

# **THE RUSH TO DEVELOPMENT**

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**ECONOMIC CHANGE  
AND POLITICAL STRUGGLE  
IN SOUTH KOREA**

**MARTIN HART-LANDSBERG**



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## CHAPTER 3

### POLICY IMPLEMENTATION: STATE DIRECTION OF NATIONAL ECONOMIC ACTIVITY

While most economists recognize the existence of the planning structure described in the previous chapter, almost all discount its significance in terms of actual state direction of economic activity. For example, Paul Kuznets, an economist and East Asian specialist, has written:

The coincidence of rapid growth and economic planning, and the primacy of the Economic Planning Board in the circle of economic ministries have led some observers to misconstrue the function of planning and overemphasize the role of government in the Korean economy. Planning does not entail government control of resource allocation, but rather involves a set of activities designed to sustain rather than to repress market functions. The government acts by providing information, reducing risks, and altering incentives rather than by fiat or by assuming market or enterprise functions.<sup>1</sup>

This statement seriously misrepresents the purpose and practice of planning in South Korea. As we will see, planning was undertaken to guide ongoing state efforts to diversify and strengthen the country's industrial base to achieve maximum rates of economic growth. In this chapter, we will examine how the government used its control over finance as well as state production to move economic activity along lines specified by its plan, often assuming both market and enterprise functions in the process.

State direction of credit has been the government's most powerful instrument of industrial policy. According to Leroy P. Jones and Il Sakong, who authored a landmark study on the government-business relationship in South Korea: "Government control of the banks is . . . the single most important economic factor explaining the distinctly subordinate position of the private sector."<sup>2</sup>

Although banks in South Korea were privately owned at the time of the 1961 military coup, they did not remain so for long. One month after the coup, the government arrested fifty-one business leaders on charges that they were "illicit fortune accumulators" and threatened to confiscate their assets. Soon after, however, a deal was struck. In exchange for paying sizable fines, the government agreed to exempt the businessmen from prosecution and returned all of their assets, with one major exception—their commercial bank shares.<sup>3</sup>

As a result, from 1961 until 1981, when a managed program of financial privatization was begun, the South Korean government enjoyed total control over the country's financial system, primarily through its ownership of all five nationwide commercial banks, all six special banks, and two of the country's three major nonbank financial development institutions. The Ministry of Finance was thus able to set interest rates, credit ceilings, and loan priorities as well as make budget, salary, and hiring-and-firing decisions at each individual bank.<sup>4</sup>

Also, recognizing that its control over the price and allocation of credit could be undermined by international capital flows, the government moved quickly to control private access to foreign capital: it amended the Foreign Capital Inducement Law in 1962 to require that all foreign loans be approved and guaranteed by the government. While this measure responded to foreign demands for insurance against possible default, it also gave the government, through the Economic Planning Board, the ability to decide which enterprises would have access to foreign capital. The government also took steps to control the outflow of money as well. Legislation was passed which made any illegal transfer overseas of \$1 million or more punishable with a minimum sentence of ten years imprisonment and a maximum sentence of death.

## Finance and Economic Restructuring

Credit has been a powerful lever shaping industrial activity in South Korea because of the government's aggressive and focused lending policies. During the formative stages of the country's industrial growth, for example, the government used an expansive credit policy to facilitate a rapid increase in export activity. As a result, debt-equity ratios of manufacturing firms rose rapidly from 1.2 in 1966 to 3.9 in 1971.<sup>5</sup> Firms were encouraged to borrow to expand their operations in two ways. By guaranteeing a stable source of funding for firms undertaking targeted activities, the government was able to greatly reduce the risk associated with new ventures. By subsidizing the price of credit, the government was able to significantly reduce the cost of investment and thus increase the expected rate of return for the targeted activity.

Looking at cost of capital, Jones and Sakong point out that:

Throughout the post-war period, interest rates on domestic loans have been regulated, generally at levels well below their equilibrium values . . . The general picture . . . shows that: first, the general bank rate has typically been half of the [unregulated] curb market rate; and second, the real bank rate has often been negative and generally below even the most conservative estimates of the opportunity cost of capital. The result has been excess demand followed by the necessity of non-price rationing devices.<sup>6</sup>

When the United States and the IMF pressured the South Korean government to accept a stabilization program in 1965 which included a doubling of domestic interest rates, the government responded by increasing the inflow of foreign funds to selected firms. With the cost of foreign borrowing far lower than the domestic cost of funds, in fact negative in real terms, the government was able to ensure, at the cost of a rapid growth in foreign debt, that favored firms and activities would continue to receive access to credit at preferential prices.<sup>7</sup> Interest rate differentials for the period from 1966 to 1970 highlight the significance government credit allocation decisions had for a firm's decision-making and profitability: annual average domestic bank-lending rates were 24.4 percent; annual average unregulated curb market rates were 54.2 percent; and annual average foreign interest rates were 6.4 percent. The interest rate differential between domestic and foreign bank

lending rates was 12.9 percent, even after adjusting for exchange rate movements.<sup>8</sup>

Not surprisingly, the government used its monopoly over finance to shape overall business activity along lines specified by its plan. There was no middle ground: firms willing to operate within the logic of the government's plan could look forward to significant financial support. Those who refused were left with no choice but to seek funds in the very expensive curb market.

By the mid-1960s, the government had declared exporting and certain import-substitution activities that were seen as export-supporting to be priority activities. And, as the South Korean economist Byung-Nak Song describes:

The export targets agreed upon between the government and individual firms were taken by businessmen as equivalent to compulsory orders. Firms which failed to achieve their export targets without a plausible excuse ran the risk of heavy administrative sanctions from the government. During the 1960s, the export promotion strategy was dominated by the government, which was the primary decision-maker in "Korea, Inc."<sup>9</sup>

In response to government initiatives, exports became increasingly central to all economic activity. For example, manufactured goods produced for export rose from 8 percent of final demand in 1963, to 22 percent in 1966, and to 40.1 percent in 1973. Employment in the production of manufactures for export rose from 6.4 percent of total manufacturing employment in 1963, to 16.5 percent in 1966, and to 34.5 percent in 1973.<sup>10</sup> From 1965 to 1975, the ratio of exports to GNP more than tripled and manufacturing's contribution to GNP more than doubled.<sup>11</sup>

The resulting industrial transformation of the South Korean economy is perhaps best illustrated by the changing composition of South Korean exports. The top six exports in order of dollar value in 1961 were basic ores, iron ore, fish, raw silk, vegetables, and swine. In 1971 they were clothing, plywood, other manufactures including wigs and toys, electrical machinery, raw silk, and basic ores. In 1976, they were clothing, footwear, fabrics, electrical machinery, plywood, and telecommunications equipment.<sup>12</sup>

However, even while sales of basic labor-intensive manufactures—such as textiles and clothing, electronic parts and components, and footwear—continued to drive South Korea's export-led

economy well into the 1970s, state officials began planning early in the decade for yet another major restructuring of the economy. In spite of the country's export success, South Korea was still running a trade deficit. Moreover, other third world producers with even lower wage costs were also beginning to export basic labor-intensive manufactures in competition with South Korean firms. The government's response was its 1973 Heavy and Chemical Industrial (HCI) Plan. Designed to both upgrade and diversify South Korean exports, as well as reduce the country's import dependence, the plan targeted the development of six new industries: iron and steel, petrochemicals, electronics, machinery, shipbuilding, and transport equipment.

As before, the state relied heavily, although not solely, on financial incentives to achieve its desired ends. More specifically, the government made use of a number of different targeted policy loans to encourage investment in these new industries. In 1978, these policy loans accounted for approximately 45 percent of total domestic credit and 75 percent of total bank loans.<sup>13</sup> Among the most important were export loans, Machinery Industry Promotion Fund loans, and National Investment Fund loans.

The National Investment Fund, for example, was set up in 1973 specifically to fund heavy and chemical industries. Between 1974 and 1980, the heavy, chemical, and power industries combined received 80 percent to 90 percent of all of its loans.<sup>14</sup> As a result of this policy, heavy and chemical-goods producers enjoyed not only greater access to capital, but also had significantly lower costs than did producers of light manufacturers, in some years as much as 35 percent lower.<sup>15</sup>

One measure of the government's success in implementing its plan was the resulting structural change in the South Korean economy. As shown in Table 3.1, from 1975 to 1980, the industrial center of the South Korean economy, in terms of both gross output and value added, shifted from light to heavy and chemical manufacturing industries. The same was true for exports: the share of heavy and chemical goods in merchandise exports rose from 14 percent in 1971 to 38 percent in 1979, and to 60 percent in 1984.<sup>16</sup>

Significantly, South Korea's Heavy and Chemical Industrial Plan was opposed by most Western advisors, including those at the World Bank, who believed that South Korea's international comparative

TABLE 3.1  
Structural Change in Manufacturing  
(in percentage terms)

	Gross output			Value added			Employment					
	1970	1975	1980	1970	1975	1980	1970	1975	1980			
<i>Light industry</i>	28.4	29.5	24.7	22.1	12.8	14.5	13.7	13.6	9.2	13.5	13.8	13.0
Food, beverages, and tobacco	15.9	14.4	10.8	9.6	6.2	6.3	6.2	5.9	2.5	2.8	2.9	3.0
Textiles and leather	7.1	9.9	8.4	7.0	3.8	5.5	4.9	3.9	4.0	7.9	7.4	6.5
Lumber and wood products	1.4	1.2	1.0	0.9	0.7	0.5	0.4	0.4	0.6	0.6	0.7	0.6
Paper printing and publishing	1.4	1.4	1.6	1.8	1.1	1.3	1.4	1.4	0.6	0.7	0.9	0.9
Nonmetallic metal manufacturing	1.4	1.5	1.9	1.8	1.1	1.3	1.4	1.4	0.6	0.7	0.9	0.9
Miscellaneous manufacturing	1.2	1.1	1.0	1.0	1.0	0.9	0.8	0.8	0.9	0.7	1.1	1.1
<i>Heavy and chemical products</i>	11.9	20.9	26.3	27.9	7.2	11.6	14.5	15.9	3.2	5.7	7.9	9.2
Chemical and chemical products	5.9	10.8	12.6	11.8	4.0	5.9	6.7	6.3	1.2	1.9	2.5	2.7
Primary metal manufacturing	2.0	3.4	5.1	5.0	0.7	1.0	1.7	1.8	0.4	0.5	0.7	0.9
Metal products and machinery	4.0	6.7	8.6	11.2	2.5	4.7	6.1	7.9	1.6	3.3	4.7	5.6

Source: World Bank, Korea: *Managing the Industrial Transition*, vol. 2, p. 3.

advantage continued to remain with light manufacturing. Park disagreed and, to protect his initiative from these advisors, he had his economic secretariat rather than the more Western-influenced EPB undertake the actual development of the plan. This, then, was a plan decided upon by the president and implemented through direct and active government intervention.

Despite its initial opposition, even the World Bank has been forced to declare South Korea's industrial transformation an economic success. In its 1987 report on South Korea, it summarized the results of Park's HCI plan as follows:

... Korean comparative advantage has clearly emerged over the last 10 years in shipbuilding, electrical equipment, metal products, and iron and steel—all extensions of the HCI sector. Although costly to establish, these capital-intensive industries have now reached the level of international competitiveness, and may legitimately be described as successful infant industries. . . . More broadly, the initial transition to capital-intensive exports owes its success and speed to the interventions of the 1970s in establishing industries of sufficient scale to be internationally competitive.<sup>17</sup>

My intention here is not to engage in a thorough analysis of South Korea's Heavy and Chemical Industry Plan. While it helped lay the groundwork for South Korea's economic growth during the 1980s, the plan was, as we will see in Chapter 9, far from an unambiguous success in economic much less social and political terms. Rather, my aim is to show how the government aggressively used its control over credit in concert with other instruments of state policy such as licensing, state production, and trade and foreign investment restrictions to shape the broad outlines of the South Korean economy.

### Finance and Industrial Organization

Credit policy was also used to shape the country's industrial organization. Because South Korean planners believed that large firms were better able to respond to state initiatives as well as easier to monitor than small firms, state policy promoted the development of an economy dominated by large producers.

Government preference for large firms was often translated into policy in the following way: the MITI would grant a firm approval for an industrial project. Typically, the project would be financed by one-fifth equity and four-fifth loans. If the firm succeeded at the project, often with additional assistance on the part of the government, it would normally be granted approval for yet another project. That project too would be financed largely by new government-provided credits. In this way, a firm, if favored by the government, could rapidly grow and expand its activities from one area into many others with very little original start-up money.

One result of this policy can be seen by looking at changes in employment size per enterprise over the 1970s. From 1973 to 1978, the average number of employees per enterprise grew from ap-

proximately fifty in 1973 to seventy-two in 1978.<sup>18</sup> Large firms, those employing over 300 workers, increased their average employment size over this same period from approximately 883 workers to 984 workers.<sup>19</sup> By 1978, these large firms were employing over half of all manufacturing employees and producing about two-thirds of manufacturing output.<sup>20</sup>

To strengthen their ability to implement desired policies, state planners combined support for large-scale production with limited market competition. Table 3.2 shows that from 1970 to 1977, there was a significant increase in the percentage of commodities sold in terms of market value, by monopoly producers. While this trend reversed from 1977 to 1982, it did not signify greater state commitment to free-market competition. Rather, reflecting government determination to maintain the upper hand in its dealings with individual producers, oligopoly was favored to become the dominant form of economic organization.

One natural result of this policy was a rapid growth in aggregate concentration. According to World Bank figures, the top one hundred South Korean manufacturing firms accounted for 40.6 percent of total manufacturing sales in 1970, 43.6 percent in 1972, 44.9 percent in 1977, and 46.8 percent in 1982. By contrast, the top one hundred manufacturing firms in Japan accounted for only 28.4 percent of total sales in 1975 and 27.3 percent in 1980.<sup>21</sup> In short, South Korean industrial development produced one of the highest levels of economic concentration in the capitalist world.

By far the most important characteristic of South Korea's industrial organization is ownership of these dominant firms by a few large family-run conglomerates, called chaebol. With government industrial policy supporting the expansion of existing business groups rather than the establishment of new independent firms, the average number of firms per chaebol rose steadily from 4.2 percent in 1970 to 14.3 percent in 1979.<sup>22</sup> The *Far Eastern Economic Review* describes the end result of this state-supported dynamic as follows:

Virtually the whole economy has fallen under the domination of about 50 business groups locally called chaebol. . . . Producing and marketing everything from bread to aircraft engines (Samsung), from razor-blades to TV sets and from toothpaste to micro-chips (Lucky-Goldstar), from automobiles to ships and from housing units to furniture (Hyundai),

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TABLE 3.2  
Market Structure of South Korean Manufacturing  
(by percent)

	1970	1974	1977	1982
<i>Monopoly</i> <sup>a</sup>				
Commodities	29.6	30.8	31.6	23.6
Sales	8.7	12.7	16.3	11.4
<i>Duopoly</i> <sup>b</sup>				
Commodities	18.7	17.9	20.1	11.1
Sales	16.3	12.6	11.0	6.6
<i>Oligopoly</i> <sup>c</sup>				
Commodities	33.2	34.2	32.0	47.4
Sales	35.1	38.6	33.9	50.6
<i>Total noncompetitive</i>				
Commodities	81.5	82.8	83.7	82.1
Sales	61.1	63.9	61.2	68.6
<i>Competitive</i>				
Commodities	18.5	17.2	16.3	17.9
Sales	39.9	36.1	38.8	31.4

<sup>a</sup> Firm concentration exceeds 80 percent.

<sup>b</sup> Top two firms produce more than 80 percent.

<sup>c</sup> Top three firms produce more than 60 percent.

Source: Korea: *Managing the Industrial Transition* (Washington, D.C.: World Bank, vol. 2, p. 30).

they have literally left no stone unturned in their expansion and control of domestic industries and markets.<sup>22</sup>

The top ten chaebol, the 1989 dollar value of their sales, total employment, and main products—are listed in Table 3.3. To illustrate their dominance over the South Korean economy, the four largest, sometimes called the super chaebol, had combined sales equal to approximately 45 percent of South Korea's total GNP. Of course, as noted above, each chaebol is composed of numerous firms involved in a variety of business activities. Samsung, for example, has forty-eight principle affiliates, Hyundai has forty-two, Lucky-Goldstar has sixty-two, and Daewoo has twenty-four.<sup>24</sup>

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TABLE 3.3  
South Korea's Ten Largest Chaebol

Company	1989 sales (billions \$)	Number of employees	Major products
Samsung	34.3	160,596	Electronics, semiconductors, aerospace, food, machinery, apparel, trading, insurance, advertising
Hyundai	32.5	142,630	Construction services, autos, shipbuilding, electronics, heavy machinery, furniture, trading, insurance, advertising
Lucky-Goldstar	23.1	88,403	Electronics, semiconductors, telecommunications, oil and petrochemicals, chemicals, trading, insurance, advertising
Daewoo	18.1	120,000	Electronics, machinery, auto parts, shipbuilding, aerospace, trading, financial services
Sunkyong	9.4	17,985	Oil refining, petrochemicals, polyester products
Ssangyong	7.5	16,870	Cement, auto parts, machinery, trading, financial services
Hyosung	5.2	24,000	Trading
Hanjin	4.8	26,683	Transportation
Korea	4.6	18,291	Petrochemicals, advertising, explosives, financial services
Kia	4.4	23,733	Auto parts

Sources: Sam Jameson, "Families Still Keep Grip on S. Korea's Conglomerates," *Los Angeles Times*, 10 December 1990; "Korea's Powerhouses Are Under Siege," *Business Week*, 20 November 1989; 52; Richard M. Steers et al., *The Chaebol: Korea's New Industrial Might* (New York: Harper and Row, 1989), p. 36.

*Finance, the Chaebol, and Industrialization*

The economic rise of the chaebol was closely tied to the government's heavy and chemical industrialization drive because, among other reasons to be discussed later, the government found the chaebol form of organization ideally suited to carry out its plans for a rapid expansion of production. Most chaebol are still owned and controlled by their original founder and/or his family. Hyundai, for example, is owned and run by Chung Ju-Yung and his family. Similarly, Samsung is run by the family of the founder Lee Byung-Chull, and Lucky-Goldstar is controlled by the interrelated Koo and Huh families. Such family control is often maintained by the establishment of a "cultural foundation" through which a large percentage of the stock of each company in the chaebol is owned.<sup>25</sup>

Even though the chaebol may have dozens of subsidiaries, each with its own president, they remain operationally unified under the directives of the chairman because of this tight system of family control. This command structure, in addition to a unified planning and coordination office, gives the chaebol, through its chairman, the ability to respond quickly to new opportunities and draw on the collective resources and experiences of all member companies. Thus, from the government's point of view, these business groups were an ideal vehicle for promoting the country's rapid expansion into new capital-intensive areas of production. Kim Suk Won, chairman of the Ssangyong Group, describes this system of state selection and direction of chaebol activity as "comparable to the government development plans of socialist countries."<sup>26</sup>

**A Case Study: Shipbuilding**

Shipbuilding offers an excellent example of how the chaebol were able to serve the state as an effective instrument of industrial policy. The initial impetus for South Korea's advance into shipbuilding came from President Park Chung Hee, who pressured the head of Hyundai to expand his business group's activities to include shipbuilding.<sup>27</sup> At the time, Hyundai had no shipyard or experience in shipbuilding. Moreover, no shipyard in South Korea had ever built a vessel larger than 10,000 tons.

Hyundai's first shipbuilding contract was signed in 1972, with a Greek ship owner, for the construction of two tankers, each over

240,000 tons; delivery dates were set for July and December 1974.<sup>28</sup> This success was possible largely because of government efforts which included financial support for the construction of the shipyard and extensive financial guarantees for the first contract.

The newly formed Hyundai Shipbuilding and Heavy Industries began work in 1973 but was late in meeting its deadlines. Unfortunately, by the time the ships were ready for delivery, the shipping market had collapsed; only one ship was accepted. Hyundai was again late with two very large crude carriers ordered by a Japanese company and then again with an order for two more carriers for a Hong Kong firm. All four vessels were refused by the contracting parties.

By 1975, Hyundai Shipbuilding and Heavy Industries found itself holding several tankers and facing financial disaster. But having supported the venture from the beginning, the government continued to offer the company assistance. Most important, it gave orders that all oil imported from the Middle East had to be shipped in South Korean-owned ships. After some initial resistance, the Korea Oil Corporation (a government-Gulf Oil Company joint venture) began using Hyundai's tankers.<sup>30</sup>

Not long after, Hyundai established its own general trading company, the Hyundai Merchant Marine Company, which in 1976, purchased all of Hyundai's unsold ships for its own use. This decision to enter the merchant marine business was supported by the government's decision to launch a new system of General Trading Companies (GTC). This system, to be described in more detail later, was designed to push exports. If companies met export requirements designated by the government, they would be granted GTC status and receive a number of special privileges, the most important of which was access to credit at especially low interest rates. Hyundai's merchant marine company not only saved Hyundai's shipbuilding venture, it also gave the chaebol an important advantage in the race to boost exports and win GTC status.

Hyundai began construction of its first ship in 1973 and its shipbuilding affiliate survived largely due to government policies such as those mentioned above. Yet, less than a decade later, Hyundai became the world's largest shipbuilder.<sup>31</sup> In trying to answer the question of how it was possible, even accounting for extensive government support, that a company with no previous shipbuilding

experience could grow so quickly and maintain its forward motion in an industry widely known for instability, we come to appreciate the economic advantages of the chaebol business structure.

For example, even though Hyundai Shipbuilding and Heavy Industries had no direct experience in shipbuilding, the Hyundai group was able to compensate for this shortcoming by drawing on the engineering and construction expertise of Hyundai Construction, the workplace organizational knowledge of Hyundai Motors, and the production control experience of Hyundai Cement. Within the unified command structure of the chaebol, engineers, supervisors, managers, workers, and funds were easily transferred from subsidiary to subsidiary as needed.<sup>32</sup> Moreover, the chaebol structure allowed Hyundai to balance off losses in shipping with gains from other subsidiaries, such as those producing automobiles or electronics.

#### *Finance, the Chaebol, and Exports*

As noted above, the government had been successful in harnessing the chaebol, through the General Trading Company system, to boost the nation's export efforts. The system was started in 1975, with the MTI awarding GTC status to trading companies if they successfully met certain government standards in terms of company size, number of overseas branch offices, and, most important, annual export performance. Within a year, thirteen trading companies had qualified. Four, however, eventually lost their status because of poor performance, the last in 1985.

To force these trading companies to maximize exports, the government continually raised the minimum export requirement. Even though this policy kept the costs of participation high for those firms involved, the rewards were substantial. Successful trading companies gained access to bank loans at extremely low interest rates, the right to import selected products for resale, and membership on special committees that advised the Economic Planning Board.<sup>33</sup> One measure of the system's success: the share of exports handled by the ten largest general trading companies rose from 13.6 percent in 1976 to 51.3 percent in 1983.<sup>34</sup>

Not surprisingly, it was the largest business groups, such as Sam-

sung and Hyundai, that had the resources to launch trading companies able to win GTC status. Employing the added financial benefits associated with GTC status to strengthen the economic position of the entire business group, these chaebol were able to rapidly out-perform their non-chaebol competitors. As George E. Ogle has commented: "The GTC system, the switch to heavy industry and the giant leap forward by the chaebol, all went hand in hand."<sup>35</sup>

Chaebol domination of economic activity exposes yet another misconception that mainstream economists have about the South Korean economic experience. Not only did these economists underestimate the economic role of the state, they have also seriously overstated the importance of free-market competitive entrepreneurship. As we have seen, South Korea's economic rise and industrial transformation was powered by a few large business groups whose growth and activities can best be explained with reference to state directives and initiatives, the most important being financial.

#### *Finance, Wealth, and Power*

While control over finance enabled the state to shape chaebol and thus private sector economic activity, it also served as a powerful instrument of political control and personal enrichment for state leaders. This point is probably best illustrated by the following example: under the rule of President Chun Doo Hwan, Park Chung Hee's successor, it became standard practice for the large chaebol to make "donations" to the work of the Ilhae Foundation and the New Village Movement. The first, organized ostensibly to conduct research on questions related to reunification, was controlled by Chun himself. The second, allegedly organized to support rural development, was run by Chun's younger brother.

This corporate giving was commonly understood to be a payoff directly to the president and his brother to ensure good chaebol working relations with the government. It was not voluntary, however, as Yang Chang Mo, the head of the Kukje-JCC group, was to discover. In 1984, he gave only \$400,000 to the New Village Movement, while the leaders of the other large chaebol each gave over \$1 million. Mr. Yang also refused to make any contribution to the Ilhae Foundation.

At the time, Kukje-ICC was the seventh-largest business group in South Korea, with 21-member companies in areas such as steel, textiles, machinery, footwear, tires, and overseas construction. In 1983, it had trade revenues of \$3 billion and a network of forty overseas branches that did business with one hundred countries. But like other businesses in South Korea, Kukje-ICC had grown rapidly through funds borrowed from the government-controlled banking system. While subsidized credit was put to great advantage by the chaebol, it was also their Achilles' heel. As one South Korean banker explained: "Anytime the government chooses to close a company or break it up, it can do so. All it has to do is call the so-called Korean commercial banks, which it controls, and tell them not to refinance a company's debt."<sup>36</sup>

In this case, President Chun, angered by Mr. Yang's actions, ordered Kukje-ICC's four main creditor banks to stop honoring the chaebol's checks. Within a few weeks, Kukje-ICC, with no alternative financing available, was forced to declare bankruptcy. The banks took control of all the company's assets and, under government direction, proceeded to sell them at discounted prices to the other more politically loyal chaebol. The efficiency of this system was clear: A major chaebol collapsed, but no plants were idled or workers unemployed. The government, through its control over the financial system, simply reassigned assets from one chaebol to another.

Well aware of their financial vulnerability, most chaebol have sought to increase their economic and political independence from the state by pushing for deregulation and privatization of the South Korean banking system.<sup>37</sup> In fact, the combination of chaebol and U.S. government pressure has forced the South Korean government to loosen its direct control over the country's financial markets. In 1981, for example, the government began selling its shares in the five nationwide commercial banks.

To minimize its loss of control to the chaebol, the state restricted its privatization program in a number of ways, such as limiting single shareholders (except for joint venture banks) to a maximum 8 percent of total ownership. These efforts had not been completely successful, however, and the chaebol were clearly able to increase their financial strength through the 1980s. But while this development indicates a change in the balance of power between the state and chaebol, it did not mean that the state had completely lost its

ability to control the price or allocation of bank credit. For example, bank lending and deposit rates continue to be regulated by the state through so-called "window-guidance" from the Bank of Korea. Moreover, the government has once again increased its use of policy loans, which require banks to make loans according to criteria and at interest rates established by the government itself. Finally, as the major stockholder in all banks, the Ministry of Finance ensures its continuing control over bank decisions by placing its own officials in mid-level management positions throughout the banking system, as well as exercising veto rights over the selection of top bank management. Thus, after more than ten years of government privatization, South Korean banks continue to operate largely under the direction of the state.

Neither the chaebol nor the U.S. government has, of course, conceded to the state in this struggle for control over finance. In fact, the state pledged, under pressure, to further deregulate the country's financial system gradually over the decade of the 1990s. It remains to be seen, however, what kind of financial reform will, in fact, be implemented. While these developments and their significance for South Korea's economic and political future will be considered more fully in Part III, at least two comments are appropriate here.

First, this struggle over finance underscores the main point of this section: state control over the price and allocation of credit has been central to the state's ability to direct private economic activity and thus South Korea's rapid growth and economic transformation. Second, as forces internal and external to South Korea continue to weaken the ability of the state to direct economic activity, there is strong reason to believe that South Korea's past economic progress will prove difficult to sustain.

#### *State Production*

While direction of credit was the government's single most important instrument of industrial policy, it was far from the only one. As we will see in this section, the South Korean state also made extensive use of nonfinancial public enterprises to spur and direct the country's economic growth. In fact, according to Jones

and Sakong, South Korea "has utilized the intervention mechanism of public ownership to an extent which parallels that of many countries advocating a socialist pattern of society."<sup>38</sup>

There is a long history of public enterprise in Korea, although before colonization by Japan it was largely one of state production of luxury goods (such as green celedon pottery) for elites. Under Japanese rule, the public sector in Korea was greatly expanded in both size as well as scope of activity. As a result, public enterprises generated almost one-quarter of total government revenue from 1910 to 1920 and over half of all state revenue from 1926 to 1945.<sup>39</sup>

Those Japanese public enterprises operating in southern Korea were seized by the U.S. military at the end of World War II and eventually given to the newly established South Korean government in 1948. But, under pressure from the United States, Syngman Rhee sold off all but thirty-six of them to South Korean businessmen before his ouster in 1960. With Park's military takeover, however, this trend toward privatization was reversed. The new government's nationalization of the banking system perhaps best symbolized Park's different understanding of the importance of state ownership as a tool for industrialization. As Byung-Nak Song explains:

The [Park] government PE [public enterprise] policy in the 1960s and 1970s was to establish PEs in any area if they were essential in expanding Korea's export capacity and could not be properly handled by private enterprises. Thus the government established PEs to handle even such items as iron and steel, petroleum and chemicals, and tourism, that are normally considered to be traditional areas of private business.<sup>40</sup>

In what follows I will briefly highlight the expansion and significance of state activity in the period of its most rapid growth, 1963 to 1972. In many ways, state infrastructure activity, by rapidly creating an industrial framework within which private producers could thrive, functioned as a leading sector during South Korea's early years of industrial growth. Every year from 1961 to 1969, for example, government social overhead capital grew at a faster rate than did manufacturing or any other sector of the economy.<sup>41</sup>

The public sector as a whole grew more than three times in absolute size from 1963 to 1972. This increase translates into a real average annual growth rate of 14.5 percent as compared to a 9.5 percent rate of growth for the economy as a whole and a 12.2 percent rate of growth for the non-agricultural sector.<sup>42</sup> Moreover, most of

this growth came from new enterprises established by the Park government and not from the expansion of those that existed prior to his coming to power.

Nearly half of all public enterprises added during this period (in terms of 1972 value added) were in manufacturing. As a result, even though manufacturing activity grew rapidly from 1963 to 1972, the public sector share of manufacturing output (in terms of value added) remained roughly constant at 15 percent. Thus, state manufacturing activity grew as rapidly as did that of the private sector.

In terms of strategic location, those public enterprises established by Park, especially in manufacturing, had extremely high backward and forward linkages relative to those of any other sector of the economy. Control of these firms thus gave the South Korean state considerable leverage to shape the overall direction of the economy. State firms were also among the most capital intensive in the entire economy, averaging twice the capital intensity of firms in manufacturing. South Korea's public firms were also among the country's largest. In 1972, for example, twelve of the country's sixteen largest firms were state owned. Finally, public sector operations were heavily import-substituting; without them, according to some estimates, the nation's current account deficit would have been approximately 25 percent larger.

As we can see, public sector firms operating in a variety of fields—transport and communication; electricity, water, and sanitation; mining; and manufacturing—played a leading role in South Korea's rapid economic transformation. They created the physical infrastructure needed by private producers as well as ensured timely production of those industrial products essential for the expansion and diversification of South Korean industry. To elaborate on this point, I will present two examples of public sector activity: the first illustrates how state infrastructure activity was used to promote export activity; the second illustrates how state production was used to promote South Korea's industrial restructuring.

#### Infrastructure and Exports

Beginning in 1967, Park had the Ministry of Construction undertake construction of a series of industrial estates to be operated by the state-owned Export Industry Public Corporation.<sup>43</sup> This program of estate building was an important part of the government's export

promotion policies. It encouraged, by providing subsidized modern factory sites and a supporting infrastructure, rapid expansion of business activity along lines determined by the state.

By the end of the decade the government opened new estates in Seoul, Masan, and Kumi. Following implementation of the Regional Industrial Development Law in 1969, the government further committed itself to establish at least one industrial estate in every provincial capital.<sup>44</sup> By the end of 1981, twenty-three government-owned-and-operated industrial estates were providing facilities and services to over 2200 firms.<sup>45</sup>

While enhancing private profitability, these estates also functioned as a powerful instrument of government control over corporate activity. For example, firms that did not meet government-mandated export targets were often punished by the MTT with loss of those basic services provided by the estate, including electricity, water, and telephones.<sup>46</sup>

#### State Production and Industrial Deepening

The government also played a direct production role in advancing South Korea's industrial deepening, most important, perhaps, through the establishment of the Pohang Iron and Steel Company Ltd. (POSCO), one of the country's most successful public enterprises. South Korean planners attempted to launch an integrated iron- and steel-making industry as early as the mid-1960s. At that time, aid donors, including the World Bank, refused to lend the government the necessary money, arguing that because South Korea lacked iron ore, steel-making skills, and a large market, it should obtain its steel from efficient Japanese producers.

The South Korean government persisted, however, and eventually succeeded in forming POSCO in 1968. Although foreign project advisors suggested that South Korea enter the steel business with only a small and limited operation, the government ordered sixteen plants with facilities to cover the full range of integrated steel mill activity including a railway system. One indicator of the success of this venture is the fact that POSCO is now one of the lowest-cost steel producers in the world.<sup>47</sup>

POSCO's founding is a good example of the South Korean government's determination to maintain national control over strategic areas of production. Rather than import steel or invite a

foreign corporation to undertake and control production, the government turned to foreign loans and foreign technology to establish its own state-owned enterprise. The state was forced to rely on foreign expertise for almost all phases of POSCO's creation, from preinvestment feasibility studies, personal training, and actual construction to process engineering and production control skills. POSCO itself was responsible only for the actual physical labor involved in the construction.<sup>48</sup> But given the South Korean government's commitment to steel as an integral part of an overall protected industrialization strategy, POSCO has since become increasingly self-reliant.

For example, in 1977 POSCO bought approximately 44 percent of its consumables from local suppliers; in 1984 it was 75 percent. The percentage of capital goods purchased locally has also risen.<sup>49</sup> In 1987, POSCO expanded its steel facilities from its first location at Pohang to include a second steel works at Kwangyang. This second facility is considered by many to be the most modern and fully automated steel plant in the world. While only 12 percent of spending on equipment for POSCO's first steel complex went to South Korean firms, this figure rose to approximately 50 percent in the case of the second facility.<sup>50</sup> POSCO is now involved in a joint venture with USX, supplying the U.S. firm with semfinished steel from its Kwangyang facility, as well as helping it modernize its Pittsburg, California, steel operations.

Although POSCO made a profit every year since it began operation in 1973, this record has only been achieved with substantial government support. Besides relatively low labor costs, the company has also benefited from government-guaranteed long-term, low-interest foreign loans and substantially discounted user rates for railroad services, port services, water supply, and gas.<sup>51</sup> This program of support illustrates how South Korea's efficient steel industry is the result of sustained and substantial government intervention, and not free-market forces. POSCO received this level of support because the government expected it to do far more than produce quality steel at low prices. POSCO has lived up to these expectations by playing a major role in South Korea's transition from exporter of labor-intensive manufactures to producer and exporter of capital-intensive, higher value-added products. By providing high-quality, low-cost steel, it enabled producers in automobiles,

shipbuilding, construction, and electronics to successfully compete in international markets.

South Korea's present industrial success would not have been possible had the state not taken leadership to establish public sector production in a number of strategic sectors of the economy, such as steel. The establishment of POSCO, the country's largest single investment at almost \$4 billion, was part of a broader pattern of direct state activity to transform the economy. For example, public enterprise investment as a share of total investment rose from 19 percent in 1970 to more than 33 percent in 1975.<sup>52</sup>

In fact, until the early 1970s, there were those within the military and state planning apparatus who wanted to build on the example of POSCO and continue to establish new heavy and chemical industries under direct state ownership.<sup>53</sup> A number of factors, however, including the need to maintain positive relations with the United States, eventually led the state to promote private ownership through the chaebol as the dominant form of enterprise. Reflecting this change in emphasis, public enterprise investment shares fell to approximately 28 percent in 1980 and 16 percent in 1986. Nevertheless, the absolute size of public sector activity, in terms of value added, investment, and employment, continued to grow over this same period.<sup>54</sup>

### *Conclusion*

The point of this chapter is to highlight the role of the state as the driving force behind South Korea's rapid economic transformation. In contrast to the comments of Paul Kuznets, whose quote began this chapter, it is, I believe, no exaggeration to say that the state, through its planning and direct involvement in both finance and production, was responsible for almost all aspects of every major economic decision made over the decades of the 1960s and 1970s, the period when South Korea was designated a free-market miracle by mainstream analysts. One of the lessons we can learn from the South Korean experience, then, is that a highly aggressive and interventionist state is very capable of achieving economic "success."

Effective implementation of state plans depends, however, on

more than just attention to national economic activity. Because imports and multinational corporate activity can, if unrestricted, easily overwhelm state attempts to control market entry, prices, and production, successful national planning also requires regulation of international economic activity. The South Korean experience proves the wisdom of this statement. As we will see in the next chapter, the South Korean government defended its domestic initiatives with a complex and effective system of regulation of foreign trade, foreign exchange use, and foreign direct investment.

## CHAPTER 4

# POLICY IMPLEMENTATION: STATE REGULATION OF INTERNATIONAL ECONOMIC ACTIVITY

We have so far examined the organization and operation of South Korea's planning network, highlighting the state's use of credit policy and public-sector activity to shape and direct national economic activity. To complete this discussion of policy implementation, we will now focus on the various strategies and procedures by which the state regulated foreign trade, foreign exchange use, and foreign direct investment.

### *Regulation of Trade*

The South Korean government has used a number of non-price mechanisms to limit imports into South Korea. First and most direct, all importers are required to have an import license. Working through the Korea Foreign Traders' Association (KFTA), which all traders must join, the MTT sets the standards for obtaining such a licence. Eligibility is usually conditional on satisfactory export performance, which is in turn based on government-determined annual requirements. Import licenses can also be quite detailed, in some cases specifying the types of products that can be imported. By limiting the number and breath of the licenses, the government is able to maintain some control over importers and imports.

Even more significant in terms of government efforts to regulate imports are the following visible and less visible controls on the quantity of imports:

*Visible restrictions.* The MTT regularly lists products whose import the government wants restricted because they are considered to be luxury goods, similar to domestically produced goods, or goods considered dangerous to public health or morals. Such goods must meet special "discretionary licensing requirements" to be imported; thus even licensed traders are required to apply for special permission to import these goods. Products that have been listed as restricted include pharmaceuticals, machinery, sewing machines, watch-movement parts, alcoholic beverage base, and automobile components.

*Less visible restrictions.* In 1967, the government shifted its import control system from a positive to a negative list system. Under the positive list system goods listed could not be imported unless explicit government permission is granted. Under the negative list system, goods listed are supposedly approved automatically for import without the need for additional governmental permission.

South Korea's trade liberalization is usually measured by the "import liberalization ratio," the percentage of imported goods that are listed as automatically approved and thus allegedly not subject to governmental nonprice restrictions. In 1988, South Korean trade officials asserted that since their country's import liberalization ratio had reached 95 percent for manufactures, South Korea had an open market-based trading system.<sup>1</sup> However, the Automatic Approval (AA) list system has many exceptions which allow the South Korean government to regulate foreign trade as it deems necessary. Among the most important are special laws, import area diversification measures, and surveillance measures.

*Special laws.* These laws affect even those items declared AA by the MTT. Among the most important are the Petroleum Refining Industry Law, Textile Machinery Import Law, Grain Control Law, Pharmaceutical Law, and Fertilizer Control Law. In a valuable study of South Korean trade practices in 1982, Richard Luedde-Neurath found that out of \$14.2 billion of AA-classified imports, imports supposedly not subject to quantitative restrictions, approximately \$8.7 billion fell under one kind of special law or another. As such, they required special permission from a relevant agency before their importation could be allowed.<sup>2</sup>

*Import area diversification measures.* Since 1977 the South Korean government has used import area diversification measures

to limit or restrict imports, especially by country. These measures can be used to control imports of items that are already under restriction; they can also be used to influence the quantity and origin of imports listed as AA. According to estimates made by Luedde-Neurath, an additional \$2.1 billion of AA-listed imports in 1982 were also affected by this measure and thus required special permission.

Imports falling under the import area diversification law must be approved by the Korea Foreign Traders' Association. Such approval must be obtained regardless of the country from which the goods are purchased, thereby making the law product as well as area specific. Automobiles are one of several significant imports regulated by this trade measure, and its effectiveness can be illustrated by the fact that no Japanese cars produced in Japan are sold in South Korea.

*Surveillance measures.* Introduced in 1978, surveillance measures were originally designed to allow the government to monitor the domestic effects of a trade liberalization initiative. They are now used for general import control purposes. Products listed for surveillance are all AA items. Initially the system was one of ex-post monitoring by the KFTA and the MTI. This was changed in 1979 when the MTI announced that surveillance imports would now require prior approval by the Korea Foreign Traders' Association at its twice-monthly meetings. Each import and its domestic impact are considered on a case-by-case basis.<sup>3</sup>

Finally, the government has also used a number of special customs and excise duties to restrict imports. As Luedde-Neurath explains:

To anyone familiar with the fact that tariffs in Korea do not currently exceed 150 per cent (formally 200 per cent), even on the most luxurious of import items, it must come as somewhat of a surprise to hear references to 400 per cent duties on golf clubs, 500 per cent on French wines, and 933 per cent on imported whisky.

The explanation lies in an array of "other" taxes that crawl out of the woodwork when the import of nonessential items is actually attempted: education tax, defense tax, special expense tax, etc. Their effect, in combination with high tariffs, is thoroughly to discourage undesirable imports.<sup>4</sup>

Such restrictions have enabled the South Korean government to tightly regulate imports. As a result, according to the MTI, luxury goods, broadly defined, constitute less than 3 percent of the country's total imports.<sup>5</sup> These restrictions have also enabled the government to direct economic activity according to its own priorities. The automobile industry illustrates the way the state has successfully combined domestic and international policy tools to pursue its industrial objectives.

#### *A Case Study of Industrial Policy: Automobile Production*

South Korea's auto industry has gone through a number of changes in response to a series of government initiatives. Phase one (1962-66) was characterized by import-processing. Semi-knocked-down components were imported from foreign car manufacturers and assembled locally. The Industry was protected by the Motor Vehicle Industry Protection Law (1962) which made the importation of assembled vehicles or parts not related to assembly uses illegal. Phase two (1967-71) was characterized by the creation of an import-substitution industry. Local production of parts and components was emphasized under the "Basic Plan for Promotion of the Motor Vehicle Industry" (1967). Phase three (1972-79) was characterized by the development of "indigenous" models of passenger cars under the "Long-Term Plan for Motor Vehicle Industry Promotion" (1973). Phase four began in 1979 with government designation of the car industry as a strategic export center.<sup>6</sup>

In response to government planning, the car industry in South Korea has emerged as one of the most successful in the third world. For example, exports of cars grew 20 percent in 1983-1984, 42.6 percent in 1984-1984, and 60 percent in 1985-1986.<sup>7</sup> By 1988, South Korean automakers were producing over one million vehicles a year, with slightly over half of this number being sold abroad. This success, as I will show next, has little to do with free-market, free-trade policies.

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### Government Control over Prices

There is no price competition between South Korean passenger car producers within South Korea. All domestic prices are set by the government based on engine size.

### Government Control over Market Entry

In 1981, fearing that the South Korean auto industry had expanded too rapidly and was in danger of undermining its own competitiveness, the government decided to protect the industry by limiting the number of producing firms to the existing five and freezing their particular areas of production. Initially Hyundai Motor Co., Daewoo Motor Co., and Kia Motor Co. were the only companies allowed to produce passenger cars. Kia was the only company allowed to produce lightweight trucks. These three firms as well as Ssangyong and Asia Motors were, however, all granted permission to produce nonpassenger commercial vehicles such as heavy trucks, buses, and tractors.

In 1985, Samsung, which had been frozen out of the industry, petitioned the government for permission to join a passenger car joint venture with Chrysler Corporation. The government said no, citing the industrial rationalization provisions of the Industrial Development Law, which gives it the authority to reject any new enterprise that it believes might negatively affect the nation's economy.

Finally in July 1989, the government agreed to end its closure of the industry. Samsung again sought to enter, but this time as a producer of commercial vehicles rather than passenger cars. However, to engage in production, Samsung needed to import technology and components. Unfortunately for Samsung, because the South Korean government also had the regulatory power to limit imports of technology, it needed to receive government approval before it could finalize its import agreement with Nissan Diesel Motor Company.

After a forty-day investigation period, the MTI returned Samsung's petition without approval. Permission was denied, according to the MTI, because the Nissan technology that Samsung wanted to import was similar to technology already imported by Ssangyong Motor Company. As Lee Kyong-Tae, chief of the MTI investigation team said, "Samsung's participation in the manufacture of commercial vehicles would not contribute to the industry."<sup>8</sup>

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### Government Control over Imports

The government has also carefully protected the development of the auto industry through strict import controls. For example, only recently did the government classify automobile imports as automatically approved. Cars with engines over 2000cc were classified AA in July 1987 and cars with engines smaller than 2000cc in April 1988. Before then, the government had direct authority to restrict automobile imports. The effect of such trade controls was clear: a total of 305 foreign cars were sold in South Korea in 1988, none from Japan. This compares with over 500,000 South Korean cars sold abroad in the same year.

With greater market freedom, however, car imports began to grow rapidly. Over 300 cars were sold in the first five months of 1989. Ford alone sold nearly 500 of its Mercury Sables in the fourth quarter of 1989 and more than 300 a month through March 1990.<sup>9</sup> The government's response was an anti-import campaign directed at both consumers and importers. The campaign was effective, producing a sharp drop in automobile imports. Ford, for example, sold only eighty-eight cars in July.

The campaign worked as follows: consumer demand for foreign cars was greatly reduced by an aggressive government tax offensive. According to a *Los Angeles Times* report:

A government official got hold of a list of 200 South Koreans who had placed orders for a European luxury car. . . . One by one, the customers were contacted by telephone and told their tax filings would be investigated if they went through with the purchase. . . . All the orders were canceled.<sup>10</sup>

South Korean car buyers are also required to purchase special bonds to support subway construction when buying a new automobile. In May 1990, to further reduce sales of foreign cars, the government raised the required subway bond purchase, making the increase substantially greater for a buyer of an imported rather than a domestic automobile. For example, the bond purchase requirement for a Mercedes buyer went up over four and one-half times to approximately 14 million won (\$20,000), while the requirement for a buyer of a domestic luxury car went up only 50 percent to 5.9 million won (\$8,500).<sup>11</sup>

Importers did not escape government pressure either. Kia, a 10 percent-owned affiliate of Ford, was Ford's sales outlet for the Mercury Sable. But as the *Wall Street Journal* explained:

Recently, Kia cut its advertising for the Sables and then its orders from Ford. Why? Because, Kia says, the Korean government told it to. Government leaders thought Korea was importing too many foreign cars.<sup>12</sup>

This brief case study of the auto industry illustrates two salient points. First, government intervention in this industry has been decisive at the macro level in terms of shaping overall automobile activity and at the micro level in terms of deciding such issues as firm entry, product specialization, pricing, and access to technology. Second, these government initiatives succeeded in creating an internationally competitive automobile industry, largely as a result of the government's ability to create a closed and profitable domestic market from which to support its export campaign.

It should also be noted, however, that anti-import campaigns such as the one described above are now being openly challenged by foreign companies and their governments, the United States in particular. In fact, South Korea's continuing determination to restrict access to its markets has already begun to trigger, in response, new and more far-reaching protectionist measures in the more advanced capitalist countries. The political dynamics and economic significance of the growing international struggle to force open South Korea's domestic markets will be considered in more detail in Part III.

#### *Regulation of Foreign Exchange Use*

South Korea also regulates imports through its ability to influence business use of foreign exchange. Each year, the Ministry of Finance receives a detailed assessment of import requirements from the various producer associations on behalf of their members. That information is then used to establish a foreign exchange demand and supply plan which sets general guidelines for foreign exchange use by the associations. The plan is administered by the individual foreign exchange banks, but it is the responsibility of the individual associations to inform their member firms of the guidelines and, if necessary, to organize a procedure for rationing imports among

them.<sup>13</sup> This process is not designed or intended to rigidly fix a precise foreign exchange distribution or use. It does, however, offer the government yet another way to monitor international transactions and, when necessary, limit imports for a given group regardless of whether they were listed as AA.

#### *Regulation of Foreign Direct Investment*

South Korea's planners have also supported their initiatives with aggressive regulation of foreign direct investment. In fact, South Korea currently has one of the most restrictive foreign investment codes in the world. Before examining the various state structures and policies used by planners to direct multinational corporate activity, I will briefly review the development of South Korea's regulatory framework as well as the country's experience with foreign direct investment.

The Foreign Capital Inducement Act (FCLA), enacted in 1960, was South Korea's first attempt to establish a legal framework for foreign lending and direct investment. This act provided a number of incentives to foreign investors but, given South Korea's unstable political situation, it proved difficult to attract multinational corporate activity. The first foreign investment project did not begin until 1962.

The Park regime's early attempts to attract multinational corporations were largely unsuccessful. Conditions rapidly changed, however, beginning in 1965. Above all, relations between Japan and South Korea were formally normalized that year. Moreover, the South Korean economy was by then growing rapidly. Later, the government began offering new incentives for foreign investors, including access to the country's first free trade zone in Masan. In response, foreign firms, especially Japanese, began greatly increasing their direct investment in South Korea.

Viewing this growing foreign presence with some alarm, the South Korean government began to re-evaluate its relatively open door policy for foreign direct investment. As Bohm-young Koo, a special economic advisor to the minister of the Economic Planning Board explains:

The government began to feel that unlimited approval of foreign in-

vestment might create some adverse effects on the domestic economy, such as the control of domestic industry by foreign firms and the resultant problem of implementing development strategies, an increase in vulnerability in times of external shocks due to potential massive withdrawals, and a hindrance to the development of indigenous firms.<sup>14</sup>

Thus, in 1973, along with the publication of its heavy and chemical industrialization plan, the government substantially revised the FCI. New eligibility requirements were announced by the government, denying any foreign investments that might disrupt either the supply or demand of raw materials and intermediate capital goods or undermine the position of national firms in either domestic or overseas markets. In addition, joint ventures were assigned priority over wholly-owned foreign ventures, and both export and minimum-per-project investment standards were enacted.

In short, by the early 1970s, the South Korean government was determined to promote production by nationally owned and controlled firms, even at the cost of greater foreign borrowing or import of foreign technology. Foreign direct investment would be restricted to only those projects that offered substantial foreign marketing benefits or advanced technical production skills.

#### The Record on Foreign Direct Investment

South Korea has been relatively successful in limiting multinational corporate investment. For example, from 1967 to 1971, the period covered by the second five-year plan, foreign direct investment equaled only 3.7 percent of net foreign capital inflows into South Korea. During that same period, the equivalent percentage was 36.6 percent in Mexico; 33.8 percent in Brazil; and 26.1 percent in Thailand. From 1972 to 1976, the period covered by the third five-year plan and the launching of the heavy and chemical industrial drive, foreign direct investment still equaled only 7.9 percent of net foreign capital inflows, as compared with 22.9 percent in Brazil, 16 percent in Mexico, and 28 percent in Thailand.<sup>15</sup>

From 1962 (when the first foreign project was initiated) to 1985, only \$2.65 billion of foreign direct investment was approved and only \$1.9 billion actually invested. Over that same period, \$7 billion was invested in Singapore, \$8 billion in Taiwan, \$17 billion in Mexico, and \$24 billion in Brazil.<sup>16</sup>

South Korea was also successful in limiting foreign direct investment to joint ventures. A 1977 study of sixty-six countries found South Korea to be the country with the lowest percentage of wholly owned foreign firms—approximately 17 percent. Next was Israel with 30 percent, followed by Japan with 33 percent. More recent figures show a significant decline in South Korea's percentage: between 1981 and 1985, only 10.7 percent of all foreign investment proposals approved were for wholly owned foreign firms; majority-owned foreign firms accounted for only another 28.1 percent.<sup>17</sup>

These aggregate figures do, however, tend to understate the impact of multinational activity in South Korea. While multinational activity accounted for less than 4 percent of South Korea's overall Gross National Product in 1977, its impact in manufacturing was substantially greater. Multinationals accounted for 16 percent of total manufacturing output and over 10 percent of manufacturing employment. They also produced almost 19 percent of South Korea's total exports.<sup>18</sup>

Although significant, it is also true that the South Korean state was able to confine multinational corporations to those industries and activities consistent with its own priorities. In the early days of industrialization, government policy attempted to channel foreign direct investment into development of synthetic fibers for textile production and into major import-substitution projects in petroleum refining and chemical fertilizers. By late 1960s, the government shifted its emphasis toward directing foreign investment into production of apparel, textiles, and electronics for export. Then, in the mid-1970s, priority was placed on directing multinational activity into targeted capital-intensive heavy and chemical industries such as chemicals, machinery, electronics, and metal products.

The effectiveness of government policy can be seen in the following statistics from 1978: the export/sales ratio of multinationals was especially high in targeted light manufacturing industries such as apparel (99.5 percent), textiles (72.2 percent), and electric and electronics (65.4 percent). Multinational corporations were also major producers in targeted import-substitution industries such as petroleum (90.4 percent of local output), chemicals (44.2 percent), electric and electronics (40.9 percent), and metal assembly and machinery (24 percent).<sup>19</sup>

## State Structures of Regulation

South Korea's success in managing multinational activity owes much to its regulatory system as defined under the Foreign Capital Inducement Act. According to this act, all foreign direct investment must be evaluated by the Foreign Capital Deliberation Committee, initially part of the EPB, but since 1981 under the jurisdiction of the Ministry of Finance. The approval process begins with a multinational corporation submitting a detailed proposal stating the terms of its proposed project, including the monetary value of the investment, the nature of the technology to be transferred, the projected output level and export/output ratio, and design of recruitment and training programs.<sup>20</sup> Such information is used by the South Korean government to not only evaluate proposed foreign direct investment activity, but also monitor approved projects.

The Foreign Capital Deliberation Committee, composed of top officials from a number of government ministries (including the Ministry of Finance, the Ministry of Trade and Industry, and the Ministry of Science and Technology) has ultimate authority to approve or reject a proposal. After receiving a proposal, the Committee distributes it to each of the relevant ministries for their own individual evaluation: the Ministry of Finance looks at the proposal from the point of view of its balance of payments implications; the Ministry of Trade and Industry considers its impact on domestic producers; the Ministry of Science and Technology looks at its impact on domestic technological development.

If any one ministry opposes the proposal it is then rejected. The government has never approved an application for foreign investment for a venture designed to produce domestic consumer goods. Moreover, no foreign firm, regardless of industry, has ever been allowed to purchase or take over an existing South Korean firm.

If all of the individual ministries approve, then the committee is empowered to negotiate with the foreign company over the precise terms or conditions under which the investment will take place. These negotiations are far from pro forma, even if the investment is part of a joint venture operation and both parties have agreed upon the terms. The Foreign Capital Deliberation Committee has often demanded renegotiation of already signed contracts if economic conditions substantially change, asking for an increase in

exports or greater domestic content in production. In some cases it has even used the Foreign Exchange Control Law to block payment of previously agreed upon service charges.<sup>21</sup>

In general, proposals for foreign direct investment in targeted capital-intensive, import-substituting industries have been supported when the government believed that it had no other alternative to obtain needed technology or raw materials. In these cases, the government offered very profitable investment incentives while negotiating very detailed agreements that specify the technology to be transferred and/or the quantity and nature of raw materials to be supplied.

In general, proposals for foreign direct investment in labor-intensive, low-technology sectors win approval only if the projects are export oriented and the government is seeking access to new foreign markets. Agreements for these kinds of investments include very high export requirements and restrictions on domestic sales.

We can see the outcome of this negotiating process in the following breakdown of contract terms for agreements signed in 1986: 38 percent of all agreements with foreign investors had specific export-level requirements; 80 percent had specific technological transfer requirements; 36 percent had specific requirements for raw material supply; and 28 percent contained agreements whereby foreign firms were required to help South Korean firms gain access to export markets. At least one of the above requirements was present in over 92 percent of the investment agreements; at least two or more were specified in over 68 percent.<sup>22</sup>

Such agreements are also closely monitored by specialized agencies in the relevant ministries. For example, the Ministry of Trade and Industry has a Foreign Investment Control Bureau whose job it is to oversee the operational activities of foreign firms. These firms must submit monthly reports which include such sensitive information as output levels, imports and exports, profit rates, domestic content, taxes paid, and numbers and nationality of employed personnel. This information is used to not only ensure that foreign firms follow existing agreements, but also strengthen the government's position in future contract renewal negotiations.

The Bureau of Customs, part of the Ministry of Finance, keeps watch over imports and exports to see that foreign firms follow

South Korean trade laws, do not import more than they are allowed based on agreements, and that charges for equipment as part of intrafirm trade are not overstated. The Ministry of Finance inspects foreign exchange transactions to ensure that multinational corporations finance their activities with foreign rather than domestic funds. Combined with the above-mentioned restriction on foreign takeovers, this policy helps to ensure that multinational corporate investment will contribute to, rather than replace, domestic activity.

#### *Disinvestment Policy*

As noted above, the South Korean state has a strong preference for joint ventures in which majority ownership is held by domestic firms. When ventures with foreign ownership levels exceeding 50 percent are approved, it is usually because they produce exclusively for export markets or transfer a key technology that cannot otherwise be purchased. However, even in these cases, it is state policy to seek eventual foreign disinvestment, leading to South Korean majority control.

This disinvestment is pursued in a number of ways. During negotiations with foreign firms the government will attempt to limit foreign representation on the board of directors to the percentage of stock owned by the foreign firm. Similarly, the government will seek contract terms that provide for significant technical and managerial training for South Korean personnel. Most important, the government will try to convince the foreign firm to accept a contract containing a divestiture agreement. This agreement would normally become operational after a given period of time (ten years) or after a certain level of profits have been earned (150 percent of original investment). South Korean firms would then typically be given the opportunity to purchase a sufficient percentage of shares (15 percent) to give them operational and financial control of the joint venture.

Because such restrictions tend to reduce South Korea's attractiveness to foreign firms, the South Korean government has had to entice foreign producers with generous financial and tax incentives or monopoly rights. Most multinationals have been willing to accept South Korean terms, agreeing to eventually yield control over the joint venture in exchange for extremely attractive short-term busi-

ness conditions. To illustrate this process, I will present two case studies of foreign disinvestment.<sup>23</sup>

#### **A Case Study: Foreign Disinvestment in Electronics and Textiles**

In the late 1960s and early 1970s, several Japanese consumer electronic and textile producers established facilities in South Korea to take advantage of the country's low-cost labor force. To attract them, the South Korean government was forced to provide tax breaks and low utility costs as well as allow them financial and operational control of their operations. In exchange, the Japanese firms had to enter into joint venture agreements and accept disinvestment stipulations.

These stipulations, requiring the Japanese firms to sell sufficient stock to give their South Korean partners majority control, came into effect beginning in the mid-1970s. The Japanese initially resisted, but South Korean state pressure eventually forced them to comply. To ensure a smooth and rapid transfer of management control, the government also offered the affected South Korean firms low-cost financing for the stock purchase.

The result: most Japanese electronics producers, including Mashushita, Toshiba, and Sony, sold all of their shares to their South Korean partners. The South Korean firms continued operations as nationally owned enterprises. Most Japanese textile producers decided to remain and accept minority status. For example, one Japanese firm ended up reducing its equity holdings from 50 percent to 33.5 percent, and turning over financial and operational control over the joint-venture to its South Korean partner.

#### **A Case Study: Foreign Disinvestment in Oil Refining**

In 1962, South Korean planners designated oil refining as a strategic import-substitution area. But, with no national firms having the necessary technological capability, the government was forced to seek foreign direct investment. Offering substantial financial incentives, the government succeeded in attracting Gulf Oil into a joint-venture agreement which created the Korea Oil Company. Gulf Oil was allowed total operational and financial control over the enterprise.

In 1965, the government decided to further expand the production capacity of the sector and deliberately sought out a new foreign partner for the venture. This time a joint venture was formed between Caltex and the government-selected Gold Star Corporation. The government was forced to offer Caltex a number of incentives, including price supports, tax breaks, and financial and operational control of the joint venture.

Further industry growth led to a 1968 joint venture between Union Oil Corporation and the Korean Explosives Corporation and a 1976 joint venture between the National Iran Oil Corporation and Ssangyong Corporation. However, in contrast to Gulf and Caltex, which enjoyed total operational and financial control over their joint ventures, Union Oil was able to negotiate total operational control but only 50 percent financial control. The National Iran Oil Corporation held an even weaker position, with only 50 percent financial control and no operational control.

By the late 1970s, sufficient national expertise had been developed to allow the government to begin a process of "nationalizing" the oil industry. After the overthrow of the Shah of Iran, the South Korean government loaned money to Ssangyong to buy out the Iranian National Oil Corporation. It then negotiated buy-outs with both Gulf and Union. By 1983, only Caltex was left, and it was forced by the government to renegotiate its contract, giving Gold Star operational and financial control over the joint venture.

South Korea's continuing progress in developing its own oil refining capabilities is reflected in the terms of a 1986 joint venture agreement between British Petroleum and Kukdong Corporation. British Petroleum holds 40 percent of equity and supplies raw materials; Kukdong has financial and operational control of the enterprise. Thus, as a result of state policy, South Korea now has significant control over an industry that was once dominated by foreign firms. It purchases its own oil on a contractual basis or on the spot market, transports the great majority of it in its own ships, and does all of its own refining in firms under South Korean financial and operation control.

Through such policies and actions as described in this chapter, the South Korean state is able to protect national firms and markets from foreign corporate control. This behavior reflects the government's strong commitment to maintain an economic environ-

ment responsive to nationally centered initiatives. In short, by combining planning and state direction of domestic economic activity with aggressive regulation of international economic activity, South Korea has been able to build a relatively diverse industrial base in a very short period of time.

#### *Evaluating the Role of the State in South Korea Industrialization*

I have so far accepted mainstream praise for South Korea's achievements without challenge and focused my efforts on refuting the conventional wisdom that attributes the country's economic success to its reliance on free-market, free-trade policies. I have done so through a detailed examination of the logic and operation of South Korean state planning and policy implementation. However, in using the South Korean state and its industrial policies as my point of entry into a larger study of the South Korean experience, I have sought only to affirm the effectiveness of social regulation of economic activity, not South Korea's specific approach to economic development.

It would be a serious mistake to conclude this work here, satisfied at having demonstrated the "superiority" of state intervention over market forces. Refutation of free-market mythology as it concerns South Korea is an important accomplishment. But it addresses only one aspect of South Korea's rapid growth. Left unaddressed are issues related to the quality, sustainability, and social consequences of this growth, issues that lead to the question of whether the South Korean economic strategy, now more accurately understood, continues to be deserving of promotion. It is this question that I will attempt to address next.

As we will see in Part II, while South Korea has indeed grown rapidly, it did so in a manner designed to enrich the few at the expense of the many. The South Korean approach to development, based on brutal dictatorship and inequality, does not deserve our support. In fact, growing numbers of South Koreans, in response to the contradictions and class conflict inherent in their country's state capitalist development, are now rapidly organizing in an effort to radically transform their own system.

Thus, while the South Korean experience underscores the importance of the state, it also makes clear that we cannot ignore the social relations that define and shape its policies. South Korea, not surprisingly, has both positive and negative lessons to teach us. Recognizing this reality means that we must do more than simply inform those who hope to emulate the South Korean "economic miracle" that it was produced by aggressive state planning and intervention, not market forces. Rather, we have the more difficult task of helping working people everywhere understand the repressive and exploitative nature of the South Korean experience while simultaneously drawing upon it to illuminate the possibilities it suggests for new and more progressive forms of social organization.

## PART II

# THE SOUTH KOREAN EXPERIENCE: THE STATE AND CLASS STRUGGLE