more to ask. There is a silence. Then the South Korean factory boss decides it is his turn to ask something. Does this Englishman, he wonders, believe that by the turn of the century South Korea will overtake Japan? It is a stunning question, like asking whether Poland will overtake Germany in half a decade. But the factory manager does not hesitate to put forward his own opinion. Yes, South Korea will overtake Japan, he declares, because "Koreans are fundamentally superior."

South Koreans have grown used to thinking they are supermen. Three decades ago the average Korean earned around $100 a y Indian or Ghanaian. Today South Korea's GNP per head is $8,500, 30 times India's and 20 times Ghana's. Two decades ago the streets of the capital, Seoul, were empty but for a few government cars; neon signs were a forbidden extravagance. Now the streets are clogged with cars, and neon illuminates the night. Seoul is full of glamorous people, trendy bars and department stores as over-stuffed with goodies as are their Japanese equivalents.

Cities that have only just appeared on the map are now exporting fancy goods to dozens of far-flung countries. In the 1960s Ulsan was just a small town. Today its dry docks are a sculpture park of arched steel cranes; the world's biggest car plant is just along the road. "We built a lot in 20 years, as much as other countries built in 100," says a retired politician. "Quick, quick, quick: that is Korea."

South Korea's economic success is breathtaking. It stands as proof that a country held down for most of this century by brutal colonisation (by Japan, from 1910 to 1945) and civil war (against communist North Korea, from 1950 to 1953) can leap from poverty to affluence in one generation. It is proof, too, that a lack of natural resources need be no obstacle to development. This year South Korea became the first former basket case to graduate from the ranks of the World Bank's borrowers. Other graduates, such as Australia and Singapore, were never so poor to begin with. South Korea has now in turn become a lender to developing countries. In his speech to mark the occasion, Russ Cheetham, the World Bank's vice-president for East Asia and the Pacific, talked enthusiastically about the "Korean model".

This model has much in common with Japan's. Like Japan in its per development—roughly from 1950 to 1980—South Korea is hostile to inward foreign investment and imported consumer goods, and ruthlessly focused on exports. Like Japan, it combines world-class manufacturing w
developed agricultural and service sectors. South Korea's government, more than Japan's, has told firms what kind of factories to build, and caused prices to be bent to fit in with its industrial policy.

This resemblance is not coincidental. Park Chung Hee, the military strongman who commanded South Korea from 1961 to 1979, was educated in Japanese military academies, and was said to be more comfortable speaking Japanese than Korean. The economy that he built with his Japanese-educated friends was modelled on Japan's example. Park's ideas often appalled orthodox development economists steeped in the conventional wisdom of that era. Inspired by Japan's success, Park had the nerve to ignore them.

In the late 1960s western donors refused to back Park's plan to build a steel mill in South Korea, arguing that a peasant economy could not support a successful steel industry. But Park Tae Joon, the man in charge of the steel plan, had been educated at Waseda, one of Japan's top universities. He crossed the Sea of Japan to secure promises of investment and technical advice from his old friends. Posco, the steel company thus born, is now the world's second-biggest.

Other heavy industries, launched with similar disregard for the orthodoxies of that time, have been equally successful. In the early 1970s some westerners were inclined to laugh at South Korea's decision to build ships. Now it is Korea's turn to laugh: its shipbuilding industry is challenging Japan's as the world's largest. South Korea threw itself into the electronics business too; now Samsung Electronics has become the world's biggest maker of memory chips.

Which Korean model?

This eye-popping growth explains why South Korean factory managers talk of overtaking Japan, and why international institutions such as the World Bank are impressed by the "Korean model". Confusingly, this model means different things to different people. To the Bank, it means a judicious mixture of macroeconomic stability, private enterprise, competition, investment in education, and strikingly successful (for the most part) subsidies for exporters. At the same time, South Korea's example sustains those who emphasise that prices need not be free nor markets open. Development, they say, is not a job for the invisible hand. The state can successfully lead a charge into "strategic" heavy industry.

Indonesia, for example, has defied orthodox economic advice by launching into aerospace. When sceptics ask whether it has a comparative advantage in high-tech manufacturing of this kind, B.J. Habibie, the technology minister and champion of the project, points to South Korea as proof that comparative advantage is something a determined government can create.

Yet there is an irony in this heterogeneous adulation. By the time that foreigners started to admire the Korean model, it was beginning to fall from favour at home, like the Japanese one before it. Plenty of pessimists in Seoul's innumerable think-tanks say that South Korea are vulnerable, and that their vulnerability stems largely from its vaunted development model. Ever since Park Chung Hee's assassination in 1979,
South Korea has been struggling to undo much of what he built. But Park's legacy has proved durable.

In part, this criticism of Park marks a shift of generations. Until his death, South Korea was run by men who had grown up under Japanese rule and who looked to Japan for inspiration. But in 1979 the first Korean to earn an MBA from Harvard was appointed to the job of deputy prime minister, the top economics post. Since then the alumni of American universities have dominated the ministries and boardrooms. Today half the chairmen of South Korea's 30 business groups have been educated at American universities, and only a quarter at Japanese ones.

But this generation gap explains only a small part of the pessimism. Park's system produced real growth of nearly 10% a year (see chart 4 next page) mainly because it was remarkably good at mobilising resources. To borrow an analogy from Paul Krugman, an economist at California's Stanford University, South Korea's expansion, like that of other Asian tigers, r development of communist states. In the 1950s some East European economies achieved spectacular growth by squeezing more and more savings and labour out of their people. But this kind of authoritarian advance is neither pleasant nor sustainable.

South Korea's labour policies were especially unpleasant. The country was built by men who worked appalling hours, led by obsessive bosses who, along with their workers, slept on the docks and construction sites, Kim Woo Choong, who founded the Daewoo industrial group in 1967, never took a day off until his son was killed in a car crash in 1990. His employees were expected to work six days a week, 12 hours a day, until the mid-1980s. Anybody who protested got fired, or jailed. Under Park Chung Hee as well as under South Korea's next soldier-president, Chun Doo Hwan, labour disputes were generally resolved by troops, tear gas and truncheons.

Authoritarianism, the good fortune of a growing workforce, and an education system that served the needs of industry ensured that South Korea's economy benefited from a steadily increasing supply of skilled and dedicated labour. Meanwhile the repression of savers spurred investment. In 1972, for example, when many firms found themselves unable to service foreign debts, Park Chung Hee decreed that, for the next three years, domestic creditors should expect no repayments of principal or interest. For most of the ensuing decade ordinary South Korean savers suffered negative real interest rates on their deposits. The proceeds were passed on to industry, in the form of subsidies to encourage investment.

A question of efficiency

Such financial repression is not unusual in the third world. South Korea's version of it was relatively mild. But it added to other pressures, all intended to speed the mobilisation of resources. The World Bank reckons that nearly two-thirds of the growth between 1960 and 1989 reflects the accumulation of inputs rather than improvements in efficiency. That assessment may be over-generous. Lawrence Lau, another economist at Stanford, has calculated that the growth of
inputs, particularly of capital, accounted for between 86% and 100% of South Korea's growth. In other words, the efficiency with which those inputs are used may actually have been declining. By contrast, efficiency gains accounted for two-thirds of the growth in France and the former West Germany.

These figures help to explain why Koreans have not always shared foreigners' admiration of their country's economic record. The development model chosen by Park Chung Hee achieved growth mainly through sacrifice. Ordinary Koreans were forced to work non-stop; then part of what they saved (and they saved prodigiously) was, in effect, taxed away to support investment. The rulers declared that only a strong South Korea could stand firm against the communist North and against the big powers--Japan, Russia, China--that bump up against its borders. In the end, however, a mix of economic and political repression drove South Koreans to revolt. After a series of violent strikes and riots in 1987, the generals had to bow to popular demands for democracy.

That marked a turning point in the economy too. Democracy has brought trade unions, which have achieved higher pay and shorter working hours. Leisure is no longer taboo; younger South Koreans, unlike their parents, are determined to enjoy themselves. Now that shifting money abroad has become easier, South Koreans will no longer put up with the confiscation of their savings. Nor will they tolerate the damage to the environment and the neglect of safety that came with headlong growth--and that are still haunting the country. Last year a bridge collapsed, a ferry sank, and a domestic airliner crashed. In April more than 100 people died in a huge gas explosion.

In future, South Korean growth will depend more on efficiency and less on the mere accumulation of inputs. Many South Koreans reckon that to achieve greater efficiency, they will need to reverse the policies of Park Chung Hee. State direction of industry makes no sense now that private firms have grown sophisticated. State subsidies for industry make no sense now that the subsidised firms have grown big enough to suffocate competition. And state control of finance has crippled South Korea's banking system.

South Korea is striving not only to reverse old policies but--even more ambitiously--to change its citizens' way of thinking. Park preached discipline, but these days South Korea wants to encourage creative people that come up with new products. Park was a nationalist, but today President Kim Young Sam has made "globalisation" his slogan. The hard work epitomised by Daewoo's founder is no longer regarded as a sure route to success. Lee Hahn Koo, the head of Daewoo's in-house research institute, gives three speeches a week urging his countrymen to become lateral-thinking internationalists.

This survey is about South Korea's struggle with the legacy of Park Chung Hee. It is a struggle that encompasses politics as although the essentials of democracy are firm, South Korea's authoritarian past still casts a shadow over civil rights, the rule of law, and popular trust in government. First, though, the survey will consider a problem not of Park's making, yet which bears closely on his country's fate: the challenge of communist North Korea.
TABULAR OR GRAPHIC MATERIAL SET FORTH IN THIS DOCUMENT IS NOT DISPLAYABLE

illustration photograph table graph

----- INDEX REFERENCES -----

KEY WORDS: DEMOCRACY INDUSTRIAL PROMOTION KOREA, SOUTH

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The civilian emperor: South Korea's remarkable transition to democracy has some way to go.

LIFE under South Korea's generals was not always much better than life in North Korea. Park Chung Hee's Korean Central Intelligence Agency virtually ran the country; the main check on its power came from other intelligence services. Opposition leaders were locked up and sometimes tortured; those who fled abroad lived in fear of government assassins. Thatched roofs were banned for being backward. Unexplained absences from school could be severely punished. There were even echoes of the personality cult of Kim Il Sung. When Park was assassinated in 1979, "the heavens trembled and the earth shook," according to a funeral speech; indeed, "nature seemed to wither".

Park's authoritarianism survived him. After a brief interregnum, he was succeeded by an equally repressive general, Chun Doo Hwan. In 1980 General Chun's troops crushed a pro-democracy demonstration in the cit killing at least 200 civilians—a South Korean version of China's Tiananmen Square massacre. Like Park, General Chun encouraged a personality cult. According to his official biography, his mother rec future birth in a dream: a handsome man with a crown on his head walked out of a rainbow and called her "mother".

Then South Korea changed. In 1987 industrial workers, along with students and office workers in Seoul, took to the streets to demand democracy. Another bloody suppression would have scuppered South Korea's plans to host the 1988 Olympics, so Chun Doo Hwan gave in. Since 1988 South Korea has been ruled by presidents properly elected before taking office, not after seizing power like Park and Chun. The first of these elected presidents was Roh Tae Woo, another retired general. Since 1993 South Korea has been led by President Kim Young Sam, a civilian who had spent much of his career fighting the old military governments.

The spread of democracy

In many ways, this transformation has been remarkable. South Korea used to be more repressive than its fellow "tigers", now it is more democratic. Newspapers, once strictly controlled, have started to criticise the government. Nobody in South Korea now thinks for a moment that the generals will grab power again. The army has meekly accepted Mr Kim's firing of hundreds of officers. Democracy is spreading to the provinces. This month, for the first time since Park Chung Hee's coup, governors, mayors and county chiefs will be elected. To discourage corruption, the president last year pushed through an ethics law, requiring ministers and officials to declare their assets. He has also scrapped rules permitting South Koreans to hold bank accounts and property under false names.
Yet, for all the recent advances, Park Chung Hee still casts a shadow over South Korean politics. The intelligence services still wield vast power; in February it emerged that they had plotted to subvert this month's local elections. The National Security Law, which empowers the state to lock up just about anyone it dislikes, remains on the statute books. Talk of repeal is "taboo", according to one former cabinet minister.

The arbitrariness of Park's rule persists as well. Mr Kim has intimidated enemies, for example, by using tax inspectors against them. Chung Ju Yung, the founder of Hyundai, South Korea's biggest conglomerate (chaebol), stood in the 1992 presidential election against Mr Kim. Having lost, he received a suspended three-year prison sentence for infringing the campaign-finance laws, and his companies were refused permission to raise capital on the international bond market.

Hints of Park's aloofness, his encouragement of ye crushing potential rivals also surface in the present government. Mr Kim does not welcome criticism, and shuffles his ministers about. In January he fired his number two in the Democratic Liberal Party. The successor' qualification for the job was to be a non-entity. Mr Kim may not be a general, but he behaves almost as imperiously as the military rulers before him. In March he tried to change the local-election law that he himself pushed through in 1994. Fearing that his party would be humiliated at the polls, the president suggested that candidates should stand as independents rather than on a party ticket. It took violent protests to persuade him to back down.

Park's most damaging legacy is regionalism. Not that he invented this: South Koreans are obsessed with their provincial roots, to the point that genteel households keep records of their family tree going back for centuries. But Park's two decades at the top concentrated wealth and power among people from the area around Taegu, a city in the south-east. By the time he died, the Taegu contingent had such a hold on the army's senior ranks that it supplied the next two rulers, Chun Doo Hwan and Roh Tae Woo. Taegu men and Taegu firms hogged the best government jobs and contracts.

Local heroes

Thanks to this factionalism, South Korean elections are not about big national questions; they are expressions of regional jealousy. Cho Soon Sung, an opposition member of the assembly, laughs about how easily he won his seat in Cholla, a poor region that resents Taegu's dominance. His rival was the president's spokesman, a senior figure with plenty of campaign funds, but not a local man. Mr Cho, for his part, had worked out that 28% of the voters in his district shared his surname. Moreover, with the aid of his family tree, he had traced hundreds of families whose men had married a Cho daughter. By playing on these kinship ties, Mr Cho won a landslide victory.

South Korea's imperial presidency encourages regionalism, since rule by one man necessarily prevents rule by a coalition of leaders from different parts of the country. At the same time, regionalism encourages imperiousness, since it reduces party politics to squabbles that have nothing to do with national issues. The assembly cannot play...
its intended role of balancing the president's power. So South Korea is run by ministers whom the president hires and fires--usually technocrats, often from think-tanks or universities. The president's own secretariat, high-powered and unelected too, wields considerable authority.

This creates a damaging divide. The business of government is carried out by brainy backroom boys. Politics and elections run on a largely separate track, which has little to do with policy. This will delay the natural process by which South Korean politics ought to outgrow regionalism. If the brainy ministers had to stand for election, they might take policy to the polls, so that national elections might gradually start to reflect national issues. S Sang Mok, the technocratic former health minister who is also an assemblyman, says he tries to bridge the gap. But he concedes that it is likely to be years before regionalism is vanquished.

In sum, the long years of authoritarian rule bred arbitrar that undermine the principles of equality before the law and democratic accountability. This has nasty economic consequences. It fosters resentment of government and of people who prospered thanks to political connection from time to time the government's technocratic style gives way to unnerving bouts of populism.

This was especially true under President Kim's predecessor, Roh Tae Woo. In search of popular support, Mr Roh boosted spending on housing from under 5% to over 9% of GNP. That caused the price of labour and materials in the construction industry to soar, pushing overall inflation up to 9.3% in 1991. Since resources were being diverted into housing, exports flagged. The government was forced to rescue several prominent firms. Growth slowed to just over 5% a year. South Koreans, used to seeing their economy grow in leaps and bounds, called this a recession.

Mr Kim's answer to this crisis was another dose of populism. Soon after taking office, he announced a stimulus package which is partly responsible for overheating the economy, now swelling at nearly 9% a year in real terms. He also intervened in the stockmarket to prevent it from rising too fast: ordinary South Koreans do not like to see rich speculators making too much money. He promised farmers that he would not allow a single grain of foreign rice into South Korea, only to face riots when he signed the Uruguay round agreement on trade liberalisation.

No political system is immune to populism, but South Korea's is particularly vulnerable because of Park's authoritarian legacy. Some outsiders, observing South Korea's spectacular economic growth, are tempted to conclude that autocracy is good for development. But it leaves behind weaknesses that are hard to repair--even in a country where the transition to democracy has gone as well as in South Korea. And these weaknesses are not just political: they extend to industry and finance.
---- INDEX REFERENCES ----

KEY WORDS: DEMOCRACY KOREA, SOUTH

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IN POLITICS, South Korea has been trying to undo Park Chung Hee's model since 1987, when military rule gave way to elected governments. In economics, the revolt against Park came straight after his death. But even though the tide turned 15 years ago, it has not yet erased Park's footprints. His habit of suppressing markets still bedevils South Korea's economy.

In the last few years of his rule, from 1973 to 1979, Park led a charge into the metals, machinery and chemicals industries. Firms investing in these areas were showered with cheap loans and other subsidies. "Policy loans" (i.e., cheap money mandated by the state) accounted for 60% of lending by South Korea's main banks over the period. State intervention in the economy grew on all fronts: to export a product, 120 documents were needed. The Korean model—in the sense of state intervention aimed at creating industrial champions—was at its zenith.

The experience of one of South Korea's big chaebol provides a good illustration of how it worked. In the 1970s Park ordered Daewoo, a chaebol specialising in textiles, to take over a machine-tool maker and a shipyard, and to get into car making. To comply, Daewoo had to borrow on an astonishing scale; by the end of the decade, its debt-equity ratio had reached 900% (the average for American manufacturers is under 200%). When the second oil shock struck, Daewoo had to be rescued by the government.

Pretty much the same could be said for the entire South Korean economy. South Korea's external debt in 1980 amounted to 49% of GNP—a heavier burden than famously indebted Brazil's (31%) or Mexico's (31%). Other things were going wrong too. The huge borrowing failed to boost South Korea's exports as much as Park had hoped. In 1980 the current-account deficit soared to nearly 9% of GNP. Thanks to the second oil shock, South Korea's GDP in 1980 shrank by 2.2% while inflation hit 29%.

Had Park lived a few years longer, he might have destroyed South Korea's economic miracle altogether. But Park's assassination made way for a new commanding officer who, acknowledging his ignorance of economics, handed power to a team of technocrats trained at American universities. They devalued the won, imposed an IMF-backed austerity package and cut subsidies to heavy industry, thus averting a crisis along Latin American lines. But they failed to root out two features of Park's rule: the habit of state intervention, and the damaging concentration of South Korean industry.

Holding the leash

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The technocrats who took control after Park's death were determined to end state direction of industrial investment. By the 1980s the government no longer had any excuse for directing industry's plans, since private firms were stuffed with planners of their own, many of them brandishing doctorates from foreign universities. The technocrats also argued—with some feeling—that state direction of firms entailed a moral hazard: they were having to rescue dozens of dud projects started by Park in the 1970s.

Both these anti-intervention arguments are still heard in Seoul today. Last year the government, to prove it was serious about cutting the state's role, went so far as to abolish the Economic Planning Board, the ministry created by Park to run his industrial policy. As a gesture, this was grand—the equivalent of Japan getting rid of its Ministry of International Trade and Industry (MITI). But the reality is that South Korea's government has still not kicked the habit of meddling in industry.

The government says it is up to firms to decide what products to make—but it is currently giving large tax breaks to its fledgling aerospace industry. This is a special case, you see: South Korea needs to make aircraft in order to guarantee its security. But there are other special cases too. In March the trade ministry put together a consortium of South Korea's car makers which will pool resources to make parts. The ministry's role in this was not even discreet: its official in charge of cars briefed the press on the new scheme.

The bureaucrats also reckon that telephones are special. Three years ago they backed a digital standard for mobile phones, and ordered private firms to develop it. The chosen standard was particularly high-tech: it would support a larger volume of calls than other systems, but was harder and more expensive to develop. Other governments left the choice of standard to private firms. By uniting South Korea's energies behind the best standard, the bureaucrats hoped to ensure that their firms would leapfrog American and Japanese rivals.

The evidence so far suggests that this gamble will fail, according to Richard Samuelson of S.G. Warburg, a stockbroker. Firms in other countries, which have adopted less sophisticated standards than South Korea's, are selling thousands of mobile phones that use them. The South Koreans are still getting the bugs out of their technology. The episode, albeit on a fairly modest scale, recalls the mistakes of Park Chung Hee's heavy-industry drive—even though for the past 15 years South Korea's technocrats have been vowing not to repeat them.

The persistence of this kind of intervention goes to show that bureaucrats, like anyone else, find power addictive. But intervention persists for a deeper reason too. Thanks to Park's industrial policies, private firms have grown used to being bailed out. Their investment plans are therefore unrestrained by caution. If the government let them do as they pleased, the result would probably be an investment boom that blew up the economy.

Take the behaviour of the Samsung group. Last year Samsung launched itself into the car industry, even though three other South Korean firms already make cars and another plans to; even though its rivals
have ambitious expansion plans; and even though the growth of the
domestic car market is slowing. South Korea's three established car
makers plan to expand their joint annual capacity from 2.6m now to 4m
by 2000, according to Suh Chung Mo, an analyst at SsangYong Investment.
Domestic demand by then will be around 2m cars. So South Korea's firms
will have to export more than half the cars they make, up from a third
of their total output at the moment.

Taken by itself, this looks just slightly risky. But Samsung's plans
are not confined to cars. It is leading a Sino-Korean venture into
aerospace, building new semiconductor plants, even eyeing up Hollywood.
The group's planned investments this year alone come to a staggering
7.8 trillion won ($10.2 billion), about a fifth more than is planned by
the 17 firms that make up the core of Japan's Mitsubishi empire. All
this investment is aimed at quadrupling Samsung's sales by 2001. That
means over $200 billion worth of goods, more than the entire output of
a country the size of Sweden.

Samsung's expansion plans are larger than life mainly because it is
on good terms with the government. That gives it access to permits--
to enter new industries, or to raise new capital--that rival chaebol would
be denied. Where other firms do secure permission to invest, they show
little hesitation: heavy manufacturing investment by South Korean firms
rose 62% last year, and is due to go up another 65% this year. The
moral for South Korea's economy is clear: firms will rein back on
investment only if the government makes them. A decade and a half after
Park's death, the attitudes he instilled oblige the state to go on
managing the economy.

This obligation is reinforced by another of Park's unhelpful
legacies. The policy of targeting heavy industry fostered the growth of
huge firms to reap economies of scale. The bias towards bigness was
reinforced by the government's implicit promise to rescue projects that
went wrong. And Park fattened his favourite firms by allocating them
bargain-rate loans, ensuring that the development of the
not-so-favoured was hampered by scarce and expensive capital.

As a result South Korea, unlike other Asian tigers, suffers an
unhealthy concentration of economic power (see chart 7). At the start
of the 1980s the value added by South Korea's top ten conglomerates
amounted to 20% of the country's manufacturing output; by the end of
the decade this share had edged up to 23%. Measured by sales, the
chaebol's power is even greater: the top two, Hyundai and Samsung,
together have sales equivalent to a quarter of South Korea's economy.

A cosy club

But the economy is not merely dominated by a handful of firms; it is
a handful of people. Founding families are reckoned to own 60% of the
equity in the top 30 chaebol; three-quarters of their member firms are
not even listed on the stockmarket. This stokes resentment of wealth:
the founders grew rich on their friendly links with military dictators.
The chaebol's size also distorts competition. A chaebol subsidiary, however badly run, is likely to squeeze an independent rival out of business, because its enjoys a ready-made customer base, political contacts and easy access to capital. On top of this, the chaebol firm can often bear a loss for several years, since its parent has deep pockets. This gives rise to a cruel irony. In most economies, the creation of a new firm is reckoned to enhance competition and hence efficiency. But in South Korea the opposite is often true: the establishment of one new chaebol subsidiary may have the effect of driving several small firms under, even if the newcomer is not especially efficient.

This is another reason why even liberal economists in South Korea sometimes favour government intervention. The authors of the country's fair-trade rules, who sincerely aim to promote competition, have felt obliged to bar the entry of chaebol into many types of industry. These restricted areas have multiplied at an alarming rate, growing from 33 in 1979 to 237 ten years later. In their attempt to undo the legacy of policy, South Korea's technocrats have spun a new web of red tape.

Just as the intervention of the 1970s created the chaebol problem, so the anti-chaebol intervention of the 1980s has had unintended and unwelcome consequences. The market-entry restrictions, intended to protect small firms, often sheltered chaebol that were already in those markets. And small firms that did benefit from the restrictions were not always efficient. So the government has changed tack: last year it struck off 58 industries from its list of restricted areas. But the experience of the past 15 years suggests that such tinkering will do nothing to overcome the chaebol's dominance.

The biggest worry about the chaebol, however, is the threat they pose to economic stability. They grew big by piling up huge debts, which makes them vulnerable: a slump in sales could rapidly render them incapable of keeping to their repayment schedules. The bankruptcy of a large group could bury the banking system in bad debts, dulling economic growth and triggering yet more bankruptcies.

This nearly came to pass in 1985, when the collapse of Kukje, the sixth-biggest chaebol, forced banks to write off or roll over 900 billion won of loans. Amidst rumours that other big groups might go under too, the government had to provide vast quantities of cheap loans over the following two years in order to prop up wobbling chaebol.

Similar dramas continue to take place. In February a construction company belonging to Duksan, a smallish chaebol, defaulted on its loans, triggering the collapse of the whole company. In April Yuwon Construction, another firm hit by the housing slump, went under. Together these two firms left irrecoverable debts totalling nearly 1 trillion won. Korea First Bank, Yuwon's main lender, faces losses of around 350 billion won.

The government has sternly refused to rescue Duksan or Yuwon, claiming this as proof of its laisser-faire credentials. Yet it has felt obliged to provide soft loans to Duksan's subcontractors. Besides, the government's stand-offishness reflects this year's flat-out economic g the chance that two bankruptcies will push other big firms under. A senior finance-ministry official concedes that if growth slows...
down, future bankruptcies may require a full-blown rescue.

That points to yet another reason why South Korea's government finds it hard to avoid intervening in the economy. The collapse of a big chaebol threatens the stability of South Korea's financial system, so the government is more or less obliged to guarantee the chaebol's stability. This implicit guarantee, in turn, encourages chaebol to carry on investing wildly. They therefore grow bigger still; and the prospect of their collapse becomes even more nightmarish. Park Chung Hee created a monster that no mandarin can master.

Giant-taming

This is not for want of trying. The government has been grappling with the chaebol for the past decade, anxious in particular to reduce the threat they pose to the financial system. In 1986 it passed an amendment to the fair-trade law to stop chaebol member firms guaranteeing loans for others in their group, so that if one part of a chaebol failed it would not bring the whole group down. For the same reason, the amendment also imposed limits on cross-shareholdings. A third set of rules pushed the chaebol to reduce their indebtedness by issuing fresh equity.

These policies, like the earlier one of restricting the chaebol's entry into new markets, have grown horribly elaborate. The limits on loan guarantees and cross-shareholdings have been reinforced. At the same time, the government has tried to segregate risk by ordering the chaebol to specialise in two or three core areas. Yet more directives cap the total bank loans that may be extended to the chaebol. Earlier this year the government added yet another layer of rules; the chaebol do their best to appear worried. The biggest have announced restructuring plans designed to cut the he it will cut its subsidiaries from 50 to 23 by 1998; and the founder's family will reduce its stake from 61% to 39% of the group's equity. Samsung says it will thin out its subsidiaries from 50 to 24; Daewoo promises to come down from 21 to 14, and to reduce the founder's stake from 42% to under 20%.

Not all these changes are for real. The chaebol are more inclined to sell subsidiaries to the boss's relatives than to outsiders: Samsung has transferred its food business to its chairman's nephew, and a department store to his sister. Other subsidiaries will not be sold at all, but merely merged into a sister company. Meanwhile the Byzantine restrictions on loan guarantees have done little to limit the big firms' ability witness Samsung's expansion.

In the end, the chaebol reforms depend on the reform of South Korea's financial system. The chaebol's runaway investment plans have to be checked by the government because the banks are unable to do so. The chaebol are dangerously in debt because South Korea's stockmarket has offered them too few opportunities to raise equity capital. South Korea needs to transfer the job of monitoring firms' risks from the state to financial institutions. The trouble is that Park left financial firms in too weak a state to monitor anything.
IN INDUSTRY, Park Chung Hee created Frankenstein companies that are
dangerous if left unsupervised yet near-impossible to control. His
contribution to South Korea's financial system was even more
misbegotten. In the early 1960s Park nationalised the banks and took
charge of their lending. Capital was allocated by government more than
by the market. The backlash against this intervention began immediately
after Park's death. But, as in industry, Park's financial legacy has
proved lasting.

In the 1970s Park ordered banks to lend to pet industries at negative
real interest rates. This loose-money policy made South Korea the only
Asian tiger to suffer damaging inflation. In 1980, with inflation
hitting 29%, the technocrats resolved to control prices. Unfortunately
they also had to worry about that other product of Park's easy-money
years, the vastly indebted chaebol. These two priorities pulled the
technocrats in opposite directions, causing unseemly contortion.

To fight inflation, the technocrats raised interest rates; but higher
rates risked driving big borrowers to default. They therefore had to
mix high rates with special low-rate loans for wobbly firms. These soft
loans, in turn, threatened to rekindle inflation. In desperation, the
technocrats resorted to ordering companies to keep their prices down.

At first sight, price controls seem to have worked tolerably well:
inflation fell to 7.1% in 1982, and has averaged 5.3% a year since
then. But a second look reveals a less encouraging picture. Government
orders to keep prices down have prompted firms to keep quality down as
well. Inflation has been bottled up, not tamed. In a few areas it has
blown its cork, notably in the land market. At prevailing prices, South
Korea's land is worth around ten times as much as its GNP; by contrast,
Japan's famously expensive land at the height of its financial bubble
was worth only five times GNP.

Land drain

Expensive land constantly threatens to inflate other prices too. Even
a modest rise in land prices of, say, 5% is enough to generate an
investment profit equal to half the economy's entire output for a year.
Anyone who owns land suddenly has money to burn. This, in turn,
provokes fresh waves of government intervention. In January all South
Koreans under 20, and all South Korean students, were banned from using
credit cards.

In short, the government has managed to keep inflation in check only
by maintaining Park's suffocating interventionism. As well as price
controls and bans on credit cards, this has meant keeping South Korea's
capital market largely closed to foreigners. The government is
terrified by the prospect of foreign investors flooding South Korea with cash and stoking inflation.

The trouble is that South Korea cannot stay closed indefinitely. This year the country applied for membership of the OECD, for which looser capital controls are one of the conditions. Besides, capital controls impose a heavy cost on South Korean firms, which can raise cash from foreigners far more cheaply than from domestic lenders. The struggle to keep inflation in check makes South Korea's interest rates punishingly high: the rate on ten-year corporate bonds is 9-10% in real terms.

South Korea is therefore opening a bit. In 1992 foreigners were allowed to buy South Korean securities, up to a ceiling of 10% of the equity of each quoted firm. Last December the ceiling rose to 12%; this July it is due to go up to 15%. Two South Korean firms were allowed to get themselves listed on New York's stock exchange last year. The ceiling on offshore bond issuance by South Korean firms is being raised, and on present plans is due to disappear completely by the end of this decade.

Crawl to freedom

Yet all this progress is painfully slow: several less developed states--Thailand, Malaysia, even Sri Lanka--have cut back restrictions on foreign access to their stockmarkets much more boldly. Foreign money men in Seoul blame the snail's pace on the finance ministry's addiction to controlling the economy. Yet the problem is more intractable than that. Park Chung Hee's financial policy undermined South Korea's ability to control inflation through conventional interest-rate measures. His successors therefore resort to blunter tools, never mind their liberal scruples.

After Park's death, the technocrats resolved to end state control of banks. South Korea's four commercial banks were privatised during the 1980s, and five new ones were allowed to open up. Interest rates were gradually freed, and the old rules preventing competition among different types of financial institution were relaxed. All this was meant to create lenders that could take over the government's role in distributing capital independence into the banks has proved as hard as relinquishing Park's legacy of inflation.

The banks' freedom has been undermined by the persistence of state-mandated "policy loans", which in 1990 accounted for 54% of bank lending slightly down on ten years earlier. Besides, Park left the banks too weak to stand on their own. During the 1980s many of Park's pet projects went bust, leaving dud loans that by 1987 accounted for nearly 10% of commercial bank total lending. Had they not been propped up by the government, the banks would have sunk with their borrowers.

Like inflation, the bad-loan problems have been suppressed, but the authorities live in fear of their re-emergence. Only 2.2% of commercial banks' loans are classified as underperforming now. But as part of the anti-inflation fight, the banks are required to hand 11.5% of their deposits to the central bank, hampering their efforts to expand lending.
room for hundreds of small "non-bank" lenders to spring up, and to thrive on relative freedom from government interference. The Seoul office of McKinsey, a management consultancy, estimates that South Korea has one lender per 6,000 people, a density about five times as great as the OECD average.

As a result, even South Korea's biggest banks lack the economies of scale needed to invest in computers and know-how, which puts them among the world's least efficient banks (see chart 8). This inefficiency is growing more critical. The deregulation of interest rates is raising banks' cost of funds while lending money is likely to grow riskier. The government may turn out to be serious about its stated policy of not rescuing bankrupt firms, leaving banks to shoulder the cost of failure. Financial deregulation may encourage the banks' bigger customers to issue bonds and shares rather than relying on loans, forcing banks to seek out smaller and riskier borrowers.

[TABULAR DATA OMITTED]

For any banking system, deregulation is perilous. In South Korea, the extreme regulation of the past, coupled with the legacy of bad debts, is prompting even the most liberal technocrat to advocate dismantling the controls. The longer the process is drawn out, however, the longer it will be before banks are ready to take over from the government in watching over industry.

The technocrats have made scarcely more progress in promoting stockmarket. In 1987 they introduced new rules making it easier for firms to issue equity, in the hope that this would reduce their worrying dependence on debt. Stock issuance ballooned: in 1989 14.7 trillion won worth of shares were issued, 50 times more than in 1985. Share prices, as measured by Seoul's KOSPI index, tripled between the start of 1987 and their peak in 1989. Then the KOSPI crashed. It bounced up again in 1993-94, but the bureaucrats' enthusiasm for the stockmarket did not.

While the market was falling in 1989-92, the finance ministry announced a series of "stabilisation plans". The issuance of new shares was discouraged to avoid depressing the market further. Banks, securities firms and insurers were ordered to buy shares, and required to contribute to a government fund that joined in the buying. At one point the ministry banned financial firms from being net sellers of shares on any day.

Then, when the market turned up, the government turned about. In 1993-94 it ordered financial firms not to bid the market up too high; one furious foreign broker recalls being ordered to sell a stock that he was making too much money on. In January this year the government formally announced that the market had risen too high and that its market-stabilisation fund would start dumping the stocks accumulated earlier. This meddling has prevented recent issuance of new shares from matching the 1989 level. Because the government feared that stock prices were too high, it insisted that new issues be priced below market levels. Companies have therefore preferred to issue bonds, perpetuating their nerve-wracking indebtedness.
By manipulating share prices, the government has also squandered a chance to reduce its role in overseeing industry. A freer stockmarket, in which prices reflect the views of private investors, would act as a discipline on South Korean firms: good ones would be rewarded with high share prices and a chance to raise plenty of fresh cash, while bad ones would be penalised. But South Korea's share prices barely reflect private investors' views. The government does not trust the stockmarket to look after itself, let alone to keep an eye on South Korean companies.

South Korea has shrunk from scrapping capital controls for fear of rekindling inflation. It has delayed banking deregulation because the banks are so weak. And it has meddled in the stockmarket lest crashing shares undermine growth, so driving South Korea's vastly indebted firms into bankruptcy. In finance, even more than in politics or industry, the legacy of Park Chung Hee has proved monstrously hard to unravel.

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Against the clock: South Korea is running out of time to deregulate.

IN THE early stages of a country's development, state leadership of the economy often seems to make sense: private firms are weak, markets are rudimentary. Governments are tempted to intervene, convinced that they will retreat when their economies are advanced enough to make liberal policies sensible. This survey has argued that South Korea presents a cautionary tale. Its policy-makers resolved to switch to liberal policies 15 years ago. They are still struggling.

Yet for all Park Chung Hee's faults and dangerous legacies, his country has done wonderfully well. When a popular revolt brought democracy in 1987, Park's critics thought that South Korea's high-growth days might be numbered. Trade unions drove up wages. Growing quantities of capital could no longer be relied upon to stoke growth, since no democratic government could go on confiscating savings. Even so, the South Korean economy has barely slowed down: its average real growth in 1987-94 has been over 8%.

This is partly because of an extraordinary piece of good luck. Two years before democracy broke out, the yen began a meteoric rise, giving South Korean exporters a chance to pinch many of Japan's customers. Since the Plaza Accord in 1985, the yen's value has doubled against the won. Although it has risen sharply against other currencies too, South Korea has gained more than most because it competes so directly with Japanese companies.

A decade ago Japan's strengths lay in heavy industries such as chemicals, ships, electronics and cars. Today these industries account for two-thirds of South Korea's exports, while the strong yen has forced Japan on to the defensive. South Korea is challenging Japan's position as the world's leading maker of ships and memory chips; it has its eyes set firmly on consumer electronics and cars. Growth through sacrifice under Park Chung Hee has given way to growth courtesy of the currency markets.

But South Korea has also continued to do well for another, less accidental reason. The country is at that glorious stage of development when it is brimming with learning and ideas but has not yet become complacent. Anyone who is anyone in South Korea seems to have a doctorate, often from America; everyone is bent on mastering new technologies and business methods. South Koreans fret constantly that they have not yet caught up with Japan, or that they may be overtaken by the next pack of tigers of sophistication and anxiety drives South Korea forward at a cracking pace. "When I go home to Los Angeles, it seems things are in slow motion," says James Bemowski, the boss of McKinsey's Korea office.

This drive gives South Korea's big firms a brash energy that their Japanese competitors lack. During the slowdown of the past five years,
Japanese companies have restructured as gently as possible. South Korean firms have enjoyed splendid growth, yet are desperate to improve themselves. Few Japanese firms deign to ask management consultants for advice. But consultancies in Seoul are inundated with requests for smart ideas.

South Koreans show no sign of developing the suffocating caution of their white-collar counterparts in Japan. Chaebol men think nothing of quitting to move to a rival firm or to set up their own. One manager at Hyundai Electronics says that three-quarters of the colleagues who joined the firm with him 12 years ago have since left. There is no equivalent to Japan's tribe of "window-gazers", office workers with nothing to do.

This dynamism is helping South Korea to climb the development ladder. South Korean manufacturers know how to assemble just about anything these days, but they are still weak in research and development. The top three South Korean electronics firms spend the equivalent of 5.9% of sales on R&D, still below the average 6.7% for the top eight Japanese firms. Yet that figure will rise rapidly. Over the past three years annual spending at Samsung Electronics has doubled to $1.2 billion. Hyundai Motor, South Korea's biggest car maker, aims to boost R&D spending from 4.7% of sales last year to 7% in 2000. This year Hyundai completed development of a second engine of its own, using nobody else's technology; until recently, Hyundai had been building all its engines under licence from Japan's Mitsubishi Motors.

After R&D, the next rung on the ladder is marketing. Until recently, South Korean brands were barely known abroad, not least because the under foreign labels. But now South Korean firms are increasingly building their own brands: this year Daewoo Motors, for example, starts selling cars under its own name in Europe. Samsung Electronics now sells three-fifths its PCs and nearly all its televisions under its own logo.

Hyundai Motor, which always used its own name, is redoubling its effort to boost its brand image. The number of workers in the firm's export-marketing department in Seoul has doubled since 1990, and the network of foreign dealers has grown even faster. Last year Hyundai started to enter its cars in international rallies; foreign motoring correspondents are wooed with increasingly lavish trips; a sports car will soon be added to Hyundai's range to liven up the image of its staple products.

In both marketing and R&D, South Korean firms' strategy is to learn from foreigners. In this they are loyal to the one great strength of Park C Hee's development model. Unlike the governments of India or Brazil, which built heavy industries to serve customers at home, Park backed only projects that promised to boost exports. Firms aspiring to win government support therefore had to produce goods to international standards.

This determination to learn from the world has become even stronger as the chaebol have started to invest abroad, and as more South Koreans travel. Last year South Korean firms' outward investment was 88% up on the year before; most of the expansion was in Asia, but South Korean firms are also building car plants in Canada and Uzbekistan, and an
electronics complex in Britain. As the new factories go up, more South Korean managers will be sent abroad. To prepare for this, Samsung has given some 2,000 employees a year off with no mission but get to know a foreign country.

Japanese lessons

South Korea's big firms are an impressive lot. This, to be fair, is largely thanks to the help that Park gave them. The years of rapid growth by sacrifice have given them a formidable momentum. And the outward focus that Park taught has made them keen to learn, which means that the moment generally converted into real gains--provided the bureaucrats restrain their more extreme impulses.

Thanks to the strengths of its big firms, South Korea's economy will probably remain among the world's top performers for the rest of this decade. That may lead many to conclude that there was not much wrong with the Korean model after all, despite the repressive regulation that it engendered. It is this view that poses the gravest threat to Korea's success the century.

South Koreans need look no further than Japan to see that a combination of strong exporters with strong regulation eventually brings trouble. Growing exports together with a domestic market too regulated to allow in imports will land South Korea with a trade surplus. Already the chronic trade deficits that plagued South Korea during Park's rule have all but gone; it will not be long before they give way to chronic surpluses. Japan's example suggests that South Korea's currency may then rise until it undermines its growth-generating exporters.

Rather than marvel at their continuing growth, South Koreans need to deregulate their economy before it gets into the kind of trouble that Japan now faces. Their government needs to stop deciding what firms may sell, what they may charge, and how much they may borrow. It needs to allow market discipline to act on South Korea's coddled farmers and service firms, not just on its big exporters. And it has to accept that markets give some rewards to people who are unworthy in official eyes--notably foreigners. Foreign consumer goods and foreign investment, both rare in South Korea, need to be made more welcome.

In short, South Koreans need to step up their 15-year fight against Park development model. This is hard, but not impossible. No man's legacy lasts forever. Already South Korea's military emperors have given way to a civilian one, who will in turn grow less imperial. The chaebol continue to overshadow the economy, but their alarming indebtedness has eased a little. Financial markets remain depressed, but less so than in the past. Driven by their unique mix of energy and paranoia, South Koreans are the first to agree that more needs to be done.

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