Introduction - Viewpoint of Analysis

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0.1 The Economic Crisis in East Asia and Korea/Taiwan: Differences, Similarities and Contagion of the Crisis

0.1.1 The currency crisis in Korea

In the autumn of 1997, the Korean economy experienced a rapid outflow of short-term capital and the value of the won plummeted. On November 21, the Korean government asked the International Monetary Fund for an emergency loan. Even after the Korean government and the IMF announced a bailout package, however, funds kept flowing out of the country and its currency showed no sign of leveling out. On December 24, the IMF, the World Bank and a number of major industrialized countries announced an early implementation and expansion of financial assistance to Korea, and in January 1998, the Korean government and a group of foreign creditors reached a broad accord on the rescheduling of its debts. With these steps in place, Korea was able to bring its currency crisis under control and, for the time being, to keep it from further deterioration.

0.1.2 Factors underlying the currency crisis in Korea

In 1997, Thailand, Indonesia and Korea were successively struck by the currency crisis. There have been lively and broad debate about why these specific countries were hit by the currency crisis. People have pointed to the activities of hedge funds and other international speculators, as well as tardy policy responses stemming from the respective political problems these countries had[1]. As far as problems in economic management are concerned, the consensus in these discussions seems to be that they had the following three points in common[2].

First, they had inadequate financial systems. While they went ahead with financial liberalization and the decontroling of cross-border capital transactions starting in the latter half of the 1980s, their domestic financial systems had not undergone corresponding changes. Korea had aggressively pushed ahead with financial liberalization in the 1990s in a bid to become qualified as a member of the Organization for Economic Cooperation and Development (OECD). As we will discuss in Chapter 4, however, the liberalization of fund management lagged behind that of procurement, leading to a rapid, unilateral inflow of overseas funds. In 1996, the government gave approval to the establishment of a large group of merchant banks (nonbank institutions), which competed with the national commercial banks in absorbing funds from abroad and investing them in the domestic market. However, regulatory and supervisory systems were inadequate, as shown by the separation of supervisory agencies, with the Bank of Korea overseeing banks and the Ministry of Finance and Economy taking charge of merchant banks.

The second problem had to do with the huge current-account deficits, and the financing of these deficits with short-term foreign capital. Korea recorded a slight current-account surplus in 1993, but slipped into the red in 1994. Its current-account deficit expanded rapidly, and reaching a record $23 billion in 1996. In that year, a large number of merchant banks were established, and they, together with commercial banks, aggressively introduced short-term funds from abroad which they invested in the domestic market.

The third point was the inadequate management of foreign exchange rates. East Asian countries had essentially pegged their currencies to the U.S. dollar in order to facilitate investment from abroad. But this dollar-peg policy resulted in overvalued effective exchange rates for their currencies following the Japanese yen's depreciation starting in 1995, as well as due to other factors, leading to decline in international competitiveness and export performance. Korea had a de facto managed float system for its currency, the won. Though Korea's current-account deficit expanded from 1994 onward, the won did not weaken against the dollar. In the face of the yen's further depreciation in 1996, Korean exports plunged substantially and the current-account deficit surged. The insufficient devaluation of the won thereafter led to the latest currency crisis.

0.1.3 Taiwan: currency crisis averted, but effects of the economic crisis are felt

In contrast with Korea, Taiwan has so far escaped a serious currency crisis. In light of the factors which contributed to the currency crisis in other countries, which we discussed above, Taiwan lagged behind Korea in the deregulation of external capital transactions, as explained in Chapter 4, preventing short-term foreign capital from flowing into Taiwan in large amounts. In addition, Taiwan's current account has consistently registered surpluses since the early 1970s, without any problems in the management of the currency's exchange rates. Taiwan holds one of the largest foreign exchange reserves in the world, and thus there was little room for speculators to mount an attack on its currency.

However, Taiwan has not been able to stay completely aloof from the economic crisis which overtook the entire East Asian region. Korea, Thailand and Indonesia, all of which went through currency crises, experienced severe credit crunches and subsequent rapid deteriorations in their real economies in 1998, falling into situations that could be called a general economic crisis. The worsening of their real economies had a contagion effect on other Asian countries through trading activity. Taiwan saw its exports to these countries decrease, and its economic growth slow in 1998. Moreover, the case of steel trade, as we discuss in Chapter 3 shows that export drives by Korean companies, mired in the domestic slump, are have had a major impact on Taiwanese firms. With the Taiwanese economy stagnating, bankruptcies of financial institutions and other problems have emerged. As we discussed in detail in Chapter 2 Taiwan also went ahead with financial liberalization without fully adequate supervision in place. As a result, the number of financial institutions grew, with a concomitant intensification of competition, spawning laxity in risk management. The situation allowed some companies to indulge themselves in reckless money games, and when the economic slowdown caused them to run aground, financial institutions with close business ties to such firms immediately faced a swelling of bad loans.

0.1.4 The perspective of this report

As Korea and Taiwan found themselves suffering from the effects of the East Asian economic crisis, there were clear difference between the two, in that Korea faced a currency crisis while Taiwan did not. However, the economic crisis eventually spread to Taiwan, and this showed that Taiwan in fact had problems that were similar to those found in Korea. This report is intended to analyze the differences and similarities between Korea and Taiwan in the crisis, as well as the problems involved in the contagion of the crisis.

In this analysis, we focus on problems involving the entire economic structure, including industrial structures and corporate systems, as the background behind the outbreak of the crisis, rather than the immediate factors behind the currency crisis. It is undeniable that the latest crisis was caused by policy failures in such areas as exchange rates, financial systems and financial liberalization. Without these failures, the crisis would not have taken place. But the financial system, for example, is just one subsystems in the national economy, and cannot be discussed in total isolation from other subsystems, such as corporate systems. Also, since the swelling of current-account deficits reflected high investment potential, it must be explained not only from the inflow of funds but also from the real sector.

In the next section, we will attempt to show that the differences in economic structures and economic crises between Korea and Taiwan may have been caused by the differences in their mechanisms of economic development.

0.2 Development Mechanisms and Economic Crisis

0.2.1 The development mechanisms of Korea and Taiwan

Together with other researchers, we previously carried out a comparative study of the economic development mechanisms of Korea and Taiwan up to the mid-1980s[3]. The principal conclusions of that study were the following two points.

First, while both Korea and Taiwan stood out among postwar-period developing economies in the success of their economic development, both of which shared the pattern of export-led industrialization and high dependence on the U.S. and Japanese economies, there were non-negligible differences between their underlying development mechanisms. We clarified these differences through analyses of total factor productivity, size of businesses, and the development processes of specific manufacturing sectors. In summary, the differences between the development mechanisms of the two countries involved the roles of state and market, or of governments and the private sectors. In Korea, the government provided the leadership in economic development, and created and nurtured industrial conglomerates called chaebols, which acted as combat troops, dancing to the tune played by the government. In Taiwan, on the other hand, government only played a limited role in its economic development. In particular, government involvement in the export sector was marginal, and this "space left unattended" was left in the hands of the private sector. Taiwanese private firms moved actively in that space, as is shown by the rapid growth of small businesses.

Our second conclusion was that the differences in the roles of government and private sector had been regulated by economic, political and social factors. We tentatively presented three specific explanatory factors: the level of development at the start of postwar economic development, the relationship between state and society, and the principles behind the formation of social networks.

0.2.2 Development mechanisms and economic crisis

0.2.2.(1) Internal changes: decreasing governmental role and rising wages

As we discussed above, up until the latter half of the 1980s, Korea and Taiwan were able to maintain economic growth through different, but similarly rational, mechanisms. In addition, it should be noted that in both cases these mechanisms were based on low wages. Korea's mechanism was sustained by foreign currencies earned through labor-intensive industries, while Taiwanese private firms were able. to entered international markets by means of cheap labor.

As the economic environment changed in the 1990s, however, Korea found that its development mechanism not easily adaptable while Taiwan found it possible to accommodate its own mechanism. The changes in the economic environment can be divided into internal and external ones. First, the internal changes which stood out in Korea were a decrease in the government's role, and an increase in wages that accompanied the high economic growth since the late 1980s.

In Korea, the government's of the development mechanism began to shrink gradually in the 1980s. The Korean government, by the 1990s, was no longer a leader determining the direction of industrial development. However, the government-led economic development gave birth to industrial conglomerates called chaebols, which now lead the country's economic development in the place of the government.

The following two observations are of importance from the present point of view regarding the process of chaebol formation under the government-led economic development. First, the Korean government viewed economies of scale as important, and favored the intensive use of funds raised at home and overseas. The chaebols were formed with a concentrated infusion of funds, under this line of thinking. Second, within this framework of economic development, the bulk of the risks was borne by the government. In the 1980s, as the government's leadership role ebbed and the chaebols began to stand on their own, these characteristics were retained in the following manner. First, the intensive use of funds continued to be a source of competitiveness for chaebols even after the 1980s; and second, chaebols failed to sharpen their sense of risk and continued to rely heavily on borrowings. Moreover, since the government, while lessening its leadership role in industrial development, retained its influence over banks, or in other words, since banks failed to acquire full independence in management, the banks failed to discipline the chaebol effectively, which aggravated the lack of sensitivity to risks among the chaebol.

As a result, the chaebols continued their active investment despite scaled-back government support, and continued their high dependence on borrowings from both domestic and overseas markets. Moreover, the decreasing influence of the government resulted in the loss of an important monitoring mechanism. In addition, as labor-intensive industries swiftly lost competitiveness amid rising wages since the latter half of the 1980s, the chaebol groups had to place an increasingly disproportionate emphasis on capital-intensive industries, using their abilities to mobilize funds as the main source of competitiveness. These characteristics of chaebol-led economic development formed the background for the forthcoming crisis. High debt-equity ratios greatly raised the risk of defaults and an increased leaning toward the mass production of equipment-dependent concentrated items spawned the danger of erratic fluctuations in exports and expanding trade deficits resulting from high levels of imports.

In Taiwan, on the other hand, the private sector had no choice but to find its own development path in the absence of strong leadership from the government. In comparison with Korea, Taiwan's private firms could not find a source of competitiveness in massive funding power, and their independent efforts led to an orientation toward niche markets and a strengthening of links to the U.S. markets. Second, as they had to shoulder most of risks themselves, they acquired a sharp sense of risk and grew cautious about borrowing. On the strength of these characteristics, they were able to break new ground in such areas as personal computers and peripheral equipment by creating a flexible structure of manufacturing and distribution based on division-of-labor networks among firms, even in the face of rising labor costs and the eroding competitiveness of labor-intensive products; and they were able to accomplish this without relying on funding power, as their Korean peers did. The current stability of the Taiwanese economy is founded on these factors.

0.2.2.(2) External changes: global shifts of capital and Japan's economic slump

As for changes in the external environment, the first factor that must be mentioned is the changing international financial situation. At present, funds shift globally at an extremely fast speed. In such a climate, it can be assumed that Korea's development mechanism harbored great risks resulting from its heavy dependence on borrowings from overseas.

The second noticeable change took place in the economic circumstances of the industrialized countries starting in the early 1990s. Tracking Korea's industrial development, we find that it has followed in the footsteps of Japan's postwar development. In the latter half of the 1960s, the Korean government focused on the development of heavy and chemical industries, and launched shipbuilding, steel and automobile industries. These had been Japan's leading industries in the 1950s, 1960s, and 1970s, respectively. In the 1980s, when the leadership of industrial development was passed from government to the chaebols, Korea started its semiconductor industry, which was a rising industry in Japan at that time. This is an indication that in Korea, both government and chaebols regarded Japan as a model for industrial development. Korea achieved its growth by filling spaces where Japanese industries left.

The problem for Korea, in this regard, is that the Japanese economy came to a standstill in the 1990s, and this increased the intensity of competition between Japanese and Korean industries. In the meantime, Korea had relatively weak linkages with the U.S. economy, which had shifted into high gear as if to replace the stagnating Japan, and thus the dynamism of the expanding U.S. economy failed to be fully conveyed to Korea.

In contrast to Korea, the development mechanism of Taiwan can be said to have been more responsive to the changes in the external environment in the 1990s. First, Taiwan, because of the low debt-equity ratios of companies and the macroeconomic strength derived from its constant trade surpluses, was more resilient to drastic changes in the international financial situation. Second, though the Taiwanese government had once regarded Japan as a model, its industrial development in the 1980s onward increasingly deviated from this model and the Taiwanese economy gradually strengthened its linkages with the U.S.. Consequently, Taiwan felt only a faint blow from the stalling of the Japanese economy, but it fully enjoyed the benefits of the booming U.S. economy.

0.2.3 Considering responses to the economic crisis

The aim of this report is not to discuss responses to the economic crisis, but we can still offer an approach that might be adopted, by considering possible responses through an analysis of development mechanisms. The approach we describe below will be particularly useful in terms of medium- and long-term responses.

A development mechanism is a system made up of several subsystems. Therefore, when a factor that acted as an immediate trigger for a crisis is to be reformed, the effort still requires an adjustment of the whole system. For example, if a Korean company had to lower its debt-equity ratio and in particular to curb borrowings from overseas, it would lose much of its ability to mobilize funding, the very source of its competitiveness, unless an alternative source of funding, such as an expansion of direct financing, could be created. The optimal solution would be for other factors to make up for the decline in competitiveness based on funding power, but this would require considerable time. Therefore, it seems necessary to be careful in selecting procedures and duration when designing medium- and long-term responses from the viewpoint of development mechanisms.

Notes:

1. In Korea, the government of President Kim Young Sam became a lame duck administration in 1997 ahead of the presidential election, and lost the ability to implement effective policies. In addition, election-conscious politicians shied away from taking the drastic but painful measures needed to deal with the crisis, thus making the arrival of the (currency) crisis inevitable. Though this is a very important subject, the current report could not cover it. We will plan to consider this subject in the future.
2. There are numerous articles and commentaries on the Asian currency crisis. Among those available at present, one of the best-organized articles is Kawai, Masahiro, "Higashi Ajia Tsuka/Kinyu Kiki to Nihon" (East Asia's Currency/Financial Crisis and Japan) in *Sekai*, March 1998, pp.84-88. We consulted his article in the following discussions.
3. The results of this comparative study were included in Tamio Hattori and Yukihito Sato ed., *Kankoku Taiwan no Hatten Mekanizumu* (Development Mechanisms in Korea and Taiwan), Tokyo: Institute of Developing Economies, 1996. This report was written as an extension of that comparative study, taking into account the latest economic crisis.