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# A Comparative Analysis of Financial Liberalization in Korea and Taiwan through 'Path Dependence'

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# A Comparative Analysis of Financial Liberalization in Korea and Taiwan through 'Path Dependence'

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**Ocean, Kwon**

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# A Comparative Analysis of Financial Liberalization in Korea and Taiwan through 'Path Dependence'

'徑路依存性' 槪念을 통한 韓國과 臺灣의
金融自由化 比較 分析

指導敎授 李根

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# Abstract

Korea and Taiwan are regarded as typical examples of developmental states. Both countries experienced rapid growth under authoritarian regimes and have continued sustainable development after their transitions to democratic rule in the late 1980s.

The 1997 East Asian financial crisis, however, had strikingly differing effects on Korea and Taiwan. In Korea the press of investors seeking to withdraw their capital created unsustainable pressure on foreign exchange reserves, forcing the Korean government to allow a drastic devaluation of the won and to seek the support of the International Monetary Fund (IMF). In contrast, Taiwan initially appeared to have escaped the East Asian contagion largely unscathed. Its currency underwent a most and orderly decline of about 17 percent from the end of 1996 to the end of 1998. No major Taiwanese banks or manufacturing companies collapsed. And although the growth of Taiwan's economy slowed in 1998, it recorded a gain of just under 5 percent, second only to China in East Asia and still one of the world's stellar growth performance.

As a matter of fact, the Asian financial crisis was mainly caused by mismanaged financial liberalization and financial market panic in the region.

Interestingly, there are salient differences in financial liberalization in the late 1980s and 1990s between the two countries. Financial liberalization in Korea was rapid, reckless and ill-designed, effectively sidelining the traditional capacities of the state to intervene strategically in the economy. Liberalization was also accompanied by the build-up of massive amounts of short-term foreign debt, over-investment in critical export industries, and a debt-riddled banking sector, eventually culminating in near financial meltdown. In Taiwan, on the other hand, financial liberalization was a far more cautious and considered affair, and was carried out in conjunction with the maintenance, and sometimes the enhancement, of the state's capacity to strategically intervene in the economy to promote financial stability and economic growth.

Then, why did these two nations pursue different approaches to financial liberalization? This study intends to analyze the reasons for divergent paths to financial liberalization in Korea and Taiwan through the lens of historical institutionalism. The main argument of this study is that divergent paths to financial liberalization in Korea and Taiwan can be well explained by historically constituted unique institutions and different state-business relations in both countries.

The case studies of Korea and Taiwan show that unique historical

experience exerts a great influence on the early stage of institutional formation in a significant way. And once institutions are formed, they are developed by repeated historical experience on the historical path. Later, policy makers' freedom to maneuver is constrained by the historically constituted institutions. For instance, the early formation process of a capitalist class during the 1950s, constrained by historical experience, different industrialization strategies in 1960s and 1970s, and the legacies of markedly different approaches to capital allocation and government-business relations continued to exert a profound influence on the countries' developmental trajectories and financial liberalization process in the 1980s and the 1990s.

**Key words**: financial liberalization, historical institutionalism, critical juncture, path dependence, policy loans, the heavy chemical industrialization drive, the 1997 East Asian financial crisis.

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# I. Introduction

## 1. Research Background and Research Question

Korea and Taiwan are regarded as typical examples of developmental states. Both countries experienced rapid growth under authoritarian regimes and have continued sustainable development after their transitions to democratic rule in the late 1980s. To varying degrees, Korea and Taiwan also share other similar characteristics such as Confucian culture, national division, small and open economies, high quality human resources, high interest in education, and slow processes of democratic consolidation with economic stagnation. (Lim 2009)(p.3)

The 1997 East Asian financial crisis, however, had strikingly differing effects on Korea and Taiwan. In Korea the press of investors seeking to withdraw their capital created unsustainable pressure on foreign exchange reserves, forcing the Korean government to allow a drastic devaluation of the won and to seek the support of the International Monetary Fund (IMF). In contrast, Taiwan initially appeared to have escaped the East Asian contagion largely unscathed. Its currency underwent a most and orderly decline of about 17 percent from the end of 1996 to the end of 1998. No major Taiwanese banks

or manufacturing companies collapsed. And although the growth of Taiwan's economy slowed in 1998, it recorded a gain of just under 5 percent, second only to China in East Asia and still one of the world's stellar growth performance. (Noble and Ravenhill 2000)(p.80)

As a matter of fact, the Asian financial crisis was mainly caused by mismanaged financial liberalization and financial market panic in the region. (Chang, Park et al. 1998) Interestingly, there are salient differences in financial liberalization in the late 1980s and 1990s between the two countries. In the 1990s, both of these countries embarked upon a process of financial liberalization, and maintained the momentum towards this end up until the onset of the 1997 Asian financial crisis. In light of the recent crisis, no two paths to financial liberalization appear more divergent than those taken by South Korea and Taiwan. (Thurbon 2001)(p.242)

Financial liberalization in Korea was rapid, reckless and ill-designed, effectively sidelining the traditional capacities of the state to intervene strategically in the economy. Liberalization was also accompanied by the build-up of massive amounts of short-term foreign debt, over-investment in critical export industries, and a debt-riddled banking sector, eventually culminating in near financial meltdown. In Taiwan, on the other hand, financial liberalization

was a far more cautious and considered affair, and was carried out in conjunction with the maintenance, and sometimes the enhancement, of the state's capacity to strategically intervene in the economy to promote financial stability and economic growth. (Thurbon 2001)(p.242)

Then, why did these two nations pursue different approaches to financial liberalization? This study considers that the two divergent paths to financial liberalization were heavily influenced by historically constituted political economies in both countries. Thus, this study will examine whether the early policy decisions of political elite, constrained by antecedent conditions, have made a constant impact on developmental trajectories and financial liberalization in the end. Especially, the 1970s heavy and chemical industrialization (HCI) drive in both countries, resulting in divergent industrial and financial structures, will be the main focus of this study.

## 2. Scope of Research

In the early 1980s, in Korea and Taiwan, financial liberalization started gradually because of domestic economic problems but accelerated in the latter half of the decade and the early 1990s after the backdrop of the intensifying democratization and globalization. Since this study analyzes domestic

institutional formation and development influencing the liberalization process in a historical institutional perspective, it will not focus on international factors such as the US administration's bilateral and multilateral pressure to open up Asian markets and the structural constraints of financial globalization.

Moreover, this study will examine distinct national paths of economic development and particular historical trajectories in Korea and Taiwan in order to compare antecedent conditions, critical juncture, and path dependence from the late 1940s till the mid 1990s. In Korea, antecedent conditions are the Korean War and its aftermath, and the absolute influence of the US presence on the Korean peninsula in 1950s. Those in Taiwan are the defeat on the Mainland and retreat to Taiwan in 1949, and the KMT elite's mistrust of Taiwanese people. During the 1950s, both governments endeavored to rebuild the nations and get out of poverty through economic development. The 1960s and 1970s are the periods when Korea and Taiwan implemented industrialization strategies such as the shift to export-oriented industrialization (EOI) in 1960s and the EOI deepening (heavy and chemical industrialization drive) in 1970s. Especially, both countries were at a 'critical juncture' in the 1970s, when their industrial and financial structures have become very different due to divergent paths to industrialization.

## 3. Literature Review and Significance of the Study

Regarding comparative studies of Korea and Taiwan on their politics and economies, many researches and studies have been conducted so far. Among those, there are some representative studies such as Tun-jen Cheng (1990) and Noble and Ravenhill (2000). Tun-jen Cheng argues in 'Political Regimes and Development Strategies: South Korea and Taiwan' that while both ways lead to success, there are debates on which approach makes better sense economically: South Korea's growth-first policy, its promotion of large industrial combines, and its heavy use of sector-specific, discretionary industrial policy; or Taiwan's policy of growth only with stability, its reliance on small and medium enterprises, and its more general industrial policy. (Gereffi and Wyman 1990)(p.171) Although the author didn't analyze the process of financial liberalization in both countries, his historical approach to paths of industrialization provides some valuable knowledge and wisdom.

Furthermore, 'The Good, the Bad and the Ugly? Korea, Taiwan and the Asian Financial Crisis' authored by Noble and Ravenhill presents a valuable comparative analysis of the industrial sector, the financial sector, and political sources of financial policy in the two countries. The authors argue that compared to Korea, Taiwanese government policy, particularly financial policy,

led to an industrial structure with greater roles for both state and market – and much less private oligopoly. (Noble and Ravenhill 2000)(p.92) Also, the legacies of Korea's big push capitalism and Taiwan's bifurcated capitalism continue to exert a profound influence on the countries' developmental trajectories. (Noble and Ravenhill 2000)(p.107)

Regarding comparative studies of financial liberalization in Korea and Taiwan, there are a few major studies by scholars like Elizabeth Thurbon, Haeran Lim, and Xiaoke Zhang. According to Thurbon, the Korean approach to financial liberalization was too rapid and ill-designed because it focused on the freeing of regulatory controls in the pursuit of OECD accession with little regard for the impact of these measures on the domestic economy. (Thurbon 2001)(p.250) In Korea, liberalization did in fact involve the near wholesale relinquishment of the state's policy instruments to intervene in the economy to promote financial stability and economic growth. The Taiwanese case, however, demonstrates that where political will exists and institutional structure allows, states may effectively combine financial liberalization with re-regulation to enhance the capacity to strategically intervene in the economy to developmental ends. (Thurbon 2001)(p.261)

In addition, Thurbon (2003) points out in 'Ideational Inconsistency and

Institutional Incapacity: Why Financial Liberalization in South Korea Went Horribly Wrong' that the ideational inconsistency and institutional incapacity that came about after 1993 were key factors in explaining the nature of Korea's particular approach to liberalization. (Thurbon 2003)(pp.358-359) Neoliberal ideas about the desirability of state retreat from the economy, and the MOF-EPB merger and deteriorating relations between the MOFE and the BOK resulted in fast liberalization without prudential regulation and supervision. (Thurbon 2003)(pp.356-358)

Contrary to other research on financial liberalization, Lim (2009) analyzes the impact of democracy on financial reform before and after the Asian Financial Crisis in Korea and Taiwan. She points out that the pattern of financial liberalization and reform can be categorized as "fast liberalization, delayed reform, and forced reform" in Korea. Democratization strengthened the political power of the *chaebol* in Korea and decreased the autonomy and efficiency of the bureaucracy. (Lim 2009)(p.30) Financial liberalization in Taiwan, on the other hand, is characterized as "slow and gradual liberalization and stalemated reform." Taiwan's history and national identity provided the country with structural constraints which emphasized macroeconomic stability and led to conservative policies in financial institutions. (Lim 2009)(p.31)

Finally, Zhang (2002) offers a comprehensive explanation of different liberalization patterns in key areas such as interest liberalization, bank privatization, entry barrier deregulation, functional de-segmentation, capital decontrol, and financial re-regulation and supervision. To account for different liberalization patterns, it suggests an institutional explanation of financial policy choices. It asserts that the differences in reform approaches and outcomes stem from fundamental differences in the domestic institutions that shape the aggregation and articulation of private preferences for and public-sector interests in financial liberalization. (Zhang 2002)(p.409)

According to Zhang's argument, business-government relations in Korea were structured in ways that granted the organizationally resourceful *chaebol* privileged entrée to the center of financial policy-making and did not allow for effective oversight by broad public interests and groups. Equally, key state economic and regulatory agencies found it hard to insulate themselves from the influence of business groups and politicians. In Taiwan, the more effectively regulated financial reform rested with the distinctive organizational structures of economic policy-making within the private sector and the state. The fragmented industrial structure undercut the ability of private enterprises to organize effective group-based lobbying and to bring adequate political resources to bear on the reform process. The internal structure of the economic bureaucracy

further limited the influence of private actors over the course of government policy. (Zhang 2002)(pp.433-434)

This study basically concurs with Zhang's point of view, which emphasizes an institutional explanation of financial liberalization process. Especially, his explanation of institutional configuration of the state and business is impressive. However, Zhang's article doesn't offer the historical analysis of institutional formation and development process concerning financial liberalization. For example, it doesn't have any data on the early formation process of a capitalist class in 1950s nor the evolutionary processes of the CBC and the BOK. Considering this shortcoming, this study will examine historical institutional formation and development processes concerning financial liberalization in Korea and Taiwan through key concepts such as antecedent conditions, critical juncture, and path dependence in historical institutionalism.

In this way, this study could not only provide a deeper understanding of historical origins of institutional formation and development concerning financial liberalization, but also clearly compare two different paths to liberalization process in a broader historical context.

# II. Theoretical Background

## 1. Theoretical Background: historical institutionalism

Historical institutionalism [1] is one of the three variants of new institutionalism that arose within political science in late 1980s and early 1990s. (Lasan 2012)(p.76) The three variants of "new institutionalism" are namely rational choice institutionalism, historical institutionalism and sociological institutionalism. (Lasan 2012)(p.77) The basic idea behind historical institutionalism is that the policy choices made when an institution is created or a policy initiated will have a long-range determining impact on future policy. One way to describe this argument is 'path dependence.' When an organization or a political program is defined, there is a tendency that the original policy choice engenders institutions that bind (or prescribe) future choice. The path may be changed, but it requires great political craftsmanship to do so. The implication is that institutions are rarely (or never) constructed from scratch but are always influenced by existing formal or informal institutions. (Nørgaard

[1] The term came out of a small workshop held in Boulder, Colorado in January 1989. Participants included Douglas Ashford, Colleen Dunlavy, Peter Hall, Ellen Immergut, Desmond King, Frank Longstreth, Jonas Pontusson, Peter Katzenstein, Bo Rothstein, Sven Steinmo, Kathleen Thelen, George Tsebilis, Theda Skocpol and Margaret Weir. *Structuring politics: Historical Institutionalism in comparative politics* (1992) grew out of this workshop. (Steinmo 2008)(p.150)

2001)(p.28)

The main claim of historical institutionalism is that political relationships have to be viewed over time. As Paul Pierson states, in contrast to the snapshot approach that most political scientists employ, placing politics in time can enrich our understanding of complex social dynamics and can give us a better explanation for the social outcomes. In other words, history is important because it creates the context which shapes the choices of actors. (Lasan 2012)(p.77)

Several key assumptions differentiate (broadly speaking) the historical institutionalist view from its intellectual competitors. First, an individual's interests cannot be derived automatically from his/her economic conditions because a range of potential preference positions are consistent with any material circumstances. Second, institutions (and ideas) are important independent (or at least mediating) variables in the articulation of interests or preferences. Institutions, groups, and networks are critical to the cognitive processes shaping preferences, as they selectively expose members to new ideas and foster broader political identities. Third, timing, sequencing and path dependencies shape interests. Choices made at critical junctures or points of political upheaval often lead to institutional arrangements and policy solutions

that lock in subsequent choices. Thus scholars writing in this tradition view national economic and social initiatives as largely defined and constrained by the past. Fourth, strategic choice – especially on the part of state actors – plays a (varying) role in historical institutionalist theories. Finally, from these assumptions follows a recognition of diversity of national models of growth: institutions, strategies, and policies differ across broader institutional settings. These institutional arrangements and strategic choices may or may not be functional, as institutional development is often precipitated by contingent circumstances. (Coates 2005)(pp.48-49)

Scholars working in this tradition have developed compelling methodological and theoretical justifications for historically-grounded investigations – by which they mean not just looking at the past, but looking at *processes over time*. Historically informed investigation also sensitizes investigators to temporal boundary conditions, or period effects, with respect to claims about causal relationships. (Pierson and Skocpol 2002)(p.6)

An appreciation of increasing returns dynamics is one important justification for the focus on issues of timing and sequencing that constitutes a second important theoretical rationale for focusing on historical processes. In path dependent processes, the order of events may make a fundamental difference.

Historical institutionalists tracing broad patterns of political development across a number of countries often argue that the timing and sequence of particular events or processes can matter a great deal. (Pierson and Skocpol 2002)(p.7)

Another theoretical justification for focusing on historical process is to draw attention to lengthy, large-scale, but often very slow-moving social processes. Historical institutionalists seek to be attentive to the unfolding of both causal processes and important political outcomes over extended periods of time. Most political scientists are strongly predisposed to focus on aspects of causal processes and outcomes that unfold very rapidly. Yet many things in the social world take a long time to happen. Some causal processes and outcomes occur slowly because they are incremental – it simply takes a long time for them to add up to anything. (Pierson and Skocpol 2002)(p.9) Because some crucial social conditions may change only slowly, analysts studying a narrow time frame will be strongly inclined to take them as fixed and therefore irrelevant to their causal accounts. (Pierson and Skocpol 2002)(p.9) Thus, ahistorical analyses typically seek to consider the effects of institutions while "holding constant" other variables – but these variables are in part the long-term consequences of institutional structures. (Pierson and Skocpol 2002)(p.10)

## 2. Key Concepts: critical juncture and path dependence

A central example of why history may be causally critical involves claims about *path dependence*[2] that are common in historical institutionalist scholarship. "Path dependence" can be a faddish term, lacking clear meaning, but in the best historical institutionalist scholarship it refers to the dynamics of self-reinforcing or positive feedback processes in a political system – what economists call "increasing returns" processes. A clear logic is involved in strictly defined path dependent processes: Outcomes at a "critical juncture" trigger feedback mechanisms that reinforce the recurrence of a particular pattern into the future. Path dependent processes have very interesting characteristics. They can be highly influenced by relatively modest perturbations at early stages. Once actors have ventured far down a particular path, however, they are likely to find it very difficult to reverse course. Political alternatives that were once quite plausible may become irretrievably lost. Thus, events or processes occurring during and immediately following critical junctures emerge as crucial. (Pierson and Skocpol 2002)(p.6)

Several points are important to note: First, critical junctures are periods of political uncertainty, in which the outcome from political decisions is open-

[2] 'Path dependence' explains how the set of decisions one faces for any given circumstance is limited by the decisions one has made in the past, even though past circumstances may no longer be relevant.

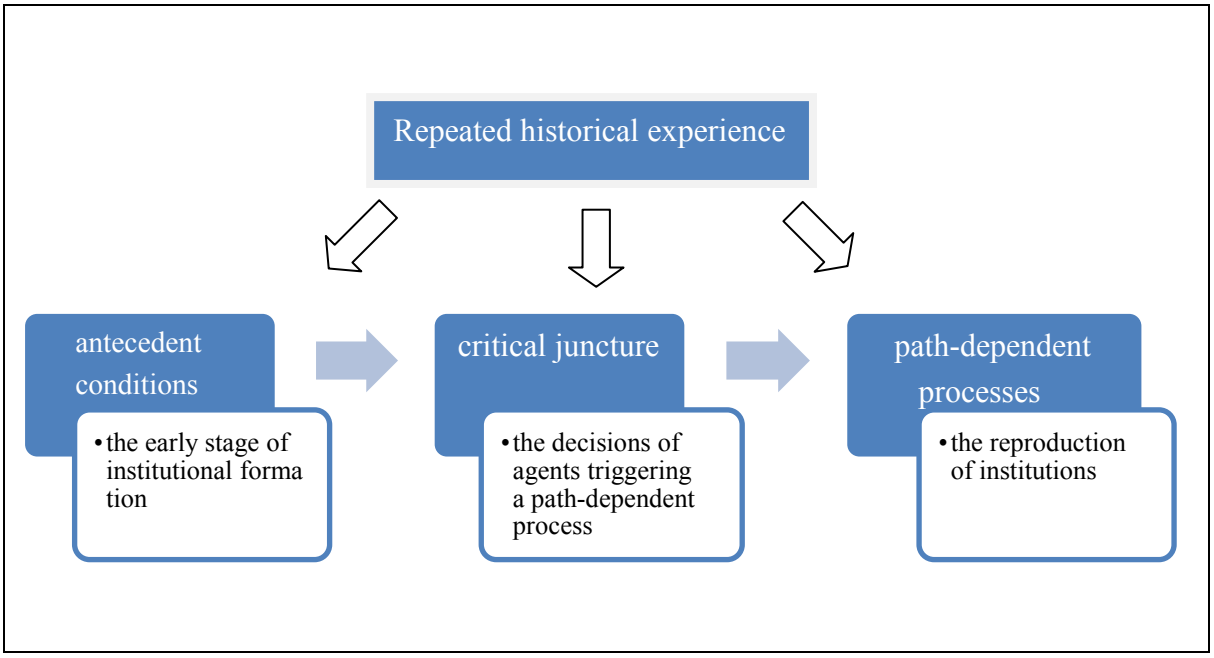
ended. Second, in order to qualify as a critical juncture, the decisions of agents must trigger a path-dependent process that lasts much longer than the time-frame within which these decisions are being undertaken. Third, a heightened probability that change can occur does not mean that change is bound to occur. Critical junctures trigger path-dependent processes; once a particular institution has been created, they become "locked in" and are reproduced over time. Historical institutionalists use various terms for the reproduction of institutions: "increasing returns", "positive feedback", "self-reinforcing mechanisms". (Erdmann, Stroh et al. 2011)(p.13)

The institutions of a nation's political economy are inextricably bound up with its history in two respects. On the one hand, they are created by actions, statutory or otherwise, that establish formal institutions and their operating procedures. On the other hand, repeated historical experience builds up a set of common expectations that allows the actors to coordinate effectively with each other. Among other things, this implies that the institutions central to the operation of the political economy should not be seen as entities that are created at one point in time and can then be assumed to operate effectively afterwards. To remain viable, the shared understandings associated with them must be reaffirmed periodically by appropriate historical experience. (Hall and Soskice 2001)(pp.13-14)

The new institutional scholarship expects national economies to perform differently, and *not* to converge, because of the possibility of path dependence in growth performance over time, and because of the existence of parallel 'virtuous' and 'vicious' circles of growth and decline that pull and keep economies apart. The result, if the bulk of the new institutionalist scholarship is right, is the necessary emergence and persistence of different national economies and different national trajectories – each with its own origins back in time, each with its own track record of evolution and change. As Hollingsworth put it, 'a society's social system of production is very path-dependent and system-specific. There are broad types of such national economies – the new institutionalist literature of late has made much of the distinction between liberal and coordinated market economies – but even within those broad categories, from a new institutionalist perspective national variations are to be expected, welcomed, and observed over time. For there are historically induced differences of institutional form here: 'the particular historical course of each nation's development creates a political economy', as Zysman has it, 'with a distinctive institutional structure for governing the markets of labor, land, capital and goods'. The claim here is that 'distinct national paths of economic development and particular technological trajectories are an outgrowth of an institutionally specific context with which each economy operates'. (Coates 2005)(pp.17-18)

Based on key concepts such as antecedent conditions, critical juncture, and path dependence from historical institutionalism, I come up with the following flowchart. (Figure 1) First, unique historical experience influences the early stage of institutional formation in a significant way. Second, once institutions are formed, they are developed by repeated historical experience on the historical path. Finally, policy makers' freedom to maneuver is constrained in the historically constituted institutional structures. In fact, institutional structures have a certain functional logic that dictates certain types of policy choices and channels actors toward certain types of strategic choices. (Coates 2005)(p.57)

**Figure 1. Path dependence**




Source: the author's summary

# III. Historical Experience and Its Implications

## 1. The Korean Case (The Rise of Private Capital)

After gaining independence from Japan in 1945, postcolonial South Korea was turned over to the American military government (AMG) and then managed by exiled South Korean leaders. (Gereffi and Wyman 1990)(p.146) A historical factor specific to postwar South Korea is the early formation of a capitalist class in and for itself. Low in capacity for political co-optation and mobilization, the regime in Korea must ensure economic performance and secure ample political funds in order to acquire legitimacy. (Gereffi and Wyman 1990)(p.143) The most decisive factor for the making of a capitalist class in South Korea was the privatization of the immense property[3] that the colonial government left behind. (Gereffi and Wyman 1990)(p.146) For example, under a South Korean-American agreement in 1954, Rhee committed himself to relinquishing state-owned enterprises (SOEs) and state-owned banks. Subsequently more than fifty major industrial enterprises were privatized. Then in 1957 the commercial banks were sold. (Gereffi and Wyman 1990)(p.147)

[3] The total value of the inherited property is estimated to be about ₩305.3 billion. The value was nine times as many as the total annual expenditures. (Seonggonghoedaehakgyo and Kim Jineop 2001)(p.122)

Table 1 shows the postwar number of transfer of inherited property to private ownership. Given this sort of institutional restructuring of the economy, it is arguable that the United States acted as a catalyst for the formation of a capitalist class in South Korea. (Gereffi and Wyman 1990)(p.147)

**Table 1. The postwar number of transfer of inherited property to private ownership**

| Year | Corporation | Real Estate | Others | Total |
|---|---|---|---|---|
| 1953 | 121 | 39,693 | 322 | 40,134 |
| 1954 | 233 | 92,735 | 95 | 93,063 |
| 1955 | 165 | 63,717 | 217 | 64,099 |
| 1956 | 61 | 36,418 | 162 | 36,641 |
| 1957 | 23 | 8,784 | 75 | 8,882 |

Source: Kim Daehwan(1998), hangukhyeondaesaui jaeinsik 4, (p.204)

Founders of state-supported businesses from after the Korean War in 1953 to 1961 established the first *chaebol*, not through the working out of market forces, but through a process of "political capitalism." The industrial empires of Samsung, Hyundai, Lucky, and Kia began during this era. Their founders received state favors, including the noncompetitive and below-market purchase of Japanese colonial businesses, in exchange for large contributions to Rhee and other politicians. (Orru, Biggart et al. 1996)(p.225) Close to political power and with ample capital resources, the newly emerged capitalists were in a position to

reap further economic gains. (Gereffi and Wyman 1990)(pp.147-148)

After the 1961 coup, the military regime nationalized commercial banks by repressing the shares held by large stockholders, which were mostly big business owners who had been accused of illicit wealth accumulation in the aftermath of the 1960 Student Revolution. (Haggard, Lee et al. 1993)(p.26) A few days after the coup took place, Park formed the Committee for Investigation and Execution of the Illicit Wealth Accumulation Act, a piece of legislation enacted but unenforced after Rhee's fall. Park used the act to round up the heads[4] of all the major *chaebol* and, not incidentally, to seek the support of public opinion. (Orru, Biggart et al. 1996)(p.226) Soon, the military regime pardoned the leading businessmen in exchange for economic cooperation and chose growth over redistribution as the basis of political legitimacy. This political change forced businesses to organize themselves to protect their property rights by acting on behalf of the interests of the political elite. (Gereffi and Wyman 1990)(p.159)

And as a small, resource-poor yet labor-surplus economy, Korea made a turn

[4] Byung Chul Lee, founder of the Samsung *chaebol*, was a leading target of the act. Official calculations placed Lee's illicit wealth at 800 million won, 19% of the nation's wealth. (Orru, Biggart et al. 1996)(p.226)

toward Export-Oriented Industrialization (EOI) rather than a deepening of Import-Substitution Industrialization (ISI) or an acceleration of primary exports from 1963 to 1965. (Gereffi and Wyman 1990)(p.153) In order to successfully carry out EOI, the Korean government chose private capital as its strategic partner, and it gave birth to an alliance of accumulation between the military regime and the leading businesses. (Gereffi and Wyman 1990)(pp.158-159)

The initiation of EOI was based on the use of abundant labor as the major input factor and on exploiting the export market. In the early 1970s, these factors could no longer be taken for granted. (Gereffi and Wyman 1990)(p.161) Therefore, in 1973 South Korea launched heavy and chemical industrialization (HCI) to upgrade their industrial structures. (Gereffi and Wyman 1990)(pp.162-163) During this period, the *chaebol* in Korea grew significantly under the auspice of the government.

After the successful HCI drive in 1970s, the *chaebol* had seen explosive growth over the mid-to-late 1980s, when international economic conditions ameliorated thanks to low oil price, low interest rate and the depreciation of the dollar. Basically, big business enjoys substantial leverage in any political system, a reflection of the structural power of capital. In few industrialized economies, however, is economic power as concentrated as it is in Korea. (Noble and

Ravenhill 2000)(p.100)

Meanwhile, the EOI strategy with the development of large conglomerates induced the government to use finance as a major industrial policy instrument. The Bank of Korea (BOK) was established in 1950 under the Bank of Korea Act. Until the 6th amendment of the Bank of Korea Act in 1997, the BOK had been subordinated to the government, having played only a minor role in economic policy-making process. By amending the Bank of Korea Act in May 1962, President Park made it clear that it was the government, not the central bank, that was ultimately responsible for monetary and financial policy. (Haggard, Lee et al. 1993)(p.27) The reason for that is Korea tolerated price instability for growth. The logic of the Korean approach—hierarchical, unbalanced, and command-oriented—calls for the intensive use of resources to foster a highly select and obedient big business sector to carry out the specific tasks the leadership may assign. (Gereffi and Wyman 1990)(pp.142)

Not only the BOK, but commercial banks were also used as a tool for economic development. Although most banks in Korea were largely in private hands in the 1960s and 1970s, they were de facto public enterprises because legislation introduced in 1961 limited the voting rights of private shareholders. (Noble and Ravenhill 2000)(p.92) Continued government controls on bank

interest rates led to a significant growth first in the curb market, then in the share of non-bank financial institutions as they were encouraged by the government as a means of restricting the curb market. (Noble and Ravenhill 2000)(p.93) Moreover, policy loans still constituted between 40 and 50 percent of total lending through 1992. (Noble and Ravenhill 2000)(p.93) These policy loans left two significant legacies. First, they spawned a large quantity of non-performing assets, estimated at more than 10 percent of all loans in the mid 1980s. (Noble and Ravenhill 2000)(p.93) Second, policy loans and consequent non-performing assets contributed to the low profitability of banks. (Noble and Ravenhill 2000)(p.93) Thus, the legacy of Korea's big push capitalism that directed massive amounts of bank lending to *chaebol* continued to exert a profound influence on the country's developmental trajectory in 1980s and 1990s.

## 2. The Taiwanese Case (The Supremacy of the State over Business)

At the end of World War II in 1945, Japan surrendered Taiwan and associated islands to the Republic of China (ROC) forces, which had been established in mainland China in 1912. Following the Chinese civil war Chinese Communists took full control of mainland China and founded the People's Republic of China (PRC) in 1949. The ROC resettled its government to Taiwan.

In the process of decolonization, the Kuomintang (KMT) regime centralized state power, established its hegemony over the society, and, in particular, subdued a previously recalcitrant capitalist class. (Gereffi and Wyman 1990)(p.143) As a result, analysts referred to the KMT of the authoritarian period as a 'quasi-Leninist' party. The wide range of enterprises[5] inherited from the Japanese upon the retrocession of Taiwan enhanced the party-state's already impressive capabilities. (Noble and Ravenhill 2000)(p.101) Especially, its inheritance of Japanese property reversed the party's prewar dependence on the private sector. (Haggard, Lee et al. 1993)(p.59)

In contrast to Korea, the development of Korean-style conglomerates was virtually impossible in the first three decades of the post-War era. (Pempel 1999)(p.193) Because of the KMT elite's mistrust of the Taiwanese[6], the KMT

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[5] In the years immediately after World War Ⅱ, the KMT government moved quickly to claim the enterprises owned by the Japanese government, including the railway system, banks, and a number of agricultural and industrial firms. (Orru, Biggart et al. 1996)(p.243)

[6] On the evening of February 27, 1947, after Monopoly Bureau agents beat a woman selling cigarettes on the black market and shot a protesting bystander, a Taipei crowd attacked a police station, set fire to a police vehicle, and went on a rampage. On February 28, larger crowds turned their anger against all mainlanders and their Taiwanese colonies. On May 8, around 13,000 troops from the mainland came to Taiwan and opened war on the Taiwanese, unleashing a fortnight of terror and looting. The Nationalists intended to liquidate the

lacked the incentive to find or create a big business partner and, indeed, feared that big business could compromise its goals and structural integrity. (Noble and Ravenhill 2000)(p.102) In fact, the mainlander elite discouraged concentration of wealth for both political and ideological reasons. First, the KMT had implemented a comprehensive land reform (i.e., a redistribution of wealth) between 1948 and 1951 to prevent Communist insurgence in the rural area. Second, a decentralized industrial structure served the political interests of the ruling elite well. Overconcentration of industrial power and wealth not only might pose a potential political threat to the mainlander elite, but could undermine the KMT's claim that it embodies the interest of all classes. On the other hand, the myriad of SMEs[7] that grew around the state-sponsored, export-oriented industrialization strategy has enabled the KMT to broaden its social base; the emerging industrial structure addressed both growth and equity issues with a high degree of effectiveness. More importantly, the monopoly or near-monopoly of the state-owned enterprises[8] (SOEs) had preempted the private

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Taiwanese intellectual and social elite. Figures for the total number of victims island-wide range from 10,000 to 20,000. This is the so-called *"2-28 Incident."* The Taiwanese people lost faith in the Nationalists. (Gold 1986)(pp.50-52)

[7] Taiwan's huge economic growth has occurred in the export manufacturing sector, and that sector is dominated by small and medium-sized businesses. (Orru, Biggart et al. 1996)(p.290)

[8] In the 1950s, state-owned enterprises accounted for nearly 50% of the value added in the manufacturing sectors, but this portion declined quickly until 1971,

participation in the financial sector, the public utility sector, and most of the capital-intensive industries from the very beginning. (Pempel 1999)(p.193)

Furthermore, an historical legacy of the rampant inflation suffered under the Kuomintang (KMT) on the mainland, and the desire to avoid the negative economic and political ramifications of inflationary pressure in the future came to be reflected in the bureaucratic structures established by the KMT on Taiwan; when the Central Bank of China (CBC) was reopened on Taiwan in 1961, its independence was immediately guaranteed, and the Bank in turn identified the minimization of inflation as its primary objective. (Thurbon 2001)(p.251) In fact, the CBC has long occupied the commanding heights of the state economic bureaucracy; its governor is always considered the most senior economic minister. For example, many finance ministers were themselves former deputy governors of the CBC. The Ministry of Finance traditionally has played second fiddle to the CBC as far as banking regulation is concerned. The bank can overrule the Finance Ministry, which deals with the constituencies in the financial sector more directly, over the sequence and timetable of financial deregulation and internationalization. (Pempel 1999)(p.189)

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when it leveled out at an average for the next 15 years of 14%. In contrast, in Japan and Korea the state-owned sector constituted less than 5% by the 1990s. (Orru, Biggart et al. 1996)(pp.242-243)

In the period of 1970s a decentralized industrial structure without Korean-style conglomerates and the autonomous status of the CBC induced the KMT regime to follow ‘a gradualist approach’ to industrial transformation, which is very different from ‘a big push approach’ taken by Korea. Basically, policies to promote small-and medium-sized industries, and to balance agricultural and industrial sectors, contradicted the “big push” approach to HCI. (Gereffi and Wyman 1990)(p.167)

Consequently, Taiwan’s policy of growth only with stability, its reliance on small and medium enterprises, and its more general industrial policy enabled the KMT regime to maintain a macroeconomic stability in the 1980s and 90s, while the Korean *chaebol’s* heavy dependence on debt had a profound effect on the vulnerability of the Korean economy to economic downturns, including externally generated crises. (Noble and Ravenhill 2000)(p.85) Table 2 presents a brief comparison of Korean and Taiwanese historical paths.

**Table 2. A brief comparison between Korean and Taiwanese historical paths**

| | **1949-1960**<br>**(antecedent conditions)** | **1960s** | **1970s**<br>**(critical juncture)** |
|---|---|---|---|
| **Korea** | The Korean War<br>(1950-1953)<br><br>**Privatization of enterprises appropriated from Japan**<br><br>The collusion between government and business (economic rent-seeking)<br><br>**The early formation of a capitalist class** | **EOI (Centralized)**<br><br>The sword-won alliance<br><br>**Subordination of BOK to the government** (1961)<br><br>**Financial repression**<br><br>Foreign borrowing preferred | **EOI Deepening:**<br>'big push capitalism'<br><br>**The HCI drive with *chaebol***<br>(The growth-first strategy)<br><br>**The high-debt model**<br>**(high corporate debt-equity ratio & large non-performing debts)**<br><br>Foreign borrowing preferred |
| **Taiwan** | The defeat on the Mainland<br>(1949)<br><br>The KMT elite's mistrust of Taiwanese people<br><br>**The KMT's inheritance of Japanese property**<br><br>**The making of a strong party state** | **EOI (Decentralized)**<br><br>A loose developmental coalition<br><br>**Independence of the CBC**<br>(1961)<br><br>Macroeconomic stability<br><br>FDI preferred | **EOI Deepening:**<br>'bifurcated capitalism'<br><br>**The HCI drive with S.O.E. & S.M.E.**<br>(The policy of growth only with stability)<br><br>**Low corporate debt-equity ratio & much less non-performing debts**<br><br>FDI preferred |

Source: the author's summary

## 3. The HCI Drive in 1970s (Critical Juncture)

In the previous section, I attempted to present a brief comparison of Korean and Taiwanese historical paths, particularly with regard to the relationship between the state and industrial capital. As mentioned before, in the process of decolonization, the Kuomintang (KMT) regime centralized state power, established its hegemony over the society, and, in particular, subdued a previously recalcitrant capitalist class. In contrast, the Rhee regime in South Korea (1948-1960) disbanded its mass mobilizational organizations and, due in large measure to American influence, privatized the economy, fostering first a dependent, but later a powerful, capitalist class. (Gereffi and Wyman 1990)(p.143) Indeed, a strategic choice of state elites, constrained by antecedent conditions, resulted in different industrialization strategies and resultant financial policy tools in both countries throughout the history. In this section, I attempt to focus on the 1970s heavy and chemical industrialization (HCI) drive, which brought a significant change in the state-business relationship, resulting in different industrial structures in both societies.

After the successful shift to export-oriented industrialization (EOI) from import substitution industrialization (ISI) in 1960s, the economy reached a transitional point where an industrial restructuring was both necessary and

possible. (Gereffi and Wyman 1990)(p.162) Both Taiwan and South Korea were facing a three-dimensional pressure: from below the second tier NICs; from above, creeping protectionism in the West; and inside, the shrinking labor pool, hence rising wage levels, especially in Taiwan. Moreover while EOI proved to be a successful strategy for growth, its risk for small economies—their sensitivity and vulnerability to external economic conditions—was also high. (Gereffi and Wyman 1990)(p.161) For these reasons, in 1973 both Korea and Taiwan launched heavy and chemical industrialization (HCI) to upgrade their industrial structures. (Gereffi and Wyman 1990)(p.163) Korea and Taiwan deepened their EOI in different ways. Essentially Korea undertook a big push approach[9] while Taiwan followed a gradualist approach to industrial transformation. Korea aimed to turn HCI into the new backbone of national exports while Taiwan strengthened existing industries. Both attempted to balance the protection of upstream import substitution industries with the export competitiveness of downstream industries, but the conflict between these two goals was resolved more in favor of the former in Korea while the reverse was true for Taiwan. (Gereffi and Wyman 1990)(p.163)

In Korea, however, the more direct impetus for heavy industrialization was

[9] It refers to directing massive amounts of bank lending to *chaebol* for industrial development.

political. President Park Chung Hee, who had barely won the 1971 presidential election, proclaimed martial law in October 1972[10], banned political activity, closed the universities temporarily, and imposed press censorship. Under the pretext of meeting the growing military threat from North Korea[11], the U.S. plan to withdraw its ground forces, and the deteriorating world trade environment, he undertook a constitutional reform. The new Yushin Constitution was meant to strengthen Park's authoritarian rule of the country. In the face of strong opposition, Park justified the illegitimate constitutional change at a press conference in January 1973 by presenting a bold vision of "$10 billion worth of exports and a $1,000 per capita income by the early 1980s" as a midterm goal of the Yushin regime. At the same time, he proclaimed that the government would direct all energies to the development of heavy and chemical industries in an effort to achieve those goals. (Haggard, Lee et al. 1993)(p.35)

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[10] In that year, there was another significant incident concerning the HCI drive. The historical measures, announced as the Presidential Emergency Decree for Economic Stability and Growth of August 3, 1972, placed a moratorium on all private loans incurred by firms. In any case, the emergency decree helped pave the way for the government's heavy and chemical industrialization drive in the 1970s, the success of which hinged so much on the availability of cheap long-term capital. (Haggard, Lee et al. 1993)(pp.30-31)

[11] Stephan Haggard and Tun-jen Cheng (1987) argued that motivated in part by military concerns, Korea went further along this path, attempting a big push in heavy and chemical industries which resulted in a further concentration of domestic industry. (Deyo 1987)(p.123)

In short, President Park's extraordinary commitment to heavy industrialization and his apparent control over actual investment decisions were meant to reduce the "strategic uncertainty" involved in heavy industry investments. As long as private investors acquiesced to the political leadership's vision of the desired politico-economic order, they could secure the resources and support necessary to make otherwise highly risky business undertakings profitable. In this way, the government and private investors forged a "strategic interdependence" in the sense that private investors could now reasonably expect that they could influence the government's economic policy-making. (Haggard, Lee et al. 1993)(p.36)

Indeed, as the heavy and chemical industrialization drive began, the Korean government felt the need to strengthen further its control over banks. It thus established more specialized state-run banks[12] and earmarked a portion of commercial bank funds as "policy loans" that were channeled toward key heavy industry sectors. (Haggard, Lee et al. 1993)(p.31) With this selective and

[12] The primary source of heavy industries' long-term investment capital was the KDB. It provided long-term loans, underwrote corporate bonds and stocks, and guaranteed foreign loans. Another new financial institution was the Export-Import Bank of Korea, which provided medium- and long-term financing for domestic exporters and foreign importers of Korea's heavy industry goods and underwrote export insurance for domestic corporations and financial institutions. (Haggard, Lee et al. 1993)(pp.36-37)

discretionary credit allocation system, the government could channel greater financial resources toward “strategic” heavy and chemical industries. The high rate of economic and export growth and the significant deepening of industrial structure and the composition of exports in the 1970s can be traced to this policy of selective credit allocation. (Haggard, Lee et al. 1993)(p.32)

Such expansion of preferential policy loans resulted in a sharp increase in their share of total bank credit from less than 40 percent in 1971 to 68.7 percent in 1978. Thanks to preferential policy loans, more than 77 percent of total manufacturing investment during 1976-1978 was undertaken in the heavy and chemical industries, which accounted for only about 50 percent of total manufacturing output. As of the end of 1978, the outstanding balance of various policy loans for the heavy and chemical industries constituted 92.8 percent of total loans to the manufacturing sector. (Haggard, Lee et al. 1993)(p.37)

In addition to domestic credit, the government guaranteed foreign loans in these privileged sectors. From 1973 to 1979, the EPB channeled toward the heavy and chemical industries $3.8 billion (of which $172.5 million was in public loans), which is equivalent to 32 percent of total foreign loans, whose payments were guaranteed by the KDB and other banking institutions. From 1977 onward, the trend accelerated, with these industries accounting for more

than 80 percent of total foreign loans and for all public foreign loans in the manufacturing sector. This left less than 20 percent of total foreign lending for light industries. (Haggard, Lee et al. 1993)(pp.37-38)

Thus, this pattern of finance encouraged the concentration of credit and oligopoly, resulting in the top 100 *chaebol* soaking up close to 70 percent of total outstanding loans in the late 1970s. There were three salient consequences of this pattern of finance. First, because this low-cost financing was geared to creating industrial capacity rather than profitability, the *chaebol* featured staggering debt-to-equity ratios[13] and a large accumulation of non-performing loans. Second, the size of debt and the potentially devastating social impact of bankruptcy resulted in the socialization of this high-risk industrial expansion. Third, the *chaebol* used some of these funds speculatively, purchasing real estate or relending the money in the curb market. This expanded corporate control in society but also deepened resentment across various classes over their privilege[14] and complicity in repressive politics. (Underhill 1997)(p.228)

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[13] In 1988 the average debt ratio of Korean manufacturing firms was **296.0**, compared with the ratios for firms in Taiwan of **84.3**; Japan, **243.0**; and the United States, **138.2**. (Haggard, Lee et al. 1993)(p.49) This in turn caused high debt-servicing costs, contributing to the generally low levels of profitability of Korean corporations.

[14] The real cost of funds for the *chaebol* was minus 6.7 percent from 1974-80. The political alliance between the state and *chaebol* and the strategy of creating

Thus, it is clear that big business and the *chaebol* stood to benefit heavily from the credit allocation system. In particular, as the *chaebol* and big business grew in size and economic weight, their direct and indirect influence on the government's credit allocation policy grew; this is evidenced by the major changes in the government's credit policies, which matched closely with the diversification strategies of *chaebol*. (Haggard, Lee et al. 1993)(p.38) For example, the government has since 1975 designated certain firms as general trading companies, which are all owned by the largest *chaebol*. The establishment of general trading companies had several policy objectives: (1) strengthening overseas marketing capabilities, (2) seeking economies of scale, and (3) acting as agents for medium- and small-scale producers. The government granted these general trading companies preferential treatment in international bidding, loosened restrictions on their importation of raw materials, and provided funds for the stockpiling of finished export goods. (Haggard, Lee et al. 1993)(p.38) Moreover, the government's use of past export performance as a criterion for the renewal of status as a general trading company, led *chaebol* to rely heavily on and actively seek merger and acquisitions of medium- and small-scale enterprises in broad lines of business. (Haggard, Lee et al.

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economies of scale in capital-intensive industries ensured that there were insufficient bank funds for small- and medium-sized enterprises (SMEs). They were forced to borrow household savings through the informal curb market at rates in excess of 18 percent. (Underhill 1997)(p.228)

1993)(pp.38-39)

Furthermore, *chaebol*'s active participation in the financial industry has also enhanced their privileged position in the preferential financial system. Because they have been allowed to acquire controlling shares of non-bank financial intermediaries since the 1970s and because they could increase their equity holdings in commercial banks directly and indirectly after their privatization in the 1980s, they could not only borrow much of their working capital from the NBFIs but they could also influence the decision making of the commercial banks. Moreover, they utilized idle funds through the NBFIs under their control. (p.40)

In sum, during the 1970s HCI drive, the Korean government used finance as a major industrial policy instrument. The mechanism to induce big business to invest in sectors that the government had regarded as strategic or important was invariably through selective credit allocation. Over time, as these large business groups grew further in size and political strength, the nature of the state-business relationship changed accordingly. Their large size became a liability to policymakers as the viability of big business turned into a matter of great importance to the nation's economic stability and employment. In addition, with the establishment of a pluralistic political system in Korea, *chaebol* groups'

influence on policy-making became stronger because they were a potent political force. (Haggard, Lee et al. 1993)(pp.53-54)

In contrast to the big push of Korea, Taiwan followed a pattern of 'bifurcated capitalism'. Rather than sponsoring the growth of giant private conglomerates, the government in Taiwan maintained a stronger state sector and provided more space for small private firms. Publicly owned enterprises comprised a significant share of manufacturing output, particularly for basic commodities, and dominated many service sectors, including finance, transportation and telecommunications. When the Taiwanese government moved to strengthen the heavy industrial base in the 1970s, it relied upon state-owned enterprises[15] rather than fostering large private conglomerates. (Noble and Ravenhill 2000)(p.88)

Contrary to the Korean credit allocation system, the Taiwanese government avoided policy loans, instead relying primarily upon alternative tools such as tax incentives, research subsidies, land planning and labor immigration. Rather than favoring large companies, this approach systematically lowered entry barriers to

[15] Many heavy industries, such as petroleum refining, aluminum production, and fertilizers, remained in state hands, limiting the penetration of foreign firms. (Deyo 1987) (p.116)

favor small and medium-sized firms. For example, the Industrial Technology Research Institute (ITRI), a quasi-public research organization, conducted contract research and organized research and development consortia that made it possible for small manufacturers to compete in high-tech industries. (Noble and Ravenhill 2000)(p.88)

There is another significant difference in external dependencies between Korea and Taiwan. Whereas capital-poor Korea relied on foreign financing until the 1980s, Taiwan has been able to rely on a combination of domestic savings, overseas Chinese remittances and, the late 1960s, steadily rising trade surpluses, to avoid external debt. The Taiwanese state has been more welcoming to the presence of foreign industrial capital in key sectors than its Korean counterpart. (Underhill 1997)(p.235) For example, by 1971, overseas Chinese and other foreign investments amounted to roughly one-seventh of total registered capital (about the same as in Brazil), although statistics on foreign investment are problematic. Foreign investments, however, have been concentrated in electronics, chemicals, and textiles destined for export. Foreign investments have not mushroomed with the government's turn to heavy industry. According to one account, between 1973 and 1980, foreign firms were responsible for as much as half of total investment and as much as 20% of total exports in the electronics sector, but they were responsible for only 10% of total investment in

manufacturing. (Evans, Rueschemeyer et al. 1985)(p.93)

Finally, in the 1960s and 1970s, Taiwan maintained very high levels of investment. However, unlike the case in Korea[16], savings were even higher, leading to persistent current account surpluses (and to lower rates of inflation and real interest). (Noble and Ravenhill 2000)(p.98) For example, savings as a percentage of national income were less than 5% in 1952, 6.5% in 1962, 26.8% in 1972, and almost one-third a decade later. The composition of savings has also altered. The share of foreign savings has nose-dived, from around 40% in 1952-60, the heyday of U.S. aid, to a *negative* percentage in the period since 1972, whereas the shares of both public and private domestic savings have risen. (Evans, Rueschemeyer et al. 1985)(p.97) As a result, Taiwan did not become highly indebted to international banks to finance its heavy industry.

In sum, compared to Korea, Taiwanese government policy, particularly financial policy, led to the development of a decentralized industrial structure,

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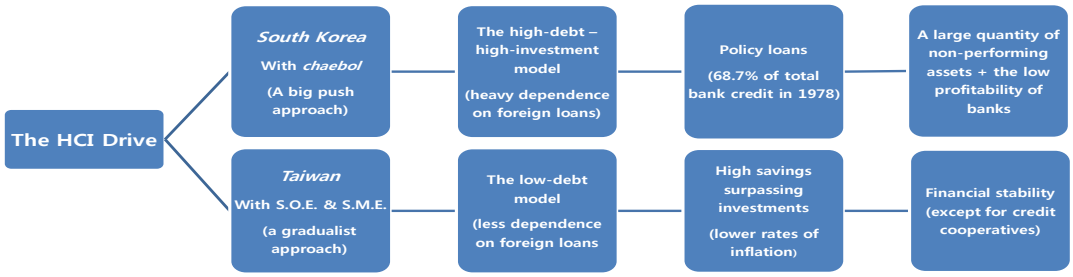
[16] With savings lagging behind investments, Korea ran persistent current account deficits. Foreign borrowing covered the deficits; direct foreign investment, long discouraged by the government and unwelcomed by *chaebol*, remained extremely limited. Korea's heavy dependence on foreign loans was the foundation of sporadic balance of payments crises when downturns in the global economy triggered debt servicing problems. (Noble and Ravenhill 2000)(p.97)

domestically financed growth, a sound corporate financing structure, and alternative tools such as tax incentives and research subsidies for industrial upgrading primarily as a result of a political calculation for maintaining a stable macroeconomic environment as well as for guarding against the rise of big indigenous capital. Also, government policy over the mid-to-late 1970s emphasized the provision of large-scale infrastructure, but new state-owned enterprises were formed in petrochemicals, shipbuilding, and steel as well. The state's role also grew over the 1970s in the development of technology-intensive industries. Furthermore, a more open attitude toward foreign direct investment opened opportunities for small local firms to supply parts and components at the same time that it crimped the development of large conglomerates. (Noble and Ravenhill 2000)(p.92) Finally, Taiwan did not become highly indebted to international banks to finance its heavy industry thanks to domestic savings surpassing investments. Figure 2 presents a brief comparison of the HCI drive in Korea and Taiwan.

**Figure 2. A brief comparison of the HCI drive in Korea and Taiwan**




Source: the author's summary

# IV. Financial Liberalization in Korea and Taiwan

## 1. A Comparison of the Korean Approach and the Taiwanese Approach

In Korea, the policy legacies of the heavy industrialization drive in the 1970s were immense. In particular, the excessive and duplicative investments made by *chaebol* in many heavy industry sectors were problematic. Heavy industry plants exhibited surplus capacity owing to insufficient demand in Korea and in export markets; many large investment projects had long lead times and required additional capital for loan repayment and operational purposes. But banks were not in a position to respond to these demands, which entailed high risks. (Haggard, Lee et al. 1993)(p.40) Tables 3 and 4 clearly show the policy legacies of the HCI drive in Korea in terms of corporate profitability and bank performance.

**Table 3. Corporate profitability and financial structures in Korea and Taiwan**

| | *Return on assets* | *Ratio of debt to equity* | *Interest coverage*[a] |
|---|---|---|---|
| **Korea** | | | |
| 1988 | 4.4 | 2.82 | n.a. |
| 1990 | 4.1 | 3.11 | n.a. |
| 1992 | 3.9 | 3.37 | 1.42 |
| 1994 | 3.4 | 3.53 | 1.89 |
| 1996 | 3.1 | 3.55 | 1.07 |
| **Taiwan** | | | |
| 1988 | n.a. | n.a. | n.a. |
| 1990 | n.a. | n.a. | n.a. |
| 1992 | 6.2 | 0.88 | 5.73 |
| 1994 | 6.8 | 0.89 | 6.30 |
| 1996 | 6.6 | 0.80 | 4.08 |

Source: Zhang 2002 (p.418)

**Table 4. Main indicators of bank performance in Korea and Taiwan**

| | *Profitability* | | *Asset position* | | |
|---|---|---|---|---|---|
| | *Return on assets* | *Return on equity* | *Non-performing loans/total lending* | *Capital adequacy ratio* | *Foreign liability–asset ratio* |
| **Korea** | | | | | |
| 1992 | 0.56 | 6.69 | n.a. | 11.18 | n.a. |
| 1993 | 0.45 | 5.90 | n.a. | 11.00 | 2.52 |
| 1994 | 0.42 | 6.09 | n.a. | 10.62 | 2.61 |
| 1995 | 0.32 | 4.19 | n.a. | 9.33 | 3.04 |
| 1996 | 0.26 | 3.80 | 8.00 | 9.14 | 3.33 |
| 1997 | –0.93 | –14.18 | 16.00 | 7.04 | 2.02 |
| **Taiwan** | | | | | |
| 1992 | 0.99 | n.a. | n.a. | n.a. | n.a. |
| 1993 | 1.14 | n.a. | n.a. | 21.40 | n.a. |
| 1994 | 1.10 | n.a. | n.a. | 15.40 | n.a. |
| 1995 | 0.92 | n.a. | n.a. | 13.35 | 0.69 |
| 1996 | 0.94 | n.a. | 4.00 | 13.05 | 0.68 |
| 1997 | 0.84 | n.a. | 3.80 | 11.80 | 0.71 |

Source: Zhang 2002 (p.419)

On the contrary, thanks to the risk-averse state bankers, Taiwan's financial sector was immune from the problem of nonperforming debts seen in Korea. The extralegal and even illegal practices of private financial institutions, however, have been a severe problem. Scandals in private lending not only sent shock waves through the organized financial sector but also drew widespread criticism of state domination of finance. Inefficiency of the financial sector was especially salient and pronounced after 1986 under conditions of excess liquidity, which was a result of chronic trade surpluses[17], and pressure from Taiwan's trade partners for large-scale currency appreciation[18]. More than anything else, the excess liquidity associated with the surpluses impelled the government to commit itself to financial liberalization in the late 1980s.

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[17] Starting from 1981, the trade surplus in Taiwan has increased drastically. For example, while the trade surplus accounted for only 1.3 percent of the GNP in 1981, it increased to 15.3 percent in 1985, and then to 19.2 percent in 1987. (Amsden and Wang 1992)(p.148)

[18] A floating exchange rate resulted in a 40 percent appreciation of the NT dollar between 1986-89. The export-dependent manufacturers, confronting high asset prices, an appreciated currency, and the threat of American trade sanctions, shifted much of their production to Southeast Asia and, later, Southeastern China. Emboldened by the new political openness, they now openly lobbied to be able to raise funds overseas to finance foreign investments and to raise money more cheaply than at home. (Underhill 1997)(p.238)

Under these circumstances, financial market reform[19] started gradually in the early 1980s[20] but accelerated in the latter half of the decade and the early 1990s. (Zhang 2002)(p.412) While reform processes in Korea and Taiwan can be generally characterized as gradual and incremental, their respective reform approaches and sequences displayed marked differences in all key areas of liberalization. (Zhang 2002)(p.412)

First of all, Korea adopted a highly cautious and piecemeal approach to interest rate deregulation. As had been the case in the previous decades, the government maintained strict controls over financial prices in the 1980s, despite its pledges to liberalize them, and did not make serious efforts to free the major interest rates until the early and mid-1990s. Continued state intervention in sectoral credit allocation mirrored the halting pattern of interest rate liberalization. The most telling illustration was the persistence of the various

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[19] Financial liberalization refers to deregulation, whereas financial reform includes reregulation as well as restructuring, although both terms are often used interchangeably. (Lim 2009)(p.11)

[20] At that time, America's turn towards monetarism and Paul Volcker's high interest rate policy precipitated the escalation of global interest rates. This undermined the Korean strategy of borrowing money cheaply overseas by threatening to dramatically increase Korea's already significant debt exposure. This was compounded by a drop in global demand and vigorous attempts by the Reagan administration to open up Korea's financial system to American banks. (Underhill 1997)(p.229)

policy loans extended by banking institutions. (Zhang 2002)(p.412) Taiwan, by contrast, began to reorient interest rate policy towards a freer and more flexible mode of operation in the early 1980s, and succeeded in deregulating all types of interest rates at the end of the decade. In parallel with the steady progress in interest rates liberalization, the government streamlined its preferential credit schemes. Such schemes, significant only for small and medium-sized enterprises and of marginal application in industrial targeting, headed towards greater marginality as a policy tool. (Zhang 2002)(pp.412-413)

Second, while the Korean government was reluctant to loosen its grip on interest rates and credit allocation, it moved more quickly with the privatization of commercial banks. Within less than two years from early 1981, the divestiture of government-owned shares in five major commercial banks was completed[21]; banks that were incorporated in subsequent years remained in private hands. (Zhang 2002)(p.413) In Taiwan, bank privatization ran a slow and zigzag course. Until 1991, a decade after Korean banks had been privatized, virtually all banks were publicly owned. While the Taiwanese authorities tried to move away from state-monopolized finance ever since, the banking sector

[21] The five privatized commercial banks were the Commercial Bank of Korea (1972), Hanil Bank (1981), Korea First Bank (1982), the Bank of Seoul and Trust Company (1982), and the Chohung Bank (1983). (Haggard, Lee et al. 1993)(pp.43-45)

was privatized so slowly that the central and provincial governments had remained major shareholders in many key institutions by the late 1990s. (Zhang 2002)(p.413)

Third, along with the program of bank privatization, the Korean financial authorities also took relatively swift measures to deregulate entry barriers. From the early 1980s, Korea began to license more non-bank financial institutions (NBFIs) and open the way for new entry in the commercial banking sector. In Taiwan, by contrast, the government was reluctant to allow new entrants in the banking and non-bank financial sectors. Although financial authorities issued a dozen licenses for new private banks[22] in the early 1990s, they used administrative oversight to control the growth of these banks and to ensure the continued dominance of state-owned banks. Restrictions on the establishment of new NBFIs were even more draconian. Not only did the number of incumbent NBFIs remain relatively limited, some types of institutions, such as merchant banks and finance companies which assumed an increasingly active role in financial intermediation in Korea, were totally absent in Taiwan. (Zhang 2002)(p.413)

Fourth, Korea and Taiwan differed even more dramatically in their

[22] All the applications for new bank licenses came from Taiwanese business groups anxious for their own 'central treasury'. (Underhill 1997)(p.238)

respective approaches to removing the regulatory barriers that had created the functional segmentation between banks and NBFIs. Until the early 1990s, the Korean government had maintained extensive controls over the operations of commercial banks, but allowed NBFIs significant immunity from various regulatory requirements. (Zhang 2002)(p.413) In its efforts to liberalize competitive restraints, the Taiwanese government invariably gave commercial and specialized banks policy favors, often to the disadvantage of NBFIs. The amendment of the banking law in July 1989 granted banks such a wide business scope that Taiwan moved clearly towards universal banking. On the other hand, financial authorities were very cautious about allowing NBFIs to diversify and broaden their service offerings. (Zhang 2002)(pp.413-414)

Fifth, in foreign capital decontrol, as in domestic financial reform, Korea and Taiwan diverged in important ways. The divergence was reflected not so much in their general approach to liberalizing external financial transactions, which both featured gradual processes, as in the sequencing order in which the various components of their capital accounts were opened. The Korean government considerably liberalized short-term foreign borrowing by domestic commercial and merchant banks while maintaining strict restrictions on foreign direct investment and long-term foreign borrowing. In Taiwan, the authorities opened the capital account in a reversed order: they moved more quickly to reduce

limits on foreign direct investment and other long-term transactions but constantly held short-term borrowings and portfolio investments on a tight leash. Even after deciding to remove many capital controls in the late 1980s, the government kept a vigilant eye on the level and composition of foreign borrowings. Similarly, they made painstaking efforts to limit the exposure of the domestic financial system to international markets by curtailing foreign participation in the capital market and restricting the internationalization of the local currency. (Zhang 2002)(p.414) The figures in Table 5 capture growing imbalances in foreign debt accumulation in the early and mid-1990s.

**Table 5. Foreign debt in Korea and Taiwan**

| | *Foreign debt as % of GDP* | *Short-term debt as % of total foreign reserves* | *Ratio of foreign liabilities to assets* |
|---|---|---|---|
| **Korea** | | | |
| 1990 | 13.79 | 72.13 | n.a. |
| 1991 | 13.51 | 81.75 | n.a. |
| 1992 | 14.34 | 69.62 | n.a. |
| 1993 | 14.18 | 60.31 | 2.97 |
| 1994 | 14.32 | 54.06 | 2.97 |
| 1995 | 23.80 | 171.45 | 3.32 |
| 1996 | 28.40 | 203.23 | 3.75 |
| 1997 | n.a. | n.a. | 2.51 |
| **Taiwan** | | | |
| 1990 | 11.04 | 21.56 | n.a. |
| 1991 | 10.73 | 20.21 | n.a. |
| 1992 | 9.37 | 21.00 | n.a. |
| 1993 | 10.44 | 23.64 | 0.64 |
| 1994 | 10.87 | 21.76 | 0.59 |
| 1995 | 10.40 | 21.64 | 0.61 |
| 1996 | 10.07 | 21.31 | 0.61 |
| 1997 | n.a. | n.a. | 0.62 |

Source: Zhang 2002 (p.415)

A final feature that set Korea apart from Taiwan was the way in which the system of financial regulation was reformed in the process of market liberalization. In Korea, significant financial opening over the 1980s and early 1990s was not matched by consistent efforts to establish an effective institutional framework of supervision and regulation. Although the government initiated regulatory reforms amidst mounting banking weaknesses in 1992, these tended to be partial in scope and inefficient in implementation. By contrast, the Taiwanese authorities made sustained attempts to strengthen prudential regulations while liberalizing the financial market. When licensing new private banks in the early 1990s, financial authorities set very high capital requirements, strictly limited the ownership of business groups and imposed heavy penalties against offenders. Regulatory tightening was accompanied by institutional improvement. The Monetary Affairs Department of the Finance Ministry, which comprised crucial supervisory functions, was upgraded to the bureau status and its staff was expanded fourfold to 329. (Zhang 2002)(p.414)

In short, the Korean approach to financial liberalization was largely rapid, reckless and ill-designed, compared to the Taiwanese approach, which was slow, careful and well-designed to make private firms and the economy as a whole less vulnerable to externally generated crises. (Table 6) Then why did the two countries carry out different approaches to financial liberalization? That is the

question that the next section will turn to.

**Table 6. A brief comparison between the Korean and Taiwanese approaches**

| Key areas | Korea | Reason | Taiwan | Reason |
|---|---|---|---|---|
| **Interest rate deregulation and policy loans** | highly cautious | resistance from *chaebol*, bureaucrats and political elite | fast | no resistance from *chaebol* |
| **Privatization of commercial banks** | fast | little resistance from social groups | slow | strong resistance from bank employees and provincial governments |
| **Entry barriers deregulation** | fast | strong demand from *chaebol* | slow | no strong demand from social groups |
| **Removal of regulatory barriers** | to the advantage of NBFIs | strong demand from *chaebol* | to the disadvantage of NBFIs | very cautious financial authorities |
| **Foreign capital decontrol** | short term foreign borrowing recommended | resistance from *chaebol*, policy failure | FDI and long-term foreign borrowing recommended | prudential supervision |
| **Financial reregulation and supervision** | not working properly | intra-agency conflicts | working properly | the role of CBC |

Source: Zhang 2002 (pp.412-433)

## 2. Differences in State Institutions

### (1) The Korean Case

As mentioned in the previous section, the subordination of the central bank, the Bank of Korea (BOK), to the government was one of the most important defining features of financial policy-making. From its inception in 1950, the BOK failed to take root as the center of monetary management and fulfilled its policy functions at the direction of political elites. Successive post-war governments had a direct stake in bringing the BOK under their control and in mobilizing the central banking system for rapid industrialization. Korean central bankers thus did not enjoy any strong legal mandate to pursue independent policy objectives and played a passive role in the formulation of monetary and financial policies. The actual policy-making process was dominated by the Finance Ministry and the Economic Planning Board (later the Ministry of Finance and Economy, a merger between the two institutions) and heavily influenced by the spending-oriented Ministry of Trade and Industry. (Zhang 2002)(p.425)

Actually, the BOK supported interest rate liberalization and preferential credit reduction in order to contain inflationary pressures and to reduce its

burden of providing soft loans to banks. Concerned about the negative effects of entry barrier deregulation on financial supervision, central bankers wanted to restrict the licensing of new financial institutions, particularly in the NBFI sector. They stood for a cautious approach to opening the capital account for fear that the influx of foreign short-term funds would compromise the efficiency of monetary management. The subordinate status of the BOK, however, made it difficult for central bankers to pursue their reform policy preferences. (Zhang 2002)(pp.425-426)

The halting pattern of interest rate and credit decontrols also underlined the desire of the government to continue with financial controls. In the first place, the development model based on the heavy use of repressed interest rates and subsidized credit to promote industrial growth was well established within the economic bureaucracy. Concerned that interest deregulation and preferential credit reduction would impair the export performance and international competitiveness of Korean industry, financial and industrial bureaucrats were reluctant to push for rapid liberalization. Furthermore, continued financial controls buttressed the efforts of the Finance Ministry officials to maintain their regulatory power over the commanding heights of the economy. Finally, politicians intended to exploit continued financial controls to dispense political patronage, seek donations and bribes from the business sector, and secure bases

of coalitional support. (Zhang 2002)(p.426)

Reluctant to liberalize interest rates and reduce the preferential credit scheme, the Korean government saw bank privatization and entry deregulation as an alternative way to promote competition and efficiency in the financial system. (Zhang 2002)(p.426) The establishment of new banks was intended to rejuvenate the ability of the banking sector to mobilize more investment funds. Similarly, bank privatization also represented official efforts to improve the performance of banks. (Zhang 2002)(p.426)

The play of bureaucratic interests also accounted for the uneven approach to functional de-segmentation. As Finance Ministry officials refused to give privatized banks genuine operational freedom for industry and other policy purposes, they opted to nurture the growth of NBFIs as a way to develop the shallow financial structure. (Zhang 2002)(p.426) This biased treatment reflected the fact that the Finance Ministry supervised most categories of NBFIs and relied upon them for the execution of its supervisory functions. Furthermore, Finance Ministry officials were eager to promote the development of NBFIs because many of them retired into top positions in the sector in a process known as *amakudari*. (Zhang 2002)(pp.426-427)

In capital account liberalization, the impact of programmatic government interests was equally substantial. While the *segehwa* or internationalization policy initiated by the Kim Young-Sam government in a bid to join the OECD accelerated the process of capital decontrols in the early and mid-1990, it was not directly responsible for the selective manner in which such decontrols were implemented. Selective capital decontrols, which mirrored the desire of the *chaebol* to gain access to overseas funds and to contain foreign competitors, was coterminous with the economic and political concerns of the government. Fearful about undue external influences on the economy, the government was reluctant to open the domestic industrial sector and capital market for greater foreign participation. Efforts to control foreign investors were reinforced by the practical need of limiting long-term foreign borrowings as a means of managing capital flows. (Zhang 2002)(p.427)

Finally, the problems of financial liberalization in Korea also rested with the weakness of regulation. Regulatory failure stemmed from political and institutional constraints on the formulation and enforcement of regulatory rules as much as from technical deficiencies. One such constraint was the differential regulatory treatment of banks and NBFIs and the failure to formulate uniform supervisory standards. As a manifestation of the asymmetrical power relationship between the BOK and the Finance Ministry, supervision of NBFIs

was much more lax; so lax actually that regulators were not aware until too late of their reckless lending to *chaebol* firms and large debt maturity discrepancies. (Zhang 2002)(p.427) Moreover, the conflicts between the MOFE and the BOK further complicated the inefficiency of prudential regulation in the early and mid-1990s. (Zhang 2002)(p.427)

(2) The Taiwanese Case

The structure of economic policy-making institutions within the Taiwanese state was considerably different from Korea. Perhaps the most prominent feature of that structure was the autonomous status of the Central Bank of China (CBC). (Zhang 2002)(p.429) The origins of central bank independence lay in the Chinese hyperinflation of the late 1940s that contributed to the defeat of the KMT on the mainland and in the persevering efforts on the part of political leaders to prevent the recurrence of financial chaos. (Zhang 2002)(p.429) Central bankers were thus able to conduct their macro and micro policy functions with a high degree of independence unmatched by any other economic technocrats in Taiwan. (Zhang 2002)(p.430) The political independence of the CBC underpinned the ability of central bankers to define and pursue financial reform in line with their policy interests. The long-standing orthodoxy that emphasized price stability was deeply embedded in the policy-

making process of the CBC. (Zhang 2002)(p.430)

The CBC is formally a part of the cabinet, but in practice it is always under the direct control of the president. The governor of the CBC is almost always hand-picked by the president, rather than premier. The bank occupies a unique position in the state apparatus, because it is at the same time a part of the economic bureaucracy and a part of the national security apparatus, which falls under the exclusive purview of the president. As a result, the CBC has long occupied the commanding heights of the state economic bureaucracy; its governor[23] is always considered the most senior economic minister. (Pempel 1999)(p.189)

Moreover, the CBC is more than just a monetary authority. It is also entrusted with an extensive regulatory authority over the banking sector and capital market. Some of its supervisory and investigative authority overlaps with the Ministry of Finance, and many finance ministers were themselves

[23] Compared to the governors of the BOK who served their terms for 2.5 years on average for the last 55 years, the average term of the Taiwanese counterparts was 6.4 years from 1961 to 2006. Especially, Taiwan had only 3 governors from 1960 till 1989. It implies that the CBC and its governors enjoyed a lot more autonomy from the political power or the MOF than the Korean counterparts. (Byun Younghak 2006)(p.192)

former deputy governors of the CBC. The Ministry of Finance traditionally has played second fiddle to the CBC as far as banking regulation is concerned. The bank can overrule the Finance Ministry, which deals with the constituencies in the financial sector more directly, over the sequence and timetable of financial deregulation and internationalization. (Pempel 1999)(p.189)

As a major determinant of price stability is the exchange rate, and as the exchange rate can be adversely affected by fluctuations in the stock market, the liberalization of capital movements has been a major concern of the CBC. Indeed, the CBC's conservative approach to capital account liberalization has often pitted it against the Ministry of Finance (MOF), which is generally regarded as a much stronger advocate of liberalization. However, the CBC has retained a structural position of power within the state apparatus; in addition to control over the banking system and capital market. (Thurbon 2001)(p.251)

In terms of liberalizing foreign access to Taiwan's stock exchange, the CBC has often used its discretionary powers to override the MOF's liberalizing measures in the name of financial stability. For example, in 1991, the MOF passed a law permitting Qualified Foreign Institutional Investors (QFIIs) to invest directly in Taiwan's stock market. However, in February 1992, it was discovered that some foreigners who had been speculating in the foreign

exchange market. The CBC immediately intervened and imposed a complete ban on all further foreign remittances. (Thurbon 2001)(p.252)

The CBC retains similar discretionary powers over the scheduling of foreign exchange liberalization. While the CBC had originally agreed to the schedule set by the MOF to fully liberalize the foreign exchange market by the year 2000, the schedule remained conditional upon CBC powers under the Statute for the Administration of Foreign Exchange (SAFE; a very apt acronym). Under the Statute, the CBC is able to make extraordinary interventions in the market to the point of closing it down completely. (Thurbon 2001)(p.252)

The key point is that in Taiwan the CBC has pursued liberalization whilst retaining the power to intervene to restrict speculative activities should the need arise (which it did), thus ensuring that liberalization meets the broader goals of economic stability and growth. Management of the liberalization of the foreign exchange market thus highlights the cautious and guarded approach to liberalization that was pursued under the guidance of the CBC. (Thurbon 2001)(p.253)

The liberalization of Taiwan's banking sector began in earnest in 1991 with

the issuing of new licenses for private banks.[24] This move was followed in 1993 by the revision of regulations by the Ministry of Finance to make it easier for financial institutions to set up new branches, leading to the proliferation of banking institutions in Taiwan. However, banking liberalization has been approached with the same air of caution, emphasizing the introduction and enforcement of supervisory and regulatory mechanisms to ensure the viability of financial institutions. To begin, as a condition of establishment, commercial banks are required to have a minimum paid-in capital of NT$10 billion which is an extremely high standard, much higher than that demanded by other Asian countries. Once established, Taiwan's banking law stipulates that banks must satisfy the Bank of International Settlements (BIS) capital adequacy requirement of 8 per cent. In 1997, the capital adequacy ratio for banks in Taiwan far exceeded that minimum, reaching 11.4 percent. (Thurbon 2001)(p.256)

In conjunction with regulations to ensure the soundness of the banking sector, Taiwan has stepped up its supervisory functions as liberalization has proceeded. In July 1991, the Bureau of Monetary Affairs (BOMA) was

[24] The new 15 commercial banks were limited to five branches only and were not allowed to deal with foreign exchange transactions or, in the initial three years, with securities. (Haggard, Lee et al. 1993)(p.75)

established under the Ministry of Finance, and entrusted with the function of the supervision and regulation of the banking sector. (Thurbon 2001)(p.256) Whilst the government liberalization plan for the banking sector has also included the privatization of state-owned banks, this has been a long and drawn-out process, the first banks were privatized only in 1998. As such, the government's privatization plan has had little impact on financial stability in Taiwan. (Thurbon 2001)(p.257)

Interestingly, whilst the government has pursued a policy of financial liberalization throughout the 1990s, this has been accompanied by the expansion of methods of development financing, indicating that financial liberalization has not necessarily involved the diminution of the state's developmental role in Taiwan. (Thurbon 2001)(p.257) Since the 1960s, the government on Taiwan has employed development financing as a key tool for promoting industrial development. Since its reopening in 1961, the CBC has maintained a strong commitment to the promotion of economic development through development financing, as set out in Article 2 of the Central Bank of China Act, establishing numerous developmental financing schemes to this end. For example, since 1990, the CBC has extended financial support to facilitate the internationalization of Taiwanese firms. On 15 April 1990, the CBC promulgated its guidelines for the utilization of the country's massive foreign

exchange reserves to finance local firms' overseas investments. (Thurbon 2001)(p.257)

The government's enduring commitment to developmentalism despite financial liberalization is further evidenced by the maintenance of institutional mechanisms of coordination, most importantly the developmental pilot agency. Contrary to the Korean case, Taiwan has kept its developmental institutions firmly intact, 'adapting them as needed to new circumstances but never abandoning their coordinating and lead-setting role'. (Thurbon 2001)(p.258)

### 3. Government-Business Relationship

#### (1) The Korean Case

In Korea, big push capitalism rested on a coalition of the military and large business, a 'sword-won alliance', in the words of Tun-jen Cheng. The military gave big business access to economic rents in exchange for political donations. (Noble and Ravenhill 2000)(p.99) The dominant role of *chaebol* greatly complicated the task of economic liberalization. Successive governments feared that liberalization, especially of the financial system, would have the unintended consequence of enabling *chaebol* to carve an even more dominant role in the

economy. In an economy as lopsided as that of Korea, market solutions would not necessarily produce a flatter playing field. (Noble and Ravenhill 2000)(pp.87-88)

In the period since the first democratic elections in 1987, the economic power of *chaebol* continued to increase. In 1986, the four largest *chaebol* contributed 5.7 per cent of Korea's GNP; by 1995 their share had grown to 9.3 percent. (Noble and Ravenhill 2000)(p.100) Moreover, democratization arguably strengthened the political power of big business in Korea. Korean national elections are very expensive, and the political parties have no independent funds on which to draw. The Federation of Korean Industries (FKI), the *chaebol's* principal lobby group, has been the largest source of political funding in Korea since its establishment in August 1961. Additional funding came from individual businesses: it is evident that larger firms withheld contributions if candidates were perceived to be anti-*chaebol*. (Noble and Ravenhill 2000)(p.100)

The *chaebol* were constantly opposed to interest rate liberalization, fearing that they would be subjected to fluctuating and higher interest rates. By the same token, they also vigorously resisted the scale-down of the preferential credit scheme on which they relied to maintain their international

competitiveness and to expand and diversify their business lines at low credit risk. Throughout the 1980s, the large business sector, under the coordination of the FKI, was able to delay and even to block efforts to free interest rates and reduce policy loans. It was not until the early 1990s when *chaebol* firms came to depend more on NBFI funds and direct financing that they became more tolerant towards deregulated financial prices. (Zhang 2002)(p.424)

Korea's rapid move towards the deregulation of entry barriers in the domestic banking sector also partly reflected the interests of the *chaebol*. The establishment of new commercial banks provided business groups with the opportunity to own and control those banks in order to meet their rapidly increasing capital needs more flexibly and, more important, to gain financial and political independence from the state. The impact of *chaebol* preferences was more discernible in functional de-segmentation. The rapid liberalization of competitive restraints in general and the impressive growth of the NBFI sector in particular were partly due to the increasing business group ownership of NBFIs.[25] The growing *chaebol* hold on the NBFI sector stemmed mainly from

[25] The proliferation of NBFIs also provided space for the *chaebol* to circumvent rules on bank loans and bank ownership by acquiring their own financial institutions. Increased lending rates coupled with the state's tight monetary policy of the mid-1980s provided further incentive for the *chaebol* to acquire NBFIs. By the end of the decade they had gained control of 50 percent of all NBFIs.

two factors. First, denied ownership and control of newly licensed commercial banks due to strict shareholding restrictions[26], big business groups saw the rapid growth of non-bank financial firms as an alternative conduit for financing their operations. Second, in the mid- and late 1980s, many *chaebol* firms began to rely increasingly upon NBFIs for their investment funds largely in response to the tight controls imposed by the government on the extension of bank loans to the large business scope; some business leaders even lobbied for greater NBFI operational autonomy on behalf of their non-bank financial subsidiaries. (Zhang 2002)(p.424)

Selective capital decontrols, which biased capital inflows towards short-term maturity, were congruent with the preferences of the *chaebol* and their powerful status in the Korean political economy. The *chaebol* opposed the move to liberalize FDI activities and foreign entry into the domestic market for fear of increased competition and diluted ownership controls, but they supported those deregulation measures that provided them with enhanced access to cheap foreign loans. (Zhang 2002)(pp.424-425) *Chaebol* firms hankered for short-term funds mainly because such funds were cheaper and easier to raise international

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(Underhill 1997)(p.230)

[26] These kinds of shareholding restrictions have existed due to the sad experience of privatization in the 1950s, when *chaebol* acquired the controlling shares of four privatized banks and monopolized bank loans. (Haggard, Lee et al. 1993)(p.26)

financial markets. Enhanced access to cheap foreign funds was particularly important in the early 1990s when *chaebols* were desperate for low-cost financing to counteract the deterioration of industrial performance that resulted from rising wages and diminishing profitability. (Zhang 2002)(p.425)

In sum, financial liberalization in Korea was captured by domestic elites as a vehicle for pursuing particularistic interests. The capture problem stemmed from deep institutional failures. Government-business relations were structured in ways that granted the organizationally resourceful *chaebol* privileged entrée to the center of financial policy-making and did not allow for effective oversight by broad public interests and groups. Equally, key state economic and regulatory agencies found it hard to insulate themselves from the influence of business groups. (Zhang 2002)(p.433)

(2) The Taiwanese Case

Because of the existence of the unusually well-organized and autonomous ruling Kuomintang (KMT) party in Taiwan, Taiwan differed from Korea in the institutional configuration of the state and the private sector. Unlike the structurally fragmented and fluid political parties in Korea, the party system in Taiwan was highly institutionalized and stable. The ruling KMT party, which

had dominated the political scene until the late 1990s, was unusually well-organized and run in a hierarchical fashion. Together with the fact that the KMT had independent financial resources[27] at its disposal and enjoyed extensive control over the state apparatus, this organizational strength enabled the party to operate independently of social pressure. (Zhang 2002)(p.430)

Moreover, the KMT, being an oversized, richly endowed, and automatically governed political machine, provided the institutional foundation for the undisrupted political dominance of its national leadership over local factions and big business. Unlike the Liberal Democratic Party in Japan or the ruling parties in South Korea, the KMT, which owned a huge array of business interests itself, relied little on political donations by the business community. Through the exercise of purse power, business interests can capture individual lawmakers or even an entire local faction, but not the ruling party. The political democratization, so far, has not transfigured the KMT's power structure at the core. (Pempel 1999)(p.195) Furthermore, the political support of the business

[27] According to Karl J. Fields, with total assets valued at US$42 billion, it is undoubtedly the richest party in the world. These assets include over US$25 billion in property both in Taiwan and abroad, and income is generated both in the form of rents and sales. Opposition politicians rightly argue that the KMT party-owned enterprises and assets give the party a huge and unfair comparative advantage in electoral contests. (Fields 1998)

community was not a weighty factor in sustaining the political security of the regime, which has based its legitimacy on international recognition, its irreplaceable function in protecting the island from the aggression of mainland China, and its effectiveness in bringing about economic prosperity. (Pempel 1999)(p.194)

Against the backdrop of the intensifying democratization and economic deregulation in the late 1980s, business elites began to seize control over electoral and parliamentarian processes and to challenge the dominant position of the state. (Zhang 2002)(pp.428-429) However, the influence of the special business interests over economic policy-making had clear limits. The business community as a political force had many weaknesses. The big business elite still craved particularistic ties and proprietary return from political investment, but it shunned building the permanent organizational base and impersonal links necessary for broad-based collective actions. As a result, the business community was a far from cohesive entity in both organizational and ideological terms. (Pempel 1999)(p.195)

In sum, because of its unabated staying power and incontestable hegemonic presence in society of the KMT, which remained a hierarchically structured constellation of entrenched state and party elite based permanently in the state

and party apparatus (Pempel 1999)(p.197), private capital in Taiwan was not able to assert itself as an autonomous and organized political actor in the policy-making process, and neither were its interests well represented in the party power structure. (Pempel 1999)(p.193) Therefore, economic technocrats in the CBC and the Finance Ministry still had a decisive say in devising the priority and timetable of deregulation and liberalization and in the design of the new regulatory scheme and mechanism. (Pempel 1999)(p.196)

# V. Conclusion

This study intended to analyze the reasons for divergent paths to financial liberalization in Korea and Taiwan through the lens of historical institutionalism. The main argument of this study is that divergent paths to financial liberalization in Korea and Taiwan can be well explained by historically constituted unique institutions and different state-business relations in both countries. These case studies of Korea and Taiwan have shown that unique historical experience exerts a great influence on the early stage of institutional formation in a significant way. And once institutions are formed, they are developed by repeated historical experience on the historical path. Later, policy makers' freedom to maneuver is constrained by the historically constituted institutions.

In Korea, the privatization of state-owned enterprises and state-owned banks appropriated from Japan, and economic rent-seeking through the collusion between government and business had made a fundamental impact on the early formation of a capitalist class in 1950s. Later the newly emerged capitalists in the 1950s grew into *chaebol* in the process of industrialization under the auspice of government. After the 1961 coup, the military regime chose the capitalist class as their strategic partner for industrialization. Especially, the successful

HCI drive in 1970s led to the rise of *chaebol,* and the structural power of *chaebol* consequently began to weaken the state autonomy. After the 1987 democratization, *chaebol's* demand for less government intervention became even more visible. In the process of a blind economic liberalization, the Kim government, the first civilian government, even abandoned industrial policy, giving up its coordinating role in investment. Thus, institutional incapacity and the changing government-business relationship heavily influenced the speed and sequence of financial liberalization in Korea, only representing the interests of *chaebol*.

In Taiwan, after the KMT's defeat on the Mainland and its retreat to Taiwan, the KMT regime centralized state power, established its hegemony over the society, and, in particular, subdued a previously recalcitrant capitalist class. Because of the KMT elite's mistrust of Taiwanese people, they nationalized the wide range of enterprises inherited from the Japanese upon the retrocession of Taiwan, enhancing the party-state's already impressive capabilities. Actually, the KMT lacked the incentive to find or create a big business partner and, indeed, feared that big business could undermine its goals and structural integrity. As a result, the KMT carried out industrialization through the state-owned enterprises and the myriad of SMEs in the 1960s and 1970s. This decentralized industrial structure without Korea-style conglomerates induced

the regime to follow ‘a gradualist approach’ to industrial transformation, which is very different from ‘a big push approach’ taken by Korea. There is another example of historical path dependence: the autonomy of the CBC. The origins of central bank independence lay in the Chinese hyperinflation of the late 1940s that contributed to the defeat of the KMT on the mainland and in the persevering efforts on the part of political leaders to prevent the recurrence of financial chaos. Despite an intra-agency conflict with the MOF and pressures from private capital, the CBC has retained a structural position of power within the state apparatus, playing an important role in maintaining macroeconomic stability and in reregulating and supervising the financial sector. In short, the decentralized industrial structure, the enduring autonomy of the CBC, and the institutional capacity shown by the KMT regime all contributed to a slow, cautious, well-designed financial liberalization in Taiwan.

Unfortunately, this study has serious limitations because it didn’t pay much attention to international factors. As Robert Wade notes, “the problem with internally-focused explanations is that they take the external context as given.” (Lukauskas and Rivera-Batiz 2001)(p.196) Since Korea and Taiwan have a small, open economy, international political and economic fluctuations have had a direct impact on national economies. The clear examples are the collapse of the Bretton Woods system in 1971, the two oil crises in 1970s, America’s turn

towards monetarism and Paul Volcker's high interest rate policy in early 1980s, the Plaza Accord in 1985, a surge of world liquidity in the 1980s and 1990s, to name a few. Especially, the Clinton administration's bilateral and multilateral pressure to open up Asian commodity and financial markets in the 1990s might be one of the most important factors for quick financial opening and liberalization in Asia. (Lukauskas and Rivera-Batiz 2001)(p.202-213)

However, as shown in this historically informed investigation, it is well proved that the legacies of unique historical experience, and the ensuing institutional formation and development on historical paths continue to exert a profound influence on the speed and sequence of financial liberalization in Korea and Taiwan.

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# 국문초록

동아시아의 대표적인 발전국가로 간주되는 한국과 대만은 권위주의체제 하에서 고도경제성장을 이뤄냈으며 1980년대 후반 민주화 이후에도 지속적인 경제발전을 이룩했다. 하지만 1997년 아시아 금융위기는 두 나라에 상이한 결과를 가져왔다. 한국은 엄청난 규모의 단기 해외차입금을 갚지 못하여 유동성위기를 겪으면서 수많은 기업들과 금융기관들이 도산하였고 결국 IMF 구제금융을 받은 후에야 유동성 위기를 극복할 수 있었다. 반면에 대만은 한국과 같은 유동성 위기도 발생하지 않았고, 기업과 금융기관의 대규모 파산과 같은 일도 경험하지 않은 채 아시아 금융위기의 충격을 극복할 수 있었다.

많은 학자들이 아시아 금융위기는 성급하게 추진된 금융자유화와 금융시장의 패닉에 의해 발생했다고 주장한다. 흥미롭게도 한국과 대만은 1980년대와 90년대에 금융자유화를 추진하는 과정에서 커다란 차이점을 보였다. 한국은 적절한 금융 규제 및 감독시스템이 마련되지 않은 상태에서 급속하고 무모한 금융자유화를 추진하였고 이는 단기 외채의 급증, 기업들의 과잉투자, 금융권의 부실채권 급증과 맞물리면서 아시아 금융위기의 외부충격이 가해졌을 때 경제시스템 전반의 붕괴를 가져왔다. 반면에 대만은 안정적인 금융감독시스템을 유지하면서 점진적이고 신중한 자유화 조치를 취한 결과, 한국과 같은 국가부도사태를 미연에 방지할 수 있었다.

그렇다면 성공적인 국가개입을 통하여 기적적인 경제성장을 이룩한 한국과 대만이 왜 1980, 90년대에 상이한 금융자유화 경로를 추구했을까? 본 연구는 역사제도주의의 핵심개념인 '경로의존성'을 통해 양국의 금융자유화와 관련된 역사적 배경 및 경제 발전 경로를 비교·분석하여, 양국이 상이한 금융자유화를 추진한 원인이 역사적으로 형성된 독특한 제도들과 국가-사회 관계에 있다고 주장한다.

본 연구의 사례 연구에 따르면, 제2차 세계대전 이후의 독특한 역사적 경험은 초창기 제도 형성과정에 지대한 영향을 미치며, 일단 제도가 형성된 이후에는 그 제도들은 반복적인 역사적 경험에 의해서 발전해 나간다. 이후에 정책결정자들의 정책 선택은 역사적으로 형성된 제도들에 의해 제약을 받게 된다. 예를 들어, 한국에서는 1950년대 일제자산의 민간에의 불하, 1960년대 수출주도 산업화 전략, 1970년대 정책금융을 통한 대기업 중심의 중화학공업화 추진과정을 통해 민간대기업(일명 재벌)이 성장·발전하게 되었고 이는 1980년대 후반의 민주화와 맞물리면서 국가자율성을 약화시키는 주요한 요인이 되었다. 결과적으로, 한국의 금융자유화는 재벌들의 이익을 대변하는 방식으로 급속하고 무모하게 추진되었고 1997년 아시아 금융위기 시에 심대한 경제적 타격을 입게 되었다. 반면에, 대만에서는 중국 본토에서 패퇴한 국민당 엘리트들이 일제가 남긴 자산을 모두 국유화하여 국가자율성을 위한 물적 토대를 확보할 수 있었고, 민간대기업의 성장을 억제하는 한편 국영기업과 중소기업 중심의 산업화 전략을 추구하였다. 따라서 대만에서는 한국과 같은 재벌의 성장이 애초부터 불가능했으며 민간 자본에 의한 국가자율성 약화도 한국에 비해 훨씬 덜했다. 또한, 대만중앙은행을 중심으로 안정적인 거시경제정책을 펼친 결과, 기업들의 부채비율과 금융권의 부실채권비율이 한국에 비해 훨씬 낮았다. 이러한 역사적 배경과 발전경로 덕분에 대만 정부는 금융개혁의 필요성이 부각되었던 1980년대에 민간 자본의 영향으로부터 훨씬 자유로울 수 있었고, 금융 재규제 및 감독시스템을 충분히 강화하면서 신중하고 점진적인 금융자유화 정책을 펼칠 수 있었다.

**주제어**: 금융자유화, 역사제도주의, 중대한 국면, 경로의존성, 정책금융, 중화학공업화, 1997년 아시아 금융위기.