

1-1-1999

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Recommended Citation

Ellen J. Shin, *The International Monetary Fund: Is It the Right or Wrong Prescription for Korea*, 22 HASTINGS INT'L & COMP. L. REV. 597 (1999).

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The International Monetary Fund: Is it the Right or Wrong Prescription for Korea?

BY ELLEN J. SHIN*

I. Introduction

In 1953, South Korea (Korea) emerged as a war torn country¹ with one half-century of colonialism behind it.² Since then, Korea has become a major contender in the international market through tremendous export-oriented growth. From 1995 to the beginning of 1997, Korea's economic growth averaged almost eight percent per year.³ Euphoria reached its height in late 1996 when then President Kim Young Sam⁴ proudly declared that Korea had come of age as an advanced economy with membership in the Organization for Economic Cooperation and Development,⁵ an organization comprised of top industrial nations.⁶ In mid-1997, Korea's per-capita

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1. The Korean war started in 1950 and ended in 1953 with a division that continues to this day between North and South Korea.

2. Korea was under Japanese annexation from 1910-1945. Japanese colonization of Korea ended when the United States bombed Hiroshima in 1945.

3. Yung Chul Park, *Investment Boom, Financial Bust: The Crisis in Korea*, BROOKINGS REV., Summer 1998, at 14. Similarly, Korea's average real growth from 1987-1994 was over eight percent. See *Against the Clock: South Korea Is Running out of Time to Deregulate*, ECONOMIST, June 3, 1995, at 17.

4. Kim Young Sam emerged as the fourteenth President of the Republic of Korea in 1992. Incidentally, he won that election by defeating current President Kim Dae Jung. See David Holley, *Battle of the Kims Unsettles South Korea*, L.A. TIMES, Jan. 24, 1996, at A1. All Korean names will be referred to in their traditional format of family surname followed by their name.

5. For an overview of the OECD, see generally *What is OECD?* (visited Apr. 1, 1999) <<http://www.oecd.org/about/general/index.htm>>.

6. Bruce Cumings, *Can the New President Rein in the Conglomerates and Establish a Lasting Peace with the North*, 22 IN THESE TIMES, Feb. 22, 1998, at 15.

income exceeded \$10,000 nationwide and \$20,000 in the major cities.⁷ It was also the world's third-largest automobile exporter and one of the largest steel producers and shipbuilders in the global arena.⁸ As the world's eleventh largest economy,⁹ Korea had achieved economic success.

However, by the end of 1997 the nation's economic success story quickly faded. The "Asian financial crisis"¹⁰ had spread to Korea. Between November 19, 1997, when Korea first approached the International Monetary Fund (IMF)¹¹ for a bailout, and December 24, 1997, the Korean won fell more than fifty percent against the U.S. dollar.¹² The stock price index fell from 498 to 350, and the short-term market rate of interest increased to a forty percent annual rate.¹³

How could this have happened? The answer appears to lie in the undoing of a group of diversified, family-owned conglomerates, termed *chaebol*,¹⁴ which collapsed under billions of dollars in bank loans in early 1997.¹⁵ Consequently, concerns arose regarding the

7. Craig P. Ehrlich & Jay K. Lee, *Governance of Korea's Chaebols: Role in Crisis, Coming Changes: How the Chaebols Got to This Point, Reform Measures* (pt. 1), FOREIGN INVESTMENT, Mar. 15, 1998, at 9.

8. *See id.*

9. *See id.*

10. The crisis began in mid-1997 in Thailand, and by the end of the year had spread from Thailand to Indonesia and Korea, as well as other Asian countries. The crisis led to sharp declines in the currency, stock market, and other asset prices of a number of Asian countries. *See generally The IMF's Response to the Asian Crisis* (last modified Jan. 17, 1999) <<http://www.imf.org/External/np/exr/facts/asia.htm>>.

11. The IMF is a cooperative institution comprised of 182 countries that consult with one another to maintain a stable system of buying and selling their currencies, enabling payments in foreign money to take place between countries smoothly and without delay. *See generally* David D. Driscoll, *What is the International Monetary Fund?* (visited Mar. 4, 1999) <<http://www.imf.org/external/pubs/ft/exrp/what.htm>>.

12. *See* Park, *supra* note 3.

13. *See id.*

14. A typical *chaebol* consists of dozens of cross-funded subsidiaries that make diverse products such as ships, microchips, textiles, electronics, home appliances, car manufacturing, shipbuilding, steel-making and petrochemicals. *See* Paul Shin, *IMF Bailout May Finally Tame South Korea's Giant Conglomerates*, NEWS-TIMES (last modified Dec. 4, 1997) <<http://www.newstimes.com/archive97/dec0497/inf.htm>>; *see also* James Crotty & Gary Dymski, *Can the Korean Labor Movement Defeat the IMF?*, DOLLARS & SENSE, Nov-Dec. 1998, at 3 (includes related article on the Korean Confederation of Trade Unions' letter criticizing the IMF restructuring programs).

15. *See* Timothy Lane et al., *Preliminary Copy IMF-Supported Programs in Indonesia, Korea and Thailand: A Preliminary Assessment*, (International Monetary Fund), Jan. 1999, at 13.

soundness of *chaebol*¹⁶ and Korean financial institutions.¹⁷ Faced with difficulties from their short-term lending liabilities, Korean banks sought help from the government Bank of Korea, which shifted foreign exchange reserves to the banks' offshore branches and announced it would guarantee foreign loans made to Korean banks.¹⁸

Critics accuse the IMF of being a doctor with one prescription, austerity, that it administers whatever the disease.¹⁹ Over the past year, the IMF has been severely criticized about its role in Korea and in the greater Asian financial crisis.²⁰ In particular, the criticism stems from the stringent conditionality requirements of the bailout package put together by the IMF.²¹ In this respect, the traditional remedy prescribed by the IMF of higher interest rates and government surpluses, designed to reduce inflation and restore investor confidence, is inappropriate for dealing with the economic problems of Asia.²² In the past, the IMF focused on countries with high foreign debts, wasteful government spending habits, and loose monetary policies (i.e. Argentina, Bulgaria and Mexico).²³ However, analysts agree that the Asian countries had relatively prudent fiscal and monetary policies when the crisis hit, and that problems arose mainly from the financial and corporate sectors.²⁴

This Note begins by looking at some of the underlying problems that led to the collapse of the Korean economy at the end of 1997. In particular, it will address the lack of governance of Korea's *chaebol* and its predictable role in the recent crisis. It then discusses the IMF's program for stability and solutions, focusing primarily on the

16. The concerns about the future viability of *chaebol* in the Korean economy was illustrated and highlighted in a 1995 Economist article. See *The Frankenstein Economy: The Economic Miracle Has its Darker Sides*, ECONOMIST, June 3, 1995, at 10 [hereinafter *The Frankenstein Economy*].

17. See Lane et al., *supra* note 15.

18. See *id.*

19. See Lester Thurow, *Asian Crisis Put IMF to the Test*, BOSTON GLOBE, Jan. 27, 1998, available in 1998 WL9114356.

20. See generally Jeffrey Sachs, *The IMF and the Asian Flu*, AMERICAN PROSPECT, Mar.-Apr. 1998, at 16. For a further discussion of the Asian financial crisis, see generally Stanley Fischer, *The IMF and the Asian Crisis* (last modified Mar. 20, 1998) <<http://www.imf.org/external/np/speeches/1998/032098.HTM>>.

21. See *id.*

22. John J. Kim & Gregory Gerdes, *International Institutions*, 32 INT'L LAW. 575, 585 (1998).

23. See *id.*

24. See Lane et al., *supra* note 15, at 116.

conditionality requirements²⁵ for financial restructuring and other structural reforms such as corporate governance. Additionally, the law and policy of IMF conditionality will be questioned. Finally, this Note addresses the question of whether an international bailout was the correct prescription for the Korean financial crisis. While this article will focus on the IMF's role²⁶ in the Korean financial crisis, the country's economic and political history will also be discussed as a point of departure.

II. The Case of Korea

A. *The Korean Financial Crisis*²⁷

Heavy investment, an improper financial opening and the government's inability to get out of a mess it helped create all contributed to the financial crisis in Korea.²⁸

The first of a string of major corporate defaults in 1997 came from Hanbo Steel²⁹ ("Hanbo"), the nation's fourteenth largest *chaebol*.³⁰ An investigation into the collapse revealed ties between politicians and the company.³¹ Two months later, in March 1997,

25. See Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, art. V, § 3(a), 60 Stat. 1401, 1406. The term "conditionality" in the IMF's Articles of Agreement refers to the policies the IMF expects a member State to follow in order to use the IMF's general resources. See generally ERIK DENTERS, LAW AND POLICY OF IMF CONDITIONALITY 95 (1996). Korea's conditionality requirements for IMF funding are outlined in their agreement with the IMF. See *Republic of Korea IMF Stand-By Arrangement, Summary of the Economic Program* (last modified Dec. 5, 1997) <<http://www.imf.org/external/np/oth/korea.htm>> [hereinafter *Summary of Economic Program*].

26. The roles of the IMF are set out in article I of the Articles of Agreement, which have remained essentially unchanged over the past fifty years. They include the following: promote international monetary cooperation, facilitate the expansion and balanced growth of international trade, promote exchange stability, maintain orderly exchange arrangements, prevent competitive depreciation, assist in establishing the convertibility of currencies, make the general resources of the IMF available to help members deal with maladjustments in their balance of payments and help shorten the duration and lessen the degree of disequilibrium in balance of payments. See Articles of Agreement of the International Monetary Fund, *supra* note 25, at art I, 60 Stat. at 1401-1402.

27. For an overview of the sequence of events leading to the Korean financial crisis, see generally Lane et al., *supra* note 15, at 13-14.

28. See generally Park, *supra* note 3.

29. See Ehrlich & Lee, *supra* note 7.

30. See Park, *supra* note 3.

31. See *id.*

Sammi Steel Co. (Sammi), a unit of another *chaebol*, Sammi Group, defaulted on its loans.³² By July 1997, Kia Group, Korea's eighth largest *chaebol*, also collapsed.³³ The domino effect of *chaebol* collapses led to a lack of confidence in Korea's economy. This became evident when Japanese banks, which extended short-term loans to Korea's *chaebol*, further tightened credit in mid-1997.³⁴

Altogether, eight of Korea's *chaebol* went bankrupt in 1997, leaving domestic banks with a tremendous amount of bad debt.³⁵ At the end of 1996, the thirty largest *chaebol* had an average debt-to-equity ratio of more than four hundred percent, compared with seventy percent in the United States.³⁶ Moreover, the average debt-to-equity ratio of these companies rose sharply to almost 520 percent by the end of 1997.³⁷ Essentially, this presented a threat to Korea's economic stability. With astronomical debt, the *chaebol* became vulnerable to a slump in sales, which could rapidly render them incapable of meeting their repayment schedules.³⁸ As a result, because *chaebol* debt was short-term, denominated in foreign currency, supported by cross-payment guarantees and closely intertwined with the government, *chaebol* were vulnerable to a downturn in the international economy.³⁹

B. The Chaebol and Its Influence

Following a military coup in 1961, Park Chung Hee (Park) took control of the Korean government.⁴⁰ At the time, Korea was among the poorest countries in the world, with rising unemployment, falling growth and dwindling U.S. aid.⁴¹ During his eighteen years of rule, Park's regime implemented an ambitious economic agenda centered

32. See *Korea Chronology*, CHRISTIAN SCI. MONITOR, Dec. 22, 1997, at B7.

33. See *id.*

34. See Cumings, *supra* note 6.

35. *Asia's Financial Crisis: Linked to Its Economic Miracle?* (pt. 1), May 15, 1998, JEI REP., at 5.

36. See *id.*

37. See Ehrlich & Lee, *supra* note 7.

38. See *The Frankenstein Economy*, *supra* note 16.

39. See generally *id.*

40. Alan S. Gutterman, *Japan and Korea: Contrasts and Comparisons in Regulatory Policies of Cooperative Growth Economics*, 8 INT'L TAX & BUS. L. WINTER 1991, at 267, 278.

41. Sandra Sugawara, *Can S. Korea Do Business Without Bribes? Nation Hopes Reform of Old System Won't Stifle Growth*, WASH. POST, Oct. 6, 1996, at H1.

upon export-oriented growth.⁴² Park's agenda included a series of five-year plans focused on building the economy.⁴³ Over the course of such five-year plans, a tacit agreement evolved between the government and *chaebol*.⁴⁴

Companies like Hyundai and Samsung, which are now household names, entered one new industry after another. For example, in the 1970s, the government ordered Daewoo, a *chaebol* specializing in textiles, to enter the automotive industry.⁴⁵ To comply, Daewoo had to borrow an enormous amount.⁴⁶ By the end of the decade, Daewoo's debt-equity ratio was nine hundred percent (that of the average U.S. manufacturer is under two hundred percent).⁴⁷ As part of its quid pro quo exchange, *chaebol* such as Daewoo provided political support for the party in office in the form of streams of cash passing between industrialists and politicians.⁴⁸ This tacit agreement benefited the *chaebol* because it made defaulting difficult. Consequently, because the *chaebol* were always highly leveraged, with very high debt-equity ratios, and usually lower profit rates than smaller firms, they required periodic monetary injections into their ever expanding operations.⁴⁹

The governments that followed took office with a pledge to dismantle the close government-*chaebol* relationship, but failed to keep their promises.⁵⁰ The pervasiveness of corruption in Korean politics escalated with the indictment of two former presidents, Chun

42. *See id.*

43. *See id.*

44. The government-*chaebol* relationship can be described as follows: the Korean government would inform the *chaebol* about which industry it should enter, and provide that company with the necessary money, usually at bargain interest rates. The government would be involved in decisions on the direction, scope and management of the company. The government would also protect the *chaebol* from foreign competition, and even "excessive" domestic competition. In addition, the government helped keep labor costs low by using its intelligence agency to suppress labor leaders. *Chaebol* were also assured of a government bailout should it become necessary. As such, the *chaebol* expanded sometimes recklessly and with little consideration of risk. Over time, the *chaebol* entered into just about every Korean industry. *See* Sugawara, *supra* note 42.

45. *See The Frankenstein Economy, supra* note 16.

46. *See id.*

47. *See id.*

48. *See Shin, supra* note 14.

49. *See The Chaebol That Ate Korea, ECONOMIST*, Nov. 14, 1998, at 67.

50. *See Shin, supra* note 14.

Doo Hwan (Chun) and Roh Tae Woo (Roh), for extensive bribery.⁵¹ Besides criminal penalties, Chun and Roh were ordered to pay forfeitures of the U.S. equivalent of \$276 million and \$350 million, respectively, reflecting the fraud funds each was convicted of amassing.⁵² In addition, the heads of nine *chaebol* were convicted of bribery.⁵³ They received prison terms or suspended sentences.⁵⁴ Although former Korean president Kim Young Sam⁵⁵ was not found to be personally involved in any wrongdoing, many of his close aides, and even his son, were convicted of taking bribes from businessmen.⁵⁶

The fears that *chaebol* have become so big and powerful that the government can no longer control them are well-founded.⁵⁷ For example, at the beginning of the 1980s, the value added by Korea's top ten *chaebol* came to twenty percent of the country's manufacturing output; by the end of the decade, this share edged up to twenty-three percent.⁵⁸ Measured by sales, *chaebol*'s power is even greater; the top two, Hyundai and Samsung, together have sales equivalent to a quarter of Korea's economy.⁵⁹ As a result of the financial crisis in Korea and the greater financial crisis in Asia, President Kim Dae Jung acknowledged the pressing need to change the pervasive and corrupt relationship between the government and *chaebol*.⁶⁰ Indeed, he asserted that "[t]his unfortunate development

51. *See id.*

52. *See* James Walsh, *Deadly Reckoning: South Korea Visits a Historic Vengeance on Two of Its Recent Presidents*, TIME, Sept. 9, 1996, at 20.

53. *See* Sugawara, *supra* note 42.

54. *See id.* In addition to the *chaebol* convicted of bribery, nine former senior government officials were also sentenced to seven year prison terms for crimes such as money laundering, bribe brokering and passing illicit payments to the two former presidents. *See* Sonni Efron, 4 *S. Korean Tycoons Get Prison in Bribery Case; Corruption: The Sentences Shock the Business Community, Which Had Thought the Men too Important to Jail: Many Predict Presidential Pardons*, L.A. TIMES, Aug. 27, 1996, at A1.

55. As part of his campaign pledge, Kim Young Sam promised to root out corruption. During his presidency, he pushed through laws requiring top officials to publicly declare their assets and forbidding financial accounts from being listed under false names. *See id.*

56. *See id.*

57. *See* *The Frankenstein Economy*, *supra* note 16.

58. *See id.*

59. *See id.*

60. *See generally* Kim Dae-Jung, Let Us Open a New Era: Overcoming National Crisis and Taking a New Leap Forward (last modified Feb. 25, 1993) <<http://www.kiep.go.kr/IMF/speech.html>> (inaugural Address by Kim Dae-Jung, the fifteenth President of the Republic of Korea).

would not have taken place if the political, economic and financial leaders of this country were not tainted by a collusive link between politics and business and by government-directed banking practices and if the large business groups did not have a large number of uncompetitive subsidiaries.”⁶¹

III. The IMF Stand-By Arrangement⁶²

A. *The IMF's Program in Korea*

Following the dramatic plunge of the Korean won on the foreign exchange market in December 1997,⁶³ Korea reached an agreement with the IMF on a \$57 billion stabilization package⁶⁴ that required conditions on financial, corporate, labor, investment and other trade-related structural reforms.⁶⁵ The short-term objectives behind the program include: building the conditions for an early return of confidence to curb the unavoidable slowdown of gross domestic product growth in 1998, followed by a potential recovery in 1999; containing inflation at or below five percent; and building international reserves to more than two months of imports by the end of 1998.⁶⁶ Shortly after its inception, however, the IMF program depressed wages and created massive unemployment, plunging Korea into a deep recession.⁶⁷ The fifty percent devaluation of the won

61. *See id.*

62. *See Summary of Economic Program, supra* note 25.

63. The won depreciated over twenty percent against the U.S. dollar and Korea's usable foreign exchange reserves shrunk to \$6 billion dollars. *See* July '98 Turning Point for Korea: IMF Report, KOREA TIMES, Jan. 21, 1999, *available in* 1999 WL 5589708.

64. Out of the \$57 billion dollar loan package to Korea, the IMF contributed \$21 billion. *See* New Illness, Same Old Medicine, *ECONOMIST*, Dec. 13, 1997, at 65. About \$5.6 billion of the total was made available immediately; another \$3.6 billion was made available December 18, 1997, following the first review of the government's economic and financial program, and a further \$2 billion was made available January 8, 1998 following the second review. The remaining \$9.6 billion will be made available subject to Korea meeting performance targets and, in some cases, further program reviews. *See IMF Approves Three-Year Stand-By Credit to Support Korea's Economic, Financial Program*, IMF SURVEY, (International Monetary Fund, Washington, D.C.), Dec. 15, 1997, at 388 [hereinafter *Three-Year Stand-By Credit*].

65. *See generally Summary of Economic Program, supra* note 25. During loan negotiations, the IMF seeks to negotiate an agreed upon economic program to restore macroeconomic stability and lay the conditions for sustainable and equitable growth, paying careful regard to the social costs of adjustment.

66. *See Three-Year Stand-By Credit, supra* note 64, at 389.

67. In its defense, the IMF asserted that the growth slowdown Korea experienced

inevitably changed the livelihood of many Koreans overnight.

The IMF program seeks a comprehensive strategy to restructure and recapitalize the financial sector and make it more transparent, market-oriented, and better supervised through tighter monetary posturing and significant fiscal adjustment.⁶⁵ The program includes measures to reduce the high degree of reliance of corporations and financial institutions on short-term debt and allows a better diversification of risk in the economy.⁶⁹

However, the centerpiece of the IMF program contains a comprehensive financial sector restructuring and strengthening to make it sound, transparent, and more efficient.⁷⁰ This is the central focus behind the financial sector.⁷¹ The strategy comprises three broad elements: a clear and firm exit policy, strong market and supervisory discipline and increased discipline.⁷² The exit policy seeks to ensure the rapid denouement of troubled financial institutions in a manner that minimizes systemic distress and avoids moral hazard.⁷³ Troubled financial institutions will be closed or, if they are deemed viable, restructured and/or recapitalized.⁷⁴ For example, on December 2, 1997, the government suspended nine insolvent merchant banks.⁷⁵ In accordance with the IMF's program, these banks must submit appropriate restructuring plans within 30 days which will be assessed by the IMF and, if not approved, the institution will have its license revoked.⁷⁶ These actions have helped to streamline companies and make them more efficient.⁷⁷

To address strong market and supervisory discipline, the program calls for a conversion to improved international practices

happened before the IMF entered the picture. In addition, without their assistance, in all likelihood, there would have been an even greater recession. *See Aim of Korea Program Is to Stanch Immediate Crisis, Permit Return to Stability and Growth*, IMF SURVEY, (International Monetary Fund, Washington, D.C.), Dec. 15, 1997, at 387.

68. *See Three-Year Stand-By Credit*, *supra* note 64.

69. *See id.*

70. *See id.*

71. *See id.*

72. *See id.*

73. *See id.*

74. *See Summary of Economic Program*, *supra* note 25.

75. *See id.*

76. *See id.*

77. The rationale is that companies will be more fiscally prudent about the industries they decide to join.

regarding banking, accounting, auditing and disclosure standards.⁷⁸ Large financial institutions will be required to have their financial statements audited by internationally recognized firms.⁷⁹ To lead the financial sector restructuring effort, the government created Financial Supervisory Committee in Korea, an autonomous restructuring agency.⁸⁰

As part of its reform package, the IMF program also contains other structural measures, such as trade liberalization, capital account liberalization, corporate governance and corporate structure, labor market reform, and an information provision.⁸¹ For example, the program breaks down Korea's banking system while creating conditions that enable the speedy acquisition of the most profitable industrial assets by foreign capital,⁸² an idea unheard of a decade ago. The program lifted the ceiling on individual foreign ownership to fifty percent by the end of 1997 and to fifty-five percent by February 1998.⁸³ It also requires further trade liberalization as well as the opening of the domestic bond market to foreign capital.⁸⁴ Under legislation demanded by the IMF, the program permits one hundred percent ownership by foreign merchant banks: "foreign financial institutions will be allowed to purchase equity in domestic banks without restriction."⁸⁵ To facilitate labor market reform in Korea, the employment insurance system will be strengthened and private job placement agencies and temporary employment agencies will be allowed to operate.⁸⁶

In a radical departure from its prior policy,⁸⁷ Korea complied

78. See *Summary of Economic Program*, *supra* note 25.

79. See *Three-Year Stand-By Credit*, *supra* note 64.

80. See R. Carter Pate and Denise C. Andrews, *The IMF Rescue: Asian Economies Propose Turnaround Plans to Obtain Financing*, 17 AM. BANKR. INST. J., November 1998, available in 1998 ABI JNL LEXIS 217.

81. See *Summary of Economic Program*, *supra* note 25.

82. See *supra* note 67.

83. See *id.* at 390.

84. See *id.* at 387.

85. Until the recent economic crisis in Korea, foreigners conducting business in Korea were limited by restrictive regulations, ambiguous business standards and public hostility. See *IMF—One Year After (5); Foreigners Support Direction of Reforms, but Complain About Speed, Enforcement*, KOREA HERALD, Nov. 29, 1998, available in 1998 WL 20206307; See *Summary of Economic Program*, *supra* note 25.

86. See *Three-Year Stand-By Credit*, *supra* note 64.

87. Korea is traditionally very suspicious of foreign investment. This tradition makes sense considering the fact that Korea is a small country between China and Japan and has a long history of battling both countries to achieve its own

with the IMF's conditional requirements by forging ahead with reform, implementing new laws⁸³ and lifting restrictions on foreigners doing business in the country.⁸⁹ In its most recent letter of intent,⁹⁰ the government stated that the first round of corporate sector restructuring was completed in December 1998.⁹¹ The top five *chaebol* and their creditor banks have formulated Capital Structure Improvement Plans that focus on corporate workouts and the exchange of affiliates between groups.⁹² Under the debt workout framework established in conjunction with the World Bank, important progress has been made in restructuring the top six to sixty-four *chaebol*.⁹³ Additionally, tripartite discussions between government, business and labor have enhanced labor market flexibility.⁹⁴

B. How Does IMF Conditionality Work?

At any level, funds received from the IMF are conditional.⁹⁵ The conditionality of IMF loans is explained in part by the IMF's obligation to ensure that its resources continue to be available to other members.⁹⁶ In addition, the criteria and conditions set forth by the IMF bailout packages force member countries seeking financial assistance to adopt stabilization programs to reduce the various

independence.

88. The Korean National Assembly enacted four new laws relating to foreign investment and the Korean financial market. They are the Foreign Investment Act, the Securities Investment Company Act, the Asset Securitization Act and the Foreign Exchange Trading Act. *See generally Laws Recently Enacted Relating to Foreign Investment and Financial Markets*, WORLD REP., Nov. 1, 1998, available in WL 10487951.

89. *See IMF Stand-By Credit, Performance Targets*, 19 E. ASIAN EXECUTIVE REP., Sept. 15, 1997, at 18.

90. Letters of Intent are prepared by the member country. They describe the policies and updates that a country intends to implement in the context of its request for financial support from the IMF. *See About Member Country Publications* (visited May 8, 1999) <<http://www.imf.org/external/np/loi/mempuba/html>>.

91. *See Korea Letter of Intent and Memorandum on Economic Policies* (last modified March 10, 1999) <<http://www.imf.org/external/np/loi/1999/031099.html>>.

92. *See id.*

93. *See id.*

94. *See id.*

95. *See Articles of Agreement of the International Monetary Fund*, *supra* note 25, at art. V, §3, 60 Stat. at 1406; *see also* Dominique Carreau, *Why Not Merge the International Monetary Fund (IMF) with the International Bank for Reconstruction and Development (World Bank)*, 62 FORDHAM L. REV. 1989, 1996 (1994).

96. *See Carreau, supra* note 95, at 1997.

internal and external imbalances at the root of their international financial difficulties.⁹⁷ Member countries receiving IMF assistance are thus placed in a position of international financial trusteeship.⁹⁸ In many ways, the IMF operates much like a credit union,⁹⁹ with countries placing deposits in the Fund ("quotas"), which are then available to loan to member countries who need to borrow and who meet the necessary conditions. Member countries' quotas serve various purposes. First, they form a pool of money that the IMF can draw from to lend to member countries in financial difficulty.¹⁰⁰ Second, they are the basis for determining how much the contributing member can borrow from the IMF or receive from the IMF in periodic allocations of special assets ("special drawing rights").¹⁰¹ The more a member contributes, the more it can borrow in time of need.¹⁰² Third, they determine the voting power of the member.¹⁰³ As such, the size of a member country's quota typically reflects the size of its economy and its role in the world economy.¹⁰⁴ For example, the United States has more than 265,000 votes, or about eighteen percent of the total votes;¹⁰⁵ Palau, which became a member in December 1997, has the smallest percent of total votes, 0.002.¹⁰⁶

The rule of law is fundamental for determining the scope and content of the conditionality requirements of the IMF agreement because the IMF and its members countries must conduct their business within the framework of the treaty establishing the IMF.¹⁰⁷ This framework is laid out in the IMF's Articles of Agreement and in the regulations derived from it.¹⁰⁸ Commercial bank and creditor countries, on the other hand, are not bound by any formal regulations and can refuse to grant credit at their own commercial or political discretion.¹⁰⁹ As an intergovernmental organization, each member

97. *See id.*

98. *See id.*

99. *See Fischer, supra* note 20.

100. *See Driscoll, supra* note 11.

101. *See id.*

102. *See id.*

103. *See id.*

104. *See Fischer, supra* note 20.

105. *See Carreau, supra* note 95.

106. *See Driscoll, supra* note 11.

107. *See* Articles of Agreement of the International Monetary Fund, *supra* note 25, at art. I-XX, 60 Stat. at 1401-1429.

108. *See id.*

109. *See DENTERS, supra* note 25, at 6.

country can make an IMF claim because of its balance of payments or its reserve position.¹¹⁰ However, according to article V, the IMF has the right to block a request for IMF funds if adequate safeguards are not present.¹¹¹ As such, conditionality is a consequence of the requirement of adequate safeguards.¹¹²

C. *The Underlying Tension*

The interplay between the requirement of adequate safeguards and the sovereignty of the member countries of the IMF inevitably creates a tension between the two.¹¹³ Specifically, what is the scope of the conditional requirements that the IMF can impose on a member State?¹¹⁴ In particular, this feature of fund lending by the IMF raises the larger question about whose interests¹¹⁵ are actually served in a country's IMF adjustment program. In Korea, the bailout (financed by G7 governments,¹¹⁶ the IMF, the World Bank and the Asian Development Bank) will not necessarily result in capital inflows into Korea.¹¹⁷ As discussed below, this is because the bailout to a large extent serves the interests of the international banking community, enabling U.S., European and Japanese banks.¹¹⁸

Korea's decision to accelerate the opening of its automobile and financial sectors reflected pressures from major shareholders (Japan

110. *See id.*

111. *See* Articles of Agreement of the International Monetary, *supra* note 25.

112. *See* DENTERS, *supra* note 25, at 6.

113. *See id.*

114. *See id.*

115. *See generally* Devesh Kapur, *The IMF: A Cure or a Curse?* *International Monetary Fund*, FOREIGN POL'Y, June 22, 1998, at 114 (includes related articles on the IMF and the World Bank).

116. The G7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. The first G7 summit was held at Chateau de Rambouillet, France on November 15-17, 1975. Its focus was to achieve a workable international monetary system. Since then, G7 summits have been held annually to discuss major international issues and to respond effectively to potential threats to the international system. The leaders also give direction to the international community by setting priorities, forging common policies or establishing patterns of cooperation on transnational challenges, and providing guidance to established international organizations. *See G7/Summit of The Eight: History and Purpose* (last modified June 3, 1997)

<http://www.state.gov/www/issues/economic/summit/fs_summit_history.html>.

117. *See* Kapur, *supra* note 115.

118. *See id.*

and the United States);¹¹⁹ Korea's high tech and manufacturing economy is also up for grabs. Presumably many Western corporations will be able to go on a shopping spree, buying up industrial assets at extremely low prices.¹²⁰ For example, Taiwanese businesses have made deals to acquire two five-star hotels in Korea at bargain prices.¹²¹ The devaluation of the won has depressed the dollar value of Korean assets facilitating such acquisitions.

In the context of the Asian financial crisis, international banking and financial institutions, rather than the IMF, have come to play an indirect role in the process of macro-economic reform.¹²² Essentially what has happened is that G7 governments have come to the rescue of the merchant and commercial banks by agreeing to finance the bailout. Yet, to undertake this objective, G7 national treasuries are obliged to issue large amounts of public debt invariably underwritten by large merchant banks. Thus, the beneficiaries of the bailout are also the underwriters of the public debt operation required to finance it.¹²³ This creates an absurd situation: G7 governments are financing their own indebtedness. In other words, it appears that these institutions have dictated country-level foreign exchange policy. The same Western and Japanese financial and banking institutions (routinely involved in currency and stock market speculation) are the creditors of Asia's central banks.¹²⁴ Thus, the same Western and Japanese financial institutions that pressured G7 governments to implement the bailout operations are also the ultimate beneficiaries.

D. What IMF Conditionality Will Do for Korea

The first and most important effect IMF conditionality will have on Korea is financial liberalization.¹²⁵ The IMF demanded a complete

119. *See id.*

120. In 1998, foreigners invested U.S. \$9 billion, which was more than one-third of the entire amount invested in the previous thirty-five years. *See* Sheryl WuDunn, *South Korea's Mood Swings from Bleak to Bullish*, N.Y. TIMES, Jan. 24, 1999, at 3.

121. *See End of Year Look at Economic Crisis in Korea and What it Means for Foreign Businesses*, E. ASIAN EXECUTIVE REP., Oct. 15, 1997, at 17.

122. *See* Kim & Gerdes, *supra* note 22.

123. *See* Martin Khor, IMF: Bailing Out Countries or Foreign Banks? (visited March 4, 1999) <<http://www.asienhaus.org/asiancrisis/imfasiakhor3.htm>>.

124. *See id.*

125. Even before the Korean financial crisis started, then President, Kim Young Sam, announced a policy of globalization (*seggyewha*) in 1994. This policy was designed to attract foreign investment by reducing government control. *See generally* Ehrlich & Lee, *supra* note 7. For a further discussion of the actual liberalization

liberalization of the financial sector,¹²⁶ making a higher degree of transparency and foreign takeovers of Korean banks and other financial intermediaries possible.¹²⁷ The second effect that IMF conditionality will have on Korea centers around the problems of market concentration and the *chaebol's* dominance of the Korean market.¹²⁸ At its core, the hope is that the IMF stabilization package will dismantle the *chaebol*, certainly a task that no former Korean president has been able to do. The mechanisms provided for in the IMF stand-by agreement¹²⁹ certainly make that a possibility. For example, individual corporations in need of financial help will be unable to take advantage of previous government subsidized support or tax privileges.¹³⁰ Additionally, to reduce the risk of a conglomerate venture, measures will be worked out and implemented to change the system of mutual guarantees.¹³¹ At this juncture, it is not easy to gauge how successful any reorientation of the *chaebol* will be. However, the concern lies with weaker firms like Sammi and Hanbo, the two biggest failures of 1997, and more generally, an economy that is grossly distorted by a small number of huge corporations.¹³²

By far the most questionable effect IMF conditionality will have on Korea relates to labor,¹³³ and this is where the experience of earlier IMF stabilizations is of little help. In reaction to violent demonstrations against labor reform, Chun's administration created

measures implemented, see also Jane L. Lee, *South Korea Liberalizes Foreign-Exchange Rules*, WALL ST. J., Apr. 1, 1999, at C17.

126. See *Summary of Economic Program*, *supra* note 25.

127. See *id.*

128. Currently, the ten largest *chaebol* account for approximately seventy percent of the economy. See Cumings, *supra* note 6.

129. See *Summary of Economic Program*, *supra* note 25.

130. See *id.*

131. See *id.*

132. Also consider the fact that the *chaebol's* economic success is the basic reason for its economic catapult from the 1960s onward. To dismantle the *chaebol* relationship, in the short-term, will inevitably bring its own share of negative effects.

133. As recently as December 1996, then President Kim Young Sam faced considerable opposition from thousands of workers for enacting a new labor law under pressure from the *chaebol* to lower labor costs and restore comparative export advantage. The new law ensured that the Federation of Korean Trade Unions would be the only legal labor organization in the country for five more years. In essence, the law left out a group known as the Korean Confederation of Trade Unions ("KCTU"), a group of about 500,000 members. This law allowed Korean companies to lay off workers and replace them permanently. Because Korea has no unemployment benefit or other government social safety net, thousands of workers found the law especially threatening. See Cumings, *supra* note 6.

laws designed to repress workers rights and unions.¹³⁴ Essentially, these laws restrained independent collective action.¹³⁵ Unlike in the past, Korean workers did not passively accept these policies.¹³⁶ This was because they were better educated, earned better wages, were less dispensable and had more knowledge about workers' rights. As a result, many labor groups spoke out in reaction to the government's repressive policies, and despite the government's efforts at suppression, industrial strife increased.¹³⁷

Today, Korean labor is highly organized, with a ten-year record of rapid mobilization.¹³⁸ The number of strikes and other incidents after the Chun dictatorship collapsed in 1987¹³⁹ was the highest ever recorded in the world, and today strong unions exist among all classes of workers.¹⁴⁰ This makes the situation quite different from the early 1980s. A labor market with powerful organizations that provide strong disincentives for layoffs means that the IMF must tread very carefully with the Korean labor market reform.¹⁴¹ If there is a widespread perception that labor is bearing the brunt of stabilization disproportionately, disputes can be expected to occur. If on the other hand, Korean workers perceive that everyone is equally sharing the burden, especially the *chaebol*, it is likely that the IMF stabilization package can succeed. This appears to be the current situation. Since 1987, Korean labor has become sensitized to coalesce themselves with the middle class if their demands are to be met. Thus, a fair and broad sharing of austerity will encourage both middle class workers and industrial workers to support genuine reforms.

134. See Jennifer L. Porges, *The Development of Korean Labor Law and the Impact of the American System*, 12 COMP. LAB. L.J. 335, 353 (1991).

135. See *id.*

136. See *id.*

137. See *id.* at 354.

138. See *id.*

139. In 1987, industrial workers, students and office workers in Seoul took to the streets to demand democracy. Another demonstration would have ruined Korea's opportunity to host the 1988 Olympics. Therefore, Chun decided to give in to the public's demands for a democratic presidential election. See *The Civilian Emperor: South Korea's Remarkable Transition to Democracy Has Some Way to Go*, ECONOMIST, June 3, 1995, at 8.

140. Labor groups, such as the KCTU, oppose the restructuring imposed by the IMF. See, e.g., Crotty & Dymski, *supra* note 14.

141. As part of its agreement with Korea, the IMF enforced massive lay-offs of Korean workers. The IMF said its prescription would not cause widespread distress if Korea enacted unemployment compensation laws. See Cumings, *supra* note 6.

IV. The IMF Prescription: Should International Bailouts Occur at All?

On one side of the spectrum, the IMF prescription for Korea is lauded by many scholars as necessary to prevent a much larger financial meltdown.¹⁴² The theory is that, in an increasingly interdependent global economy, a financial crisis in one country can rapidly wreak financial chaos around the world.¹⁴³ In Korea's case, without an emergency injection of U.S. dollars, companies in Korea would default on their debts.¹⁴⁴ This would cause distress elsewhere, especially in Japan, where stagnation could turn into outright depression. From there the crisis could spread to the United States, Europe and the rest of the world, as banks fail, credit disappears, stock markets crash and economies collapse. This is one theory as to why some countries' governments supported the IMF's course of action.¹⁴⁵

In all likelihood, this scenario would not have taken place. At most, a financial crisis would have slowed growth only moderately in Europe and the United States. By itself, it would have posed no danger to the integrity of the global financial system. Such a recession would have occurred only if deeper financial trouble in Korea caused Japanese banks to fold, if Japan's authorities failed to contain that crisis in their own monetary system and if Western banks failed to protect their banks. However, to say the global financial meltdown was unlikely is not to say it was impossible. So one might ask, why even risk this outcome, if it can be made much smaller at a moderate cost, or at no cost? The Mexican bailout of 1995¹⁴⁶ is a good comparison. Nobody feared a market meltdown in that case, though there were concerns, justifiable in retrospect, about Latin American contagion. Guided by other considerations, the United States and the IMF nonetheless arranged support amounting to \$40 billion;¹⁴⁷ it

142. See Fischer, *supra* note 20.

143. See Phillip J. Longman & Shaheena Ahman, *The Bailout Backlash: How to Think About the IMF and Its Critics*, U.S. NEWS & WORLD REP., Feb. 2, 1998, at 37.

144. See Fischer, *supra* note 20.

145. See generally *id.*

146. The IMF organized a \$40 billion financial package for Mexico on February 1, 1995. The package prevented a default and allowed Mexico to regain access to financial markets, while limiting the impact of the crisis on other countries in the region. See Barry Eichengreen, *Bailing in the Private Sector: Burden Sharing in International Financial Crisis Management*, 23 SPG FLETCHER F. WORLD AFF. 57, Winter-Spring 1999, at 1.

147. The leaders behind the IMF-Mexico bailout believed that once confidence

worked, and confidence was restored. Mexico experienced a growth in its exports that allowed the emergency loans to be serviced at market rates and repaid. U.S. investors in Mexico did not lose out, and in the end, U.S. taxpayers did not pay any money.¹⁴⁸

On the opposite side of this argument, however, is the hidden cost of bailouts.¹⁴⁹ In a market-based system, the IMF safety net dilutes the discipline of the market.¹⁵⁰ This is because in a market-based system of finance, the risk of losing your money is not an avoidable nuisance but a fundamental requirement.¹⁵¹ For instance, if bank depositors are assured that their savings are safe no matter what, they will exercise no care in choosing their bank. This problem of "moral hazard"¹⁵² is all too familiar to central bankers. To promote safe lending in the long term, some risk must be left with depositors,¹⁵³ and far more with owners, but not so much as to make the system vulnerable to short-term instability. A trade-off must be struck, involving certain guarantees for depositors on the one hand and regulation to curb excessive risk-taking by banks on the other.

In essence, there must be a balance between the two sides. Striking the balance between short-term systemic instability and long-term moral hazard is difficult enough for domestic regulators. It is much more difficult for the IMF, who is only called in once the damage is done. Unable to act as an ongoing supervisor of Asia's financial systems, all it can do is demand reforms.

was lost, no investor would have an incentive to make additional foreign exchange available. Thus, if Mexico did not receive the funds it desperately needed from the IMF, they almost certainly would have been forced to suspend redemption of these debts, inflicting significant losses on its creditors and risking damage to its creditworthiness. *See id.*

148. Most Americans are under the misconception that the IMF imposes significant costs on U.S. taxpayers. In reality, U.S. contributions to the IMF do not add to federal spending. *See Longman & Ahman, supra* note 145.

149. *Cf.* "Bailing in" the private sector ensures that private investors will also take their share of losses. *See Eichengreen, supra* note 148.

150. *See About All Those Bailouts Now: U.S. Taxpayers Help Support the IMF. Do They Get Their Money's Worth?*, U.S. NEWS & WORLD REP., Dec. 8, 1997, at 31.

151. *See generally President's Testimony Broadcast; Lockheed Martin Moves to Acquire Comsat; Former Citicorp CEO Walter Wriston Warns Against Reliance on IMF* (CNN Moneyline News Hour with Lou Dobbs, Sept. 21, 1998).

152. In a nutshell, the term "moral hazard" is a term used to suggest that if one makes a bad loan, somebody will bail him out. *See generally President's Testimony Broadcast; Lockheed Martin Moves to Acquire Comsat; Former Citicorp CEO Walter Wriston Warns Against Reliance on IMF* (CNN Moneyline News Hour with Lou Dobbs, Sept. 21, 1998).

153. This is the essence of a free-market based economy.

V. Conclusion

In light of all the criticisms of the IMF's conditional requirements, should the IMF have left Korea alone? Given the small yet significant risk of systemic failure and the opportunity to spare the Korean economy pain, it was right to intervene. To be sure, the historical problems of the lack of governance of Korea's *chaebol* and its seemingly unbreakable relationship with the government in many ways led to the Korean financial crisis. Efforts to overcome these historical problems were addressed by then President Kim Young Sam's attempts at *chaebol* reform. Although these ideas may have been helpful, they were certainly not the type of widespread reform that the IMF program was able to achieve.

While the IMF's prescription may have been painful in the short-term, it is almost certain that the IMF-led bailout and its conditional requirements of the Korean economy may accomplish one thing no past government could accomplish: dissolve the country's seemingly indestructible *chaebol*.¹⁵⁴ Foreign companies in Korea looking for medium- to long-term business can seek solace that in the long run, the Korean economy will emerge stronger because of the changes underway in accordance with the IMF program. Undeniably, it will take time to reform three decades of the government-*chaebol* model. Perhaps then, the Korean "miracle on the Han" will depend more on efficiency and less on the multiplication of wealth.

154. See Shin, *supra* note 14.

