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**RAISING A TIGER: THE KOREAN GOVERNMENT'S RESTRCUTURING  
PLANS AFTER THE FINANCIAL CRISIS**

**- A Case Study on the Rise and Fall of Samsung Automobile Company -**

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## **Raising a Tiger: Constrained Developmental State of Korea**

### **Abstract:**

Although acclaimed as one the most successful late-industrializers in the world, the financial crisis of 1997 challenged the study of economic development to revisit Korea's 'economic miracle'. The literature has been divided for the last two decades. Especially for Korea, perhaps the most controversial issue has been on the role of the Korean government and its intervention in the economy. One of the most dominant views on this issue has been that Korea's success has been mostly due to active and productive partnership between the state and private sector, while economic policies have been largely insulated from institutional and political influences. Using the example of Samsung's failed automobile company as a case study, this article analyzes the government's restructuring efforts, especially those related to large conglomerates in chaebols, during and after the financial crisis. It argues that Korea's policy apparatus has been largely captured by clientele political concerns, which hindered the economic bureaucracy from implementing effective policies. The implication from this paper is that unlike a number of previous studies, the government's economic policies were not insulated from political pressure, and that it has constrained the government's ability to discipline the firms based on their economic policies – revealing many underlying limitations of Korea's political economy.

### **Keywords:**

East Asia; Korea; Political Economy; Developmental State; Economic Development Planning and Policy; Industrial Policy; Government Policy and Regulation on Corporate and Financial Governance

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## I. INTRODUCTION

1. Korea has been one of the most successful economies in the world, posting an average GNP growth rate of about 7 percent between 1962 and 1992. Then, with the crisis, Korea had to seek assistance from the World Bank and International Monetary Fund (IMF) as well as other multilateral development institutions, a move which was even described by some in Korea as a loss of economic sovereignty. Apparently, Korea went from what was described by Lall (1997: 13) as ‘...probably the most successful industrializer among the developing countries’ to one where the ‘...system has always been intrinsically unstable, and therefore vulnerable to exactly the sort of financial calamity that has now befallen it’ (Woo-Cumings 1997). This article attempts to reconcile this discrepancy on Korea as exposed through the crisis by analyzing the recent political economic paths of its development.

2. One of the most significant and controversial issues concerning Korea remains to be whether its downfall was at least partially (but significantly) caused by the ways in which it has developed.<sup>1</sup> If so, then it seems to indicate that the value of Korea’s economic development model needs to be critically considered again. Furthermore, a suggestion that Korea’s model was effective for its earlier development but later on led to the crisis should present a logical quandary to the students of economic development.

3. The main argument of this article is that the legacy of active government intervention (as in ‘industrial strategy’) and the close public private partnership (as in ‘developmental state’) have which significantly contributed to Korea’s recent struggles as shown through the financial crisis. Furthermore, due to such crony capitalism, the ability of the bureaucracy to formulate rational and consistent economic policies as well as the unified will of the political leadership for economic development have been greatly constrained.

4. This article uses the case of the recently failed Samsung Motors Company (SMC). Samsung Group, the premier chaebol of Korea, is the parent company of SMC. Initially, the government bureaucrats forbade the company from being launched, fearing it could create an ‘over-competition’ in the automobile industry. However, based on much intensive lobbying from Samsung Group, the political leadership gave its support to the new and fifth automobile company of Korea.<sup>2</sup> Then, when the automobile company failed (especially

due to the recession following the crisis) as many expected, the government and Samsung Group fought over the rescue plans for the firm, each blaming the other for the failure. The SMC's troubles were prolonged through three presidential administrations, all showing a significant degree of inconsistent policies and political influences on economic policy-making process.

5. The main argument is based on three major observations from this research. First, the rise of chaebols' economic power also correlates with their political power, having the ability to persuade the politicians in shaping the policies. While the government developed and fostered chaebols to quicken the pace of economic growth, its own creation became too big and powerful to be controlled later on. Second, as Korea moved towards a democratic state and held competitive elections, the political leaders have tended to increasingly consider political (especially regional political) needs of their economic policies. However, it should be noted that while political influence has increased since the 1990s, when the government became less interventionist in the economy, it has always been a significant factor in Korea's economic policies – as discussed later. Furthermore, in the case of SMC, the influence of regional rivalry was also significant. Finally, the case also shows that contrary to what is argued in the developmental state literature, Korea's highly capable economic bureaucracy was not insulated from political pressures. The case study shows that the political leaders, often captured by chaebols, regularly overruled the bureaucracy's decisions on SMC.

6. This article is divided into several sections. The next section reviews the literature on Korea's economic development (especially the industrial strategy approach) and political economy (mainly the developmental state approach). Then, a brief background on the leading Korean chaebol in Samsung Group is presented, followed by the main case study on SMC. The summary and implications are presented in the conclusion.

## **II. KOREA: SELECTIVE INTERVENTION THROUGH DEVELOPMENTAL STATE**

7. Before addressing the financial crisis-Korea model issue, a brief introduction to the literature on explaining Korea's success is needed. Indeed, there are many explanations, ranging from macro-economic stability (World Bank 1993) to factor accumulation (Krugman 1994) to government intervention (Amsden

1989).<sup>3</sup> For this study, two important arguments, pointing to the active role of the government and the nature of its policy-making process, are linked and analyzed. The first approach explaining Korea's development comes from the political economy approach. Termed as developmental state (see Johnson 1987 and Woo-Cumings 1999), it generally credits the nature of its policy-making process as the key factor behind Korea's success. The second approach deals with the active intervention and selective government policies, led by such studies as Amsden (1989) and Lall (1997). For the purpose of this article, these studies can be identified as those from the 'industrial strategist' school.

8. Establishing a link between these two schools of thought is important because it provides a more comprehensive explanation of Korea's development and its policy environment. It allows the researchers on Korea's economic development to identify the sources of its success, as well as to understand the policy and political environment in which such policies can be formulated and implemented. To state more clearly, it shows how the Korean government was able to effectively devise such selective policies with (apparently) full support of the private sector. It also seems to answer the role of each major actor in working towards Korea's development.

9. This section reviews the literature on the developmental state and industrial strategy as they relate to Korea. The reviews are brief since these issues have been extensively discussed in other studies.<sup>4</sup> Moreover, the section also provides a background analysis on Korea's development, especially on the government's fostering of chaebols, and a case of selective policy through the heavy and chemical industrialization (HCI).

#### **A. Korea as a Developmental State**

10. The notion of developmental state was created by Johnson (1982) in its account of Japan's Ministry of International Trade and Industry (MITI). Johnson noted that Japan did not appear to be a planned economy or a freely liberalized capitalist economy. Rather, it joined the planning of the state with the private sector's capitalistic drives (with virtually no equity ownership by the government). It was further argued that for government's intervention (according to Johnson, led by MITI) on economic development to become

successful, such a political economic system was necessary. This was a powerful argument against neoclassical economics, which mostly believes that less government is (almost always) better.

11. In essence, developmental states can be defined as states whose politics have concentrated sufficient power, autonomy, and capacity at the center to shape, pursue, and encourage the achievement of explicit developmental objectives, whether by establishing and promoting the conditions and direction of economic growth, or by organizing it directly, or a varying combination of both. Other major components of developmental states include: (i) determined development elites, (ii) relative autonomy of the state, (iii) a powerful, competent, insulated economic bureaucracy, (iv) weak and subordinate civil society, (v) effective management of non-economic interests, and (vi) political repression, which is common, and political legitimacy is determined by economic performance (Leftwich 1995). In sum, though the market is not replaced by the state, functions of the market are constrained and led by the priority of industrialization designed by the state.

12. There are three main actors in a developmental state. The first group is the political leadership. The developmental state approach suggests that while this group will forge close ties with the big business to receive bribes and grant patronage, it is still autonomous from their clients' influence. This autonomy is particularly facilitated by the fact that many of these developmental states have authoritarian regimes. There are two factors which link the authoritarian regime to the economic development. First, as authoritarians, the state links its political legitimacy to economic growth. Its success and support from the people are defined by the effectiveness of its pursuit for growth. As it often happens, considerations of efficiency loom large only in the minds of (neoclassical) economists; efficiency, as Strange (1988) argues, does not necessarily command priority in national economic policies of developing nations, as the top priority seems to be national efficacy.<sup>5</sup> Second, as a political force, it is able to lead its people and make decisions that the market can not easily make—mainly, mobilizing the work force to share the burden of economic development. Thus, it is no coincidence that labor unions or related civil society members have not been strong in Korea as in other countries.

13. The second group is the bureaucracy – which is critical in the developmental state. Competent, meritocratic bureaucracies and the concentration of decision-making power in relatively insulated economic agencies played a crucial role in the model of the developmental state. By socializing government officials towards the common goal of economic growth, meritocratic bureaucracies limited the opportunities for rent seeking (Evans 1995). Johnson (2001) states that the insulation from political and social pressures that the bureaucracy enjoys allows it to be more experimental and undoctinaire than in the typical regimes.

14. Finally, the third group is the private sector (big business) – which has been the main instrument which the political leadership and bureaucracy could utilize in their pursuit of economic growth. As the developmental state is committed towards economic growth, it is necessary to have the cooperation of the private sector to ‘avoid an emphasis on either private profit or the state's socialization of wealth’. (Johnson 1999: 57). Evans (1995) further argues that an ‘embedded autonomy’ (in government’s relationship to business<sup>6</sup>) was the key to the developmental state’s effectiveness (in contrast to the failed and predatory states of Brazil and India). Based on this network and competency of bureaucracy, the developmental state is defined by its autonomy and capacity. However, only when *embeddedness* and *autonomy* are joined together can a state be called ‘developmental’ – as other interests can capture the state that is only embedded.

15. Much of Korea’s political economy for development can be explained via the developmental state approach. Firstly, it is true that Korea had a repressive authoritarian state which staked its legitimacy on economic growth. When Park came to power, Korea was in deep economic poverty with the GNP per capita of only \$87 in 1962. Thus, it was critical for President Park to foster economic development—in fact, in seems clear that he staked his political legitimacy on it.<sup>7</sup> Secondly, it is also clear that Korea had a very competent and hard-working bureaucracy. Based on merit-based civil service exams which were very competitive, the government was able to select from inarguably the best pool of human resources in Korea.

16. Thirdly, the large business groups in chaebols were mostly created and fostered by the government as it sought for entrepreneurs to operate the former Japanese owned businesses after the World War II-

colonial period. Then, during the Park Administration (1961-1980), the government rearranged many of the large companies to develop a selected number of large, and family-owned, business groups. Chaebols learned an important lesson from the government, when, in early 1960s, it arrested a number of chaebol owners with charges of bribery or tax evasion. Only those remaining, with close and submissive ties to the government, were able to receive support. As Table 1 shows, five of the top ten chaebols in 1994 could trace their origins back to the 1960s.

17. In discussing Korea's economic growth, the importance of chaebols cannot be over-estimated. The Park government selected a number of firms to become chaebols, supplying them with capital (with policy loans), domestic market (with import protection), cheap labor (with strict labor laws), and export assistance (with various incentives).<sup>8</sup> In return, chaebols were asked to enter targeted industries, increase production and export, as well as reduce unemployment. The government was able to discipline them by controlling capital, which was probably its most effective policy tool. It has been estimated that, from 1962 to 1985, 57.9 percent of the total loans in Korea were considered as policy loans, given mainly to chaebols at subsidized rates. Even when the banks were privatized in 1985, the policy loans increased to 67.6 percent, illustrating that such government influence continued (Chang 1993: 23).<sup>9</sup> With the control of domestic market and the resources, most chaebols were able to export to foreign markets, initially at loss-taking prices. In turn, chaebols charged artificially high prices in the domestic market, a move condoned by the government (Lee 1991: 59).<sup>10</sup>

**Table 1: Top Ten Chaebols from Late 1950s to 1994**  
(Based on Total Sales)

Late 1950s	Mid 1960s	1974	1983	1988	1994
1. Samsung <sup>b</sup>	Samsung <sup>b</sup>	Hyundai <sup>a</sup>	Hyundai <sup>a</sup>	Daewoo <sup>a</sup>	Samsung <sup>b</sup>
2. Sambo	Samho	L.G. <sup>b</sup>	Samsung <sup>b</sup>	Samsung <sup>b</sup>	Hyundai <sup>a</sup>
3. Gaipoong	L.G. <sup>b</sup>	Samsung <sup>b</sup>	Daewoo	Hyundai	Daewoo
4. Taihan	Taihan	Hanjin <sup>a</sup>	L.G. <sup>b</sup>	L.G. <sup>b</sup>	L.G. <sup>b</sup>
5. L.G. <sup>b</sup>	Gaipoong	Ssangyong <sup>a</sup>	Ssangyong <sup>a</sup>	Ssangyong <sup>a</sup>	Sunkyong
6. Dongyang	Samyang	Sunkyong <sup>a</sup>	Sunkyong	Hanjin	Lotte
7. Keukdong	Ssangyong <sup>a</sup>	Kor. Exp. <sup>a</sup>	Kor. Expos. <sup>a</sup>	Kor. Expos. <sup>a</sup>	Hanjin
8. Hankook	Hwashin	Dainong	Hanjin	Sunkyong	Ssangyong <sup>a</sup>
9. Donglip	Panbon	Dongah	Kukje	Dongah	Kor. Expos. <sup>a</sup>
10. Taichang	Dongyang	Hanil	Daelim	Kia	Kia

Note: <sup>a</sup> These firms have been top ten chaebols from early 1960 to 1994.

<sup>b</sup> These firms have been top ten chaebols from late 1950s to 1994 (Samsung & L.G.).

Source: Eun-Mee Kim (1998).

18. Thus, it seems that many of the components of developmental state were present and active in Korea. The issue remains, however, on whether the actors were solely aligned in their actions without capturing another's interest. The effectiveness of the use of 'carrots and sticks' by the government needs to be questioned, especially with the frequent clientele politics between the political leadership and big business groups. In other words, although the political leadership's seeking legitimacy through economic growth and controlling the chaebol groups via provision of rents have been important, the significance of chaebols to provide political funds to the leadership and influence its decision-making process can not be easily underestimated. In this, the bureaucracy's freedom to formulate and implement policies without political pressures needs to be questioned as well.

## **B. Industrial Strategies of Korea**

19. The studies on developmental state can be linked to another seminal group of studies, termed in this article as 'industrial strategy' school. One of the leading studies in this area was done by Amsden (1989). Amsden argues that the process of latecomer industrialization (as a process of technological learning) is marked by various market failures and inefficiencies, hence the need for government intervention. She argues that what is needed here is not to get the 'price right' (meaning market efficiency) but to get it wrong (meaning reallocating resources based on the government's intervention to seek more dynamic industrialization). In Korea's case, the ability of the government to discipline the private corporations to demand performance (as measured by export success, employment, and technological capability) has been essential. The main thrusts of this intervention include: (i) selective industrial targeting, (ii) infant industry protection, (iii) fostering of domestic entrepreneurship, and (iv) export promotion that allowed the firms to become successful technological learners and industrializers. Lall (1997: 30) concludes:

*The success of the Korean strategy was based on the Korean government's ability to devise and implement flexibly a coherent set of policies, where the different elements dealing with incentives, capabilities, and institutions supported each other; while relying on and getting cooperation of the private sector.*

20. The most intense use of the industrial policy was seen in the HCI drive.<sup>11</sup> The HCI involved having the government select a number of heavy and chemical industries (machinery, steel, ship-building, petrochemicals, automobiles, non-ferrous metals and electronics) for the most wide-ranging promotions, as shown

in Table 2. According to Chang (1996), the structural transformation of the manufacturing sector, due largely to the government's HCI during the late 1970s, was the key to its success. He also argues that a major reason for the government's effective intervention was in its selectivity. The ones involved in electronics, automobile, and heavy industries were selected based on their export potentials, technological capability, and employment opportunities they afforded. According to Chang (1996: 113), the HCI promotion has been a huge success for Korea as, he states, '...most of Korea's major industries have been designated as priority sectors at some stage and were developed through a combination of massive support from and heavy control by the state'. The other key policy tools include: rationed credits, state investment funds, preferential tax treatments, as well as import protection and entry restrictions. In exchange for this support, the firms became subject to state controls on technology, market entry, capacity expansion, and prices.

**Table 2: List of Major Government Involvement in the HCI**

Item	Machinery	Ship-building	Electronics	Petro-Chem.	Iron & Steel	Non-ferr. metals	Textiles
<b>A. Regulations</b>							
1. Entry Restrictions	•	•	•	•	•	•	•
2. Capacity Regulations							
a. Setting up Facility Standards	•	•					
b. Capacity Expansion Approval				•	•		•
c. Incentives for Facilities	•		•				
3. Production Regulation							
a. Regulation of Material Imports					•	•	
b. Production Standards	•	•	•		•	•	
c. Technology Imports	•		•		•	•	
4. Price Control				•	•		
5. Reporting and Inspection	•	•	•	•	•	•	•
<b>B. Rationalization</b>							
1. Rationalization Program	•	•	•	•			•
2. R&D Support							
a. Subsidies to R&D	•		•	•	•		
b. Joint R&D Projects			•				
<b>C. Financial Support</b>							
1. Special Purpose Fund	•	•	•		•	•	•
2. Financial Assistance	•	•	•		•	•	•
3. Subsidies							
a. Direct Subsidies	•					•	
b. Reduced Public Utility Rates	•				•		
4. Tax Preferences							
a. Special Depreciation	•						
b. Tax Reduction/Exemption	•	•	•	•	•	•	
<b>D. Special Industrial Complex</b>	•		•	•			•
1. Administrative Assistance							
a. Facilities Overseas Activities			•		•		
b. Purchase Of Raw Materials					•	•	
<b>E. Producers' Association</b>	•	•	•		•	•	•

Source: Chang (1994: 115)

21. For HCI, the government planned to invest \$9.6 billion (an enormous sum considering the size of Korea's economy at that time), with only 30 percent of the investment expected to come from the private sector. To prevent foreign ownership of strategic industries, the government set a limit of less than majority of Foreign Direct Investment in any joint venture. From 1973 to 1979, the government also allocated 32 percent of all foreign loans to HCI. The loan payments were guaranteed by Korea Development Bank (KDB) other commercial banks which were controlled by the government.

22. The promotional/interventionist policies were clearly extensive. In some ways, the business leaders had little choice but to follow the HCI plans. Those who followed the president's ambitious drive were generously rewarded, while those who refused to comply were punished (by a reduction in their access to finance). Furthermore, this was a lucrative deal for chaebols despite the HCI's high risks. The government guaranteed their foreign loans and even contributed, in various ways, about 20 to 30 percent of the costs in order for them to participate. Table 3 shows that a small number of top chaebols have dominated the HCI.

**Table 3: Major Chaebols' Participation in the HCI**

Industry	Chaebol	Industry	Chaebol
1. Automotive	Daewoo, Hyundai and Kia	1. Construction	Daewoo and Hyundai
2. Locomotive	Daewoo and Hyundai	2. Heavy Machinery	Daewoo, Hyundai and Samsung
3. Ship Engines	Daewoo, Hyundai and Ssangyong	3. Electric Power Plant Construction	Daewoo, Hyosung, Hyundai and Samsung
4. Automobile Engines (Diesel)	Daewoo, Hyundai and Kia	4. Electronics	Dae-Han Cables, L.G. and Samung
5. Ship-building	Daewoo, Hyundai and Samsung	5. Textiles	Korea Explosives, L.G. and Ssangyong

Source: Data Obtained from KDI.

23. Although criticized by many, including the World Bank, as a selective and distortive set of policies, the government did not believe that Korea could achieve its goals of political independence and sustained economic growth by simply following its comparative advantage. It ignored this basic principle, confident that it was the correct choice. A former Governor of the Bank of Korea offers a blunt description of the government's attitude:

*Don't listen to 'comparative advantage' advice. Whenever we wanted to do anything the advocates of comparative advantage said, 'We don't have comparative advantage'. In fact, we did everything we wanted, but whatever we did, we did well. (Cyhn 2003)*

This statement can only be evaluated after determining what 'doing well' can represent. It is true that government policies dramatically increased exports and overall growth. At the same time, it would be erroneous to suggest that the government intervention was the sole factor behind Korea's growth. The fact that Korea had a high level of human capital (and entrepreneurship), a reasonably stable society, the relatively open export markets, as well as the low exchange rate of Japan's yen, have all contributed to its growth. Furthermore, while the HCI did increase production and exports, it also caused many macro-economic problems. As soon as the HCI was initiated, the 1973-1974 oil crisis emerged. Internally, the government was divided into two camps: the first one (led by the Economic Planning Board [EPB]) argued that the HCI should be slowed down as a result, while the other (led by the HCIPC – the HCI Planning Committee) argued that it should continue. President Park wanted to push forward the project, investing more funds and shortening the construction period. The over-supply of HCI goods relative to demand caused inflation and inefficiency. The quickening pace of the HCI also increased costs higher than the government expected—due mostly to the inflation and excess capacity. This also raised the price of domestic consumer goods (which did not enjoy any financial assistance from the government), leading to hoarding by consumers and furthering inflation. At the industry level, the HCI promotion led to the 'gold-rush'-like entrance by firms, especially chaebols. This led to over-investment and, later, idle factories.

24. According to Pack and Westphal (1986), the HCI was costly because it was too broad based and spread out too thinly over a multitude of activities (also see Timmer 1999). Of course, while the factories were idle, interest payments due from foreign loans were snowballing.<sup>12</sup> The downturn of the economy due to HCI was an opportunity for the EPB to take power away from the Blue House's economic affairs staff. In December 1978, President Park appointed Hyon-Hwak Shin as the head of the EPB. The newly energized EPB wanted to downscale (or retreat from) the HCI and after several struggles with MOTI and the others, it convinced President Park of the need for an adjustment plan. General Doo-Hwan Chun, who became Korea's president after Park's assassination, further increased the scope of adjustment. Afterwards, in reconsidering the HCI, the EPB stated,

*Investments to HCI required mobilization of huge amounts of funds and high technology which could not be afforded in the mid-1970s. This over-investment mainly caused evaporation of the capital and chronic inflation. Over-allocation of limited resources to HCI weakened the growth of the light industry, which was major export industry, exacerbated trade deficit and unbalanced industrial structure... Based on the self-reflection that economic trouble (in the late 1970s and early 1980s) was caused by the state's mismanagement of economy, we learned to respect self-regulation by the private sector and decided to transform our economy to the direction of forging competitions in industrial policy making and management. (EPB 1994)*

An official from the Ministry of Science and Technology stated,

*The 1970's HCI-fostering policy contributed to laying the foundation for Korea's heavy industry development. But judging from those days' economic situation and world economy trend, it resulted in the weakness of Korea's international competitiveness and the decrease of Korea's world market share... (Interview)*

25. While it is beyond the scope of this article to extensively analyze the HCI's effectiveness, it is nevertheless important to note that there were significant political reasons behind the HCI selectivity as well—mainly, military purposes (Krueger 1979). With the declining U.S. aid, the Park government was not only interested in those industries that were economically beneficial, but also those that can fulfill its goal of military self-reliance. As a former general, President Park's drive to strengthen the military was important not only for national security, but also to ensure the continuance of his regime.

26. In summary, this section has attempted to show a balanced view on the impact of the government's selective policies, particularly the HCI. While these policies have given firms important opportunities to industrialize and learn foreign technologies, the inefficiencies of the HCI, distortions of the chaebol promotions, abuse of export promotion, and the erratic changes involved in foreign technology inflow (including foreign direct investments) have, at the same time, caused many significant problems for Korea. Therefore, it seems that as the selective policies have shown many problems which lead to question their overall effectiveness, it is also important to note that they have been at least partially swayed by political influences – and dominated by a few chaebol groups.

### **C. Conclusions: Linking Developmental State and Industrial Strategy**

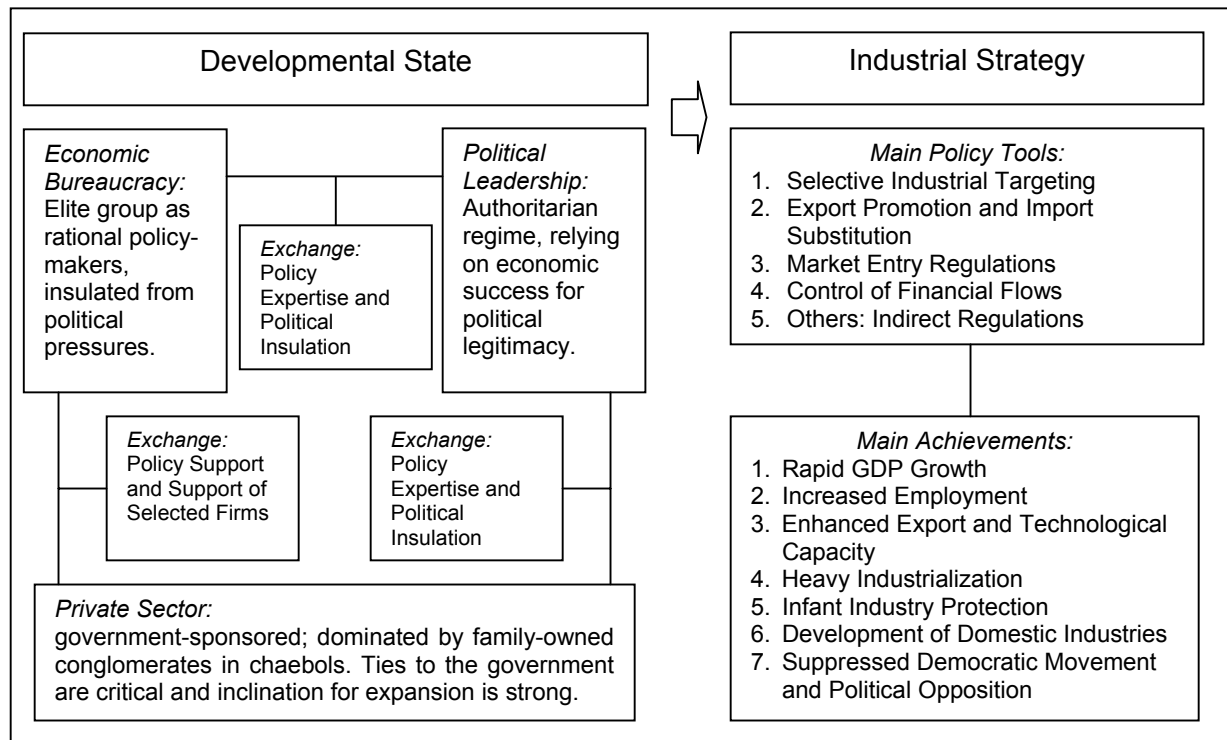
27. Linking the two schools shows that Korea can be viewed as a determined state, with both political leaders and bureaucrats staking their legitimacy on economic development. The state is able to plan for its

industrialization without much interference. If deemed necessary, the state is willing to distort the market in order to support a selected number of firms. While selecting the firms, the state is also able to control their potential abuses by strictly demanding high-level performance in return. If the firms are able to meet the demands, they are further rewarded, otherwise they are quickly punished. Indeed, in some cases, the Korean government even demanded that failing firms be acquired by more successful ones.

28. As shown in Figure 1, the developmental state creates the political economic environment where the selective industrial strategy could be formulated and implemented. The three pillars of the developmental state—political leadership, bureaucracy, and private sector—have been engaged in exchange-oriented relationship which reflects the embedded autonomy as analyzed by Evans (1995). Although many aspects of Korea's political economy reflect this approach, there are also a number of significant factors, as shown in the case study, which would require a more in-depth analysis.

29. Essentially, this article suggests that the above approaches overlooked a number of key factors in Korea's political economy, which will be illustrated by the case study below. These factors include: (i) changed (or evolved) balance of power between the state and business; (ii) political needs of the political leaders in making important economic policy decisions; (iii) ability of the business to influence economic policies in their favor; and (iv) ineffectiveness of the bureaucracy to challenge the decisions of the political leaders. In sum, the developmental state approach ignores the political needs of the state in making economic policies. This is especially true for the Korean state, which lacked political legitimacy and unity due largely to regional rivalries and economic policies which have been widely used to gain either broad or clientele political support.<sup>13</sup> At the same time, the private sector led by chaebols was increasing its power to lobby and shape economic policy decisions, sometimes using the state's political needs as leverage. The bureaucrats, thought to be independent from outside pressures and in complete trust of the leaders, were often either influenced or marginalized by both chaebols and political leaders. The political leadership often exercised its right make personnel decisions to ensure the loyalty of the bureaucracy. All these meant that, the state did not (or could not) always make sound policies based on economic needs, and that its ability to reward and punish the private sector based on its performance was seriously blurred as well.

**Figure 1: Linking Developmental State and Industrial Strategy**



### III. THE CASE STUDY OF SAMSUNG MOTORS COMPANY

30. This section presents the case study of this article. It begins with the background description of Samsung Group, the leading chaebol in Korea, followed by the case study of its entry to the automobile industry. A summary of its failure in 1998 after the financial crisis follows.

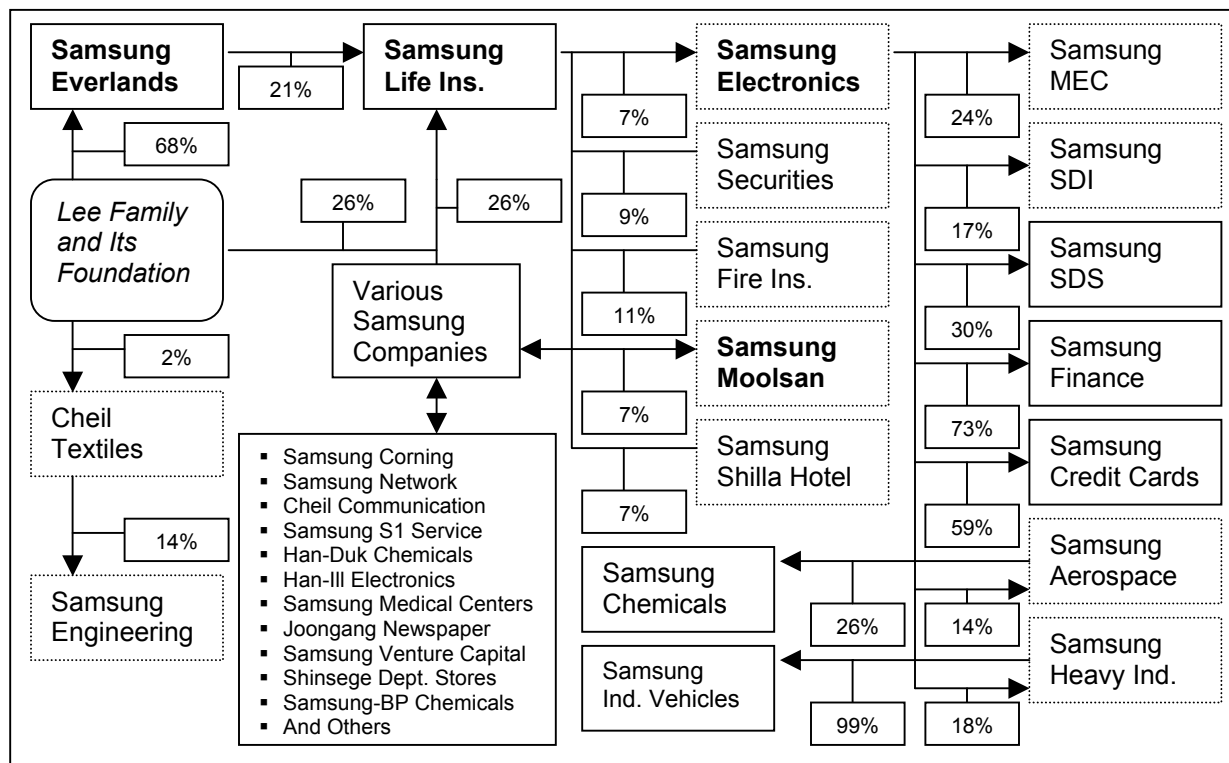
#### A. Background on Samsung Group

31. Samsung Group is perhaps most representative of Korean chaebols. Comprised of 54 affiliated companies with about 267,000 employees in 63 different countries, it posted a net sales of \$96 billion in 1997 when the SMC marketed its first series of cars. It was founded in 1938 by Byung-Chull Lee. The first company was called Samsung General Store, later to be called Samsung Moolsan or Samsung Corporation, and is now the Group's main trading company. After the Korean War, when Koreans had to import daily necessities, Samsung set up sugar and clothing production facilities which became the foundation of its growth. Since 1994, Samsung has been consistently listed among the top fifteen companies in *Global Fortune 500*.

32. Samsung Group consists of a number of companies based on cross-ownership and interlocked boards of directors (shown in Figure 2). The ownership of the companies by the Lee Family begins with Samsung Everlands, an entertainment and theme parks company. It owns Samsung Life Insurance Company, an unlisted company, which in turn owns, with other Samsung affiliates, Samsung Electronics. Samsung Moolsan, a general trading company, is another big instrument of the family in the ownership scheme. This method of ownership, which is common among other chaebols, has been a significant issue for corporate governance in Korea.

33. Despite its success, Samsung's new chairman, Keun-Hee Lee, the founder's third son, sought a new, large-scale business which Samsung could enter. Why Samsung sought the automobile industry rather than others has not been fully answered. Based on interviews, it was suggested that the management was seeking a large-scale industry with many diffusion and linkage prospects with other affiliated firms, and automobile became a 'reasonable' choice.<sup>14</sup>

**Figure 2: Ownership of Samsung Group in 1997**



Note: The listed firms are in dotted boxes.  
Source: Based on field research.

## **B. Samsung's Attempts to Enter the Automobile Industry (1992-1994)**

34. In July of 1992, Samsung's entry into the automobile industry became official with the application for technology licensing to the Ministry of Trade and Industry (MOTI). All Korean firms are required to seek the government's approval in attaining foreign technologies. Thinking this was merely procedural, Samsung was initially confident about receiving the authorization and that, even if indirectly, it would be considered as a sign of support from the government. By 1993, the plans for the automobile industry became much more publicized and further strengthened Samsung's determination. This was marked by a public seminar held by Samsung Economic Research Institute which supported SMC's establishment. The final step towards the establishment of SMC was in April of 1994, when it reached a technology licensing agreement with Japan's Nissan.

35. While Samsung was finalizing its efforts to enter the industry, the government was still divided. One side argued that Samsung had the right to enter any industry, and based on its successful track record, it would only have a positive effect on Korea's economy. Furthermore, the Korean automobile industry, then dominated by Hyundai, Daewoo, and Kia (and to a lesser degree Ssangyong), can benefit from the increased competition. Those who argued against Samsung's entry believed that this was not only a case of 'unnecessary' competition, and it would strengthen the chaebols' economic power. Thus, for them, Samsung's entry was a 'no-win' situation: if it succeeds, it would increase the chaebols' domination of the Korean economy, and if it fails, it would have a serious effect on the entire economy due to its size.

36. Nevertheless, the MOTI still delayed the approval of its technology licensing application (this became, in effect, a market entry license) and waited for the political leaders to finalize their decisions. As the decision of the SMC entrance was in the hands of political leaders (mainly the President's Office – the Blue House), it in effect became a political, rather than a simple economic, issue. Samsung was willing and quite capable of playing this 'political' game. A manifestation of this was a report that Samsung promised to build its factory in Taegu, the political home base of then President Tae-Woo Roh. However, the plan for the Taegu factory was quickly changed when Young-Sam Kim became president in 1993. President Y.S. Kim faced further dilemma in dealing with Samsung's request to enter the automobile industry, especially since then candidate Kim

argued for curtailing chaebols' economic power during the campaign. Knowing this political difficulty, Samsung promised Kim what was once promised to Roh—building the SMC operations in his political home base, Pusan. With the decline of the clothing and textile industry, Pusan's economy was facing difficulties. Samsung, as well as local politicians, argued that SMC was needed not only to boost the local economy but also to secure its political support.<sup>15</sup>

**Table 4: Total Automobile Production in Korea During the Early 1990s**

Category	1991	1992	1993	1994	1995
By Company:					
Hyundai	767,090	859,250	960,057	1,134,611	1,231,452
Kia	425,296	502,227	599,904	619,875	700,192
Daewoo	203,792	179,020	300,094	340,707	472,089
Ssangyong	24,663	21,439	22,075	46,375	54,758
Others	70,058	161,618	163,494	164,204	166,126
By Type:					
Passenger Vehicle	1,158,245	1,306,752	1,805,895	1,805,895	2,102,842
Commercial Vehicle	332,654	417,802	452,955	499,877	521,775
<b>Total</b>	<b>1,490,899</b>	<b>1,724,554</b>	<b>2,305,772</b>	<b>2,305,772</b>	<b>2,624,617</b>

Source: Kia Research Institute (1996).

37. While Samsung was pursuing to establish an automobile company, it was also seeking to acquire another automobile company. By the end of 1993, Samsung's various affiliated companies acquired up to 10 percent of Kia Motors, the second largest automobile company in Korea.<sup>16</sup> However, due to much pressure from the popular press and government, Samsung began to retreat; starting with the announcement in 1994 by Samsung Life Insurance Company that it will begin to sell its shares (about 2 percent).<sup>17</sup> Samsung was now more determined to establish its own company, as it was the only way to enter the automobile market; and further pressed the government and politicians for their endorsements. The state of the Korean automobile industry is briefly outlined in Table 4.

38. The decision became more complex as somewhat surprisingly, the Minister of MOTI publicly announced in May of 1994 that it has turned down Samsung's request for technology licensing from Nissan, thus formally blocking its entry into the industry. The minister later stated rather boldly that '...SMC can never succeed. Not only will it be a failure but it will also wrinkle our entire economy'. The Minister further cited the following reasons for disallowing the establishment of SMC: (i) redundant investments; (ii) protection of current automobile industry; and (iii) continued policy of encouraging chaebols to specialize (in which Samsung's main business was to be electronics).

**Table 5: Capital and Finance of SMC by End of 1997**

(Unit: Percentage and ₩100 million)

<b>Registered Capital</b>		<b>Loans and Financing</b>		
Pan-Pacific Investments	31.0%	<i>Banks:</i>	Hanvit Bank	₩4,300
Samsung Electronics	21.1%		Cho-Heung Bank	₩500
Samsung SDI	7.4%		Korea Exchange Bank	₩1,200
Samsung Electro-Mechanics	6.1%		Korea Development Bank	₩3,400
Samsung Heavy Industries	2.5%		Shinhan Bank	₩200
Samsung Everlands	1.2%		Koram Bank	₩700
Others	0.3%		Hanna Bank	₩200
Samsung Employees	30.3%		Kookmin Bank	₩200
<b>Total</b>	<b>₩8,054</b>		Kyongnam Bank	₩700
		<i>Non-Banks:</i>	Samsung Life Insurance Co.	₩5,400
			Various Financial Companies	₩255
			Lease	₩1,853
			Corporate Bonds	₩18,574
			Others	₩6,000
			<b>Total</b>	<b>₩43,482</b>

Source: Various Newspaper Articles.

39. Having already invested heavily into the entry, Samsung did not quit. It first sought the help from Pusan's politicians, most of whom belong to President Kim's Democratic Liberal Party. By 1994, with increasing pressures from his political followers, President Kim was beginning to change his mind. The Samsung executives considered this as a sign that they were gaining momentum. With the 'One Million Signatures for SMC' campaign active in Pusan, the political and personnel settings were now becoming firmly established for the government's support of the automobile company. It was no coincidence that the President's party was in a serious risk of losing the upcoming nation wide local election.

40. Finally, at the end of 1994, despite objections from the bureaucracy, Kim's administration approved the foreign technology licensing application, thus formally granting SMC's entrance into the automobile industry. SMC promised publicly that it would not recruit technicians from other automobile companies, and that it was to become a mainly export-oriented company, increasingly using domestic components. The make-up of its financial sources is outlined in Table 5. SMC's plant was established in Pusan on June 1995. Although SMC complained that the real estate price of ₩850,000 per 3 sq. meters was too high, the

government did not intervene. Thus, with the ambitious plan to invest over ₩10 trillion for the next ten years, Samsung began its automobile adventure in 1995, with the plan to introduce its new car line by end of 1997. Along with SMC, about 1,000 SME suppliers moved to Pusan as well.

### **C. The Financial Crisis and Fall of SMC**

41. By the end of 1997 the financial crisis hit many parts of Asia, including Korea. The economy, which averaged a healthy 6 percent growth in GDP annually during the 1990s, actually contracted by about 2 percent in 1998. This was inarguably the worst time to start a new automobile product line. Despite the 'buy Samsung car' campaign by the employees of Samsung and its affiliated companies, SMC only sold about 50,000 cars despite the production capacity of 250,000 in 1998. For the year 1998, SMC's loss was about ₩470 billion (about \$10,000 per car). It was estimated that SMC spent about \$30,000 per car, while its rivals, Hyundai and Daewoo only spent about \$3000 and \$3500 respectively.

42. To many, SMC's experience became symbolic of chaebols' failure due to over expansion. It also became a controversial topic for the presidential election of 1997, where all the major candidates, weary of Pusan's voters, promised to keep SMC alive with government support. Then candidate D.J. Kim (who was later elected) boldly claimed, '...SMC must be kept alive. It is critical not only for Pusan, but for our entire economy'.

43. Although it only began to sell in March, by the mid-1998, it was apparent that SMC could not survive the bad economy. Although Samsung Life Insurance Company made additional capital infusion, it was mostly considered as insufficient. One indication was that the Hanvit Bank, its major lender, announced that the company was basically bankrupted in June 1999. In December of 1998, only 9 months after it began, SMC came to an end as it suspended its production facilities in Pusan.

44. To rescue the failed company, there were three main suggestions, all of which came to much opposition. First, Samsung proposed that the Samsung chairman would pay for the bad debts and restructuring of SMC by his own wealth. This was to be done by having the government allow Samsung Life

Insurance Company to be listed in the Korea Stock Exchange, a move which was resisted by both the government and public interest groups. The second proposal was to sell SMC to a foreign company. However, as SMC was clouded with a debt of almost \$4 billion, it was not likely that Samsung would find a willing buyer at a good price. The government made the third proposal: it entailed swapping of troubled businesses between chaebols. In this case, the Blue House proposed that Daewoo give its electronics company to Samsung for the latter's automobile company.<sup>18</sup> Called the 'Big Deal', it leads the major chaebol groups to swap affiliated companies, so that Hyundai would specialize in automobiles and heavy industries, L.G. on chemicals, Samsung on semiconductors, and Daewoo on various other consumer products.

45. Samsung's call to list its Life Insurance Company in the stock exchange was initially approved by the government. Samsung has been seeking to list its insurance company for the past ten years. However, the government resisted since, as a cooperative (with consumers as investors), the shares should belong to the customers. If listed, the government worried that with the expected price of ₩700,000 per share, it would reaffirm Samsung's financial dominance. It was known that Samsung's affiliated companies own about 55 percent of the insurance company (worth more than ₩8 trillion). Chairman Lee owns about 20 percent, worth close to ₩3 trillion. Lee promised that his shares would be sold to pay for the debts and other restructuring costs of SMC, and place the company under court management.<sup>19</sup>

46. Although the Financial Supervisory Commission quickly endorsed the plan by Samsung, it quickly reversed its decision after being heavily criticized by the popular press and academia.<sup>20</sup> Although the call by the government during the crisis was 'sharing the pain and costs of recovery', it was estimated that the listing of the insurance company, although allowing for the restructuring of SMC, would actually make Samsung Group wealthier. Perhaps more importantly, at least in terms of political / public relations, it would also make the Lee Family much more wealthy. Furthermore, it would also give Chairman Lee's son sufficient resource to control Samsung Group – the public further criticized the continuation of the 'Emperor Management'. Due to these pressures, the government reversed its decision to allow Samsung to resolve the SMC problem by using its own financial resources.

47. Another plan which was considered involves the 'Big Deal' method. Basically, it would entail SMC going to Daewoo Group, in exchange for Daewoo Electronics. Although the government saw this as a quick solution to the SMC issue, as well as to address the ailing Daewoo Group, this plan faced much opposition from Samsung. Essentially, Samsung did not want to absorb Daewoo Electronics, and continued to press for its own survival plans as discussed. Although not discussed here, the failed Big Deal also marked a serious blow to Daewoo, which later announced bankruptcy, with its founder going to Europe for exile. Then, Samsung showed some interest in acquiring Daewoo Motors, as Hyundai acquired Kia Motors.<sup>21</sup>

48. Finally, without any restructuring plan accepted by neither the government nor Samsung, SMC was placed in court management while it was looking for an overseas buyer. After much negotiation, France's Renault purchased SMC for \$560 million (compared to the overall investment of about \$4.5 billion). About 4,000 of the 6,000 employees in SMC's Pusan factory lost their jobs. As the automobile industry made up about 10 percent of Pusan's GDP, this was a significant blow to its local economy. It resulted in the highest unemployment rate in Korea of 12 percent (when the national average was about 7 percent).

#### **IV. CONCLUSIONS AND IMPLICATIONS**

49. This article analyzed the rise and fall of SMC. Embattled with opposition from the government bureaucracy, SMC eventually had to sell to France's Renault for a fraction (about \$500 million) of its original investment. Through this, a deeper insight into Korea's political economy and its decision making process were revealed, allowing this article to argue that the chaebols' increasing political power has constrained the government's ability to formulate policies and discipline firms for not following them. As the case study showed, this "*politicalization*" of the economic policy making process was a significant factor for Korea's struggles through the financial crisis.

50. Furthermore, it seems that the SMC example was not an isolated case. There were a number of other chaebol groups which played the political game based on economic policies (Cyhn 2003). Hyundai Group, another leading group, convinced the government for its support for the establishing ties to North Korea. This effort has been less than fruitful, and has caused the near-bankruptcy of the Hyundai Group

(which is now separated from Hyundai Motors, Hyundai Heavy Industries, and others). Hyundai is part of the current government's investigation for violating the national security law – by channeling a few hundred million dollars to North Korea. Daewoo Group, once a favorite of President D.J. Kim, has filed for bankruptcy and its chairman is in current exile. The chairman's struggles with the political leadership and bureaucracy were infamous in Korea. When he threatened to release the names of the politicians and top bureaucrats whom he received bribes from Daewoo, the government forced his exile. Finally, although L.G. Group was perhaps the least affected by political considerations, it lost its semiconductor business to Hyundai through the "Big Deal" as discussed earlier. All these cases indicate that the crony capitalism is much more widespread than the SMC case presented here. Furthermore, although there are those who suggest that the government has almost eliminated its HCI-like intervention since the 1990s (see Chang 1998), the case here shows that the government was very actively involved in economy – in both macro- and firm-levels. What may be striking in this case is that the government was never absolute in its decision – easily swayed and influenced by the external actors (i.e., chaebols, regional politics) – which is contrary to the arguments of the developmental state.

51. Indeed, from the beginning, the government wavered about SMC. Strong opposition from the bureaucracy notwithstanding, Samsung lobbied intensively until President Y.S. Kim finally approved the establishment of SMC. Samsung's promise that the main factory would be located in Pusan, Kim's political base, undoubtedly influenced the decision as well. This was in conflict with the original policy framework of the government, which called for downsizing, and further specialization of chaebols. As it turns out, the bureaucracy was not insulated from political pressures, and the needs of politicians were highlighted.<sup>22</sup>

52. The apparent vacillation of the government was further revealed when, after the crisis, it was clear that SMC had to be shut down. First, the government's effort to restructure the chaebol groups was considered ineffective, as only a few chaebols have agreed to engage in the Big Deal. Furthermore, only a small number of companies were exchanged by chaebol groups based on the Big Deal plans. It has led many to question whether the decision was based on economic rationality or political efficacy. Second, the bureaucracy originally approved Samsung's plan to list its insurance company in the stock exchange but

later retracted it due to persistent complaints from the press and academia. This also shows the sensitivity of the government to popular opinion on the one hand, and the views of the bureaucracy and chaebols on the other hand. Lastly, such wavering further propelled Pusan to complain of the government's conspiracy to damage the local economy, which happens to be the rival region of then President D.J. Kim's political home base. Thus, contrary to what the developmental state approach suggests, the political leadership was not able to make its decision based solely on economic development needs.

53. The bureaucracy maintained its technical competency through this process but it was not insulated from political pressures. The changes in its top leadership allowed the politicians to lead the policy-making directions of the bureaucracy. While maintaining that Korea needs to become a more liberalized economy, such pressures further allowed the technicians to involve themselves deeply in the entire process. This has led to a number of inconsistent policies, as indicated throughout this case study.

54. The chaebol groups were able to enhance their political power because they were less dependent on the domestic market, and, ironically, because there were fewer government regulations at that time than in the 1960s to 1980s. This marked a decline in the 'rent seeking' activities that were prevalent in the past. Furthermore, as Samsung and other chaebols have become multinational enterprises, they could be less pressured by the government's rent allocation.<sup>23</sup> Combined with their ability to develop a 'clientele' relationship with the political leadership, the SMC case cannot be merely dismissed as an isolated case. Indeed, there are other similar examples involving other chaebols.<sup>24</sup>

55. The industrial strategy approach is also questioned in this article. As with the developmental state in Korea, its industrial policy making process can also be captured by political pressures thereby requiring further scrutiny. The political autonomy allowed the government to control the policy agenda and granted them the capacity to 'discipline' firms and condition various government supports on performance, thus to assure that industrial policy did not result in the gross misallocation of resources so common elsewhere in the developing world. In the case shown here, the government's decision-making was not as strong or as

efficient as expected. This is not to suggest though that Korea's bureaucracy is a weak group. Nevertheless, the political concerns seem to have been overwhelming when dealing with the SMC case.

56. The financial crisis marked an important turn in Korea's political economy, clarifying many of the issues that were hidden from the official views. It has revealed the costs of crony capitalism, which translated to the politicizing of economic policies. Korea was further viewed as being caught between liberalized market ideals and the need for distortive and selective (politically motivated) interventions. Yet, its steady and significant recovery from the crisis despite heavy political pressure has shown that Korea's highly capable bureaucracy and vibrant private sector have the main pillars to make Korea successful. Thus, while the political leadership has created the 'tigers' in chaebols who were raised so well that they were able to capture their creator, the latter also became the main engine of the *Tiger Economy* that we know today.

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## ENDNOTES:

- <sup>1</sup> In contrast to this debate, there are those who argue that the crisis was mostly caused by the volatile international financial system, as well as wrong policies remedies of the IMF, rather than weak domestic economic structure. For a summary, see Sachs (1998).
- <sup>2</sup> The other four companies are: Hyundai, Daewoo, Kia, and Ssangyong.
- <sup>3</sup> Actually, Krugman argues that Korea did not really develop. He argues that with limited growth in total factor productivity, its growth was based on factor accumulation, which, like the former-Soviet Union, will soon decrease —thus marking the decline of Korea and other East Asian countries.
- <sup>4</sup> For the studies on developmental state, see Johnson (1987), Woo-Cumings, (1999), Evans (1995), and Leftwich (1995). For the industrial strategy, see Amsden (1989), Wade (1990), Lall (1997), and Pack and Westphal (1996).
- <sup>5</sup> This is not only for Korea. As Leftwich (1995) argues, many developmental states are characterized with state institutions that are development-driven, but the development objective tends to be politically driven as well.
- <sup>6</sup> In a similar note, Campos and Root (1996) notes the effectiveness of deliberation councils—between business associations and bureaucracy, which mediated policy dialogue between the government and private sector.
- <sup>7</sup> As President Park said, '...the focal point in politics in developing nations, such as Korea is above all economic construction' (Kwon 1994: 641). Hahn-Been Lee, a former deputy prime minister during the Park government, states: 'You name one hundred largest or most conspicuous projects or plants in the 1960s and 1970s. Whatever they may be, the final decisions were made at the top of the regime' (Lie 1998: 93).
- <sup>8</sup> The rationale behind why some firms were chosen than others remains to be controversial. While there were some degree of performance measurements were utilized, many also suspect heavy political involvement as well.
- <sup>9</sup> Details of this policy are discussed in the next section.
- <sup>10</sup> As a result, Korea's cost of living (as estimated by the IMF) increased by eighteen times between the end of World War II in 1945 and 1985. This places Korea almost into the top ten among the one hundred twenty countries surveyed by the IMF (Lee 1991: 54).
- <sup>11</sup> The purpose of this article is not to extensively analyze the HCI, but mostly to study its path as an indication of the heavy government intervention.
- <sup>12</sup> Smith (1995) argues that much of the failure of the HCI, in terms of non-performing loans was accumulated in the financial sector without much regard. Thus, by making the Korean financial system more vulnerable, the costs of the HCI have been higher in some respect.
- <sup>13</sup> Here, it is important to note that no president since 1960 won an election with a majority of votes. Two presidents who served the longest terms, C.H. Park and D.W. Chun, gained power through military coup d'état. The influence of regional rivalries is also important, especially for the SMC as will be shown later.
- <sup>14</sup> Samsung was considered investing heavily into the aerospace industry, with the acquisition of the Fokker of the Netherlands.
- <sup>15</sup> As discussed later, Samsung and Pusan asked Kyoung-Shik Kang to the chairman of the committee to bring SMC to Pusan. Kang later became the Minister of Finance and Economy.
- <sup>16</sup> At that time, Kia's major shareholders were as follow: (i) Ford Motors, 10%; (ii) Mazda Motors, 8%; (iii) Kia's founding family, 2.4%; and (v) all Kia employees with almost 12%, making them the largest shareholder.
- <sup>17</sup> However, according to a National Assembly testimony, it was later discovered that the government pressured Kia to accept Samsung' bid.
- <sup>18</sup> Another controversial case involved LG's surrendering its semiconductor business to Hyundai.
- <sup>19</sup> About 20 percent of Samsung Life is owned by Samsung Everlands (another unlisted company), a company which the heir-apparent, Lee's son, owns more than 30 percent.
- <sup>20</sup> The initial decision to allow for the listing was announced in 28 June 1999, but the government (Ministry of Finance and Economy and Financial Supervisory Commission) announced its objection and need to further analyze the issue was announced on 1 July. On a related note, Kyobo Life Insurance also requested to be listed (another troubled chaebol, Daewoo, owns 30 percent of the company), and it was also rejected.
- <sup>21</sup> Also, Daewoo acquired Ssangyong earlier in 1998.
- <sup>22</sup> One key policy-maker of the government stated that Korea is currently caught between the following: (i) ideals of free market versus governed market; (ii) the need for rational economic policies versus irrational political interests; and (iii) the need to contain overbearing growth of chaebols versus fostering its private sector for further economic development.
- <sup>23</sup> One indication is that Samsung and other chaebols are now able to more easily attain capital and credit from foreign sources, and become less reliant on domestic (and mostly government controlled) banks.
- <sup>24</sup> The other examples are: Hyundai's adventure into North Korea in midst of family feud, L.G.'s restructuring and loss of its semiconductor firm, and downfall of Daewoo. In addition the bankruptcies of Kia and Hanbo groups in mid-1997 were one of the main causes for the financial crisis (Cyhn 2003). The questions to be made based on these cases for Korea's industrial strategy are not only *how* and *what* selective interventions were formulated, but also *why* and *by whom* such decisions were made.