BankBoston
BankBoston, N.A. Singapore

Emerging Markets Research: Asia

July 21, 1998

Emerging Markets Research Group

William H. Overholt
Head of Asia Research
65-390-0550
woverholt@bkb.com

Jie Hu
Vice President
65-390-4749
jhu@bkb.com

Jain Praveen
Vice President
65-390-4747
jpraveen@bkb.com

KOREA: TO THE MARKET VIA SOCIALISM

William H. Overholt

- South Korea has honored its IMF agreements better than any other troubled country.
- The crisis of foreign exchange liquidity is over. With a low debt service ratio and a prospective US$40 billion current account surplus South Korea will not in the foreseeable future lack the foreign exchange to pay its obligations.
- President Kim Dae Jung is sincere in his desire to move toward a market economy, and he sees economic democracy and political democracy as intertwined.
- On the way to a market economy, however, the government will have to recapitalize most banks and as a result will end up controlling of them. Likewise, so many companies are in trouble that the banks will effectively control most of the important companies, giving the government indirect control over big companies. South Korea will become, for an interim period, far more socialist than China.
- Despite the government's desire to reduce the chaebols' role, in the immediate future the market share of the top chaebols will greatly increase because the big five have funding and virtually nobody else does.
- A vast potential influx of foreign funds is being held up. Bank loans and bond underwritings cannot be done even for most of the best companies, which tend to be hobbled by a network of cross-guarantees. Foreign direct investments depend on local firms' being realistic about prices, and on Korean banks' willingness to write down loans realistically; so far, neither is happening.
- Both the private sector and the government lack the skills to undertake the needed bank and corporate restructuring. The solution of the domestic debt crisis, and the revival of the domestic economy, depend on a vast acquisition of foreign investment banking skills that so far is not in prospect.
- Korea has a much more decisive government than Japan and could emerge from crisis much faster. But 1999 will be a very political year and there remains some risk of Korea degenerating into a quagmire much worse than Japan's.

Emerging Markets Sales, Trading & Research.

150 Beach Road
#07-00 Gateway West
Singapore 189720

KOREA: TO THE MARKET VIA SOCIALISM

In late 1997 South Korea experienced a multiple financial crisis: a foreign debt squeeze which exhausted the country's foreign exchange reserves and would have led to pervasive private sector default without emergency foreign assistance; a drastic decline in the dollar value of the Korean won; the bankruptcies of many companies, including seven of the top 30 conglomerates, with many more bankruptcies impending; and a financial sector collapse which jeopardized the continuity of many banks and other financial institutions.

The proximate cause of these developments was the regional currency crisis, which put downward pressure on all regional currencies, upward pressure on all regional interest rates, and extreme outward pressure on short-term capital flows. But South Korea, like Thailand and Indonesia, would eventually have suffered a crisis even if no regional currency collapse had ever occurred. The Korean system of high domestic interest rates and relatively open access to cheaper foreign capital ensured an unsustainable inflow of short-term foreign money. By 1996 South Korea's short-term debt amounted to just under half of its total debt, and although the size of its total debt was quite reasonable this made it vulnerable to capital flight. The hugely leveraged balance sheets of nearly all big Korean firms ensured that one day, when interest rates rose, there would be a domestic liquidity crisis of the chaebols (as Korea's giant conglomerates are called). And the Korean financial system, which allocated money by political fiat and bribery rather than by competitive creditworthiness, together with the exclusion of foreign banks which would otherwise have brought to Korea modern skills for the efficient use of capital, ensured that capital would be allocated inefficiently; everywhere such systems lead to over-capitalization of inefficient industries, under-capitalization of efficient industries, and eventually a crisis of the real economy.

In addition to its chaebol bubble and its foreign debt crisis, South Korea had a labor bubble which had no analogue in Thailand or Indonesia. By the mid-1990s South Korean manufacturing wages were the highest in Asia outside Japan, even though South Korea's per capita GDP was only half that of Hong Kong or Singapore. This was bound to make South Korea uncompetitive and, as with the other bubbles, it inevitably had to burst. But the labor bubble is even more politically intractable than Asia's other bubbles because of its unique history.

The Fundamental Crisis: Socialist Allocation

South Korea is experiencing a classic crisis of socialism. The squeeze experienced by its banks and chaebols is precisely analogous to the squeeze being encountered by China's banks and state enterprises. Although South Korea shares with Indonesia and Thailand the problems of short-term capital flight and currency pressures, South Korea is fundamentally different in the degree to which its banks have never been real banks and its chaebols have been servants of the government. Indonesia's and particularly Thailand's banks were real banks, allocating capital according to the market and using skills similar to those used in Western banks. Thai banks made serious errors of judgment, and Indonesia's banks had weak skills and were vulnerable to corrupt pressures from the ruling family, but they made credit decisions and were subject to the rules of the market. Korean banks in contrast possessed neither credit skills nor incentives to acquire them. At the onset of the crisis, no Korean bank had a serious credit department. They lent primarily to the chaebols, based on the same kinds of political pressures and implicit guarantees that affect Chinese banks.

A skeptic might object that there is a more fundamental difference between the Chinese and Korean situations: South Korea's banks and chaebols are private, whereas China's are owned by the government. This distinction, however, is less important than it seems. Ever since Ralf Dahrendorf exposed Karl Marx's analytical shortcoming on this point, we have understood that control is more important than ownership. South Korea started off in classic socialist fashion with all banks owned by the government. The government then privatized them without sacrificing control. First, it privatized minority shares, as China is now doing with big enterprises. Then it moved to privatization of a fragmented majority, while the government retained a controlling minority position. Eventually it found that it could privatize 100 percent without sacrificing control: it limited individual ownership to a tiny fraction (initially one percent, later four percent) in order to fragment ownership, while retaining intricate regulatory powers and a veto over the top management of the bank. By exercising its retained privileges in strong fashion, the government was able to name the board and top management of the banks and thereby control their decisions. This was socialism without ownership. The result was socialist banking, right up to early 1998: the allocation of credit in virtually complete disregard for creditworthiness and the efficient use of capital.

Similarly, to a degree that resembles China more than Thailand, the chaebols were designed to be creatures of the government. They were created by the father of modern South Korea, Park Chung Hee, who set up politically loyal henchmen with privileges and credit that were denied to all other firms and, in a desperate effort to triumph over North Korea, urged them to seek size and market share without regard for profitability. The president's office worked with the chaebol managers to decide the product lines and to set annual production and export (but not profit) targets, and then the president's office decided every bank line, licensed every import, and approved every foreign loan in line with the agreed plan. This too was socialism without ownership. Since the early 1980s, the chaebols' ties to government have been gradually loosened. The president's office no longer sets annual production plans, directs the products to be produced, or licenses individual imports. But the government has continued to provide an exceptional level of protection against imports, an exceptional degree of hindrance of foreign investments that might compete with Korean firms, and non-market allocations of capital. The Korean system is structured in a way that ensures the chaebols of excessive access to credit and deprives nearly everyone else; it is so well designed for this purpose that it has remained resistant even to later strong government efforts to channel funds to small and medium size enterprises. As a result, Korean chaebols have been able to leverage themselves to a degree impossible elsewhere, to continue the pursuit of scale without regard for profitability, and to proliferate into diverse lines of business (e.g., Samsung's automobile business) without regard for market need or expected profitability.

This is modified socialism without public ownership and, in the case of industry, without socialist accountability to the government. It is more competitive than China's, with several competing firms in every market rather than one (this is the direction China too is now headed). As compared with Indonesia, state influence is truly for the state, and it passes from one president to another, whereas in Indonesia the state subsidies and regulatory privileges largely served family interests rather than the institutionalized requirements of the government. Ultimately, with all the detailed differences, South Korea's system leads to a crisis of socialism due to the systematic misallocation of capital to inefficient, politically directed uses.

Politics: Getting Ideologically Straight

Markets have been exposed to the strange phenomenon of a right-wing government getting itself into a crisis of socialism and then being replaced by a radical populist who advocates and implements a classic right-wing market reform. This has led to two conflicting interpretations: one, that the radical populist Kim Dae Jung is implementing ideologically incongruous measures because he has no choice, and, two, that he has always been an advocate of free markets. Neither of these interpretations is correct.

Park Chung Hee, the general who governed South Korea from 1961 to 1979, created the mold which shaped his successors, Chun Doo Hwan, Roh Tae Woo, and Kim Young Sam. Because he was a general and because he was on the side of the West, journalists have always portrayed him as a right-wing figure in the sense with which that phrase would be used in the United States. He was not. He was a nationalist who believed that Koreans should own Korea and he created trade and investment regimes which even today are much harsher on foreign traders and especially foreign investors than China's. (The positions that Motorola, Avon, Procter & Gamble, Coca Cola, Volkswagen, and many others hold in the China market are inconceivable in Korea.) He was a general who believed in hierarchy and patriotism. Hence he believed that the government should control the banks directly, and control industry both indirectly through the banks and directly through intricate regulation. Industry should directly serve the national interest of overshadowing North Korea, not the narrow interest of corporate profit. He was instinctively socialist; he got into trouble early in his career for helping his brother who ran a communist front, and the degree to which his government accepted private ownership reflected heavy pressure from advisors rather than his own deep conviction. And he was a radical egalitarian, who believed in massive government distortion of the market to ensure an egalitarian income distribution. His taxes made four cylinder cars cheap and six cylinder cars outrageously expensive, his taxes and subsidies made Korean urban and rural wages the most nearly equal of any in the world, and his harassment network ruthlessly tormented any capitalist who indulged in excessive conspicuous consumption. At times his radical egalitarianism was almost Maoist; when he discovered that six high schools were providing such a good education that their entrants provided half the entering class of prestigious Seoul National University (which admits solely on the basis of competitive examinations), his reaction was to close the six schools in the name of fairness.

Conversely, for four decades, both Park's allies and Western journalists have portrayed Kim Dae Jung as a classic radical, with leftist economic and political ideas and perhaps a touch of sympathy for communism. In 1980, Chun Doo Hwan sentenced him to death and justified the sentence in part by characterizing him as a communist. In the 1997 election, the leadership of the South Korean intelligence agency attempted to sabotage his campaign by having his government characterize Kim Dae Jung him as a communist sympathizer. Peruse the New York Times from the 1960s to 1996 and throughout you will find the classic leftist portrait. This is the exact opposite of the truth. Kim Dae Jung began his political career by serving and leading a political party whose roots were the landlords who resented land reform and the Christians who, having acquired a monopoly on education in the Japanese era, led the country and resented the emerging loss of their monopoly position under Park Chung Hee's program of universal education. In short, the party predominantly represented social reactionaries.

But the practicalities of politics led to decisions which gave a different veneer to Kim Dae Jung's politics. Kim Dae Jung represented a minority religion and an outcast region of the country, long neglected and long associated with poets and other non-establishment symbols. Representing such an area, and lacking ties to the military, he was condemned to be an outcast and his natural allies were the other groups who were structural outsiders; as in most other third world countries, these were the labor unions, the students, the journalists, and fellow unemployed politicians. As elsewhere, these diverse groups were united by the symbols of human rights and democracy; Kim Dae Jung was especially agile at transmuting his Christian social base and his beliefs in human rights and democracy to create both a domestic political base and an international support network. This did not mean, however, that he was the creature of his support groups in the way that the British Labour Party was once the creature of labor unions. Sometimes stark differences appeared. For instance, in 1980, following the 1979 assassination of Park Chung Hee, both Kim Dae Jung and the government drafted new constitutions; Kim Dae Jung was prepared to impose much sterner controls on labor than the government was.

For most of his political career, Kim Dae Jung's economic philosophy was inchoate. His advisors included few people with any economic expertise or business or government management experience. I interviewed him regularly from 1972 to 1980. Each time I asked him how his economic policies would differ from Park's. He invariably said that he would be more egalitarian. When I pressed him for details, he came up with policies that Park was already implementing; it was hard to outflank Park Chung Hee on the side of radical egalitarianism. Kim Dae Jung's real economic policy differences came down to resentment of the economic power of the chaebols and of the incomes of a few of their leaders--all of whom were, not coincidentally, the allies of President Park. When he was in exile at Harvard, however, Kim Dae Jung's philosophy evolved into an admiration for the American combination of fragmented market economy and political democracy, which he rightly saw as being intimately related. Just as his initially reactionary ties to

Christian groups had been creatively transformed into an internationalized human rights force, now his resentment of the chaebols now evolved into a more positive and creative admiration for aspects of the market. Still, he was far from a Western investment banker's hero of market ideals. Five years ago he published a book that was a curious amalgam of market ideas and populist ideology. Even today, he is a more consistent market advocate with foreigners than with locals; officials mention for instance that he demanded they reduce the call rate to 12% and that he demanded an increase in the rice price for farmers even though Korean subsidies already make that price four to six times the world market price. His belief in the market is genuine, but he is a politician first and economist second.

During the economic crisis of late 1997, Kim Dae Jung rose to the occasion like no other leading political figure in Asia. After an initial misstep in which he promised that, if elected, he would insist on re-negotiating the IMF agreement, he quickly made not just a virtue but also a great opportunity out of necessity. He declared himself a total believer in the IMF agreement, articulated a philosophy of moving toward a market economy, declared that that the market and democracy were interlinked and that the crisis would not have occurred if Korea had been a democracy, appeared on national television alongside George Soros, and after winning the presidential election used his philosophy to seize effective leadership of the government while his opponent still held the presidency. He led his country quickly out of the acute phase of the crisis by adhering more closely (according to IMF officials) to the IMF agreements than any other troubled country.

Now he has a staff of 40 people with the designated task of creating "DJ-nomics," which is to be, like Reaganomics, a combination of market economics and democratic ideals expounding what he sees as his personal vision of the interplay between economic and political freedom.

The Foreign Exchange Crisis

South Korea's foreign exchange crisis was structurally similar to that of other small Asian countries. Firms had borrowed too much, and too much of that borrowing was in the form of short-term foreign loans and portfolio investments. More so than elsewhere, Korean firms had not just borrowed directly but had also used their offshore subsidiaries to borrow money that was not originally counted against the country's foreign debt. When the regional crisis hit, the hot money fled, the loans were called in, the won's plunge hugely magnified the local cost of the foreign debt, the offshore borrowings of chaebol subsidiaries were suddenly counted as foreign debt, and almost overnight South Korea found it had effectively exhausted its foreign exchange reserves. The government of Kim Young Sam refused to face its problem squarely, so in December Kim Kiwhan, a former official of the Chun Doo Hwan government, got on a plane to Washington to announce that his country had exhausted its foreign exchange reserves.

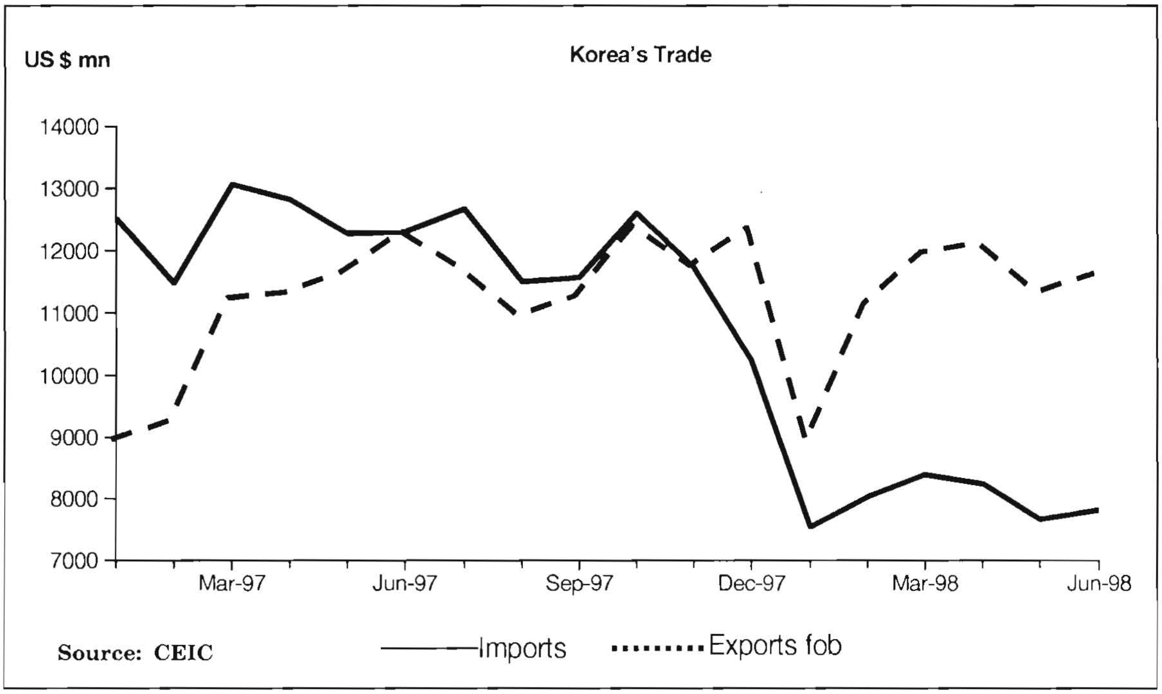
When Kim Kiwhan arrived, Washington was ready to act. Months earlier, international bankers had alerted the Federal Reserve leadership that South Korea's problems and its pivotal role in emerging markets had the making of an international catastrophe.[1] South Korea has a huge economy compared to other troubled third world countries. Its firms held something like a quarter of all Latin American securities and something like a quarter of all the Russian GKOs held outside Russia. It was a principal direct investor in Eastern Europe. Because of all this, South Korea, unlike Indonesia and Thailand, was treated as too big to fail. Hence Washington brokered, on an emergency basis, a deal whereby developed world banks promised to roll over their exposure to Korean banks. When a loan from an American bank came due, the American bank had to make a new loan of at least the same amount to some Korean bank or risk the wrath of the American regulators. This deal, more than the IMF package, saved South Korea from immediate default.

Indonesia and Thailand got no such special treatment. Part of the problem was that their debts were largely corporate rather than bank debts, which made a rollover deal more difficult technically. But the more important reason was that Korean failure was perceived as threatening the global system whereas potential Thai and Indonesian defaults were perceived as more manageable. In principle the greater technical problems of an Indonesian or Thai rollover deal could have justified a bigger effort precisely to overcome problems that in retrospect we understand to be leading toward famine for several million innocent people, but that was not the calculation in late 1997. In addition, bailing out predominantly Suharto-related firms in Indonesia was seen as politically repugnant and as political poison for a Clinton presidency that was still facing accusations over illegal campaign donations from the Indonesian firm Lippo. Washington's conversion to the theory that Korea was too big to fail, and its respect for Korean democracy, together with Kim Dae Jung's revelation on the road to Blue House that the IMF deal was sacred, were the political considerations saved Korea from international default.

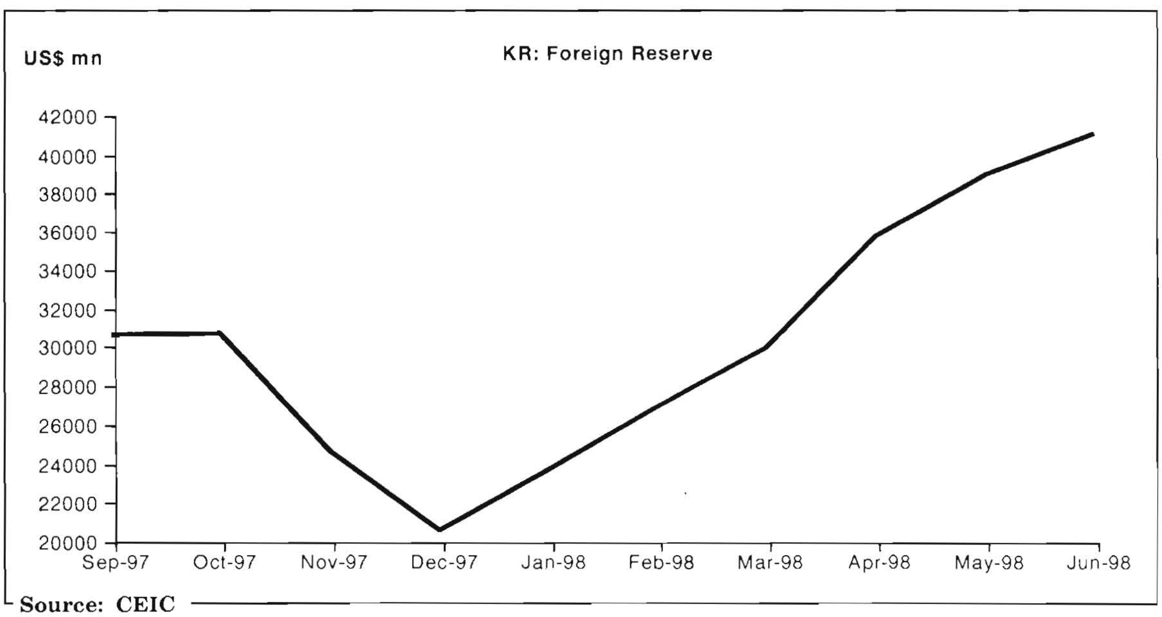
That salvation has been fully accomplished. South Korea's international debt problem was a liquidity problem, not a crisis of solvency. Earlier this year, when South Korea's current account surplus was forecast to be $20 billion, the Institute of International Finance projected a debt service ratio of just over 11%., or roughly half of the 20% which is considered reasonable for a creditworthy economy. Now the government projects a current account surplus of $40 billion in 1998 and the IMF conservatively projects $30 billion. Such surpluses cannot be sustained for long because they are achieved in part by using up accumulated inventories of imports which are essential to manufacture future exports. But even if the surplus is substantially less than the government projects, the annual debt service is now low enough, and the country's usable foreign exchange reserves are now high enough, that the crisis of sovereign debt can be regarded as past--a remarkable achievement given the intensity of the crisis just six months ago.

This achievement in turn derives from a severe contraction of the economy which has drastically reduced imports without expanding imports. As the chart on Korea's Trade shows, the collapse of imports has created a huge surplus.

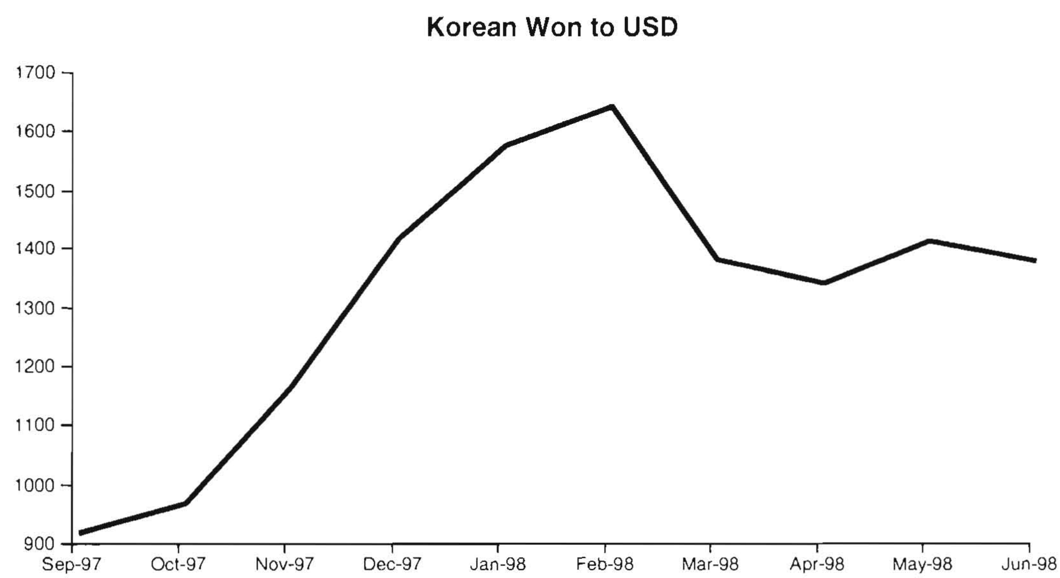
[1] This writer was one of those who detailed the extent of the potential problem to some rather surprised senior bank examiners.



Korea's foreign creditors have additional solace from the fact that the Korean government and the big companies have continued to be especially solicitous toward their foreign creditors. Generally foreigners get paid even if the locals do not. This was the case even with Kia. In Thailand foreigners usually take a back seat to Thais. In Indonesia it is not uncommon for companies to refuse to pay the foreigners even when they have the money.

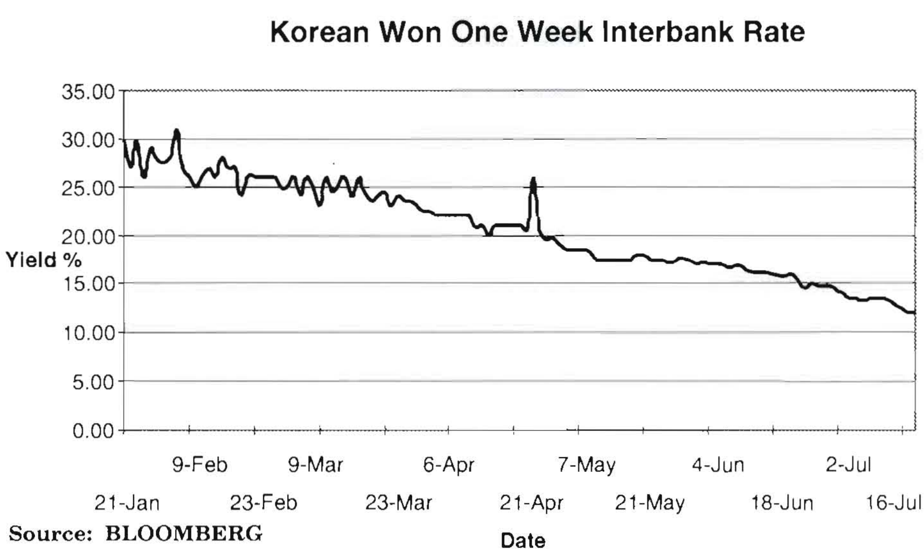


The passing of the foreign debt crisis has in turn relieved pressure on Korea's currency. For the past two months the won has remained relatively stable despite substantial declines in the dollar value of the Japanese yen. Since many Korean exports compete directly with Japan, there was previously a very tight link. Certainly competitive pressures still mean that the won cannot indefinitely withstand huge declines in the yen, but the relative de-linking that has occurred testifies to the new vitality of Korea's foreign exchange position.



Source: CEIC

The partial resolution of foreign exchange pressures has in turn enabled Korean interest rates to decline rapidly. This is crucial to, although by no means sufficient for, resolution of the credit squeeze that is endangering much of Korean industry.



Source: BLOOMBERG

Moreover, the stabilization of the exchange rate has allowed Korea to avoid the severe inflation that seemed so likely only a few months ago. Inflation for the first half was expected to be at an annual rate of about 8%, but inflation in the second quarter was negative due to the rising won.

What hasn't stabilized, of course, is economic growth, which could be around minus 6 percent for 1998, and the positions of Korean companies, a huge number of which teeter on the edge of bankruptcy.

The IMF Program

In return for its IMF bailout, Korea has imposed the usual austerity budgets and high interest rates and has made rapid and politically difficult adjustments in its policies. Notable among these have been:

Restructuring of banks and other financial institutions. The IMF demanded that Korean banks meet BIS capital adequacy ratios by a fixed date. The government required restructuring plans by the end of April and in June announced the closure of five banks whose plans for meeting those ratios were not credible.

Corporate governance and transparency reforms. Beginning in April 1998, new cross-guarantees of corporate debt within conglomerates are banned. By 1999, both financial enterprises and conglomerates are required to publish consolidated balance sheets, audited by firms with international standing, so investors will know the true performance of the banks and conglomerates and the main components of that performance. The government also strengthened the right of small shareholders to achieve redress through class action suits, and it will in the future permit both friendly and hostile takeovers by foreigners.

Labor mobility. Korean labor laws had largely prohibited layoffs. A 1997 law permitted layoffs for the purpose of restructuring but imposed a two-year grace period; now the grace period has been removed. But layoffs remain confined to financially distressed companies.

Market opening. The short-term bond market was opened to foreign participation, and the ceiling on foreign ownership of Korean companies was lifted first to 55% and then to 100%, although there are still limits on foreign ownership of government and defense firms. The government abolished all trade subsidies. Japan successfully demanded the gradual abolition of the "Import Diversification Program," which discriminated against imports from Japan.

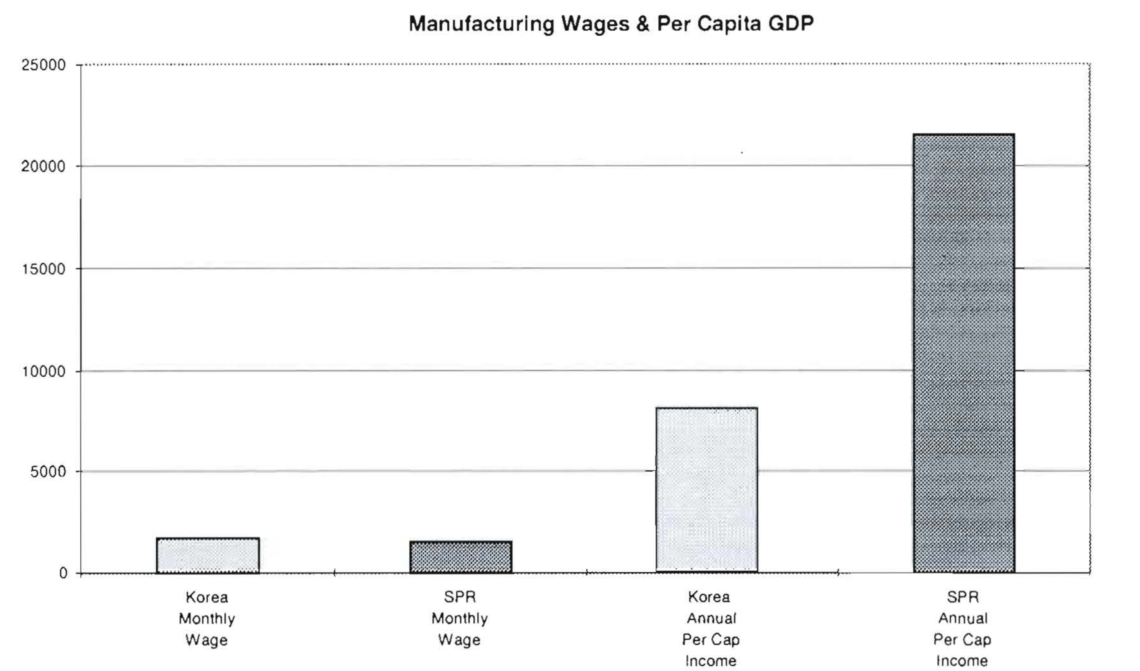
Unlike Indonesia and Thailand, South Korea actually went beyond IMF requirements. President Kim Dae Jung was dissatisfied with the pace of chaebol restructuring, so he demanded that the banks come up with a list of companies to be liquidated and insisted that the resulting list include some parts of major chaebols. He is trying to force a "big deal" whereby major chaebols would swap whole business lines in order to become more focused on profitable core businesses. The government passed 13 bills restructuring the governance of the central bank, unifying financial supervisory bodies, and pressing the banks to extend loans on commercial merits rather than political pressures. All this testifies to a proactive rather than foot-dragging approach to Korea's problems.

The Labor Bubble

As noted above, by 1996 South Korean manufacturing wages were higher than those of economies like Hong Kong and Singapore who per capita GDP was twice Korea's. The way wages got to that ridiculous level reflects a unique South Korean version of Newton's law that every action begets and equal and opposite reaction. In the 1950s South Korean unions were predominantly communist and the most radical union leaders were young women in the textile business. President Syngman Rhee managed to turn some of the communist labor leaders (males in this case) and used them in a brutal suppression of the leftist unions. Among other tactics, they had the habit of seizing the radical young women, forcing a stick into their vaginas, and then spreading the word that the women were no longer virgins--a devastating tactic in ultra-conservative traditional Korea. These same leaders dominated labor regulation until 1980. The threat from the North, the strategy of using economic prowess to surpass North Korea, the authoritarian regime, and the unity of the chaebol leaders in suppressing unions and blacklisting unruly employees all combined to create a labor market in which Korean workers worked the some of world's longest hours and had some of the world's highest accident rates. Because of the rapid growth of the economy, their wages rose at rates previously unknown, but they lagged the performance of their industries.

Democratization changed that, spectacularly. In the late 1980s, as democratization occurred, the workers were determined to get theirs back. Society sympathized with them, and anyway times were good. Within less than a decade Korean workers had achieved wages that were far ahead of the country's level of economic development, together with laws that flatly banned employers from laying them off. Nowhere else on earth did workers have such an exceptional combination of high income and total job security. Korean workers took these privileges as God-given human rights and organized cohesive and belligerent unions to defend them.

As the chart on Manufacturing Wages and Per Capita GDP shows, by 1996 Korean workers had wages higher than in countries where per capita GDP was twice as high. In fact, they had the highest wages in Asia outside Japan. This was a recipe for collapse of national competitiveness.



Source: CEIC

By the latter half of Kim Young Sam's presidency, it had become clear that excessive labor costs and labor immobility threatened the viability of Korean industry. Even the weak-kneed government of that time realized it had to do something. In order to overcome the extraordinary political power of the unions, the government held a secret session of parliament where the dominant party used its majority to ram through modest increases in employers' rights to lay off workers. The unions responded by organizing a general strike, which crippled the economy for several weeks. The opposition took every avenue to use the crisis to weaken the government. And from all over the Western world journalists and human rights organizations descended to denounce the changes as infringements of Korean workers' human rights. The changes did not go nearly far enough to save the economy, and in fact they introduced only a fraction of the labor mobility that most Western countries take for granted. But they went much too far to save the government from near-universal political condemnation outside Asia. As a result the government compromised, ensuring that the looming financial catastrophe would be worse than necessary and that the layoffs which eventually must come would be greater than would otherwise have been necessary. While the main theme of the Korean crisis was the banks' abdication of responsibility for credit and the chaebols' excess foreign and domestic debt, labor excess was a crucial secondary theme.

Once the crisis hit, Kim Dae Jung was able to establish, albeit at great political cost, the right of companies faced with imminent bankruptcy to lay off workers without waiting two years. But the right was confined to those facing imminent bankruptcy.

Even then, the unions tried to react with their signature belligerence. At Kia, the insolvent automobile manufacturer, workers demonstrated, at times violently, against the suggestion of a foreigner buying in; heaven forbid that the company's salvation should come at the cost of foreign ownership. When five insolvent banks were closed, the unions--white collar unions, not laborers--barred the doors and changed computer security codes so that transactions could not be processed; this was the sharpest possible contrast with Japanese workers, who expressed public shame that their banks had been so mismanaged that they had to close. Faced with gradual changes of this kind, the unions planned a general strike in July, although as of this writing one of the two big labor federations has withdrawn its plan to participate.

In all important cases so far during Kim Dae Jung's six-month tenure, public opinion has refused to support union intransigence and the unions have backed off. But fear of the their power and their belligerence has partially crippled response to the national crisis. As banks and industrial firms have been forced to restructure, the president has time after time insisted that they retain most of their unneeded workers. The application of this principle throughout the economy will weaken and slow the national response to the economic crisis; it will eventually mean more bankruptcies and layoffs than were once necessary. So, while the government is consistently "winning" in its confrontations with the unions, it is so far not winning enough or establishing the key principles to ensure eventual economic recovery

This leaves open two possible outcomes. The more auspicious is that Kim Dae Jung is beginning a long process of public education and political and is engaging in salami-slicing tactics that will over a period of time, through the messy but often effective kinds democratic processes that for instance eventually eliminated the U.S. budget deficit, achieve enough labor market mobility to save Korea's competitiveness. The alternative scenario is that Kim Dae Jung is using up his political capital during his honeymoon period and that he risks being immobilized by a divided government and a combination of powerful unions and powerful chaebols and being deserted by a middle class that will soon realize the situation is much worse than it has been portrayed. The structural weaknesses of the government argue in favor of the worse outcome, while the educated population, the dominant middle class, and the fact that Kim Dae Jung is not in fact the political captive of the labor unions argue in favor of the more favorable outcome. It is too soon to tell.

Divided and Weak Government Economic Management

South Korea's economic prospects are clouded by divided government and a flawed policy making system. The government is divided both at the executive level and between the legislature and the executive. The executive is divided between two parties, that of reformist and sometime populist Kim Dae Jung and that of traditionalist and establishment conservative Kim Jong Pil. The latter was the founder of the Korean CIA, which on more than one occasion plotted to have Kim Dae Jung assassinated. In the manner of politicians, they have decided to put such historical trivialities behind them and by all accounts have achieved a workable personal relationship based on Kim Dae Jung's promise to make Kim Jong Pil the prime minister and (more dubiously) to consider stepping aside as president in the future to allow Kim Jong Pil a turn.

While the two leaders have worked together, their followers are very different kinds of people. Kim Dae Jung's officials are extremely reformist and extremely inexperienced, while Kim Jong Pil's are highly experienced and opposed to reform. While Kim Dae Jung is clearly the senior partner in the coalition and is driving policy, Kim Jong Pil's political influence is greatly reinforced by resistance in the ministries, particularly the Ministry of Finance, to any fundamental reforms. The cores of the key ministries that are supposed to implement the new president's policies remain believers in the old ways, and by all accounts the Ministry of Finance adamantly opposes fundamental changes in the old quasi-socialist system.

This division of the executive is exacerbated by the government's minority position in the legislature. The opposition, which represents the pre-Kim Dae Jung establishment, holds a majority in the legislature, and this majority was reaffirmed in July 1998 by-elections. Kim Dae Jung is extremely sensitive to his need to get bills through the legislature and has concentrated on acquiring a majority, something which could be accomplished by attracting only a few legislators to change sides. Moreover, many of the legislators are old colleagues of Kim Young Sam's and remember the time when Kim Dae Jung and Kim Young Sam were fellow dissidents; they have reason to feel attracted to the new president rather than sticking with the traditionalist legislative majority.

The policy consequences of these legislative rivalries have been mitigated by shared national concern to deal with the crisis effectively. In a national crisis, the opposition are patriots first and political opponents second; it is well never to forget the homogeneity and nationalism of Koreans. Hence the opposition has never opposed any major reform, and all reform bills have passed easily. This is the political context within which Korea has become the IMF's star pupil.

On the other hand, this is still the first year of Kim Dae Jung's presidency and there is a kind of honeymoon flavor to the first year. Reform issues will eventually arise on which dissent is quite reasonable and patriotic; then political division may prove more costly. The opposition has closer ties to the chaebols than the current administration and that could mean foot-dragging on important reforms, even in the absence of broad opposition to the principles of reform, later in the presidential term. Moreover, Kim Dae Jung has, in the eyes of many Koreans, played a very partisan game rather than seeking to maximize consensus. His appointments of officials are perceived as being excessively regional and partisan, in the manner of all his predecessors, rather than seeking to create a government of national unity. And he has responded to legislative opposition on political issues by virtually shutting down the legislature and bypassing it rather than seeking a partnership

Kim Dae Jung has also, by reason of personality and presumably of bureaucratic opposition, chosen to create an extremely unwieldy policy apparatus. Authority is diffused. Nobody can decide except the president. All significant issues come to the desk of a president who is determined but also is in his seventies and in imperfect health. This is quite unlike the old system wherein economic authority was concentrated in a deputy prime minister or a presidential economic secretary and the various ministries could exercise clearly delegated authority.

This system has worked remarkably well in the first half-year of Kim Dae Jung's presidency, thanks to the air of crisis, the patriotism of all varieties of Korean politicians, and the vigor of the president. There is a serious risk, though, that as the honeymoon period fades further the weaknesses of the policymaking system could immobilize Korea's drive to reform.

Banks and Companies

South Korean banks and companies are united in a common mess. As indicated above, credit has been allocated for 37 years based on political fiat and bribery rather than on productivity or creditworthiness. The consequence of this is that the productivity of capital is only about one-half of what it would be in the U.S.[2] As in other heavily socialist economies, development of the service sector has been artificially restricted (by deprivation of capital) in favor of manufacturing, at great cost to economic growth and productivity. In banking and housing, artificial restrictions have limited choice, raised prices, and restricted innovation. Restrictions on labor mobility have led to vast overemployment in virtually every industry. The artificial availability of capital for the chaebols, and particularly for heavy industry and high tech industry, has led to overinvestment so that every sector has two or more firms beyond what the economy can sustain; restrictions on layoffs have deprived firms of the potential benefits of consolidation. This system has been sustained by policies which elicit extremely high savings rates and by the migration of cheaper labor from agriculture to industry, but the pools of excess capital and labor are eventually exhausted and this leads to a crisis of international competitiveness and hence to a financial crisis. For instance, interest rates are now 7-10% for companies in such businesses as cars, but their margins are much thinner than that, a situation that leads inexorably to crisis.

The financial crisis implies first of all a need for new capital. But there are constraints on the availability of new capital. Since the banks as well as the companies are in trouble, the banks are unwilling and unable to take on new risk. Many Korean banks are well below BIS capital adequacy standards, and most of the rest meet those standards only through refusal to mark down their holdings of equities and bonds and real estate to their current market values. Indeed the Korean banks are in such desperate straits that they are caught in a dilemma: if they don't mark their portfolios to market and unload their poor assets, they have little chance of recovery, but if they do they risk wiping out their capital and suffering closure. Survival depends upon denial. Eventually the government will have to recapitalize them. Currently the best estimate of banks' nonperforming

[2] Cf "Productivity-led Growth in Korea," McKinsey Seoul Office/McKinsey Global Institute, March 1998. This study found that, as a proportion of U.S. productivity, Korea's was 48% in autos, 54% in semiconductors, 39% in confectionery, and 58% in telecoms--but 115% in steel.

loans is 118 trillion won[3] (or $91 billion at an exchange rate of 1300). To put the banks back in decent shape, they need to cover 100 trillion of this. The government expects to pay half and expects the banks to raise half, but international experts believe the government is going to end up having to pay all of it.

Meanwhile, the banks are terrified to take on additional risk. So they invest in government securities which help their BIS ratios and refuse to invest in most companies, because that would add to their risk assets and hurt their ratios. They roll over old loans but decline to offer new loans. Anyway, most companies could not afford the current high interest rates.

As indicated above, South Korea is making more rapid progress than Thailand in breaking out of this dilemma by getting interest rates down without jeopardizing the relative stability of its currency. But for the time being the consequence of the credit squeeze is a further narrowing of an already ridiculously narrow lending spectrum. In the past, bank credit was largely limited to 30 large chaebols. Now it is largely limited to five. The remainder of the economy is being asphyxiated by lack of credit.

Another source of capital is foreigners. Korea has an enormous advantage over Indonesia and especially Thailand because it has so many world-class assets. Numerous Korean companies would like to sell their equipment and lease it back, a technique which could raise a great deal of capital if they can agree on prices. Many Korean companies are world-class competitors and therefore worth buying as firms. The value of Korean firms' assets is heavily weighted toward machinery and technology, much of it world-class, while Thailand's is heavily weighted toward real estate. And Korean law, unlike Thai, allows foreigners to own real estate, so even the real estate assets are potentially salable. All of this gives Korea the theoretical potential to unload its firms' excessive debt through sales to foreigners. And foreigners are enthusiastic to buy. As in Thailand, there is a haze of foreign investors hovering over the country looking for bargains. But for the time being only a few are buying.

One reason is Korean accounting. Korean accounting is virtually incapable of translation into international accounting standards. And the different accounting standards reflect different ways of thinking. Foreigners naturally want to buy based on the cash flow that a given piece of machinery or real estate can generate. The Korean owners still generally insist on valuing their assets based on purchase price plus the bank interest rate (compounded, naturally). It can be difficult for a foreign company to take on responsibility for the loans of Korean companies, which are typically leveraged 5 to 7 times. The price is also affected by the fact that Korean banks do not want to write down their loans to failing companies to realistic levels lest they fall below the required BIS levels. Korean labor unions are still resistant to foreign control and to reorganizations that would increase company efficiency. More generally, a profound Korean nationalism still resists foreign ownership of important local companies; in July 1998, a national campaign force the termination of a deal whereby Microsoft would buy Hangul Computer, a leading Korean-language software

[3] Some senior officials estimate that the number is more likely 150 trillion won, or 35% of GDP.

company. Foreign investors interviewed for this report also indicate that Korean companies often fail to disclose liabilities, so foreigners have become very wary about what they will buy.

Many of these problems will be worked out by the imposition of new international accounting standards and by the ruthless pressures of the market; firms will either ask market prices or they will eventually go bankrupt, and banks will write down their loans by half or they will get nothing. But this process will be very gradual, so gradual that it will test the ability of politicians to weather their citizens' disappointment with the slow turnaround.

Unlike Thailand, Korea allows foreigners to buy real estate, and the sale of real estate could create large capital inflows. But the Korean real estate market is extremely illiquid due to intricate zoning laws which narrowly define what each small plot of land may be used for. This makes it unattractive for foreigners to buy and, more generally, impedes market pressures to shift real estate toward more productive uses. It also inflates the price of land tremendously, creating discomfort for Korean families and erecting a barrier to entry for new firms which are inhibited from starting up because of the high cost of space. The zoning restrictions may be holding the price of property at double what it would be in a more liquid market, but so far there is no sign that the government has even thought about reforming the zoning laws.

Foreign banks could also be a source of capital. But they face a fundamental problem. In the past, Korean conglomerates enhanced their access to foreign loans by having different units of a group guarantee each other's loans. That tactic worked to the point of absurdity, effectively creating a vast pyramid scheme. Now Korea is paying a price for this practice. Although it has many superbly creditworthy companies based on their own cash flows, these companies' guarantees of less creditworthy affiliates make banks unwilling to take the risk that any loan might just be funneled off to cover the obligations of a company that should be going bankrupt. Again, this problem should get resolved by the government's ban on new cross-guarantees, but the old guarantees typically have two to three years to run. In the resolution of this crisis, two to three years will seem like an eternity. The government is encouraging the chaebols to sell of some good assets and use the proceeds to pay off the guarantees, but it is too early to tell whether they will do this.

The Need For Banking Skills

Ultimately, Korea must not just find new capital but must learn to use its capital more efficiently. As long as a Korean firm gets only $50 return from an investment whereas the U.S. gets $100 from an equal investment, Korean prospects will be limited. There is no strategically insuperable obstacle to Korea's improvement of its efficiency in using capital. Its workforce is exceptionally well-educated, and many of its industries possess world-class technology and world-class scale. But there are a lot of short-term hurdles. As noted, the banks cannot afford to reinvest their capital in more productive ways because if they sell their old securities and loans they reveal the true value of their portfolios and invite closure. Companies and banks cannot consolidate because they are prohibited from laying off workers and therefore cannot get the financial benefits that should flow from consolidation.

Above all, the banks should be the country's experts in efficient allocation of capital, and they should manage a process of liquidation, merger, and acquisition whereby inefficient firms are removed from business and capital is reallocated to the more efficient businesses. But the banks cannot do this, for two reasons. First, Korea has no substantial tradition of liquidating companies which become insolvent. Under the Korean system, one can foreclose on real estate but little else. (In this, they are already ahead of Thailand.) The standard procedure is either to keep the company afloat with new loans or to fold it into a stronger company, with the stricture that the stronger company should not lay off most of the workers. This system has reached its limits and won't work anymore, but new bankruptcy procedures, which would have to lead to actual liquidation in many cases, have not been institutionalized.

Second, and more fundamentally, the banks have virtually no skills at efficient reallocation of capital. They, like Chinese banks, have just been funnels for money rather than highly expert calculators of the relative productivity of different uses of capital. A Western investment banker refines the estimates of productivity to hundredths of a percentage point; Korean bankers typically have never done the calculations at all. Suddenly Korea needs these calculations, and the negotiating skills to implement them, on an awesome scale. Such a large proportion of Korean companies is in trouble that the banks need to reorganize most of Korean industry.

The required skills are available only from foreign financial institutions, which have largely been excluded from the Korean market. Now the government, recognizing the problem, has expressed willingness to sell its worst two banks to foreigners and has instructed the other banks to hire foreign investment banking advisors and to add them to the boards of directors. The recognition constitutes a fundamental change of mentality in Korean economic thinking and as such is a vital step forward, but the measures announced so far are too little and too slow. Foreigners may not want to buy the country's worst banks, and advisors/directors will hardly be able to transform the entrenched ways of thinking of institutions which have been structured for almost four decades to avoid just the kind of thinking that is now vitally necessary--particularly when the old guard is backed by what one very experienced international official describes as "fierce" determination by the Ministry of Finance to continue the old ways.

The Temporary Emergence of an Even More Socialist Economy.

This situation leads to a number of ironies. While the president is deeply committed to movement toward a more market-oriented, less government-directed economy, in the short run the government is going to end up controlling most of the banks and the banks are going to end up controlling most of the companies. Despite a wave of planned privatizations, this will put the government in control of most of the economy in the crucial election year of 1999, when there will be potentially overwhelming pressure to misuse control of the economy for just the purposes that the new president wishes to avoid.

Second, while the president has long despised the chaebols and is determined to reduce their influence, the top five chaebols are probably going to expand their control of Korea's economy by an enormous measure. They have the funding, and everyone else lacks it. In that situation, they can extend their influence rapidly. The immediate prospect for the Korean economy, therefore, is for a vast increase of government control and a great increase of chaebol control, just when most analysts and most Korean politicians agree that the economy needs to march smartly in the opposite direction.

Over time, the pressures of the market should lead to collapse of the most inefficient firms and to the rise of more efficient, more focused firms among those outside the top chaebols. At some point, the chaebols should then be confronted by firms of superior efficiency and at that point the chaebols themselves will have to become more focused and efficient or else be driven from the field. Kim Dae Jung would then achieve his goal of a more market-oriented economy, and Koreans could once again experience rapid growth. But that can happen only after several years and only after sustained reforms that will require great political courage.

Key Presidential Initiatives

Given a system that simply does not know how to enforce the rules of the market, the president has taken initiatives to jump start the process of reallocation of the nation's resources. He began by closing 55 weak companies and five of the weakest banks.

In April, banks were told to assess their positions according to new criteria and to enunciate strategies for strengthening their capital positions to BIS standards. In June, the government assessed their strategies and divided them into banks which had seemingly sound strategies, banks which were more dubious, and banks which could not make it. It then forced five weak banks to fold themselves into stronger banks. Beyond this, it is pressuring the banks of dubious status to undertake sweeping management changes and in fact has just successfully forced out the president of one of them. All this is impressive because it has been done six months into the crisis; compare Japan, where the government is still dithering almost a decade into the crisis.

However, there have been severe weaknesses in the process. The office of the president rather than the market decided which strong banks were to acquire particular weak banks; the stronger banks were reluctant, unlike their counterparts in the U.S. savings-and-loan crisis, who actively bid for the weaker ones. The stronger banks aren't all that strong, and the assets they acquire weaken their capital adequacy ratios. Although the government promised to take away the bad loans, there are reasonable concerns that the portfolios of the acquired banks disguise many serious problems. And the acquiring banks were told that they must retain most of the employees of the weak banks, which means that they cannot achieve economies from rationalization and are loaded down with aggressively resentful employees. Moreover, although the government is telling the banks to follow market practices, it is also telling them that they must roll over their loans to small and medium-sized enterprises. In short, the government severely limited the process of reallocating the nation's resources to more efficient uses.

Moreover, the government decided to save one bank, Peace Bank, which was much weaker than some of the banks it folded, because Peace Bank is held by the unions. This creates a potential future legal quagmire because shareholders of the folded banks will have potential grounds to sue for restitution on the argument that the decisions were political rather than objective. Such suits would probably begin after Kim Dae Jung's presidency is over, but some experts believe the results could be devastating to the government. Kim Dae Jung's process is politically sensitive and sensible but may be legally and financially flawed.

The pattern of these decisions is one of catering to the power of the unions even while taking concessions from them that would have been unthinkable in the past. More neutrally, the president is trying to conspicuously spread the pain in order to achieve painful reform without endangering political stability. His effort to do so has achieved impressive gains which eluded his predecessors, but he risks slowing reform dangerously and sending a message to the unions that they need not concede nearly as much as the economy in fact requires. At some point the unions and the Korean people are going to have to be told the truth about the extent of necessary layoffs and restructuring.

The president's effort to get the corporate restructuring process under way has initially been much weaker. This has proceeded at two levels. First, the president told the banks to designate companies that should be liquidated. The banks reviewed 2500 companies and came back with only about two dozen candidates for bankruptcy; the list included few companies worth notice and none from the major chaebol groups. The president then demanded a more serious list that included chaebol affiliates, and the banks came back with an expanded list which dutifully included two or three companies from each of the top chaebols (20 chaebol companies in total). Most people had never head of most of the companies, particularly those which were chaebol affiliates, and as a result the investor reaction to the process was negative. The word "laughable" came up frequently in interviews.

It is good that the president is taking the initiative and pressing hard, but the whole process shows how fearfully weak market mechanisms are in this quasi-socialist economy and how even relatively small initiatives must come personally from the president. It is in fact laughable that the banking system can only come up with a couple dozen companies that are bankrupt in an economy where it should be a more difficult process to identify the ones which aren't bankrupt, and it is ludicrous for the office of the president to be effectively in charge of designating which small companies are suitable for bankruptcy.

Bankers operating in Korea say, moreover, that the entire process of corporate restructuring in Korea is flawed. Troubled companies typically cut costs and sell off the best businesses, thereby covering some of the liabilities but leaving the company with the worst business lines and huge residual debts. In the West, the company would come up with a realistic business plan, and as part of that business plan the banks would take realistic write-downs. Recovery of the business would increase the value of the assets, leaving both the company and the banks in better shape. In Korea, the banks refuse to take the write-downs, so the recovery process fails to proceed.

On a larger scale, the president is pushing the largest chaebols to do a "big deal," a macro swap of major business lines which would reduce the number of companies in major business lines and leave the remaining consolidated businesses much stronger. For instance, the government would like Samsung to sell its nascent auto business to stronger Hyundai in return for Hyundai providing a relatively weak business line to a stronger Samsung counterpart. This too is a good concept, going to the heart of the need to reallocate resources and increase the business focus of the major companies. But as with the banks there are serious risks connected with the president's office deciding who should swap which industries, and there are serious limits to the economic benefits if the president's office then decrees that the consolidated business are not allowed to lay off significant numbers of workers.

Unions and Chaebols

Opposition to broad reforms continues to come from the old government ministries, the unions and the chaebols. The reforms have the support of the president, his party, the intelligentsia, and much of the more educated middle class. The sources of opposition remain potent, although at this point neither the chaebols nor the unions has significant support in the National Assembly or in public opinion.

The center of gravity of the economy now lies with the top five chaebols. The top 30 chaebols control the majority of the economy, and the top 5 chaebols control 70% of the production of the top 30. Hyundai is a $50 billion company in a $400 billion economy, and several other chaebols are of similar size. Outside the top five, seven of the thirty are bankrupt and five more are close to bankruptcy, so the proportionate weight of the big five is rising fast. They are resistant to the president's "big deal," which will be hard to implement without some of their support, and more broadly they remain adamantly opposed to the core idea of chaebol reform, which is a significant contraction of their scope of business in return for efficiency gains. Some of them are quietly adamant, some outspokenly, and there are caveats to their opposition, but basically they just don't buy the idea of leaner, meaner, more profit-oriented business at the expense of their size and their pet projects. Some boast that they will just let the economy get worse and worse and worse throughout 1998; then, by the election year of 1999, Kim Dae Jung will just have to realize that the only source of jobs and growth is the top chaebols, and he will just have to give them what they want, which is a reflated economy, a return to their traditional privileged access to capital, and a reversal of the superior position that labor has enjoyed since Roh Tae Woo's time.

Only 10 percent of Korean workers are unionized, and Korean workers outside the unions have reacted flexibly to the crisis, often accepting 25% pay cuts without fuss. But Korean unions pack a wallop. They can shut down the biggest companies, they have succeeded in the past at mounting general strikes, and they are willing to adopt brazen, violent tactics that disrupt the whole economy. Unemployment has risen to 1.7 million workers or 7% of the work force, and is expected to rise to 2 million by late 1998. The really big layoffs are projected to start subsequently, when the government expects the big chaebols to begin a massive restructuring. Current levels of unemployment are actually quite moderate by European standards, and in line with U.S. figures in the 1980s, but Korean unions are unaccustomed to such levels. They even reacted destructively to the folding of five banks, which will lead to layoffs of a small fraction of the 9000 employees of those banks.

The unions have nonetheless been seduced by Kim Dae Jung into joining broad tripartite talks which lead to important concessions, and they have been forced by middle class opinion to limit the scope and violence of their opposition to reform. So they have made major concessions. Most notably, companies facing bankruptcy are now allowed to lay off workers. But they have so far managed to protect their core unreasonable position, namely the laws which prohibit healthy companies from restructuring themselves in ways that involve substantial layoffs. And they have partly crippled the president's bank and industrial reforms by intimidating him.

The bottom line for the unions is that intransigence will increase future unemployment rates, not decrease them. But nowhere in the world have unions been willing to accept that logic. As a senior AFL-CIO leader told me regarding a similar problem in the U.S., "We're paid to save the jobs of these men now, not to think about the general situation years from now."

The salvation of Korean workers will come not from preserving featherbed jobs now, but from a gigantic expansion of the hitherto repressed services sector that should accompany recovery. Kim Dae Jung's problem is how to get from here to there.

Overview

So far, the president and his reformers are winning the battles. And they may well win the war. They have done the right things, and the president in particular has the right economic vision and the determination to push forward. But they face significant risks. A major political slip could quickly change the political balance. Even a serious presidential illness could potentially tip the balance.

The big decisions lie in the future:

- Korea must institutionalize a process whereby bankrupt companies are liquidated, not just folded diplomatically into other companies.
- It must get banks out of the current box where survival depends upon denial about the true value of their portfolios. This means recapitalizing them, expensively and soon.
- It must acknowledge that, if banks are to follow market practices, then the government must curtail the current practice of instructing them to roll over their loans to small and medium size enterprises.
- To reorganize industry, it must acquire foreign investment banking skills on a massive scale and use them to replace an entrenched socialist banking culture with a new culture, not just add foreign advisors at the margin.

- It must cut a macro-deal with the labor unions, telling them forthrightly that they are going to have to give up the ban on layoffs and accept much, much more unemployment than they are willing to contemplate now, and in return the government must invest massively in unemployment insurance. (The IMF believes the government has the resources to do this, but the government does not believe this.)
- It must find a way out of the situation where the banks lazily lend most of their available funds to a smaller and smaller number of huge chaebols, thus creating a kind of black hole that absorbs all available capital.
- It needs to begin enforcing existing anti-trust laws against the big chaebols.
- It needs to let the real estate market become more liquid and deflate by changing zoning laws.

The key year is 1999, not 1998. The chaebols and the unions are not stupid in believing that the political calculus could be quite different in 1999. The public is going to be very disillusioned when 1999 dawns and anticipated improvements in the situation prove to be still a distant hope. The labor unions are going to be doubly furious when they discover that what they see as the huge and unacceptable concessions they have made are only a small down payment on a very large mortgage. The president has principles, but he is a politician; he slowed down reforms, particularly a crackdown on the radical unions, prior to the local elections in the spring of 1998, and the pace of reform could once again be greatly affected by the political mood of 1999. In the year 1999, economic power is going to be concentrated as never before in Korean history. Despite some planned privatizations, the government will control most of the banks, the banks will control most of industry, and the top five chaebols will control more of the economy than ever. This will be a crucial moment where a few decisions or missteps could drastically alter the future of Korea.

At the same time, some of the decisions already made will, if fully implemented, have an accelerating reformist impact. The need to publish transparent balance sheets will force major changes in company financing and management practices. Given the ban on new cross-guarantees, the old cross-guarantees will begin to wear off and the good Korean companies will become attractive candidates for loans and joint ventures again. Sheer lack of money will force many companies to negotiate market prices with foreign white knights. Realization of the costs the Japanese have paid for foot-dragging should limit the degree to which Korean politicians can weaken the new laws. In sum, change will come but it could come in the form of grinding multi-year processes that really don't get strongly under way for a couple years yet. Any look at the scale, complexity, and inter-connectedness of the reforms needed must sober the observer and lead to acknowledgment that this is a long-term process quite unlike the relatively (relatively!) simpler adjustments some Latin American governments required in order to cope with what was basically an episode of government foreign exchange illiquidity rather than a broad and deep transformation from socialism to capitalist allocation of resources.

It is worth reiterating that South Korea has much higher education levels, much higher technology levels, and fewer legal impediments to reform than Indonesia, Thailand, and Malaysia, and that it has resolved its foreign exchange crisis much more decisively than Thailand or Indonesia. It has a dynamic president and a tradition of confronting the nation's problems much more forcefully than Japan. These, together with its high savings rate, its tradition of relatively decisive government, and its president with a much more advanced concept of how a modern economy should work, give it advantages as compared with the other troubled Asian economies.

Investment Conclusions

Korean sovereign debt is money good. The foreign liquidity crisis has been resolved much more decisively than elsewhere.

South Korea's economic fundamentals--its competitiveness, its scale, its technology and equipment, its education--are greatly superior to those of other troubled Asian countries and as such it is a better bet for a future business focus than Thailand or Indonesia.

There will be a series of avalanches of direct investment, structured finance, and loan deals as negotiations over price become more refined, accounts become more transparent, and cross guarantees wear off. The time to prepare for participation in these is now.

While 1998 is the year of deflation, 1999 will be the year of reflation. Portfolio and currency investments will be driven by that basic cycle.

As one wades through the long list of complex problems, and the political infighting it is easy to underestimate what can be accomplished by determined leadership and the cohesive policy that a patriotic national elite can produce. This country has found its way through some very complex problems in the recent past.

At the same time, the wise investor will not overestimate how quickly South Korea can return to rapid growth. And he or she will not bet the farm on a coherent and persistent reform drive until the politicians' response to the temptations of the combination of 1999 elections and overwhelming 1999 government control of the economy are clearly visible.

The wave of the future is Korea's service sector. The investor who rides this curve successfully won't have to worry about anything else.

Appendix on North Korea

North Korea has decisively lost the competition with South Korea, but the denouement remains crucial. The North has undertaken some economic reforms, such as allowing foreign investment in certain zones, permitting certain South Korean firms to operate in restricted areas, and allowing more tourists to visit North Korea. But it has refrained from doing anything on a scale that would revive an economy so weak that famine is widespread.

North Korea's failure to reform its economy has earned it the contempt of China, as has the North Korean system of demagogic family leadership which gives Chinese a shuddering reminder of the Cultural Revolution under Mao Zedong and his wife Chiang Ching. China still provides considerable aid to North Korea, but it acknowledges the fragility of the regime and has distanced itself from that regime in ways that are polite but decisive.

Recent Korean presidents have made various overtures to North Korea. As far back as 1980, Chun Doo Hwan offered to meet then North Korean President Kim Il-Sung. More recently, at the beginning of his term five years ago, Kim Young Sam sought a less strained relationship and tried giving the North 250,000 tons of desperately needed rice. He go Kim Il-Sung to agree to a summit meeting, but Kim Il-Sung died at an inopportune moment. (Chinese sources indicate that his death coincided with extreme Chinese pressure to back away from his nuclear option.) Four-party talks (the U.S., China, North Korea, and South Korea) got under way but went nowhere. As late as August 1997, Kim Young Sam was again holding out the olive branch but the grounding in South Korea of a North Korean sub whose crew killed a number of South Koreans, led to an angry, conservative, confrontational, southern public mood toward the North.

Kim Dae Jung is trying overtures again. He has gone much farther and indicated that he has no objection to direct U.S. relations with North Korea; hitherto the policy of isolating North Korea, and of the U.S. dealing with the North only to the extent that the North recognizes the South, has been sacred. The North has been largely unresponsive, and meanwhile there have been further military incidents. A South Korean fishing boat caught a North Korean submarine in its nets while the latter was intruding deep into South Korean waters. (South Korean fishing nets are apparently equipped for very big fish.) And a dead North Korean frogman recently washed up on a South Korean beach, with evidence that suggested he had been part of an armed team penetrating South Korea.. Kim Dae Jung has reacted calmly to these provocations and the South Korean public has followed him out of a sense that the North is not as fearsome as it once was.

The prevailing wish--among South Koreans, Japanese and Americans--is that North Korea will expire gradually, turning for a generation into a malleable source of cheap labor for South Korean manufacturers, rather than collapsing suddenly into a capital drain in the manner of East Germany. This is hope, however, not analysis. It might work that way, but the North Korean political bubble is even more likely to deflate violently than the South Korean financial bubble. Only the most horrific isolation and autarky have kept North Korea going, and once North Koreans are widely exposed to the realities of South Korea and the rest of the world they are likely to be very, very angry. Such anger is not conducive to passive, gradual change.

This alternative of rapid implosion raises more important risks than the mere financial. A violent upheaval in North Korea could easily spill over into the South and could easily draw the South in. The result would be a South Korean military drive to unify the peninsula. This would force China to decide whether it was willing to see a unified, non-communist Korea containing a nuclear-armed U.S. division on its border. In 1950, China gave a clear answer, no, and pushed the U.S. and Korean troops back to the middle of the peninsula at a cost of almost a million lives. In the 1990s the Chinese answer has been more nuanced. Some years ago Chinese foreign policy specialists indicated to this writer that, if Chinese-American relations were in good shape, China would be embarrassed but would probably look the other way and let unification happen--perhaps insisting that U.S. troops withdraw. On the other hand, if, as seemed the case to Chinese leaders in the mid-1990s, America seemed to be trying to dismantle China--supporting Taiwan's moves in the direction of independence, passing legislation to send an ambassador to Tibet, interfering in the Hong Kong transition, and threatening economic warfare by withdrawing China's most-favored-nation status--then China would prevent military reunification of Korea by an American ally.

President Clinton's new China policy of treating China as a partner, symbolized by his trip to China in June, 1998, has at least temporarily resolved that ambivalence. During informal Chinese-Korean talks which included retired foreign ministers, the Chinese have indicated a willingness to contemplate not just a unified Korea under Seoul's rule but also one which continued to have an American division present. This alleviates, without completely eliminating, one of the most explosive political situations in today's world. But the unquantifiable financial risk of a sudden North Korean implosion, which would likely imply both financial costs and military involvement for South Korea, remains something investors can ignore only at their peril.

In July, Kim Jong Il completes his long-sought goal of holding all the key posts: starting with army head, he became party head and now president. The consolidation of his power could bring new initiatives either for good or for ill. Nobody knows which.

William H . Overholt
Singapore