CENTER OCCASIONAL PAPER
ASIA-PACIFIC CENTER FOR SECURITY STUDIES
HONOLULU, HAWAII MAY 1998

Financial Crisis in Korea:
Implications for US-Korea Relations

Executive Summary: *1998 represents the Year of the Tiger in more ways that one. South Korea, the largest of the economies hit severely by the economic crisis, is struggling to put its internal house in order and restore confidence. US political, security, and economic interests in a stable and prosperous Korea have been reaffirmed and strengthened throughout decades of a close, mutually beneficial alliance. However, the financial crisis has underscored the permeability of political, security, and economic "interests." Korean leadership is primarily responsible for managing the challenges facing its recovery, whether they be domestic, political, or sociocultural. The United States should strive to balance its approach to helping Korea, as well as other Asian countries, by matching its strong technical response to the crisis with a firm diplomatic show of confidence which demonstrates that Korea remains a vital strategic ally.*

Introduction

The political and social fallout from the East Asian economic crisis poses new and complex challenges for the region's continued growth and stability. Asian economies face unprecedented levels of unemployment with little or no social safety structures in place, severe economic deflation due to austere International Monetary Fund (IMF) measures, social unrest, and domestic political resistance to major economic reforms. 1998 represents the Year of the Tiger in more ways than one. South Korea, the largest of the economies hit severely by the crisis, is struggling to put its internal house in order and restore confidence. What happened in South Korea? It is the only Northeast Asian economy requiring IMF assistance to fend off the financial crisis and the country economists and financial experts least expected to tumble. South Korea is also the world's eleventh largest economy and one representing a regional military "flashpoint." The impact of the economic crisis on political, security and external relations concerns, and the socio-cultural implications in South Korea, now in the midst of stabilization and recovery, warrants closer analysis.

Structural Weaknesses and a Crisis of Confidence

As South Korea moved incrementally toward liberalization in the early 1990s, longstanding structural weaknesses in Korea's financial system and real economy were exposed to the rigid disciplines of global markets. When a severe crisis of investor confidence struck the entire region—beginning in July 1997 with the devaluation of the Thai *baht*—weaknesses in Korea's economy, perceived by many as serious, but workable, suddenly proved too risky for investors, thus provoking a deleterious currency crisis in Korea.

Laura D'Andrea Tyson, President Clinton's former chief economic advisor, pointed out in a *Washington Post* editorial that when market panic takes hold, investors lose confidence not just in specific projects or sectors but in *entire countries*, bringing down the good with the bad. Although the crisis unveiled the fissures and flaws of an economic development model that outlived its usefulness, few predicted Korea would tumble as hard as it did. The force of a confidence vacuum—without a regional leader to stave off complete financial mayhem, as the United States did for Mexico's peso crisis in 1996—may have been a stronger factor than most presumed.

Structural Weaknesses Fueled by the Unhealthy Triumvirate of "Korea Inc."

Korea's financial system, corporate sector, and government elite shared an unhealthy symbiotic relationship since Park Chung Hee's adoption of the classic model of state-led economic development. Sanctioned with the authority to pick "winners"—whether it be firms or industries—and ensure a limitless flow of capital to the chosen few, the government created a host of moral hazard problems. The government's financial and policy backing led *chaebols*, or conglomerates, to develop a "too big to fail" mentality; at the same time, heavy government intervention in bank management led financial institutions to grow lax in scrutinizing loan applications for creditworthiness and risk.

As economist Cha Dong-Se of the Korea Development Institute recently posited, Korea's problems began when these three entities believed themselves "indestructible." With few cash flow problems to worry about, chaebols began overinvesting and diversifying excessively, driven less by profit margins than a desire to grow into huge self-sufficient empires. This pattern fueled a major side effect: banks lent whatever funds were available to chaebols at the expense of small and medium sized firms (SMEs), creating a "hollowed out" industrial sector.

In addition to these structural problems, Korea's economy suffered from what former finance minister Woo Nam-Duck refers to as the "four highs and three lows": high wage rates, high interest rates, high land values, and high transportation costs compounded by low technology, low value-added, and low managerial efficiency. When Korea initiated gradual liberalization in the early 1990s, these weaknesses only enhanced the increasing uncompetitiveness of Korea's domestic industries.

Events Leading Up to Korea's Currency Crisis

A new trend emerged in South Korean politics where exposing and abolishing corruption and crony capitalism became the central theme. A series of financial and political scandals surfaced during the Kim Young Sam administration, bringing down powerful legislators, corporate tycoons, heads of commercial banks, former presidents, and even the standing president's son.

From an economic perspective, Korea's currency was perceived to be overvalued since the second quarter of 1996, when the market price of the nation's main export product, semiconductors, fell by more than 70%. Other export products performed poorly as well, including steel, ships, and automobiles. Banks and companies enthusiastically borrowed short term loans for long term investments from foreign banks in the early 1990s. However, when profits dwindled in 1996, chaebols found themselves struggling to service their debts and began borrowing even more. The new political climate, however, forced financial institutions to tighten their lending practices—as the scandals demonstrated no government loyalty toward historically complicit banks. When profit expectations continued to fall in 1997, domestic and foreign investors found these investments less attractive. Increasingly concerned about the region's overall economic health, investors began moving their funds offshore. With less accommodating banks, major chaebols began to tumble, beginning with Hanbo in January 1997, followed by Sammi Steel, Kia Motors, and Jinro Group shortly thereafter.

Confidence in Korea's system rapidly eroded, causing massive capital flight. A sovereign default on Korea's debts was staved off by a record USD$57 billion IMF package and a USD$24 billion debt restructuring deal signed between the Korean government and private foreign banks. Taking into account Korea's structural weaknesses, however, these problems alone cannot account completely for the collapse. Korea was both a beneficiary *and* a victim of highly advanced, technology-driven movements of the global capital market of massive capital inflows based on excessive optimism on the part of investors and massive capital outflows based on non-economically deduced panic.

Economic Crisis, Political Transition, and Prospects for US-Korea Relations

The financial scandals of 1996 and Korea's economic problems effectively stripped former President Kim Young Sam of authority, leaving Korea leaderless for a large portion of 1997. The resurgent although brief nostalgia for former dictator Park Chung Hee does not necessarily reflect a romanticization of authoritarian rule, but instead suggests a frustrated body politic calling for stronger governance and a long-term strategic vision for Korea. For the first time in Korean electoral politics, a domestic crisis did not provoke the public to "go conservative." Rather, in a stunning turn of events, the people offered the nation's highest post to one of the most controversial figures in Korean politics, opposition leader and activist Kim Dae Jung (DJ). Although his close margin of victory may have deprived DJ of the people's mandate *per se*, Korean citizens rallied around the new leader almost instantly after the election results, regardless of whether they voted for him or not. This strong show of support by the people for DJ symbolizes democratic progress in Korea, but more importantly, a leap of faith in this perennial outsider who has spent his entire life looking in.

Identity, Anti-Americanism, and the Economic Crisis

The economic crisis has had a potentially transformative impact on Korean national identity, and in turn, nationalist sentiment. Political theorists Lowell Dittmer and Samuel Kim assert that a crisis of self-definition, or national identity, may occur when a country's agreed-upon national development trajectory is thrown open to fundamental question. Korea's rapid economic development and remarkable political achievements in recent years are a fundamental source of Korean national pride. In stark contrast, the economic crisis represents one of the most pivotal events to negatively shape modern Korean perceptions, both internal and external, equal in impact to the Japanese occupation, the Korean War, and the Kwangju massacre for most Koreans.

Anger and shame regarding the crisis and the IMF role were expressed early in the crisis through resurgent nationalism and an anti-American backlash. America's most famous diplomat, Henry Kissinger, cautioned recently that a "very virulent" kind of nationalism forms a particularly strong undercurrent in South Korea and urged restraint against promoting a sense of US triumphalism. The by-product of an austere IMF program, with prescriptions most Koreans—including many well educated elite—believe were shaped by US policymakers, could trigger an extended bout of anti-Americanism, not only in Korea, but also throughout Asia.

Bank and company closures, large scale layoffs, rising social and political unrest, and a loss of national cohesion and self-confidence are all certain to materialize in the form of a xenophobic backlash. Many Koreans believe they brought the crisis upon themselves, and thus the onus is placed on the nation's people to rebuild their own economy. While this may be true, Koreans continue to question the wisdom of parts of the IMF package, as do many economists in both the west and in Asia, and the United States' role in shaping specific parts of the IMF plan. When Korea begins to experience the real consequences of the austerity measures, for example, potential unemployment of as many as 1.5 million people, Korean politicians will deflect the people's anger by placing blame on the IMF, sowing the seeds for a renewed round of resentment.

An anti-American backlash is troubling for policymakers in the United States, Korea, and the rest of Asia for several reasons. First, it undermines regional peace and security. Foreign policy experts at a recent APC conference held in January discussed the possibility of a North Korean "miscalculation" of the South Korean financial turmoil, namely that it may perceive international financial institutions as a new source of funding for its own problems. More broadly, social and political unrest from vast unemployment, mass migration flows into and out of countries due to a lack of jobs, and ethnic tensions resulting from extended periods of recession could trigger conflicts in a region which lacks the institutional structures for peace and stability. Moreover, it may undercut regional support for a continued US military presence precisely when an American presence is necessary to buttress stability.

Second, strong anti-Americanism could trigger a negative reaction in the United States, in particular with members of Congress. Legislators are skeptical about whether these bailouts have taught Asian governments and foolish investors a lesson about prudent borrowing and lending. A backlash against the US could be interpreted as ingratitude, or worse, resentment against US support, and thus potentially undercut rationale for members to advocate a continued troop presence in the region. To make matters worse, cash-strapped Asian countries will revisit defense cost issues, from burdensharing to planned equipment purchases for modernization programs. Seoul already has approached Washington about revisiting cost issues for all of the above. In the US, cheap Asian imports will flood the markets as Asian economies try to export their way out of a recession, which might trigger another wave of calls for protectionism and fuel neo-isolationism. Congressional sentiment could be particularly prickly this year, given that many representatives are gearing up for November elections.

Third, and specifically for Korea, the backlash makes structural reform of Korea's economy harder for the new leadership. DJ is faced with the difficult task of restructuring the corporate, government, and labor sectors while attracting much needed foreign investment into his country. He simultaneously is running a carefully crafted but integral public relations campaign, from holding an American style "town hall" meeting to stumping across the country in order to convince the body politic that foreign investment is not only good for Korea, but necessary for national survival.

Although anti-American sentiment seems more subdued of late, continued Asian hostility toward the IMF will ensure a low-burn resentment against the United States for its perceived dominant role in managing the contents of the IMF packages. This perception was not helped by the fact that, at the height of the crisis in winter 1997, the United States approach to managing the economic meltdown was to downplay the diplomatic front and focus on the technical angle of the crisis. Although Secretary of State Albright and Defense Secretary Cohen were oddly absent from the region until 1998, Treasury Secretary Rubin was actively engaged in managing the crisis—but stressing throughout that he was there strictly as technical support to the IMF lead. US strategy may have been to distance itself from the politically volatile side of the financial crisis by emphasizing the technical—and seemingly less risky—part of the quagmire, but this approach led to a perceived "coupling" of US leadership with the IMF role. Korea's reaction to the "loss" of economic sovereignty to the IMF has triggered a national preoccupation with interesting sociocultural dimensions. Koreans consider themselves in the throes of the IMF *shidae*, or "IMF Age," a concept which defines every Korean's—rich or poor—newfound frugality and belt-tightening philosophy to daily living. Although the IMF's exact role in Korea's economic reform is not completely understood by all, its symbol is certainly widespread and closely linked with Korean perceptions of the United States.

Negative sentiments toward the IMF are not limited to Korea. For instance, a recent *New York Times* article pointed out that Indonesians are not as angry about the contents of the IMF agreement as they are about the "humiliating" image of Suharto hunched at a table signing the IMF deal. Indonesians are not against reform *per se*, but against reform that is imposed upon them by a foreign power. South Korea, Indonesia, and even Thailand, must maintain a balancing act between nationalistic sensitivities and much-needed reforms when considering the political feasibility of any policy. The very reforms that are critical for these ailing nations to adopt are threatened by the psychological perception that these reforms were "put upon" them through foreign pressure. Asian leaders also must keep in check a resurgence of anti-Americanism as the roles of the IMF and the United States are used as convenient scapegoats by policymakers to implement domestically tough reforms. Anti-Americanism is dangerous precisely because it is not perceived to be a real policy concern. Some think the problem simply goes away when relations warm up again, while others resign it as an unfortunate but usual sideshow of American leadership in the foreign policy arena—one of the costs of being a reluctant global sheriff.

Near and Long Term Prospects for US-Korea Relations

In the near term, both the United States and South Korea have strong political incentives to avoid confrontation, as a host of issues await—from bilateral cooperation on Four Party Talks to auto talks. Given the collapse in the won's value, Korea's Defense Minister Kim Dong-jin approached US Defense Secretary William Cohen about renegotiating Korea's USD$399 million annual tab for hosting US troops, as well as rescheduling USD$1.1 billion in payments due on arms purchases this year. Other defense planning purchases have been postponed, such as the purchase of C-17 planes and early warning aircraft. Cash-strapped Korea seeks partial alleviation of its portion of Korea Peninsula Economic Development Organization (KEDO) funding. Meanwhile, the current gap in funding for heavy fuel oil raises concerns about continued cooperation from North Korea.

Economic and trade relations pose the thorniest of near term challenges. Korea has figured prominently on the United States Trade Representative's (USTR) list of 'watch countries' as a repeat offender for years in several categories: intellectual property rights, import clearance problems, regulatory and investment barriers, and tariffs. Access barriers to Korea's auto market, however, represent one of the most politically contentious bilateral trade concerns in the immediate term. USTR designated Korea a "priority foreign country" (PFC) under the Super 301 provisions of US trade law in October 1997; PFC identification starts the one-year clock on Korea to resolve the concerns before the United States resorts to punitive sanctions.

It is in the interest of both countries to reach a quiet and amicable agreement, but how likely is such an outcome? Given Korea's economic straits, Seoul is more likely to ask Washington to soften its stance during particularly tough times. Politically, Washington has little choice. It is under real political pressure to eliminate some of Korea's countless trade barriers—especially since this is the year it loses its trade surplus with Korea, one of the hard-earned few in the Asia Pacific region. The United States also is likely to see a rise in Korean (as well as other Asian) exports into its market, forcing it to further raise the ante on improving market access. The first round of US-Korea auto talks, scheduled to begin in April, will serve as the first case—and possibly litmus test—for near term bilateral trade and economic relations.

More interesting than any near term effects of the crisis—and arguably more significant for long term US-Korea relations—is the influence of deep-seated anti-American sentiment on the bilateral dynamic. There are different dimensions of anti-Americanism in Korea. Whereas the older generation's resentment has been shaped by the division of the Peninsula and the 1980 Kwangju massacre, the younger generation's anti-American sentiment is fueled more by mercantilistic sources, like trade frictions, and a growing desire for the United States to recognize Korea's successes by treating the nation more equally. In this respect, the economic crisis of 1997 could be the defining political event for the younger generation of Korea's leaders in formulating their perceptions and attitudes about the United States.

President Kim seems cognizant of this growing concern, responding with an incredibly efficient and vocal campaign to talk in real terms about the importance of foreign investment in Korea, not only as a method of recovering from the crisis, but also as a rich source for strengthening Korean culture, education, and society. Although his present stumping is more likely to serve the country’s immediate needs for foreign dollars, defusing negative sentiments through greater communication and understanding goes a long way toward securing a more durable bilateral relationship.

US political, security, and economic interests in a stable and prosperous Korea have been reaffirmed and strengthened throughout decades of a close, mutually beneficial alliance. The economic crisis has underscored, however, the permeability of political, security, and economic "interests." As Korean leadership must work toward curbing a nationalist backlash and resentment toward the United States during the inevitably tough times ahead, US leadership must strive to balance its approach, not only with respect to Korea, but other Asian neighbors, by matching its strong technical response with a firm diplomatic show of confidence.

Jin Song is a Research Fellow with the Asia Pacific Center. She specializes on issues of political economy and Korean affairs.

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