Global Challenges and Local Responses

The East Asian experience

Edited by

Jang-Sup Shin

Routledge Studies in the Modern World Economy

Global Challenges and Local Responses

The prevalent view amongst many academics and policy makers is that globalization is a homogenizing force and that it is imperative for local economies to adopt certain global norms. This book offers a critique of the dominant attitude, offering a more complex picture of globalization based on understanding its diverse contexts. Jang-Sup Shin has collected essays that focus on the experience of the East Asian economies over the last couple of decades to present his argument.

Shin argues that globalization is not simply shaped by general forces, but is also the consequence of the complex interaction between internal and external factors. In short, globalization is realized in locality. Shin highlights how local actors seek to shape the presumed imperatives of globalization according to their own contexts and analyses the interaction between global challenges and local agency. The authors in this volume adopt a long-term historical view as a way of understanding the broader global processes that put the East Asian experience in perspective.

This book will be of great interest to research students and economists interested in economic development, political economy and the East Asian economies. It is also important reading for policy makers, as a way of understanding changes caused by the accelerated pace of globalization.

Jang-Sup Shin is Associate Professor of Economics at the National University of Singapore. He also co-authored the extremely successful *Restructuring Korea Inc* with Ha-Joon Chang, also published by Routledge.

Routledge studies in the modern world economy

1 **Interest Rates and Budget Deficits**
A study of the advanced economies
Kanhaya L. Gupta and Bakhtiar Moazzami

2 **World Trade after the Uruguay Round**
Prospects and policy options for the twenty-first century
Edited by Harald Sander and András Inotai

3 **The Flow Analysis of Labour Markets**
Edited by Ronald Schettkat

4 **Inflation and Unemployment**
Contributions to a new macroeconomic approach
Edited by Alvaro Cencini and Mauro Baranzini

5 **Macroeconomic Dimensions of Public Finance**
Essays in honour of Vito Tanzi
Edited by Mario I. Blejer and Teresa M. Ter-Minassian

6 **Fiscal Policy and Economic Reforms**
Essays in honour of Vito Tanzi
Edited by Mario I. Blejer and Teresa M. Ter-Minassian

7 **Competition Policy in the Global Economy**
Modalities for co-operation
Edited by Leonard Waverman, William S. Comanor and Akira Goto

8 **Working in the Macro Economy**
A study of the US labor market
Martin F. J. Prachowny

9 **How Does Privatization Work?**
Edited by Anthony Bennett

10 **The Economics and Politics of International Trade**
Freedom and trade: volume II
Edited by Gary Cook

11 **The Legal and Moral Aspects of International Trade**
Freedom and trade: volume III
Edited by Asif Qureshi, Hillel Steiner and Geraint Parry

12 Capital Markets and Corporate Governance in Japan, Germany and the United States
Organizational response to market inefficiencies
Helmut M. Dietl

13 Competition and Trade Policies
Coherence or conflict?
Edited by Einar Hope

14 Rice
The primary commodity
A. J. H. Latham

15 Trade, Theory and Econometrics
Essays in honour of John S. Chipman
Edited by James C. Moore, Raymond Riezman and James R. Melvin

16 Who benefits from Privatisation?
Edited by Moazzem Hossain and Justin Malbon

17 Towards a Fair Global Labour Market
Avoiding a new slave trade
Ozay Mehmet, Errol Mendes and Robert Sinding

18 Models of Futures Markets
Edited by Barry Goss

19 Venture Capital Investment
An agency analysis of UK practice
Gavin C. Reid

20 Macroeconomic Forecasting
A sociological appraisal
Robert Evans

21 Multimedia and Regional Economic Restructuring
Edited by Hans-Joachim Braczyk, Gerhard Fuchs and Hans-Georg Wolf

22 The New Industrial Geography
Regions, regulation and institutions
Edited by Trevor J. Barnes and Meric S. Gertler

23 The Employment Impact of Innovation
Evidence and policy
Edited by Marco Vivarelli and Mario Pianta

24 International Health Care Reform
A legal, economic and political analysis
Colleen Flood

25 Competition Policy Analysis
Edited by Einar Hope

26 Culture and Enterprise
The development, representation and morality of business
Don Lavoie and Emily Chamlee-Wright

27 Global Financial Crises and Reforms
Cases and caveats
B. N. Ghosh

28 Geography of Production and Economic Integration
Miroslav N. Jovanović

29 Technology, Trade and Growth in OECD Countries
Does specialisation matter?
Valentina Meliciani

30 Post-industrial Labour Markets
Profiles of North America and Scandinavia
Edited by Thomas P. Boje and Bengt Furaker

31 Capital Flows without Crisis
Reconciling capital mobility and economic stability
Edited by Dipak Dasgupta, Marc Uzan and Dominic Wilson

32 International Trade and National Welfare
Murray C. Kemp

33 Global Trading Systems at Crossroads
A post-Seattle perspective
Dilip K. Das

34 The Economics and Management of Technological Diversification
Edited by John Cantwell, Alfonso Gambardella and Ove Granstrand

35 Before and Beyond EMU
Historical lessons and future prospects
Edited by Patrick Crowley

36 Fiscal Decentralization
Ehtisham Ahmad and Vito Tanzi

37 Regionalisation of Globalised Innovation
Locations for advanced industrial development and disparities in participation
Edited by Ulrich Hilpert

38 Gold and the Modern World Economy
Edited by MoonJoong Tcha

39 Global Economic Institutions
Willem Molle

40 Global Governance and Financial Crises
Edited by Meghnad Desai and Yahia Said

41 Linking Local and Global Economies
The ties that bind
Edited by Carlo Pietrobelli and Arni Sverrisson

42 Tax Systems and Tax Reforms in Europe
Edited by Luigi Bernardi and Paola Profeta

43 Trade Liberalization and APEC
Edited by Jiro Okamoto

44 Fiscal Deficits in the Pacific Region
Edited by Akira Kohsaka

45 Financial Globalization and the Emerging Market Economies
Dilip K. Das

46 International Labor Mobility
Unemployment and increasing returns to scale
Bharati Basu

47 **Good Governance in the Era of Global Neoliberalism**
Conflict and depoliticization in Latin America, Eastern Europe, Asia and Africa
Edited by Jolle Demmers, Alex E. Fernández Jilberto and Barbara Hogenboom

48 **The International Trade System**
Alice Landau

49 **International Perspectives on Temporary Work and Workers**
Edited by John Burgess and Julia Connell

50 **Working Time and Workers' Preferences in Industrialized Countries**
Finding the balance
Edited by Jon C. Messenger

51 **Tax Systems and Tax Reforms in New EU Members**
Edited by Luigi Bernardi, Mark Chandler and Luca Gandullia

52 **Globalization and the Nation State**
The impact of the IMF and the World Bank
Edited by Gustav Ranis, James Vreeland and Stephen Kosak

53 **Macroeconomic Policies and Poverty Reduction**
Edited by Ashoka Mody and Catherine Pattillo

54 **Regional Monetary Policy**
Carlos J. Rodríguez-Fuentez

55 **Trade and Migration in the Modern World**
Carl Mosk

56 **Globalisation and the Labour Market**
Trade, technology and less-skilled workers in Europe and the United States
Edited by Robert Anderton, Paul Brenton and John Whalley

57 **Financial Crises**
Socio-economic causes and institutional context
Brenda Spotton Visano

58 **Globalization and Self-determination**
Is the nation-state under siege?
Edited by David R. Cameron, Gustav Ranis and Annalisa Zinn

59 **Developing Countries and the Doha Development Round of the WTO**
Edited by Pitou van Dijck and Gerrit Faber

60 **Immigrant Enterprise in Europe and the USA**
Prodromos Panayiotopoulos

61 **Solving the Riddle of Globalization and Development**
Edited by Manuel Agosín, David Bloom, George Chapelier and Jagdish Saigal

62 **Foreign Direct Investment and the World Economy**
Ashoka Mody

63 The World Economy
A global analysis
Horst Siebert

64 Production Organizations in Japanese Economic Development
Edited by Tetsuji Okazaki

65 The Economics of Language
International analyses
Edited by Barry R. Chiswick and Paul W. Miller

66 Street Entrepreneurs
People, place and politics in local and global perspective
Edited by John Cross and Alfonso Morales

67 Global Challenges and Local Responses
The East Asian experience
Edited by Jang-Sup Shin

Global Challenges and Local Responses

The East Asian experience

Edited by Jang-Sup Shin

Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2007
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

Simultaneously published in the USA and Canada
by Routledge
270 Madison Ave, New York, NY 10016

Routledge is an imprint of the Taylor & Francis Group, an informa business

This edition published in the Taylor & Francis e-Library, 2007.

"To purchase your own copy of this or any of Taylor & Francis or Routledge's collection of thousands of eBooks please go to www.eBookstore.tandf.co.uk."

© 2007 Selection and editorial matter, Jang-Sup Shin; individual chapters, the contributors

All rights reserved. No part of this book may be reprinted or reproduced or utilized in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data
A catalog record for this book has been requested

ISBN 0-203-09993-1 Master e-book ISBN

ISBN10: 0-415-38399-4 (hbk)
ISBN10: 0-203-09993-1 (ebk)

ISBN13: 978-0-415-38399-8 (hbk)
ISBN13: 978-0-203-09993-3 (ebk)

Contents

List of figures xi
List of tables xii
List of contributors xiii

1 Global challenges and local responses: an introduction 1
JANG-SUP SHIN

PART I
Globalization and macro-institutions 11

2 Globalization, global standards, and the future of East Asia 13
HA-JOON CHANG

3 Globalization and challenges to the developmental state: a comparison between South Korea and Singapore 31
JANG-SUP SHIN

4 Globalization and local political economy: the multi-scalar approach 50
BAE-GYOON PARK

PART II
Globalization and country experience 71

5 From East Asian "miracle" to neoliberal "mediocrity": the effects of liberalization and financial opening on the post-crisis Korean economy 73
JAMES CROTTY AND KANG-KOOK LEE

6 The Chinese response to globalization: accession to the WTO and its challenges 95
DING LU

7 Reassessing the Japanese response to globalization: causes and consequences of the Japanese financial crisis 116
MASAO ISHIKURA

8 Globalization and the Malaysian response: trade-related investment liberalization under the WTO 140
RAJAH RASIAH

PART III
Sectoral and regional responses to globalization 161

9 Globalization and trade unions: transformation of automobile trade unions in Korea and Malaysia 163
PETER WAD

10 Globalization and labor market restructuring: regional discrimination in the Korean labor market 184
CHANGHUI KANG

Index 208

Figures

3.1	Public share to gross fixed capital formation in Singapore and Korea	39
4.1	Provinces of South Korea	57
4.2	Location of free economic zones in South Korea	65
6.1	China's real GDP growth and inflation, 1997–2005	97
6.2	Growth rates of exports and imports, 1996–2005	98
6.3	China's net export and current account balance over GDP, 1996–2004	98
6.4	Components of GDP	99
6.5	Government budget balance, public debt, and government outlay as percentage shares of GDP, 1991–2004	100
6.6	Non-consumption government spending share of GDP, public debt share of GDP, and non-consumption government spending to fixed investment ratio, 1991–2004	100
6.7	Urban-to-rural household income ratio, rural household GINI coefficient, and national household GINI coefficient, 1978–2001	102
6.8	Rural and urban household GINI coefficients and regional per capita income disparity, measured by coefficient variance, 1985–2001	103
6.9	Users of science and technology research funds	110
7.1	Funds raised through the capital market (straight bonds)	120
7.2	Funds raised through the capital market (convertible bonds)	120
7.3	The proportion of bank debts to total assets in Japanese corporate sector	121
7.4	The land prices and the total market value of stocks, relative to the nominal GDP	122
7.5	Outstanding loans by industry	123
7.6	Outstanding loans as a percentage of nominal GDP	123
7.7	The Japan Premium	128
8.1	Foreign Direct Investment inflows, Malaysia, 1970–2000	152
10.1	South Korea	186

Tables

2.1 Percentage shares of public enterprises in GDP 17
2.2 State-owned enterprise investments as a proportion of gross investments in selected industrialized countries (percentages) 18
2.3 Gross sources of finance in selected countries (1970–89) 19
2.4 Capital structure of firms in selected countries (1980–91) 22
2.5 GDP *per capita* growth for selected countries 24
2.6 Average tariff rates on manufactured products for selected developed countries in their early stages of development 27
3.1 Number of financial crises: distribution by market 34
3.2 Economic performance by country groups during 1961–99 37
5.1 Economic performance after the crisis in Korea 77
5.2 Foreign capital flows in Korea after the crisis 80
6.1 Incremental capital to output ratio: China compared to Japan, South Korea, and Taiwan in their high-growth periods 101
7.1 Non-performing loans disclosed under the Financial Reconstruction Law 134
10.1 Regional distribution of population and value added in the mining and manufacturing industries 187
10.2 Number of survey respondents by residence and birth regions 189
10.3 Descriptive statistics of the recession sample 192
10.4 Probit estimates for displacement likelihood: effect of birth region, 1997–99 194–5
10.5 Probit estimates for displacement likelihood: effect of birth region, 2000–01 196–7
10.6 The probability of a median worker's displacement, 1997–99 and 2000–01 200
10.7 Distribution of birth regions of management staff in the firms listed in the Korean Stock Exchange 202

Contributors

Ha-Joon Chang has taught at the Faculty of Economics, University of Cambridge, since 1990. In addition to numerous articles in journals and edited volumes, he has published 12 books (four of them co-authored) and edited or co-edited nine. His most recent include *Kicking away the Ladder: Development Strategy in Historical Perspective* (2002), *Restructuring Korea Inc.* (with Jang-Sup Shin, 2003), *Reclaiming Development: An Alternative Economic Policy Manual* (with Ilene Grabel, 2004), and *Bad Samaritans: Rich Nations, Poor Policies, and the Threat to the Developing World* (2007). He was the winner of the 2003 Gunnar Myrdal Prize and the 2005 Wassily Leontief Prize.

James Crotty is Professor of Economics at the University of Massachusetts, Amherst campus, and Research Associate in the Political Economy Research Institute of the University of Massachusetts.

Masao Ishikura is Professor at the Graduate School of Economics, Hitotsubashi University, Tokyo.

Changhui Kang is an Assistant Professor in the Department of Economics, National University of Singapore. His areas of expertise are labor economics and the economics of education. His work has been published in international journals such as *Journal of Urban Economics*, *Journal of Population Economics*, *Economics Letters*, *Applied Economics and the Developing Economies*.

Kang-Kook Lee is Associate Professor in the Graduate School of Economics at the Ritsumeikan University, Kyoto. His publications include "A Political-economic Analysis of the Failure of Neoliberal Restructuring in Post-crisis Korea" (*Cambridge Journal of Economics*, 2002) and "Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-internal Organization in Korea" (*Asian Economic Journal*, 2002)

Ding Lu is Professor of Economics at Sophia University, Tokyo. Before joining Sophia University, he was taught at the National University of Singapore (1992–2005) and the University of Nebraska at Omaha (1991–92). Dr Lu's

research interests include international trade and investment and regional economic development. He has published several books, including *State Intervention and Business in China: the Role of Preferential Policies* (1997) and *China's Telecommunications Market: Entering a New Competitive Age* (2003).

Bae-Gyoon Park is Assistant Professor in the Department of Geography Education at the Seoul National University. He received his Ph.D. in Geography from Ohio State University and taught at the National University of Singapore. His research interests include the politics of urban development, globalization and scalar politics, and the territorialized politics of East Asian development. He has recently published papers in *Economic Geography*, *Geoforum*, and *Political Geography*. He is doing international comparative research on the spatial restructuring of East Asian states, focusing especially on such issues as spatial processes of East Asian "neo-liberalization" and scalar restructuring of governing systems in the East Asian states.

Rajah Rasiah is Professor of Technology and Innovation Policy in the Faculty of Economics and Administration, University of Malaya, Kuala Lumpur. His research focuses on the impact of transnational corporations and intellectual property rights on domestic industrial upgrading and innovations.

Jang-Sup Shin teaches in the Department of Economics, National University of Singapore. His publications include *The Economics of the Latecomers: Catching-up, Technology Transfer and Institutions in Germany, Japan and South Korea* (Routledge, 1996), *A Third Way for the Korean Economy* (1999, in Korean), and *Restructuring Korea Inc.* (with Ha-Joon Chang, Routledge, 2003). He was in journalism for 14 years until 1999, as editorial writer, deputy economics editor, Asia correspondent, and so on, for the *Maeil Business Newspaper*, South Korea's leading economic daily.

Peter Wad is Associate Professor in the Department of Intercultural Communication and Management, Copenhagen Business School. He teaches international comparative political economy in relation to developing countries. He has contributed chapters in collective volumes such as *Political Business in East Asia* (ed. Edmund T. Gomez, 2002) and articles in journals such as *International Journal of Business and Society*.

1 Global challenges and local responses

An introduction

Jang-Sup Shin[1]

Globalization is a trend that has sparked off one of the most heated debates among academics and policy-makers during the last couple of decades. The pace of globalization has indeed accelerated during this period, posing great challenges to nations, regions, governments, and corporations.

According to the earlier orthodoxy, which is still prevalent in substantial segments of policy-making circles and the academia, globalization is a homogenizing force across economies and it is therefore imperative for local economies to adopt certain global norms. Global regulatory changes such as the replacement of the General Agreement on Tariffs and Trade (GATT) system with the World Trade Organization (WTO) system, the spread of the BIS (Bank of International Settlements) capital adequacy ratio, the introduction of OECD (Organization for Economic Cooperation and Development) guidelines on corporate governance were all based on the perception that globalization requires uniform standards across countries. Many countries, including East Asian economies, have also attempted to adjust their economies and institutions to embrace these presumed requirements during the period of accelerated globalization.

There are certainly some general forces behind globalization. For instance, we have witnessed the rapid progress of technologies, especially information and communication technologies (ICTs), which has enabled firms and other organizations to better coordinate their activities across the globe. This has helped them "shrink the space", thus spreading global production networks (GPNs). Therefore, without understanding such general forces, we cannot understand globalization.

However, understanding the general forces is only a necessary condition, not a sufficient condition, to understanding globalization. Globalization is not simply shaped by general forces "out there" but also is a consequence of the complex interaction between external and internal factors. Globalization is realized in locality, characteristics of which are diverse across countries, regions and sectors. Even if there might be some general forces driving globalization, diverse local particularities condition their manifestations. Moreover, local actors seek to shape the presumed imperatives of globalization according to their own agenda. It is therefore necessary to take a step or several steps further to analyze various ways in which global challenges are perceived and met by local

actors if we are to better understand the current unfolding of globalization. It is not realistic to attempt to draw the picture of globalization and policy implications simply on the basis of the perceived general trends. We need to see both commonalities and diversities of globalization at the same time. It is also often the case that diversity is more important than commonality in understanding the reality and especially drawing policy implications for individual countries.

The recent experiences of the East Asian countries clearly show that globalization needs to be understood as a result of the interaction between global and local forces. They were main beneficiaries of the increased globalization during the postwar period because they adopted export-oriented economic growth strategies and were able to capture the new market created by rapidly expanding imports of manufactured goods by the developed countries.[2] From the 1980s, these countries also accelerated the pace of opening up their economies and are currently more deeply integrated into the global economy. However, actual manifestations of globalization in these countries are quite diverse.

China began opening up its economy from the early 1980s and has strengthened its open-door policy, eventually acceding to the WTO. But it has done so while maintaining the backbone of the socialist market economy, in which the ownership of major firms is still held by the government and cross-border capital flows are tightly regulated. Japan, which had led the East Asian "miracle", suddenly turned into a laggard of globalization during the 1990s with the decade-long economic stagnation. The country is however beginning to show signs of recovery without having abandoned its unique institutions. Korea hastened its pace of globalization in the 1990s and fell into a financial crisis in late 1997. It has since then introduced various global standard economic institutions more extensively than other East Asian countries, although the introduction of such institutions has not produced the expected results. Malaysia, though it accelerated the pace of globalization and fell into a financial crisis in the 1990s like Korea, defied calls for adopting global norms and revived its economy in its own way.

Understanding the processes of globalization

This volume contributes to the current debate on globalization by looking into related theoretical issues and historical evidence, and presenting a more complex picture of globalization. Its empirical focus lies in East Asian countries but it goes beyond them because a longer-term historical view and the understanding of broader processes on the global level are essential in putting the East Asian experience in perspective. This also serves us better in drawing policy implications from our collective investigations. Chapters 2–4 in this volume are geared to providing theoretical frameworks for understanding the process of globalization. Chapters 5–8 deal with case studies of individual countries, namely, South Korea (henceforth Korea), China, Japan and Malaysia. And the last two chapters (9–10) look into variations of responses at the sectoral and regional levels.

Ha-Joon Chang's Chapter 2, "Globalization, global standards, and the future

of East Asia", provides a theoretical and historical evaluation of the myths surrounding the "global standard" institutions (GSIs), which have been frequently presented as necessary requirements for countries to survive challenges from globalization. It first asks whether there is a need for GSIs. By employing the concept of "transition cost" (Khan 1995; Shin and Chang 2003), Chang argues that the adoption of GSIs, which can be interpreted as an attempt at reducing transaction costs, may end up with increasing the overall costs of managing institutions by increasing transition costs. In the world where individual countries start from different institutional arrangements and would have to incur costs in making transitions from previous institutions to GSIs, this consideration of transition cost is critical. There is no a priori guarantee that the global adoption of GSIs would be beneficial to the world if we consider this aspect of transition cost on top of transaction cost.

Chang then questions the real contents of GSIs which are promoted as something universal. Based on historical and cross-country evidence, he points out that major pillars of the GSIs, i.e. (1) laissez-faire industrial policy with a welcoming attitude towards foreign investors, (2) small public-enterprise sector, (3) developed stock market with easy mergers and acquisitions (M&A), (4) a regime of financial regulation that encourages "prudence" and "stability", (5) shareholder-oriented corporate governance system, and (6) flexible labour market, are in fact current-day Anglo-American institutions, and not even institutions common to all developed countries. Moreover, according to Chang, Anglo-American countries did not use many of those GSIs when they were developing countries themselves.

Viewed in this way, GSIs are most convenient institutions for the Anglo-American countries to promote their local interests globally. If we use a political geographers' terminology (Chapter 4, Bae-Gyoon Park), it can be said that local interests of Anglo-American countries "jumped" the scale of discourse from the national level to the global level by presenting their institutions as global ones. Chang also argues that the GSIs are not really superior because, up to the 1990s, the Anglo-American economies had been laggards in terms of economic growth and even their "superior" performance since the 1990s owes more to the failures of other countries than their own successes. In other words, there is no need to adopt the GSIs even from the viewpoint of transaction cost without considering the aspect of transition cost.

If Chang's chapter is geared to unraveling the myths surrounding the GSIs in general, Jang-Sup Shin's Chapter 3, "Globalization and challenges to the developmental state: a comparison between South Korea and Singapore", is directed at one particular myth of the GSIs, i.e. the one regarding the role of the state.

The view promulgated by the proponents of the GSIs is that the role of the state should be diminished with the progress of globalization. However, Shin points out one important ironic fact in the Age of Globalization: While globalization progresses with more and more assets becoming more mobile, and while attracting those mobile assets becomes more important for economic development, the role

of less mobile assets rooted in particular localities also becomes more critical to national competitiveness because they are assets complementary to the mobile assets. Among those less mobile assets, the government is the least mobile but the most important, as it is responsible for providing many complementary immobile assets.

Moreover, the role of the state becomes more important with the progress of globalization, albeit in a defensive sense. Globalization has made countries financially more vulnerable as the incidence of financial crises doubled in developed countries and quintupled in developing countries during 1973–97 compared with the period of 1945–71. In this respect, Shin argues that the role of the state in guarding its economy from possible financial crises has become more important with the progress of globalization. It may be true that some roles of the state like mobilizing domestic financial resources have become less important but the other roles have become more important with globalization, and Shin therefore argues for a disaggregate approach to understanding the role of the state.

Shin points out that the role of the state in globalization is also different according to the differences in the ways in which individual states had previously intervened in their economies. To elaborate on this, he compares different challenges from globalization to two developmental states in East Asia, namely Korea, which employed a more "substituting" strategy for economic development, and Singapore, which adopted a more "complementing" strategy for economic development.[3]

We include a political geographer's contribution in this volume because it provides an interesting framework to understand complex political processes behind policy discourses of globalization. These political economy considerations are often absent in economic analyses despite their critical importance in understanding globalization. Bae-Gyoon Park, in "Globalization and local political economy: the multi-scalar approach" (Chapter 4), presents the multi-scalar view of globalization developed by critical geographers. According to this view, major policy changes during the period of globalization including liberalization of product and services markets are not simply imposed from "above" by some mysterious global forces but are constituted from "below" by various national and sub-national forces. This is mainly because regulations have uneven spatial effects across nations and sub-national entities, and because actors situated in different scales all attempt to influence the course of regulatory changes for their own benefits.

Park presents this multi-scalar process of globalization with examples drawn from Korea's recent policy discourses of liberalization. In his analysis of Korea's "Big Deal" in the automobile industry, he shows how a program initially designed to solve problems of overcapacity on the national scale was resisted by local interests and eventually abandoned, incurring much larger adjustment costs to major companies involved and to the Korean government's finances. This is an ironic result, considering the fact that the size of population constituting the local interest of the Busan area was quite small while firms

involved in this project were the most powerful ones in Korea and while the Korean national government also held quite extensive regulatory power over its industries and regions. The Big Deal case shows that, in certain junctures of history, it is possible that even a small interest group can derail national or global projects if it can critically affect political outcomes in a country by creating "inter-scalar tensions".

If the Big Deal case is about how local interest groups resist "global" imperatives, the case of "Jeju Free City Project" is about how particular local interest groups promote their own interests by presenting them as being compatible with the presumed imperatives of globalization. In appearance, the project is overambitious and unrealistic for the small tourist island with little industrial base. Park, however, points out that the project is an outcome of pro-development forces in the region who had previously seen their attempts fail due to conflicts of interests among various groups within the island. This group saw a new opportunity to revive their developmental projects when the Korean national government adopted broad liberalization policies that were supposed to obey the "imperatives of globalization", and "jumped the politics of scale" by presenting its project as part of the country's "globalizing" project.

The East Asian experience of globalization

James Crotty and Kang-Kook Lee's "From East Asian 'miracle' to neoliberal 'mediocrity': the effects of liberalization and financial opening on the post-crisis Korean economy" (Chapter 5) is a comprehensive and detailed criticism of the introduction of the GSIs in Korea after the financial crisis. They sum up the results of the Korean restructuring after the crisis as "slow growth, high inequality, and the rise of foreign capital", contrary to the conventional view that the Korean economy recovered successfully after instituting the GSIs comprehensively. To Crotty and Lee, the slow growth and the rise of foreign capital are closely related. They emphasize the sea change in the ownership of Korean firms and banks after the crisis. The foreign ownership share of the ten largest firms (in terms of market capitalization) has risen to an astounding 54 percent by the end of 2004, from less than 20 percent before the financial crisis in 1997. That of the eight large commercial banks grew from 12 percent in 1998 to 64 percent at the end of 2004, the highest level in Asia and even higher than those in almost all Latin American countries.

According to Crotty and Lee, a main strength of the previous Korean model lay in its ability to maintain high investment rates and high growth rates, though it restricted inward FDIs and was not really open to minority shareholder participation. However, the increased foreign ownership contributed critically to reducing the amount of investment funds. Firms had to pay more dividends and engage in share buybacks to acquiesce to shareholders' demand to maintain high share prices. In fact, funds that Korean firms got from the stock market were smaller than they paid for dividends and share buybacks during 2001–04. Moreover, commercial banks shunned "risky" corporate loans and instead focused on

increasing their share in consumer credits. Crotty and Lee conclude that the introduction of the global norms only benefited foreign investors, not the Korean economy.

Ding Lu's Chapter 6, "The Chinese response to globalization: accession to the WTO and its challenges", deals with challenges China is currently facing with its accession to the WTO and details the big country's responses to those challenges. It is a bit too early to evaluate the China's performance in terms of globalization because China joined the WTO only recently and has been slow in introducing the GSIs. Lu therefore focuses on current concerns and the Chinese government's responses to alleviate them.

Lu points out that the earlier concern about the growing unemployment due to the increasing opening up of its domestic market has not been realized. This was mainly because of the booming export sector, which created enough new jobs to compensate for the loss of jobs in the import-competing industries. The large inflow of FDIs also helped China create new jobs.

However, Lu argues that the health of its banking sector is a major area of concern. The health of the sector appears to have improved substantially because the share of non-performing loans (NPLs) in total bank assets has been reduced from 25 percent in 2001 to below 15 percent in the middle of 2005, but this was due mainly to the injection of large-scale public funds and little to improvements in quality of loans. It is therefore possible that, if foreign banks begin fully operating in the domestic market, customers may move their accounts to foreign banks and the balance sheets of local banks may further deteriorate. This is probably why the Chinese government tries to maintain various regulations over the banking sector, even as it opens its financial market to foreign banks.

Lu regards income inequality as another major challenge to China in embracing globalization. With the estimated 140 million of rural surplus labor (over 18 percent of the rural population) waiting to move to cities, wages of unskilled workers at "sweatshops" would be stagnant for a long time. On the other hand, wages of skilled workers in high demand and incomes of successful entrepreneurs will continue to rise rapidly. To a country that aims to build a "socialist market economy", this growing income gap is a serious problem. This is why the Chinese president Hu Jintao mentioned that "the problems and contradictions China will face in the next decades may be even more complicated and thorny than others".

Masao Ishikura's analysis of the Japanese experience helps us fathom what might happen to China if it cannot properly deal with the financial globalization. In Chapter 7, "Reassessing the Japanese response to globalization: causes and consequences of the Japanese financial crisis", Ishikura traces the emergence of the bubble economy in the late 1980s and the subsequent bust of the bubble and the prolonged stagnation of the Japanese economy. He attributes this Japanese failure mainly to the adverse effects of financial opening without building the necessary regulatory framework and allowing sufficient time for financial institutions to adjust to the new situation.

Japan's capital market liberalization from the early 1980s was primarily a result of US pressure to open its market in an attempt to rectify a huge trade imbalance between the two countries. In the beginning, the capital market liberalization was conceived as beneficial also to the Japanese economy by providing Japanese firms with easy access to the international capital market and enabling them to lower borrowing costs. However, Ishikura argues that it weakened the Japanese banking sector considerably because large firms' dependence on domestic bank loans suddenly declined by half and the banking sector had to find new borrowers hurriedly from small and medium-sized firms and real estate companies. This structural change in the loan market resulted in accumulation of lower-quality loans in the banking sector. In most literature on the Japanese bubble economy in the late 1980s, the overall easy money policy after the Plaza Accord of 1985 is pointed as a main cause of the emergence of the bubble. According to Ishikura, however, the structural change in the bank loan market and consequent accumulation of low-quality loans was a culprit of the bubble as serious as the easy money policy.

Rajah Rasiah also deals with challenges from the WTO regime in Chapter 8, "Globalization and the Malaysian response: trade-related investment liberalization under the WTO". He views the WTO regime from a political economy perspective and asserts that it is no more than to set up new barriers by developed countries to prevent the successful expansion of exports from developing countries although it is presented as a system to help global trade expansion. Malaysia has been a champion of the developing world in advocating this contrarian view, especially under the leadership of former prime minister Mohamad Mahathir. The Malaysian response to the WTO is therefore understood as continued efforts at securing its own policy space from the challenges of globalization.

Rasiah points out that the Malaysian government has retained several incentives to stimulate investment, technological upgrading, and exports in prioritized areas, even if it claimed to have abandoned most of them after the financial crisis in 1997–98. For instance, foreign ownership of domestic assets is not freely allowed. In its offer under the General Agreement and Trade in Services (GATS), the Malaysian government still requires foreign investors to seek its approval when they are acquiring controlling ownership of domestic companies and put limitations in national treatment on land ownership.

In Malaysia's political situation, in which ethnic balance between Malays and Chinese is a paramount concern, many of state's regulations are related to its *Bumputra* policies. However, Rasiah pays more attention to the economic rationale behind those government regulations on investments, which therefore operates similarly in other developing countries. According to Rasiah, they help quickening technological capability building and strengthening macroeconomic fundamentals of developing countries though they may look impeding liberalization. He therefore argues that Malaysia should take a lead in building consensus among the Asian and other developing economies to retain control over domestic policy options under the WTO regime.

Sectoral and regional variants of globalization

Responses to globalization also vary greatly across sectors and regions. In this context, Peter Wad investigates how trade unions in Korea and Malaysia responded differently to challenges from globalization (Chapter 9, “Globalization and trade unions: transformation of automobile trade unions in Korea and Malaysia”), and Chang-Hui Kang analyzes how the same global challenges at the national level, i.e. the financial crisis of Korea, affected labor forces differently according to their different regional backgrounds (Chapter 10, “Globalization and labor market restructuring: regional discrimination in the Korean labor market”).

Wad begins with pointing out apparent convergence between Korean trade unions and Malaysian counterparts in the automobile industry: Both countries moved towards more industry-wide unions during the period when the pace of globalization was accelerated. However, Wad argues that this belies different undercurrents that shaped the transformation of their respective trade unions: In Korea, this transformation was a consequence of gaining more political power by trade unions whereas, in Malaysia, it was a result of their growing weakness.

The Korean case is especially interesting because it has been commonly argued that trade unions lose their power against capitalists because work forces are relatively less mobile while capital has become increasingly mobile with globalization. The Korean auto unions, however, became more militant and better organized, and even gained more political power after the Korean financial crisis and restructuring under the IMF program. Wad argues that this has to do with new political developments and maintenance of international competitiveness by Korean auto companies. The 1997 financial crisis helped the previous opposition leader Kim Dae Jung’s government come into power and the new government opened a political space for trade unions. Moreover, mergers and acquisitions (M&As) of domestic auto companies after the crisis also made the incumbent companies, especially Hyundai Motors, more competitive and having financial resources to accommodate labor unions’ demand for higher wages. In other words, the combination of new political developments and reorganization of the auto industry in Korea enabled its trade unions to move against the global trend, reaffirming the need of a multi-faceted analysis in understanding the actual realization of global forces in specific locations or sectors.

In Chapter 10, “Globalization and labor market restructuring: regional discrimination in the Korean labor market”, Kang shows the persistence of regional discrimination operating even under the strong pressure of globalization. Korean companies had to shed work forces as part of its restructuring after the financial crisis and adopting GSIs. But this coincided with the shift of political power from the southeastern Kyongsang Province to the southwestern Jolla Province. It was suspected that large companies, fearing a political backlash from the new government, would be more reluctant to lay off workers from the Jolla Province than the Kyongsang Province. Kang tested this hypothesis by using panel data and confirmed that Kyongsang-born workers faced a significantly higher likeli-

hood of job displacements relative to Jolla-born workers with similar characteristics. This result shows that globalization is not necessarily a process of making level playing fields. Regional discrimination persists even with globalization. In the Korean case, it only changed the direction of discrimination from one province to another.

Making sense of globalization: toward a new research agenda

Our investigation of theories and experiences related to globalization in this volume does not render any support for global adoption of the GSIs. Why then do the calls for their adoption still remain strong all over the world? Why did many non-Anglo-American countries with little to gain adopt the GSIs extensively?

More than anything else, this has to do with the interests of the developed countries, mainly of Anglo-American countries that can further promote the interests of their companies and financial institutions by making others adopt the GSIs. It is a well known fact in the corporate world that companies are competing fiercely with each other to gain power to set standards of technologies or products. This is mainly because the standard-setting power provides them with critical competitive edge against their competitors, which will eventually turn into financial benefits for the standard setters.[4] Similarly, Anglo-American companies and financial institutions are major beneficiaries of global adoption of the GSIs, which are mainly their *current* institutions. It does not really matter whether they practice/practiced these institutions seriously. As far as the GSIs suit their own interests, they have every incentive to tell other countries, "Do as I say, not as I do/did" (Chang and Green 2003).

Another reason for the widespread adoption of the GSIs has to do with local political economy, as emphasized by Park (Chapter 4). Even if the GSIs may not be desirable for the country as a whole, there are various local actors who can promote their own interests by urging their national government to adopt the GSIs by "jumping" the scale of discourse and seeking implicit and explicit alliances with "global forces". The Korean case elaborated by Crotty and Lee can be interpreted in this manner. Major beneficiaries of the Korean restructuring after the crisis were foreign financial and industrial companies that could acquire domestic assets at bargain prices and institute the governance systems to control those assets. However, this was not possible without domestic allies, ranging from some group of politicians, minority shareholders, liberal-minded bureaucrats, and so on, who advocated those restructuring programs as "global imperatives" or at least desirable for the national economy. In this respect, the various possibilities for international coalitions when a country opens its border should be further investigated.[5]

Thus seen, if we are to make greater sense of globalization, we need to understand not just the forces of technological and economic change but also political factors – not just the influences of international power politics but also local

political forces that try to exploit external economic and political forces while being also constrained by those forces. For this purpose, more in-depth empirical works should be undertaken to delineate the complex mechanism of the interaction between global challenges and local responses in concrete contexts of political economies of individual countries.

Notes

1 I thank participants of the conference "Global Challenges and Local Responses: A Comparison between Singapore, Malaysia, and South Korea", which was held in Singapore in October 2003, for enabling us to carry out this project. I also thank Beng-Hua Chua for initiating this project and the National University of Singapore for financial support (R-122-000-065-112). This volume expands on the special issue of *Global Economic Review* on "Globalization and East Asian Economies: A Reappraisal" (vol. 34, no. 4).
2 Palma (2003) argues one reason why Latin American countries fell behind East Asian countries is that they could not capture this growing import of manufactured goods from developed countries because their import-substituting strategies were based on pessimism about exporting manufactured goods to advanced countries and therefore geared only to domestic markets.
3 For details of these strategies, refer to Shin (2005).
4 For discussion on the standard wars, refer to Metcalfe and Miles (1994) and Link and Tassey (1988)
5 For a good collection of comparative studies on this kind of coalition, refer to Horowitz and Heo (2001).

References

Chang, H.-J. and D. Green (2003) *The Northern WTO Agenda on Investment: Do As We Say, Not As We Did* (Geneva, South Centre, and London: CAFOD).

Horowitz, S. and U. Heo (2001) *The Political Economy of International Financial Crisis: Interest Groups, Ideologies, and Institutions* (New York and Oxford: Rowman & Littlefield Publishers).

Khan, Mushtaq (1995) State Failure in Weak State: A Critique of New Institutionalist Explanations, in Harris, J., Hunter, J. and Lewis, C.M. (eds) *The New Institutional Economics and Third World Development* (London: Routledge).

Link, A.N. and G. Tassey (1988) Standards and the Diffusion of Advanced Technologies, *Evaluation and Program Planning* 11(1): 97–102.

Metcalfe, J.S. and I. Miles (1994) Standards, Selection and Variety: An Evolutionary Approach, *Information Economics and Policy* 6(3–4): 234–68.

Palma, G. (2003) The Latin American Economies during the Second Half of the Twentieth Century, in Chang, Ha-Joon (ed.) *Rethinking Development Economics* (London: Anthem Press).

Shin, Jang-Sup (2005) Substituting and Complementing Models of Economic Development in East Asia, *Global Economic Review* 34(1): 99–118.

Shin, Jang-Sup and Ha-Joon Chang (2003) *Restructuring Korea Inc.* (London: RoutledgeCurzon).

Part I

Globalization and macro-institutions

2 Globalization, global standards, and the future of East Asia

Ha-Joon Chang[1]

Introduction

With the recent advance in globalization, it has become popular to argue that countries need to adopt a certain set of institutions that meet the 'global standards' in order to survive in the new, borderless world. In particular, it is argued, countries that do not adopt global standard institutions will fail to grow fast, not only because the global standard institutions (henceforth GSIs) are the ones that promote growth but also because foreign investors will shun the countries with sub-standard institutions. The conviction in the virtue of the GSIs among those who promote them is so absolute that they are quite willing to impose them on reluctant countries through the so-called 'governance-related conditionalities' attached to multilateral and bilateral loans (for a critical review of this practice, see Kapur and Weber, 2000).

The areas where GSIs should be introduced are numerous, but most frequently mentioned are the following: (1) laissez-faire industrial policy, with a welcoming attitude towards foreign investors; (2) a small public-enterprise sector, supervised by politically independent regulators; (3) a developed stock market with easy M&A (mergers and acquisitions), which will ensure that the best management team available runs each enterprise; (4) a regime of financial regulation that encourages 'prudence' and 'stability', including a politically independent central bank and the strict observance of the BIS (Bank for International Settlements) capital adequacy ratio; (5) a shareholder-oriented corporate governance system, which will ensure that the corporations are run for their true owners; (6) a flexible labour market to allow quick reallocation of labour in response to price changes.

East Asia has not escaped the increasing pressure to adopt GSIs. The region had developed on the basis of economic institutions that were often very different from the GSIs (although there have been some important differences across countries within the region), making people talk of 'East Asian capitalism'. However, the decade-long stagnation in Japan that followed the bursting of the financial bubble in the early 1990s and the East Asian financial crisis of 1997 have made people question the viability of the region's economic models, and during the last several years there has been increasing pressure on the countries

in the region to abandon their 'traditional' institutions and adopt GSIs. Particularly in the case of the countries that had signed up for an agreement with the IMF, the pressure was enormous. First of all, the IMF made the adoption of GSIs – such as a politically independent central bank, free M&A rules, or the BIS capital adequacy ratio – a condition of its loans. Second, these countries were forced by the IMF and its main shareholders (especially the US) to open up their capital markets more widely. This increased the importance of foreign investors. Some of the investors indeed signalled that they wanted to see more GSIs adopted, but the domestic forces that wanted GSIs also used the increasing presence of the foreign investors as an excuse to push their agenda, sometimes well beyond what the foreign investors actually had demanded.

However, is this the right way forward for East Asia? There are many questions that we need to ask before we can answer this question. Do we need 'global standards' in institutions in the first place? If there are some benefits of having such standards, does this apply to all kinds of institutions, or just to some? How do we define GSIs? How good are they for economic development? Has the adoption of GSIs in the recent period helped the East Asian economies? Is it going to guarantee them a better future? These are the main questions that I will try to answer in this chapter.

Should there be 'global standards' in institutions?

Before deciding what are, or should be, GSIs, we first need ask whether there should be global standards in institutions in the first place.

The existence of multiple standards imposes transaction costs, as this requires 'translation' between different standards. The costs may be relatively small when the number of standards involved is small, but when the number becomes large, the cost will rise disproportionately. For example, having two standards, we need only one 'translation' between the standards, but having five standards, we need ten, not two and half, 'translations' (with x standards we need $x(x-1)/2$ 'translations' between them).

Given this, it may sound obvious that having fewer standards is better, with having just one standard being the best.[2] However, the trouble is that we are not starting with a *tabula rasa* and there are already multiple standards across the world. This means that the benefits from the reduction in transaction costs need to be set against the 'transition costs' involved in harmonizing different standards.

The transition costs may not be negligible *even* in the cases of 'neutral' institutions like the units of measurement (the length, the weight, the temperature), where the standards involved are equally desirable in terms of their inherent qualities. For example, time and mental energy will have to be expended by the people who have to adopt the new (common) units of measurement, some costs may be incurred from mistakes that people make in using the new units, and some hardware have to be changed (e.g. thermometers, scales, rulers, cash registers, labels on products).

When it comes to other more complex institutions, the transition costs may be much higher, except for those whose own standards become the world standards.

Harmonization of even relatively innocuous-looking institutions like the harmonization of accounting rules or the adoption of the BIS capital adequacy ratio can have serious implications for efficiency and distribution. For example, changes in accounting rules can importantly affect the ways in which surpluses are distributed between different stakeholders of an enterprise and the enterprise performance evaluated. The BIS capital adequacy ratio – that financial institutions should not extend loans beyond a certain multiple of their capital (at the moment, it is 12.5 times) – may look like a sensible enough thing for everyone to adopt, but in fact it is unfair for the developing countries, as their banks are required to maintain the same capital base per lending as that of their developed country counterparts, despite their relatively scarce financial resources. If the 'New Basel Accord' (or BIS II) proposed by the Basel Committee in January 2001 is adopted, it will become even more unfair for the developing countries. Under BIS II, financial institutions should apply different weights to corporate lending according to the ratings given to the borrowing company by international credit rating agencies. This means that financial institutions will become much less willing to lend to developing country corporations on account of their low credit ratings, as they will have to put aside more reserve aside than when they lend to developed country firms with high credit ratings.[3]

When it comes to even more complex institutions like, say, capital market regulations or labour market regulations, the impact of global harmonization can be far-reaching in terms of both efficiency and distribution. For example, the full opening up of the capital account and the liberalization of M&A in Korea following the 1997 crisis has not only dramatically increased the share of the stock market owned by foreigners (it used to be one of the lowest but now is one of the highest in the world) but also has made the local firms much more sensitive to short-term profit signals (lest that they will become the objects of hostile takeover bids). Consequently, Korean firms have become much less aggressive in their investment behaviour, as they first have to increase dividend payments to satisfy short-term-oriented foreign investors while keeping a large amount of cash reserve for fear of hostile takeover. The result, when combined with the IMF pressure to radically bring down the corporate debt–equity ratio, was that the country's average investment ratio as a proportion of GDP fell from 37.1 per cent during 1990–97 to 25.9 per cent during 1998–2002, significantly affecting the country's present growth dynamics and future prospect.

Are GSIs truly global?

Even if we agree that adopting a common standard at the global level may be beneficial in certain areas, the question still remains which of the competing standards should be the global standard. How have the GSIs in various areas been determined in the current discourse on GSIs?

One possibility is that the list of GSIs simply includes the institutions that are used by the highest number of countries. That this is not the case is obvious from the fact that almost all developing countries are currently under pressure to adopt the GSIs. Then are there GSIs that at least most of the developed countries use, as many people in developing countries tend to believe? They are not. They are in fact institutions that are largely confined to the Anglo-American economies, especially the US. Let us go through the items on the list we presented in the introduction one by one.

Laissez-faire industrial policy with a welcoming attitude towards foreign investors

Japan's success with interventionist industrial policy is well known. However, it was not only Japan but quite a few European developed countries – such as France, Finland, Norway, and Austria – that actively used interventionist industrial policy in order to promote their industrial catch-up.

As a part of their industrial policy, these countries have also heavily regulated foreign investment. For example, until the 1980s, Japan was virtually closed to foreign investment, while Finland went as far as classifying all enterprises with more than 20 per cent foreign ownership as 'dangerous enterprises' between the 1930s and 1987 (for further details, see Chang and Green, 2003).

Even in the US, the alleged home of laissez-faire industrial policy, the government has strongly influenced the course of industrial development through R&D expenditures in areas like defence and pharmaceuticals. Throughout the postwar period, the US government has accounted for 50–70 per cent of the country's total R&D expenditure, in contrast to less than 20 per cent in Japan, the supposed home of interventionist industrial policy. Thus seen, it may be argued that government R&D expenditure has acted as de facto industrial policy in the US.

Small public-enterprise sector

Although internationally comparable statistics are surprisingly hard to come by in this regard, the information contained in Tables 2.1 and 2.2 suggest that the US is the only developed country that has had a small public-enterprise sector throughout the last few decades, both in terms of share in GDP and share in national investment.

Although the importance of public enterprises decreased between the mid-1970s and the early 1990s in many (although by no means all) countries featured in the tables, the kind of radical privatization asked of the developing countries these days has happened only in a few countries. Of the 15 (excluding the US) developed countries shown in Table 2.2, the share of the public enterprise sector, measured by its share in total investment, has fallen significantly only in three countries since the 1970s – Japan, the Netherlands, and the UK. In the

Table 2.1 Percentage shares of public enterprises in GDP

Country	*1974–77*	*1978–85*	*1986–91*
Australia	9.2	n.a.	n.a.
Austria	14.5[a]	6.5	13.9
Belgium	n.a.	2.6	2.8
Denmark	6.3[b]	n.a.	5.1
France	11.9[c]	10.7	10.0
Germany[d]	10.3[e]	7.1	n.a.
Greece	n.a.	5.3	11.5
Italy	7.7	6.7	5.6
Netherlands	3.6[f]	n.a.	n.a.
UK	11.3	5.9	3.0
USA	n.a.	1.3	1.0

Source: The first column is from Short (1984), table 1. The last two columns are from World Bank (1995) Appendix Table A.3. Since the two sources use different data sources, they are not strictly comparable. For example, there is a huge discrepancy for the Austrian figures, which cannot be explained without going to the original data sources.

Notes
a 1976–77.
b 1974 only.
c 1974 only.
d West Germany only.
e 1976–77.
f 1971–73.

remaining 12 countries in the table, the weight of public enterprises had been rather high and stable during the period, with the weight increasing in a few countries (Denmark, Greece, and Norway).

In many countries, the supposedly privatized firms have often remained de facto public enterprises. The best example in this regard is the French automobile producer Renault. The company was nationalized after the Second World War, on account of the collaboration with the Nazis by its owner. Although it was privatized in 1996, the French government owned 43.78 per cent of its shares, accounting for 45.39 per cent of the voting rights, with another 3 per cent or so accounted for by the shares owned by the former and the present employers. By the end of 2002, the French government's share had come down to 25.91 per cent, but these shares still accounted for 31.83 per cent of voting rights, high enough to give it a controlling share (for further information, see www.renault.com/docs/finance_gb/re2002_06_RenaultShareholders.pdf).

Developed stock market with easy M&A

Non-Anglo-American countries have a bank-based financial system, with the stock market playing a secondary role in corporate restructuring. In most of these countries, hostile M&As are either banned by law or practically impossible. For example, in Germany, M&As have to be agreed by the labour unions

Table 2.2 State-owned enterprise investments as a proportion of gross investments in selected industrialized countries (%)

Country	*1974–77*	*1978–85*	*1986–91*
Australia	18.7	17.7	14.7
Austria	19.2	6.2	n.a.
Belgium	12.6	9.9	7.0
Denmark	8.3[a]	n.a.	13.5
Finland	13.6[b]	n.a.	n.a.
France	14.0	15.2	11.6
Germany[c]	12.3[d]	11.6	n.a.
Greece	16.9	16.9	19.6
Ireland	13.1	10.5	10.5
Italy	17.2	12.2	12.9
Japan	11.6	10.2	5.5
Netherlands	13.8[e]	9.1	6.0
Norway	17.7	19.6	28.6
Sweden	15.3[f]	22.0	10.1
UK	18.6	15.1	5.6
USA	4.9	3.7	3.7

Source: The first column is from Short (1984), table 1. The last two columns are from World Bank (1995) Appendix Table A.3. Since the two sources use different data sources, they are not strictly comparable. For example, there is a huge discrepancy for the Austrian figures, which cannot be explained without going to the original data sources.

Notes
a 1974 only.
b 1975 only.
c West Germany only.
d 1976–77.
e 1971–73.
f 1978–80.

through the co-determination system. For another example, in Japan, hostile M&A is made impossible by cross-shareholding between 'related enterprises' (companies belonging to the same *keiretsu*, major lending banks, insurance companies with which the company has insured itself, or other companies who sell to and buy from the enterprise concerned). It is estimated that up to 70 per cent of the shares of Japanese companies have been held by friendly investors, with this ratio not falling below 50 per cent even during the current economic stagnation, when there is great temptation to sell the shares in question. As a result, there simply aren't enough shares that can be sold and bought in the open market to make hostile M&A possible.

Also, even in the Anglo-American countries, stock markets mainly act as the 'market for corporate control' rather than as a channel of new industrial financing. Table 2.3 shows that the importance of new equity as a source of corporate financing is actually smaller in the UK and the US than in Korea, whose bank-based financial system, on the one hand, and the avoidance of stock issues for

Table 2.3 Gross sources of finance in selected countries, 1970–89 (%)

	Germany	*Japan*	*UK*	*USA*	*Korea*[a]
Internal	62.4	40.0	60.4	62.7	29.0
Bank finance	18.0	34.5	23.3	14.7	18.9
Bonds	0.9	3.9	2.3	12.8	5.7
New equity	2.3	3.9	7.0	−4.9	13.4
Trade credit	1.8	15.6	1.9	8.8	n.a.
Capital transfer	6.6	n.a.	2.3	n.a.	n.a.
Other	8.0	2.1	2.9	5.9	n.a.

Sources: Chang and Park (2004), p. 39, table 2.7.

Note
a 1972–91.

fear of losing control by whose family-owned corporations, on the other hand, are supposed to have made the country rely much more heavily on debt than stock financing, until the 1997 financial crisis. A wider data set covering other developing countries also shows that, contrary to the conventional wisdom, the stock market plays a greater role in investment financing in the developing countries than in the developed countries.

A regime of financial regulation that encourages 'prudence' and 'stability'

The global standard institutions in financial regulation are ones that are supposed to encourage 'prudence' for financial firms and 'stability' for the economy as a whole.

At the foundation of the system is a politically independent central bank that guarantees stability by being single-mindedly focused on inflation control. This is supposed to remove uncertainty about the value of returns on assets, thus encouraging investments. On top of the price stability thus guaranteed, various rules of financial regulation are introduced that encourage 'prudent' behaviours by financial firms, such as the BIS capital adequacy ratio or the Forward Looking Criteria (FLC) in lending decisions, which makes the financial firms take into account 'future business prospect' of their borrowers.

The interesting thing about these financial regulations is that, although they are Anglo-American in their character, their adoption has been quite recent even in the Anglo-American countries. Even more interestingly, these regulations have often been more enthusiastically embraced by some non-Anglo-American countries than by the Anglo-American countries themselves.

The politically independent central bank with a single-minded pursuit of low inflation is still not a reality even in some Anglo-American countries. New Zealand may have acquired such a central bank in the 1980s, with its governor's salary indexed (inversely) to the rate of inflation, but the US central bank, the Federal Reserve Board, still remains less than fully politically independent.

More importantly, it is clearly mandated to pursue growth and employment as its policy goals, and not just price stability. The UK granted 'operational independence' to its central bank, but not the full independence that the supporters of GSIs want.

Ironically, during the last decade or so, it has been the non-Anglo-American countries, most of which used to have low central bank independence (except for Germany, due to its historical legacy of post-Second-World War hyperinflation) that have acquired something very similar to the ideal central bank of the GSI discourse.

Japan's central bank, once derided as a 'branch' of the Ministry of Finance, now has enormous independence, so much so that, Hayami, its former governor, could refuse releasing more liquidity in the midst of a price deflation in 2001 on the absurd ground that he is afraid of a 'hyper-inflation' that such action may start. The European Central Bank (ECB) is heavily criticized for its total independence from the democratic process, which has enabled it to act as if unemployment does not matter.

In terms of the more direct institutions of financial regulation, they have recently changed in a way that puts undue emphasis on the 'prudence' of financial firms at the cost of the overall economy, such as the BIS ratio and the FLC.

The BIS ratio may have made the financial firms more 'prudent', but it has destabilized the economy due to its pro-cyclical nature. In a recession, an increase in bankruptcy and a fall in asset prices shrink the asset base of the financial firms, which induces them to withdraw their loans from the corporate sector in order to meet the BIS standard, which makes the recession even worse. In a boom, the opposite mechanism allows the financial firms to increase their lending even without an improvement in the underlying quality of their assets, thus fuelling the boom even further.

The FLC, likewise, may make the financial firms more 'prudent', but have a highly dampening effect on business activities, as it is based on an extremely conservative view on what prudent corporate and financial managements are. Under the previous standard, financial firms were required to set aside provisions only against those loans on which interests are not actually paid. The FLC require that financial firms set aside provisions against the loans even though interests on which are regularly paid, if borrowers' management conditions, financial status, future cash flow and so on are regarded inadequate. In judging a borrower's future business prospect, corporate debt–equity ratio is seen as one of the key considerations, which means that it discourages rapid corporate expansion based on lending, even if it may make business sense. Moreover, with the introduction of FLC, the very definition of non-performing loans (NPLs) itself has become more stringent.[4]

Shareholder-oriented corporate governance system

The alleged 'global standard' in corporate governance system is one that is based on widespread stock ownership (rather than concentrated family ownership), reliance on stock-market financing (rather than borrowing), and mechan-

isms to encourage shareholder-oriented management (such as stock options for the managers and laws that make lawsuits by minority shareholders easy). However, this is a misleading picture.

First of all, family ownership is actually quite common even in developed countries. Small European countries tend to have high ownership concentration, often controlled by family owners (David and Mach, 2002). In Sweden, one family, the Wallenberg family, controls companies which together account for 40–50 per cent of the Stockholm stock exchange. Many world-class firms, even in the US, are still controlled by families – BMW, Fiat, Peugeot, and Ford, just to look at the automobile industry.

Second, contrary to the conventional wisdom that only some Asian countries, especially Korea and Japan, have had pathologically high dependence on debt, the corporate sector in many developed countries has had high debt. As we can see from Table 2.4, the corporate sector debt–equity ratios of Japan (369 per cent), France (361 per cent) and Italy (307 per cent) are similar to Korea's. The figures for Sweden (555 per cent), Norway (538 per cent), and Finland (492 per cent) are even higher, at near or above 500 per cent. The ratio for Japan in the 1970s was also around 500 per cent.

Third, as for the so-called shareholder-oriented management, it is only the Anglo-American countries where a narrow focus on shareholder interest is widely accepted. In the other developed countries, a corporation is considered a 'community' of various stakeholders, rather than a 'property' of the shareholders as in the Anglo-American countries. And they often have mechanisms that prevent an exclusive pursuit of shareholder interest, such as the social pacts in the Scandinavian countries, the German co-determination system, or the Japanese industrial relations. Even in the Anglo-American economies, shareholder dominance has become a reality only in recent periods (since the 1980s).

Flexible labour market

Flexible labour market in the sense of free hiring and firing has not existed in any of the developed countries, perhaps except the US. Although many of them have recently moved in that direction, the move has not fundamentally changed the characteristics of their labour markets, probably except in the UK.

More importantly, the very concept of labour market flexibility employed in the mainstream discourse is highly limited. For example, if we use this concept, we cannot really explain how the workers in Sweden or Japan, which have 'rigid' labour markets by mainstream standards, have been willing to acquire new skills, take on new jobs, and accept high degrees of automation. (In fact these two countries have the highest numbers of industrial robots per worker.) The explanation has to be found in these countries' political-institutional arrangements that have made their workers accept technological change in return for employment security (at the firm level in Japan; at the economy-wide level in Sweden) and the employers' investment in retraining (centralized in Sweden; conducted mostly at the firm level in Japan).

Table 2.4 Capital structure of firms in selected countries, 1980–91

Country	*Debt–ratio*	*Long-term debt to total equity*	*Short-term debt to total equity*	*Deprecia-tion to total assets*	*Dividend to total assets*	*Earnings to total assets*
Australia	1.248	0.563	0.653	0.033	0.025	0.064
Austria	2.696	1.121	1.495	0.051	0.017	0.075
Belgium	2.023	0.764	1.259	0.039	0.022	0.092
Brazil	0.560	0.139	0.421	–	0.014	0.057
Canada	1.600	0.990	0.539	0.045	0.007	0.064
Finland	4.920	3.094	1.856	0.042	0.014	0.077
France	3.613	1.417	2.108	0.043	0.013	0.094
Germany	2.732	1.479	1.188	0.070	0.057	0.087
Hong Kong	1.322	0.309	0.967	0.017	0.019	0.121
India	2.700	0.763	1.937	0.038	0.014	0.132
Italy	3.068	1.114	1.954	0.041	0.070	0.080
Japan	3.688	0.938	2.726	0.026	0.007	0.067
Jordan	1.181	0.266	0.915	–	0.033	0.073
Korea	3.662	1.057	2.390	0.053	0.008	0.100
Malaysia	0.935	0.284	0.639	0.021	0.026	0.087
Mexico	0.817	0.375	0.442	–	–	0.076
Netherlands	2.156	0.710	1.297	0.043	0.020	0.094
New Zealand	1.527	0.752	0.776	0.030	0.025	0.106
Norway	5.375	3.495	1.880	0.049	0.009	0.092
Pakistan	2.953	0.595	2.358	0.038	0.028	0.115
Singapore	1.232	0.491	0.718	0.022	0.018	0.077
South Africa	1.115	0.597	0.518	0.013	0.062	0.206
Spain	2.746	1.086	1.649	0.040	0.016	0.095
Sweden	5.552	2.879	2.321	0.036	0.011	0.100
Switzerland	1.750	0.878	0.872	0.043	0.016	0.073
Thailand	2.215	0.518	1.769	0.030	0.029	0.129
Turkey	1.996	1.511	1.511	–	0.068	0.239
UK	1.480	1.065	1.065	0.032	0.025	0.025
USA	1.791	1.054	0.679	0.045	0.016	0.016
Zimbabwe	0.801	0.187	0.615	0.031	0.028	0.028

Source: Chang and Park (2004), p. 31, table 2.3.

Are the Anglo-American institutions superior?

When reminded of the ‘non-globality’ of the currently promoted GSIs, some of their proponents argue that in the end the Anglo-American institutions will become GSIs because they are superior to their counterparts in other countries. As the Anglo-American countries beat the others in economic competition, the others will either voluntarily adopt the Anglo-American institutions to improve their performance or be forced to adopt them in order to survive, thus in the end making the Anglo-American institutions the GSIs. Given this, they argue, it is

better to join the gang now than later – why not accept what is inevitable anyway?

However, this is based on a flawed reading of the empirical evidence. As we can see from Table 2.5, the Anglo-American countries had been laggards in terms of economic growth until the 1980s. For example, between 1950 and 1987, at 1.9 per cent, the US was literally the slowest growing in terms of per capita GDP among the 16 OECD countries, for whom (including the US) the average was 3.0 per cent. Other Anglo-American countries also grew slowly during this period, with Canada (2.0 per cent) ranking second from the bottom, Australia (2.1 per cent) coming next and the UK (2.2 per cent) ranking at joint fourth from the bottom with Switzerland. Admittedly, they were among the richest countries in the OECD in 1950 and therefore did not benefit from the 'catch-up' effects, but these are hardly performances that will pressure other countries into adopting their institutions.

The relative performance of the Anglo-American countries did improve since the 1990s. As we can see from the table, between 1990 and 2003 the Anglo-American countries moved from the bottom quartile to the top half of the growth league table (in terms of per capita GDP growth). Australia (2.6 per cent) ranked joint second with Finland after Norway (2.8 per cent) among the 16 countries, with the UK (2.4 per cent) ranking at the third, Canada (2.2 per cent) ranking at the fifth, and the US (2.0 per cent) ranking at joint seventh with Sweden and Denmark. The interesting thing is that their absolute performance (2.0–2.6 per cent) was only marginally better than their historical ones (1.9–2.2 per cent during 1950–87).

In other words, the 'improvement' in the economic performance of the Anglo-American countries since the 1990s was not mainly due to a trend increase in their growth rates but because of the collapse of growth in many previously fast-growing countries. And the growth slowdowns in these countries were the results of a mixture of exogenous factors and failures of macroeconomic/financial policies, rather than institutional reasons. The stagnation of the German economy after the reunification (the country is still pouring the equivalent of 5 per cent of GDP into what used to be East Germany) and the deep recession that Finland experienced after the collapse of the Soviet Union, which had accounted for a third of Finland's exports (although even then Finland did better than most Anglo-American countries) are the more prominent examples of such exogenous factors. Examples of macroeconomic/financial policy failures include Japan's failure to quickly recapitalize the banks following the bursting of the financial bubble in the early 1990s and the excessively tight macroeconomic policy implemented by most EU countries in preparation for European Monetary Union through the Stability Pact.

Thus seen, the assertion that the superiority of the Anglo-American institutions will eventually make them GSIs is highly misleading. Up to the 1990s, the Anglo-American economies had been laggards in terms of economic growth, while even their performance since the 1990s owes more to the failures of other countries than to their own successes.

Table 2.5 GDP *per capita* growth for selected countries (annual average compound growth rates)

Grouping	*1900–50*	*1950–87*	*1980–90*	*1990–2003*
'OECD'				
Australia	0.8	2.1	2.2	2.6
Austria	0.5	3.9	1.9	1.8
Belgium	0.8	2.8	1.9	1.8
Canada	2.0	2.0	2.1	2.2
Denmark	1.6	2.6	1.8	2.0
Finland	1.9	3.6	2.9	2.6
France	1.2	3.2	2.0	1.5
Germany	1.0[a]	3.8[a]	2.3	1.2
Italy	1.1	3.7	2.4	1.5
Japan	1.0	6.0	3.7	1.1
Netherlands	1.0	2.5	1.8	2.1
Norway	2.1	3.4	2.3	2.8
Sweden	2.0	2.7	2.2	2.0
Switzerland	1.9	2.2	1.4	0.3
UK	0.8	2.2	3.0	2.4
USA	1.7	1.9	2.4	2.0
'OECD' average	1.3	3.0	n.a.	n.a.
USSR	2.1	2.6	n.a.	−2.0[b]
Asia				
Bangladesh	−0.1	0.3	2.2	2.8
China	−0.3	4.5	9.1	8.3
India	−0.1	1.7	3.7	3.9
Indonesia	−0.1	2.5	4.5	1.9
Pakistan	−0.1	2.2	3.7	1.1
Philippines	0.4	1.4	−1.3	1.2
South Korea	0.1	5.5	7.9	4.5
Taiwan	0.4	6.1	n.a.	n.a
Thailand	0.1	3.5	6.3	2.4
'Asia' average	0.0	3.1	n.a.	n.a.
Latin America				
Argentina	1.2	1.0	−2.1	1.1
Brazil	1.8	3.2	1.0	1.0
Chile	1.8	1.0	2.7	4.1
Colombia	1.7	2.1	1.6	0.3
Mexico	1.2	2.3	−0.9	1.2
Peru	1.6	1.5	−2.1	1.9
'Latin America' average	1.6	1.9	n.a.	n.a.

Sources: The 1900–50 and 1950–87 series are from Maddison (1987). The 1980–90 series are constructed from the World Bank on-line data set, accessed in 2003, using the 1980–90 GDP growth figures and the 1980–2002 population figures. The 1990–2003 series are constructed from the 1990–2003 GDP growth figures found in table 3 of *World Development Report 2005* and the 1990–2003 population growth figures from table 2.1 of the on-line *2004 World Development Indicators*.

Notes

a West Germany only.

b Russian Federation only.

Despite this problem, the assertion is widely accepted. One reason is that the Anglo-American countries have great incentives to exploit their financial and media power to propagate the notion. As important is the fact that the elite in the non-Anglo-American countries are certain to benefit disproportionately from the adoption of the Anglo-American institutions (and the resulting increase in the upward redistribution of wealth). Given this, it is not surprising that many of these people have become advocates of the Anglo-American model.

Are free capital flows forcing countries to adopt Anglo-American institutions?

It may be argued that, even if the Anglo-American institutions are not inherently superior to non-Anglo-American institutions, countries should strive to adopt them because they are what the international investors want. After all, it may be argued, in a globalized world with free capital flows, it is the international investors who are calling the shots. Countries that do not adopt the institutions that international investors want, it is said, will be shunned by them and suffer as a result. However, this argument has many problems.

First of all, it is not clear whether international investors do necessarily care so much about a country's conformity to global standards in institutions when making investment decisions. For example, China has been able to attract a huge amount of foreign investment despite the proliferation of 'poor institutions'. This suggests that what the investors really want is often different from what the proponents of the GSIs say they want. Empirical studies show that most institutional variables are much less important than factors like the size of the market, the growth of the market, the quality of the labour force and the quality of infrastructure in determining international investment decisions (Chang, 1998).

Second, even if the adoption of GSIs bring about increased foreign investments, foreign investments are not going to be the key element in most countries' growth mechanisms. In other words, the potential value of an institution to a country should be determined more by what it will do to promote internal development rather than by what the international investors will think about them. And there are reasons to doubt, discussed elsewhere in the chapter, whether the Anglo-American institutions will promote growth and development. And we have to set these uncertain benefits against the 'transition costs' involved in adopting new standards.

Third, even if GSIs get introduced under external pressure, they may not deliver the expected results, unless they can be effectively enforced. It is possible to argue that we should welcome a certain degree of external pressure in situations where the government of a developing country is resisting the introduction of certain institutions that are obviously 'affordable' and compatible with the prevailing political and cultural norms in the society. However, we should also recognize that the introduction of institutions in countries that are not 'ready' can mean that the institutions will not function well or may even be undermined altogether. There will be also problems with institutional changes that are imposed from outside without 'local ownership', as the current jargon

has it. If that is the case, cleverer international investors will figure out that having certain institutions on paper is not the same as really having them. This means that formally introducing GSIs will make little difference to the country's attractiveness to foreign investors.

Fourth, even if we agree that there is a certain amount of 'competitive pressure' for institutional harmonization through the influence of international investors, its extent should not be exaggerated. Despite significant advances in globalization, international differences in institutional arrangements persist (Berger and Dore, 1996). Having said that, it should be acknowledged that the scope for the survival of local varieties of institutions may be smaller in developing countries, because their institutions are weaker than their counterparts in the developed countries for various reasons and because they are politically less able to withstand the external pressure to adopt GSIs.

Are the Anglo-American institutions suitable for the developing countries?

Many developed countries find the Anglo-American institutions unsuited to them. This is because, for a number of economic, political, and social reasons, they have developed very different institutions from the Anglo-American ones.

The unsuitability of the Anglo-American institutions is an even bigger problem for the developing countries. In general, the developing countries may find the Anglo-American institutions even more constraining than non-Anglo-American developed countries, as those institutions are particularly geared to guaranteeing financial stability over investment and growth, which the developing countries need more. For example, as we pointed out earlier, the Anglo-American stock market serves mainly as the market for corporate control rather than as a channel for financing new investment. For another example, the BIS-type financial regulation emphasize the safety of financial institutions over corporate investment and growth, and thus can be harmful for developing countries with greater needs to invest and grow. And so on. The generally low growth rates that the Anglo-American countries have maintained are a powerful testimony to the anti-growth nature of their institutions.

Indeed, when they were developing countries themselves, the Anglo-American countries used different institutions from the ones they are using now.

The UK in the eighteenth century and the early nineteenth, and after it the US in the mid-nineteenth until the early twentieth century, became the world's top economic nations through extensive uses of tariffs and subsidies. For example, Table 2.6 shows that even in the early nineteenth century, the UK had much higher industrial tariffs than countries like Germany, which are mistakenly known as the home of protectionism, while the US had the highest average industrial tariff rate in the world[5] throughout most of the nineteenth century and the first half of the twentieth century. Virtually all of today's developed coun-

Table 2.6 Average tariff rates on manufactured products for selected developed countries in their early stages of development (weighted average; % of value)[a]

Country	*1820b*[b]	*1875*[b]	*1913*	*1925*	*1931*	*1950*
Austria[c]	*R*	15–20	18	16	24	18
Belgium[d]	6–8	9–10	9	15	14	11
Denmark	25–35	15–20	14	10	n.a.	3
France	*R*	12–15	20	21	30	18
Germany[e]	8–12	4–6	13	20	21	26
Italy	n.a.	8–10	18	22	46	25
Japan[f]	*R*	5	30	n.a.	n.a.	n.a.
Netherlands[d]	6–8	3–5	4	6	n.a.	11
Russia	*R*	15–20	84	*R*	*R*	*R*
Spain	*R*	15–20	41	41	63	n.a.
Sweden	*R*	3–5	20	16	21	9
Switzerland	8–12	4–6	9	14	19	n.a.
UK	45–55	0	0	5	n.a.	23
USA	35–45	40–50	44	37	48	14

Source: Bairoch (1993), p. 40, table 3.3.

Notes

R Numerous and important restrictions on manufactured imports existed and therefore average tariff rates are not meaningful.

a World Bank (1991, p. 97, box table 5.2) provides a similar table, partly drawing on Bairoch's own studies that form the basis of the above table. However, the World Bank figures, although in most cases very similar to Bairoch's figures, are *unweighted* averages, which are obviously less preferable to *weighted* average figures that Bairoch provides.

b These are very approximate rates, and give range of average rates, not extremes.

c Austria–Hungary before 1925.

d In 1820 Belgium was united with the Netherlands.

e The 1820 figure is for Prussia only.

f Before 1911, Japan was obliged to keep tariff rates low (up to 5%) through a series of 'unequal treaties' with the European countries and the USA. The World Bank table cited in note *a* above gives Japan's *unweighted* average tariff rate for *all goods* (and not just manufactured goods) for the years 1925, 1930, 1950 as 13%, 19%, 4%.

tries used strong tariff protection and interventionist industrial policy when they were trying to catch up with more advanced countries (Chang 2002, ch. 2).

The US heavily regulated foreign investment when it was a net importer of capital (Chang and Green, 2003). For example, it restricted foreigners' ownership in agricultural land, mining and logging. It discriminated against foreign firms in banking and insurance, while altogether prohibiting foreign investment in coastal shipping. It banned the employment of foreign workers, thus implicitly disadvantaging foreign investors that wanted to import skilled labour from their home countries. When the UK became a capital-importing country after the Second World War, it too implemented various formal and information restrictions on foreign investment.

In short, most of the so-called GSIs are in fact institutions that had been developed by the Anglo-American countries in response to their contemporary problems. As the problems they currently face are very different from the ones

that the developing countries face, it is unlikely that these institutions are suited to the needs of the developing countries. The fact that the Anglo-American countries used many non-Anglo-American institutions when they were developing countries themselves is an additional, if indirect, proof of this.

Conclusion

In this chapter, after discussing whether there should be global standards in institutions at all, I showed how the so-called global institutions (GSIs) that most countries, including the East Asian ones, have been encouraged, or even forced, to adopt recently are not truly 'global'. Most of them are actually institutions that are found only in the Anglo-American countries, while the others may not even exist in those countries in reality (e.g. laissez-faire industrial policy, stock-market-led corporate financing, etc.).

I then critically examined two arguments that say the Anglo-American institutions should still be considered to be GSIs. The first of these arguments says that they will be adopted by everyone in the end, whether they like it or not, because they generate superior economic performance. The second argument is that countries will have to adopt these institutions sooner or later if they are to survive in a world with free capital flows, as these are institutions that the international investors like. Both of these arguments were found wanting in empirical bases.

Finally, I discussed why the Anglo-American institutions are particularly unsuited to developing countries. I argued that these are institutions that are meant for mature economies (and at that only one of many possible sets), which even the Anglo-American countries adopted only after they had achieved their economic development.

The East Asian countries will be put under particular pressure to adopt GSIs. Over the last couple of decades, most of the developing countries have adopted GSIs largely under pressure from the Washington institutions (the IMF, the World Bank, and the US Treasury). The East Asian countries have remained exceptions in this regard until recently, thanks to their good economic performance and thus their lack of dependence on the Washington institutions. In that sense, the East Asian countries are the 'final frontier' in the developing world in the battle for GSIs.

The East Asian countries should never adopt the so-called GSIs thinking that they are truly global, as they are really Anglo-American institutions dressed up as global ones. It should also be noted that, in certain aspects, even the Anglo-American countries themselves do not actually use what are taken to be the GSIs (e.g. politically independent central bank). The argument that these institutions will have to be adopted, like it or not, because they generate superior economic performance and/or they are the ones that foreign investors want, is also misleading. Our examination shows that the Anglo-American institutions have not generated superior economic performance and that they are not really the ones that the foreign investors want. The disappointing results of the Korean experiment with GSIs following the 1997 financial crisis (Shin and Chang, 2003) is

another reminder that other countries in the region need to be very wary of the 'global standard' argument.

Notes

1 I thank Jang-Sup Shin, Beng-Hua Chua, and other participants in the conference, 'Global Challenges and Local Responses: A Comparison between Singapore, Malaysia, and South Korea', for their helpful comments on the first draft of the chapter. I also thank the research support from the Korea Research Foundation through its BK21 programme at the Department of Economics, Korea University, where I was a visiting research professor when the chapter was written.

2 However, from an evolutionary perspective, a world with a greater diversity in standards may be better equipped to deal with sudden environmental changes than a world with a single standard.

3 For instance, in BIS II, if a company has a credit rating between AAA to AA^-, a 20 per cent risk weighting is applied whereas a 150 per cent risk weighting is applied to a company with a credit rating of BB^- and below. Even in Korea, with many world-class companies, most companies had credit ratings of BB^- and below as of 2001.

4 For example, in Korea, loans were classified as NPLs if the borrowers do not pay full interest for six months. The period has become three months with the introduction of the FLC.

5 Talking of 'the world' with a table with only 14 countries is not an outrageous claim as it first sounds to be, because during the period covered in the table, most countries that do not appear in the table did not have tariff-setting powers because they were either colonies or had been deprived of tariff autonomy through 'unequal treaties'.

References

Bairoch, P. (1993) *Economics and World History – Myths and Paradoxes* (Brighton: Wheatsheaf).

Berger, S. and Dore, R. (eds) (1996) *National Diversity and Global Capitalism* (Ithaca NY: Cornell University Press).

Chang, H.-J. (1998) Globalization, Transnational Corporations, and Economic Development, in D. Baker, G. Epstein and R. Pollin (eds) *Globalization and Progressive Economic Policy* (Cambridge: Cambridge University Press).

Chang, H.-J. (2002) *Kicking Away the Ladder – Development Strategy in Historical Perspective* (London: Anthem Press).

Chang, H.-J. and Green, D. (2003) *The Northern WTO Agenda on Investment: Do as we Say, Not as we Did* (Geneva, South Centre, and London: CAFOD).

Chang, H.-J. and Park, H.-J. (2004) An Alternative Perspective on Government Policy towards the *Chaebol* in Korea: Industrial Policy, Financial Regulations, and Political Democracy, in S.-H. Jwa and I. Lee (eds) *Competition and Corporate Governance in Korea: Reforming and Restructuring the Chaebol* (Cheltenham: Edward Elgar).

David, T. and Mach, A. (2002) Institutionalisation and Questioning of Ownership Restrictions in Switzerland and Sweden, a paper presented at the European Business History Annual Congress in Helsinki, 22–24 August 2002, and at the workshop of the Research Committee on Economic Sociology of the Swiss Society of Sociology, Fribourg, 12 October 2002.

Kapur, D. and Webber, R. (2000) Governance-related Conditionalities of the IFIs, G-24 Discussion Paper Series, no. 6 (Geneva: UNCTAD).

Maddison, A. (1989) *The World Economy in the Twentieth Century* (Paris: OECD).
Shin, J.-S. and Chang, H.-J. (2003) *Restructuring Korea Inc.* (London: RoutledgeCurzon).
Short, R. (1984) The Role of Public Enterprises: An International Statistical Comparison, in R. Floyd, C. Gary and R. Short (eds) *Public Enterprises in Mixed Economies: Some Macroeconomic Aspects* (Washington, DC: International Monetary Fund).
World Bank (1991) *World Development Report 1991* (New York: Oxford University Press).
World Bank (1995) *Bureaucrats in Business* (New York: Oxford University Press).

3 Globalization and challenges to the developmental state

A comparison between South Korea and Singapore

Jang-Sup Shin

Introduction

The appropriate role of the state is a topic that has generated one of the most heated debates among economists as well as other social scientists. In interpreting the developmental experience of East Asian economies, it has also been at the center of controversies, dividing researchers broadly into "free marketeers" or "statists", in which the former emphasized the role of the free market while the latter stressed that of the developmental state in making the East Asian miracle (refer to World Bank 1993; Lall 1994; Fishlow *et al.* 1996; Chang 2001).

Globalization has added another dimension to this ongoing controversy. With the acceleration of globalization, especially after the Asian financial crisis that broke out in 1997, the "free marketeers" have become more assertive. In their view, countries should allow a greater role to market forces and reduce the role of the state because globalization is perceived as a process whereby the market gains more power over the state by weakening the state's control over cross-border flows of products and services. They therefore argued that the crisis was the result of the malfunctioning of the Asian developmental states in the Age of Globalization. (For this view, refer to Frankel 2000 and Yellen 1998. For criticisms of this view, see articles in Chang *et al*. 2001.)

However, this chapter argues that, as the pace of globalization accelerates, the role of the state becomes more important in some significant respects, though it may become less important in other respects, and therefore we need to take a disaggregate approach to the role of the state. It also argues that the role actually required of the state in facing globalization is diverse across countries, reflecting their different paths of economic development and political settlements, and the state should maintain its functions as a mediator between homogenizing forces of globalization and unique characteristics of local economies.

This chapter starts by drawing a distinction between mobile factors and less mobile factors in the process of globalization and discusses changes brought about by the increased mobility in the world economy. It then pays attention to

the fact that mobile factors do not work by themselves, but interact closely with less mobile factors in a given territory. In this context, the chapter emphasizes the role of the state in determining competitiveness of nations as an agent that is least mobile, which is ultimately responsible for providing mobile actors with "complementary assets". It also argues that the role of the state in protecting its economy from increasing financial instability becomes more important with the progress of globalization. In an attempt to draw more concrete implications for the role of the state, the chapter compares the case of Singapore, which has grown through an internationalist model of development, with that of Korea, which has grown through a more nationalistic model of development. It concludes with summarizing previous discussions and drawing general policy implications.

Challenges of globalization

Globalization can be defined as a trend increase in mobility of products, services, and factors of production across national borders. The key word here is "mobility". Mobility in the world economy has been increasing continually since the Industrial Revolution, but, until recently, it was confined mostly to that of products, which can be more rightly referred to as internationalization. "The basic division of labour within the productive process was primarily organized within national economies" for more than two centuries after the Industrial Revolution, as Hobsbawm (1979: 313) observes.

Globalization has recently become a central subject in academic and policy-making discourses, mainly because the increase in mobility has been extended significantly from goods and finance to factors of production and services from the late twentieth century. The central carriers of factors of production across national borders, i.e. multinational corporations (MNCs), took off in the 1960s and have become increasingly dominant forces in the world economy.[1] They have rapidly expanded the global production networks and their cross-border activities are now extended even to research and development (R&D). It was also from the late 1970s that financial markets began integrating globally, witnessing the growing role of global financial institutions as the main carriers of services across borders.

The ever-increasing competition among corporations and financial institutions in advanced countries has been a basic underlying force in the spread of globalization.[2] However, the decisive acceleration of globalization since the 1980s was supported by two concurrent developments in technologies and regulations, which facilitated easier movement of products, services, and factors of production across borders.

First, there was a blossoming of information and communication technologies (ICTs). As a major breakthrough in "space-shrinking" technologies, the ICT Revolution has enabled firms to co-ordinate their operations on the global scale more easily thanks to drastic falls of costs involved in information creation, processing, storage and delivery.

Second, major regulatory changes in the world economy took place. The US and the UK initiated liberalization of their domestic economies and pushed for liberalization of international trade and investment from the 1980s. The wave of liberalization advanced to other developed countries and to developing countries. In this process, the World Trade Organization (WTO) was formed as a new regulatory framework to ensure freer flow of products and investments.[3]

The increased mobility has brought about the following major changes in the world economy. First, it has significantly increased the volume of financial, technical, managerial, and other resources available for individual countries, providing them with greater potential for economic growth. For countries that are mainly receivers of foreign direct investment (FDI) or portfolio investment, the greater availability of foreign capital and technologies has opened a possibility to accelerate the pace of economic growth by reducing time and effort taken in mobilizing their own resources. For countries that already have their own advanced corporations and financial institutions, the acceleration of globalization is a big opportunity to expand their businesses. In a nutshell, the higher mobility is translated into a bigger market, facilitates further division of labor in the world economy, and provides individual countries with a greater opportunity for economic growth.

Second, however, increased instability is a Siamese twin of the higher growth potential. As MNCs are organizing their production on the global scale, they are more ready to change production sites if new needs arise from competition or technological progress. From the viewpoint of individual countries, this means production activities generally become more "footloose", although the actual extent of footloosness of MNCs in individual countries needs to be investigated in detail by considering their specificities in location, industrial structure, institutions, and so forth.

It has also become easier for global financial institutions to manage their investment portfolios on the global scale. They have become more eager to liquidate their investments in regions or countries as soon as they sense the slightest signs of deteriorating prospects, and then reconstruct their portfolios according to the revised assessment of financial risk across the globe. The growing incidence of financial crises in the era of globalization can be understood as a consequence of the increasing mobility in financial resources across national borders. For instance, according to Eichengreen and Bordo (2002), the number of financial crisis increased from 21 during 1945–71 to 44 during 1971–97 for industrial countries, and from 17 during 1945–71 to 95 during 1971–97 for emerging markets, respectively. During 1971–97, a randomly selected country had as high as 10–12 percent probability of experiencing a financial crisis (Table 3.1).

Third, there has been a great "power shift" between mobile actors and less mobile actors. In the 1960s and 1970s, when East Asian countries and Latin American countries began their industrial development, MNCs were commonly regarded as entities to be accepted cautiously and therefore it was a norm that they operated under heavy government regulation. But now they are regarded as

Table 3.1 Number of financial crises: distribution by market

	Year	*Banking crises*	*Currency crises*	*Twin crises*	*All crises*
Industrial countries	1880–1913	4	2	1	7
	1919–39	11	13	12	36
	1945–71	0	21	0	21
	1973–97	9	29	6	44
Emerging markets	1880–1913	11	6	8	25
	1919–39	7	3	3	13
	1945–71	0	16	1	17
	1973–97	17	57	21	95

Source: Eichengreen and Bordo (2002), table 6.

"engines (at least catalysts) of growth" by a broad spectrum of policy-makers, academics and international institutions, and it is widely accepted that deregulation is a necessary step to attract MNCs' investments for the benefit of individual countries (refer to World Bank 2000; Dunning and Hamdani 1997; Lipsey 1997).

Notable is the rapid emergence of the financial sector as the leading sector of globalization. In terms of technologies and characteristics of businesses, financial services are more mobile than manufacturing products. They are more easily duplicable with lower marginal costs and transferable from one place to another at the speed of light. But the globalization of the financial sector had been lagging behind that of the manufacturing sector mainly because of government regulations. In most countries, the financial industry had remained principally as a domestic industry under heavy government regulation. However, once the regulations were removed, the financial sector became the most decisive force of globalization by leveraging on its higher mobility. The possibility that large amount of money can move across borders at the touch of button is threatening in managing national economies and the views of international investors have increasingly prevailed in the name of "investors' confidence", whether one agrees with it or not.[4]

This power shift is of course not one-way traffic. As competition among MNCs or financial institutions intensifies, an opportunity also emerges for recipient countries to extract gains by exploiting their competition. However, the power shift towards mobile actors has been decisive on the whole. The global players have become stronger in enforcing their logic of accumulation upon the running of the world economy while national governments have been under pressure to change their earlier practices of economic management.

The role of the state in the increasingly globalized economy

One ironic thing about globalization is that, as more and more factors become mobile, national competitiveness is more critically dependent on less mobile

factors, i.e. less globalized ones. Mobile players do not act by themselves in their global operations. Instead, they seek "location-specific factors" which will complement their own assets when they determine particular location for production or provision of financial resources (Dunning 1988; 1997). If location-specific factors of a country are not adequate, mobile players do not locate their mobile assets in the country. In this respect, the character and quality of location-specific factors, which are by definition less mobile, determine the "stickiness" of mobile assets, and consequently the competitiveness of a country in the era of globalization.

Among others, the national government is arguably the most immobile one. For example, we cannot move the Singaporean government to Korea. We can therefore say the role of the state becomes more important with the further progress of globalization, contrary to the popular perception that it should be diminished as an economy becomes globalized.[5] Underlying this observation is the fact that the state is *the ultimate system manager of the national economy*, which is responsible for providing mobile actors with man-made complementary assets. Among the location-specific factors, there are certainly non-man-made factors like natural resources and geographical position, upon which national governments can hardly exert an influence unless they attempt to change territorial boundaries. Earlier FDI by MNCs in the late nineteenth and early twentieth centuries were in fact heavily related with the access to non-man-made factors like extraction of natural resources.[6] In the current state of the world economy, however, man-made location-specific factors like policy, institutions, infrastructures and so on are far more important in locational decisions made by mobile players.[7] Within a given territory, the state is the principal agent responsible for providing these man-made complementary assets.

A basic assumption in the popular perception that the role of the state should be reduced in the era of globalization is that market forces would replace or make unnecessary much of the role previously undertaken by the state as an economy is more broadly exposed to forces of globalization. There are certainly some roles of the state that can be substituted for by the market. For instance, if domestic companies and financial institutions develop sufficiently to raise foreign money with their own credit and manage financial risks by themselves, many of the state's supports and regulations over international financial transactions become redundant.

However, we need to take a disaggregated approach to the role of the state because there are also other important functions that only the state can undertake and because some of them become more important with the progress of globalization. For instance, policy formulation and implementation are among the state's unique responsibilities, although the market situation may indicate or affect its direction. The state is also a basic provider of human capital required for economic development. The market cannot provide a legal system, which is essential in the working of the market. Political and social conflicts are resolved mainly through the state apparatus. And these functions of the state, to which the market can never provide alternatives, are still critically important in determining the quality of location-specific factors.

What should be noted is that the role required for the state in the era of globalization is more than a Smithian minimal one. When a country attempts to attract FDIs, it is often the case that the state needs to tempt them with an array of "incentives". Especially when many host countries compete to attract FDIs, the role of incentives becomes more important. The provision of incentives inevitably contains elements of industrial policy because the state needs to decide what kind of incentives will be given, who will receive them, which sector will be given a priority and so on. This is an unavoidable consequence when the state acts as a pro-active creator of complementary assets for inward FDIs, not simply a passive recipient of FDIs dictated by static "factor endowments".

Along with the role of promoting inward FDIs, the state also needs to perform the role to protect its economy from increasing instability of financial flows. In the previous section, I have stressed the connectedness of the positive and negative aspects of globalization: the increased mobility has opened a great opportunity for a country to grow faster by utilizing a greater availability of resources and markets whereas it has increased instability in the world economy.

On the whole, it seems that the positive aspects of globalization have not yet been realized while the negative aspects have been more apparent. As Table 3.2 shows, per capita income growth rate in the world economy actually decelerated when the pace of globalization accelerated. It was reduced from 3.4 percent during 1961–69 to 2.1 percent during 1970–79, to 1.4 percent during 1980–89, and again to 0.9 percent during 1990–99. And this trend of deceleration was more marked in developing countries than in developed countries.

It would be a matter of further investigation to delineate what are the factors behind this deceleration of growth rates in the world economy. However, we cannot exclude the possibility that the negative aspects of globalization could be one of them. Once a financial crisis happens, it is normally the case that the country concerned experiences some period of negative growth or stagnation. Neighboring countries are also badly affected by "contagion". When countries or companies are overly concerned with possible outbreak of financial crises, they also need to divert substantial part of their resources for economic growth to managing financial risks. In this situation, the state is the agent in the national economy, as the ultimate system manager, which is primarily responsible for guarding the economy against financial risks while providing necessary institutional and policy measures to ensure desirable rate of growth.

There is no doubt that the role of the state should be changed with the acceleration of globalization since previous policy tools like tariff protection, subsidies for local industries and so on become less available and effective. However, this does not lead automatically to a wholesale reduction in the role of the state. On the contrary, its role as the ultimate provider of location-specific advantages becomes more important. Its role to minimize possible downside effects from the increasing instability of the world economy is also equally important. In this sense, the role of the state requires revitalization, rather than diminution, with the progress of globalization.

Table 3.2 Economic performance by country groups, 1961–99

Country group	*1999 GDP per capita (US\$)*[a]	*Average annual growth rates (%)*					
		1961–69	*1970–79*	*1980–89*	*1990–99*	*1961–79*	*1980–99*
Developing countries[b]	1,301	2.9	3.4	1.6	1.5	3.2	1.5
East Asia and Pacific	1,177	2.4	5.0	5.7	5.8	3.8	5.8
South Asia	446	1.8	0.5	3.5	3.4	1.1	3.4
Europe and Central Asia	2,135	n.a.	n.a.	n.a.	−2.6	n.a.	n.a.
Middle East and North Africa	1,979	n.a.	n.a.	−1.2	1.3	n.a.	0.0
Latin America and Caribbean	3,763	2.4	3.3	−0.1	1.2	2.9	0.5
Sub-Saharan Africa	561	2.4	1.0	−0.6	−0.9	1.7	−0.7
Developed countries[c]	28,892	4.4	2.9	2.4	1.6	3.6	2.0
High-income OECD	29,578	4.4	2.9	2.4	1.5	3.6	1.9
World	5,439	3.4	2.1	1.4	0.9	2.7	1.2

Source: Adapted from World Bank (2001).

Notes

a Constant 1995 US dollars.

b Equivalent to ‘low- and middle-income economies’ in the World Bank classification.

c Equivalent to ‘high-income economies’ in the World Bank classification.

Different challenges from globalization to the states at the local level: a comparison between Singapore and South Korea

I have sketched above some general challenges from globalization posed to the national government. I have also emphasized that some roles of the state become more important with globalization while others may become less important, and argued for taking a disaggregated approach to understanding the role of the state in the era of globalization. If we want to draw more concrete implications for the role of the state, we need to go a step further and lower the level of analysis by including local characteristics of individual states. This is because the roles of the state in steering their economies have been different, reflecting their differences in paths of development, and therefore actual challenges from globalization are felt differently across countries.

Below, I will discuss these different challenges to and responses from individual states by comparing cases of Singapore and Korea, which have developed through very different routes for industrialization although they share similar characteristics as export-oriented and state-led development models. If Singapore has grown through an "internationalist" model of development, Korea has grown through a more "nationalistic" model of development, which were results of their differences in history, size, geography, internal politics, political leaders' preferences, and so on.

Before it started its industrialization programs, Singapore had developed as an entrepôt open to foreign trade, investment and labor. And, as a former British colony, it had a large English-speaking population. These initial conditions formed an environment conducive for MNCs to operate in. On the other hand, its domestic market was tiny, with a population of less than 2 million at the beginning of industrialization, and the relation with its neighbors was not easy from the start of its nationhood. In this situation, Singapore could expect a greater possibility of success by connecting its economy directly to the "First World" by inviting MNCs of advanced countries and becoming their "export platform". Singapore grew through aggressively attracting MNCs' investments by providing them with complementary assets like infrastructure, human capital, fiscal incentives and so on. From the beginning, the strategic focus of Singapore lay in exploiting complementary relations with advanced countries for its own benefit.[8]

In the 1960s, when Singapore started its industrialization, this kind of "complementing model" was an exception among developing countries.[9] However, thanks to the rapid progress in globalization thereafter, this model has been increasingly adopted as a norm for economic growth for developing countries. Even Britain, its former colonial ruler, adopted this model of growing by attracting FDIs when it attempted to revitalize its economy in the 1980s. In this respect, the complementing model was a Singaporean innovation that has later spread broadly to other parts of the world.

Although Singapore's complementing model was geared to utilizing market

forces in the world economy on a greater scale, it was not in the least just letting market forces dictate the running of the economy. The role of the state was crucial as the prime agent to formulate and implement this development strategy. It directed its efforts at two major areas.

First, as the least mobile actor in its territory, it provided foreign investors with competitive and continuously upgraded complementary assets. Its role was elevated to that of an active promoter. Officials of the Economic Development Board (EDB) were no less than missionaries of "Singapore Inc." for attracting investments from all over the world.[10]

Second, the state itself assumed the role of investors through government-linked companies (GLCs), filling areas where MNCs were not interested but which the Singaporean government regarded as strategic to the country's development. Reflecting this, the public sector share of gross fixed capital formation in Singapore was 35.6 percent in the 1960s, 26.7 percent in the 1970s, and 30.3 percent in the 1980s, much higher than that in Korea, whose economy is characterized by heavy-handed government intervention (Figure 3.1).

On the other hand, Korean industrialization was led by a nationalistic political leadership, which regarded constructing an "independent economy" as its primary objective in managing the economy. Various Five Year Plan documents, various issues of the Economic White Paper, and speeches of President Park Chung Hee have been full of emphasis on the independent economy or increases in self-sufficiency and, for this purpose, the Korean government employed systemic import substitution policies through tariffs, subsidies, regulations on FDI and technology transfer, and so on (Chang 1993, 1994; K. Lee

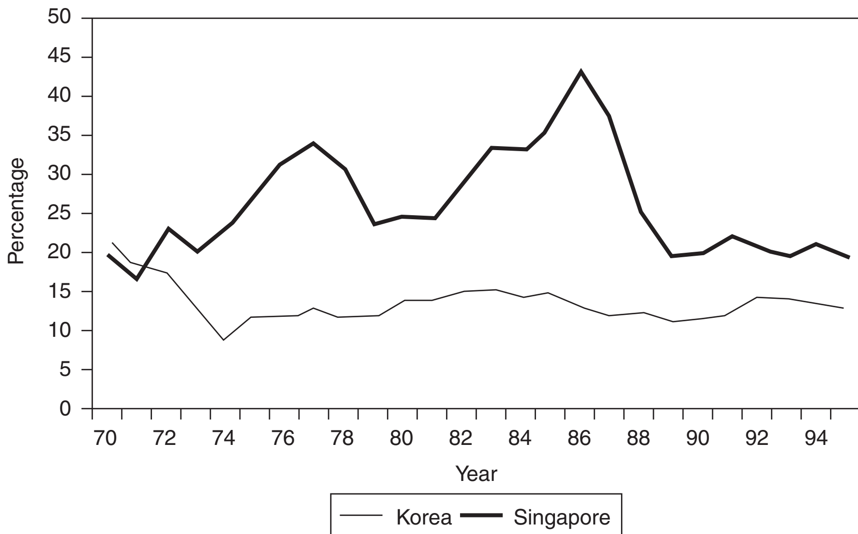

Figure 3.1 Public share to gross fixed capital formation in Singapore and Korea (source: National Statistical Office (Korea) website; Singapore Department of Statistics website).

1991). Compared with Singapore, Korea had a sizable domestic market with population of 29.1 million in 1966, based on which import substitution could occur to some extent, although this import-substituting effort had to be combined with the need for export promotion.[11] The strategic focus of the Korean model was laid on establishing *internationally competitive local companies*.

In this nationalistic or mercantilistic development model, the state was at the top. The Korean state drafted comprehensive industrial policy for export promotion and import substitution. It nationalized commercial banks and subordinated their lending decisions to its industrial policy. The state also drew foreign loans, as an alternative to FDI, by guaranteeing the credibility of domestic banks and firms. It was also responsible for human capital accumulation through the rapid expansion of the education system.

Despite the omnipresence of the state in the Korean system, the Korean state entrusted local entrepreneurs to undertake major industrial projects. It relied on public enterprises only when local entrepreneurs were not available, as in the case of the integrated steel industry (refer to Shin 1996: ch. 7) or when public ownership was necessary, at least for the time being, for some strategic purposes, like the telecommunications industry where "natural monopoly" was very easy to establish, or like some parts of the chemical industry which functioned as basic supply industries for other downstream industries. Financial resources, mobilized through the banking system or the state, were channeled mostly to the *chaebols*, the family-owned diversified business groups, which became major battalions for Korea's industrialization.

The Korean system thus built was a relatively high risk one. By trying to minimize its reliance on MNCs for capital and technologies, it relied heavily on foreign debt.[12] By extensively utilizing the banking system for industrial financing, Korea's corporate debt–equity ratio was also relatively high.[13] If foreign banks or domestic banks refrain from rolling over their loans for whatever reasons, it therefore becomes vulnerable to financial shocks.

However, during its developmental period, the Korean government managed this system risk by tightly controlling cross-border financial flows and coordinating the relation between the domestic financial sector and the corporate sector. Moreover, it should be noted that this relatively higher system risk of Korea was the flip side of the same coin of higher risk-taking capability in R&D investments and large-scale projects. The trend of R&D expenditure is one indicator in this regard. From the 1980s up to the mid-1990s, Korea constantly recorded a more than twice higher expenditure of R&D over GDP than Singapore. This gap in risk-taking capability is more pronounced in the private sector if we consider the fact that the Singaporean government still maintains a leading role in R&D investment whereas the Korean *chaebols* emerged as major initiators of R&D and large-scale projects from the 1980s.[14]

Reflecting these differences in economic systems between the two countries, the acceleration of globalization from the 1980s posed different challenges to the states of Singapore and Korea. Globalization is basically a process of diminishing distinctions between domestic and foreign markets, and those between

domestic and foreign capital. Therefore, it was in general a more difficult challenge to a country like Korea which had a system to promote local industries with tight controls over cross-border flows of products and services than a country like Singapore which had grown with less distinction between foreign and local capitals. It can be said that the degree of systemic transition following the acceleration of globalization was greater in Korea than in Singapore.

I have emphasized two major roles of the state as the ultimate system manager, which become more important with the progress of globalization: the role of providing "complementary assets" and that of keeping its economy from negative effects from the increased instability of the world market. We can compare different challenges to the states of Korea and Singapore from these two angles.

Regarding the former, the acceleration of globalization posed challenges to the Korean state that it had little experience to deal with. Previously, MNCs were marginalized in the Korean system as the country pursued a nationalistic development. The Korean state had certainly played an important role in providing infrastructure and developing human resources required for its economic development. However, changing its regulatory framework to accommodate the needs of foreign companies, and harmonizing it to reflect the interests of foreign and local companies on a more equal basis were a daunting task to come up with. It would be contentious whether or not the Korean state was unsuccessful in responding to this new challenge because its economy could maintain its industrial dynamism on its local companies even with minimal participation of foreign companies, at least until 1997 when the country fell into a financial crisis.

However, the failure of the Korean state in the latter role is evident. As discussed above, the Korean system had relatively higher risks in comparison with other East Asian NIEs even before the acceleration of globalization. So the country was the only one among East Asian NIEs to experience a financial crisis, though on smaller scale, when Latin American countries underwent debt crises in the early 1980s. As financial risk was increasing with the acceleration of globalization in the 1990s, the state had to strengthen its role of managing the financial risks of the system. However, Korea simply destroyed the previous risk managing system in the name of liberalization without instituting a new one that would accommodate the changed economic situation, and eventually fell into a full-scale financial crisis in 1997.

First, the state nearly gave up its control over foreign debt when it introduced capital account liberalization in the early 1990s. The result was that, on the eve of the financial crisis, the short-term foreign debt stood at a staggering 58 percent of total debt in 1997, although the country's total debt to GDP ratio was at a perfectly manageable 25.5 percent level.

Second, the domestic financial liberalization proceeded by issuing more licenses to financial firms without putting necessary supervision measures in place. For instance, between 1985 and the outbreak of the financial crisis in 1997, ten new commercial banks were set up, the number of "merchant banking

corporations" (short-term finance companies) was increased from six to 30, and 29 new life insurance companies came into existence. The result was a proliferation of weak financial institutions of "sub-optimal" size. A significant part of the non-performing loans accumulated in the financial sector during the 1990s can be attributed to the excessively high risks these immature financial institutions took for survival.

Third, major tools of industrial policy were abandoned, and there were no policy measures to check "over-investments" in large-scale projects in steel, automobiles, chemicals and so on. This lack of investment coordination led to high-profile bankruptcies of the *chaebols* like the Hanbo Group and the Kia Group in the build-up to the financial crisis (for details, see Chang 1998).

There were certainly adjustment failures attributable to banks and corporations. Though liberalized considerably, financial institutions were slow in strengthening their own risk management systems to survive a more open and competitive environment. The *chaebols* were also simply interested in expanding their businesses vigorously, as they had done before, without seriously considering the possible increase in financial risks along with liberalization of the economy. For instance, the *chaebols* clamored for liberalization and opening of the financial market from the late 1980s because the cost arising from financial expenses was so decisive in profitability and there remained huge differentials in interest rates between domestic and international markets.[15] The increasingly easier access to the international financial markets was viewed mainly as access to cheaper financial resources with remote concern about the financial risk related to exchange rate fluctuations.[16]

However, in a capitalist economy, it is normally the case that firms are risk-taking agents while financial institutions and the state are those who should check excessive risk-taking by firms and are responsible for stable working of the financial system. In the Korean context, financial institutions had been under tight control by the state and it was also the state that was mainly responsible for deregulation and re-regulation of the financial sector during the period before the outbreak of the financial crisis. In this respect, the failure of the state was a very significant factor in the Korean financial crisis.

On the other hand, Singapore faced relatively fewer problems from the increasing instability of the international financial market. Since it relied on MNCs for capital and technologies, it had little need to contract foreign debts. Similarly, the corporate debt level was also relatively low because local companies, being normally engaged in activities complementary to those of MNCs as subordinate partners, were less required to raise a large amount of investment funds. The lower levels of foreign debt and corporate debt, combined with its strong position in foreign currency reserves, were factors that helped Singapore to be less vulnerable to external financial shocks, although its financial market was wide open to international financial flows.

Singapore also faced little need to make a systemic transition because its system had been already geared to the imperatives of globalization and built to work with foreign companies. It is still a formidable task for the Singaporean

state to continually anticipate the next growth areas and attract investments there while providing and upgrading necessary complementary assets. As the pace of globalization accelerates, the state needs to accelerate its efforts at performing this role. However, in comparison with Korea, which had grown through a more nationalistic model, the challenge from globalization for systemic adjustment was weaker.

On the other hand, the Singaporean state seems to face a challenge from the accelerated globalization, which is qualitatively different from previous ones. One weakness of Singapore's complementing model lies in the relative underdevelopment of domestic technological capability because it did not have strong incentives to invest in R&D, as MNCs were sources of major technologies. Reflecting this, Singapore's expenditure on R&D investment had been very low even until the early 1990s when it reached advanced country status. And the weakness in the private sector R&D capability is more pronounced in comparison with other East Asian countries (Shin 2005a).

While Singapore remains a catching-up country, it might have been sufficient to try to find business areas that MNCs were willing to part with and attract them by providing complementary assets. Fortunately for Singapore, the acceleration of globalization has continuously expanded the complementary business areas even to higher-end manufacturing and service sectors, and lengthened the life span of the complementing strategy. However, it seems that there is a certain limit to the attainable growth through the complementing strategy because of the difficulty in acquiring core technologies.

From the viewpoint of MNCs, the core R&D capability, which is related with the development of new products and processes, is the last thing that they will transfer to local subsidiaries. In fact, one principal reason why MNCs globalize their operations is that economies of scale and scope involved in their core R&D activities are ever-increasing and they have to recoup the costs in development of new technologies.[17] It does not make economic sense for MNCs to separate their core R&D activities geographically. It is still an overall trend that MNCs concentrate their higher value-added production processes, including R&D, in their home countries. Although MNCs set up regional R&D centers, technologies transferred or developed there are mostly limited to those related to adapting their products to rapidly changing local market conditions.[18] No matter how far globalization progresses, and no matter how hard recipient countries try to attract them, there will be certain limit to raising the R&D capabilities of a country through provision of complementing assets.[19]

Moreover, as competition among MNCs intensifies and "time to market" becomes more important, MNCs look for investment sites where "higher-tier" suppliers provide them with some technologies and production capabilities that they urgently need to develop but do not have time to implement. If "lower-tier" suppliers are in a subordinate position to MNCs and rely on them for major technologies, these higher-tier suppliers have their own technologies and work with MNCs as nearly equal partners.[20] Since Singapore's per capita income level has reached that of advanced countries and it is increasingly difficult to maintain

price competitiveness of lower-tier suppliers, the creation of higher-tier suppliers or upgrading previous lower-tier suppliers to higher-tier ones becomes all the more important as a new injection of complementary assets.

These higher-end capabilities, i.e. core technological capabilities possessed by MNCs and technologies owned by higher-tier suppliers, are crucially important in maintaining Singapore's advanced country status, because other advanced countries keep moving ahead by leveraging them, while less advanced countries also continue to climb up the technology ladder. In this respect, it seems that Singapore has now arrived at a stage when these higher-end but less transferable capabilities become more and more important for its future growth.

Here again, the state is the principal agent responsible for shifting the strategic focus and developing necessary capabilities and institutions. As the ultimate system manager of the national economy, the state should maintain its leadership in transforming the economy for the next leap. In Singapore, the role currently required for the state is more than that of system manager because the local private sector is relatively underdeveloped as a result of the complementing strategy. It should be extended to compensate for the relative lack of capability in its private sector.

Singapore's current push towards nurturing "technopreneurship" and building a "regional knowledge center (or hub)" can be understood in this context. They are no more than state-initiated efforts to develop higher-end capabilities that are rooted in the territory and interact with mobile factors. The existence of higher-tier suppliers becomes increasingly crucial in attracting MNCs' higher-end investments and it is desirable for the state to promote them with available incentives. The existence of strong research institutes and a dense network of cooperation between research institutes and companies residing in Singapore are also essential for a knowledge center.

In the case of Korea, its private sector had already developed, to certain extent, higher-end technological and managerial capabilities that were rooted in its territory, although it is another task to utilize and further develop them for the future growth of the country. Its system was geared to developing these higher-end capabilities by taking high risks. On the other hand, this shift towards developing the local higher-end capability requires a greater systemic transition in Singapore and the state is again the agent that is mainly responsible for directing and managing this transition.

Conclusion

By focusing on the interaction between mobile factors and less mobile factors in the process of globalization, I have argued, contrary to the popular perception, the role of the state becomes more important in some significant respects as the pace of globalization accelerates. This is mainly because, as mobile factors obtain more freedom to choose locations across national borders, the quality of less mobile factors becomes more important in attracting mobile factors to a national economy and the state is the least mobile factor ultimately responsible for managing the system.

I have also compared different challenges to the developmental states of Singapore and Korea in an attempt to draw more concrete implications for the role of the state in the era of globalization. The challenges from the acceleration of globalization were not uniform across states, although we may depict the "general" challenges out of general characteristics of globalization. It seems that the challenges were greater to the states like the Korean one, which managed their economies in a more "nationalistic" way, while they were less daunting to states like the Singapore one, which developed their economies in a more internationalist way. However, the challenges were also different according to the combined effect of the level and model of development. I have argued that, once Singapore reached the status of advanced countries, the acceleration of globalization made it more imperative for the Singaporean state to help developing higher-end technological capabilities that are rooted in its territory, and, in this respect, it faced a greater need for a systemic transition.

The actual ways in which individual states respond to globalization are diverse across countries. It is neither possible nor desirable to provide "general" prescriptions for the role of the state out of presumed "general" imperative of globalization. For a better understanding of globalization, it is necessary to lower the level of analyses down to accommodate specificities of individual countries to some extent. The discourse of globalization and the role of the state will be enriched in this ongoing process of adding more lower-level analyses and recombining them in attempts at drawing policy implications at various local levels.

Acknowledgment

I thank National University of Singapore for financial support for this research (R-122-000-056-112). This chapter is an extended version of Shin (2002, 2005a).

Notes

1 MNCs have of course been present from the latter half of the nineteenth century. The stock of FDI in the world economy was also very high in the early twentieth century, reaching "over 9 per cent of world output in 1913, a figure which had not been surpassed in the early 1990s" (Bairoch and Kozul-Wright 1996: 10). However, a little over half of FDI went direct to the primary sector during this period. Moreover, MNCs were not a major driving force in the world economy and the growth of FDI in the manufacturing sector was mainly a substitute for trade in response to rising tariff barrier (Kenwood and Lougheed 1994). This was quite different from the trend in the late twentieth century when trade liberalization progressed hand in hand with the rapid spread of global production networks by MNCs.

2 For instance, global production in the semiconductor industry started by cut-throat competition among Silicon Valley firms to reduce production costs that eventually resulted in shifting their assembly processes, which could be carried out by unskilled labours, to developing countries in the 1960s (Henderson 1989; Grunwald and Flamm 1985).

3 For explanations of the progress of globalization, refer to Dicken (1998); Dunning (1997); Julius (1990); Ernst (2002); Crafts (2000).
4 Greider (1997: 258) even argues "[t]he power of global finance includes an extraordinary ability to create its own version of reality and persuade others to believe in it".
5 The following is an example of this view: "a major feature of concentration and centralisation in late capitalism is its international scale, which makes most nation states relatively insignificant elements within the operation of a world economy dominated by a small number of companies which are larger and more wealthy than many individual states" (Johnston 1982: 61).
6 In a similar vein, imperial aggressions during this period had to do with competition among nations to secure non-man-made location-specific advantages around the globe.
7 Even in the case of natural resource-seeking FDIs, it requires a stable business environment and infrastructure for extraction and delivery of natural resources, which are part of man-made location-specific factors.
8 Lee (2000); Mirza (1988); Huff (1994); Low (1998); Wong (2001).
9 For a comparison of this complementing model with the substituting model, refer to Shin (2005).
10 Refer to Chan (2002); Schein (1996).
11 However, it should be noted that the size of Korea's domestic market was much smaller than those of Japan or the bigger Latin American countries and it lacked natural resources or agricultural products to export. Therefore, its import substitution efforts had to be made along with strong export promotion efforts at earning foreign currency to import advanced equipment and intermediate goods.
12 Korea's reliance on foreign debts jumped with the heavy and chemical industrialization in the 1970s. The ratio of foreign debt to gross national product (GNP) was 10.7 percent in 1965 and increased to 28.1 percent in 1970 and further to 44.4 percent in 1980 (Shin and Chang 2003: table 3.1).
13 Similar to the case of foreign debt, corporate debt–equity ratio of Korean firms rose significantly with the beginning of the heavy and chemical industrialization. The figure for the Korean manufacturing sector remained at 119 percent on average during 1963–69, and then shot up to 342 percent on average during 1970–79. It reached its peak of 487 percent in 1980. Although the ratio was reduced later, it moved around the level of 300 percent.
14 R&D expenditure by the private sector increased 128 times from 21.7 billion won ($24.6 million, 1$=850 won) in 1976 to 2,698.8 billion won ($3,175 million) in 1990. The public sector share of R&D accordingly dropped from 64 percent in 1976 to 19 percent in 1990, similar to the level in Japan in the 1990s. Singapore's R&D/GERD ratio was less than one third of Korea up to the early 1990s and it is still about half of Korea's although the ratio increased significantly during the 1990s (Shin 1996, 2005b).
15 This domestic pressure matched perfectly well with external pressure by developed countries, especially from the US, to open Korea's financial market. For a detailed analysis of this process, refer to Park (1996).
16 In this regard, it should be noted that the loss from exchange rate change was decisive in the outbreak of the financial crisis in 1997, which amounted to 3.1 percent of total sales in the manufacturing sector. If this foreign exchange risk had been contained, Korea's manufacturing sector would have still maintained positive ordinary profits in 1997 even with series of corporate failures in the year (Shin and Chang 2003).
17 Refer to Freeman and Hagedoorn (1995); Pavitt and Patel (1999).
18 Amsden *et al.* (2001: 3) point out this aspect with their case study of the hard disk drive industry as follows. "In 1995, Southeast Asia (mostly Singapore) had virtually no nationally controlled HDD (Hard Disk Drive) companies, but it accounted for as

much as 64 percent of final global assembly and 44 percent of total global employment … Southeast Asia's wage bill, however, was only 13 percent of industry wages worldwide. Developed economies (Europe, Japan and the US), by contrast, controlled the ownership of the HDD industry's leading enterprises and were responsible for virtually all of its R&D. These economies accounted for less than one-third of both final assembly and total employment but captured more than three-fourths of the HDD industry's wage bill."

19 A similar argument can be made to the marketing capability, especially in relation with brand names. Singapore has depended its marketing channels predominantly on those of MNCs and has only a few internationally established brand names of its own. This is because a brand name is also the last thing MNCs are going to transfer to others.

20 For the conceptual distinction between "higher-tier" and "lower-tier" suppliers and their relative importance in the process of globalization, see Ernst and Kim (2002).

References

Amsden, A., Ted Tschang and Akira Goto (2001) Do Foreign Companies Conduct R&D in Developing Countries? A New Approach to Analyzing the Level of R&D with an Analysis of Singapore, ADB Institute Working Paper 14.

Bairoch, P. and R. Kozul-Wright (1996) Globalization Myths: Some Historical Reflections on Integration, Industrialization and Growth in the World Economy, UNCTAD Discussion Papers 113.

Bureau of Statistics of Taiwan website, www.stat.gov.tw/.

Chan, Chin Bock *et al.* (2002) *Heart Work* (Singapore: EDB).

Chang, Ha-Joon (2001) Rethinking East Asian Industrial Policy – Past Records and Future Prospects, in P.-K. Wong and C.-Y. Ng (eds), *Industrial Policy, Innovation and Economic Growth: The Experience of Japan and the Asian NIEs* (Singapore: Singapore University Press).

Chang, Ha-Joon, Gabriel Palma and D. Hugh Whittaker (eds) (2001) *Financial Liberalization and the Asian Crisis* (Basingstoke and New York: Palgrave).

Crafts, Nicholas (2000) Globalization and Growth in the Twentieth Century, IMF Working Paper wp/00/44.

Dicken, Peter (1998) *Global Shift: Transforming the World Economy* (London: Paul Chapman Publishing).

Dunning, John H. (1988) *Explaining International Production* (London: Unwin Hyman).

Dunning, John H. (1997) *Alliance Capitalism and Global Business* (New York: Routledge).

Dunning, J.H. and Khalil A. Hamdani (1997) (eds) *The New Globalism and Developing Countries* (Tokyo: United Nations University Press).

Eichengreen, Barry and Michael D. Bordo (2002) Crises Now and Then: What Lessons from the Last Era of Financial Globalization? NBER Working Paper 8716.

Ernst, Dieter (2002) Global Production Networks and the Changing Geography of Innovation Systems: Implications for Developing Countries, *Journal of the Economics of Innovation and New Technologies* 12/4, special issue on "Integrating Policy Perspectives in Research on Technology and Economic Growth".

Ernst, D. and Linsu Kim (2002) A Conceptual Framework, *Industry and Innovation* 9/3, special issue on "Global Production Networks, Information Technology and Local Capabilities".

Fishlow, A., C. Gwin, S. Haggard, D. Rodrik and R. Wade (1996) *Miracle or Design?*

Lessons from the East Asian Experience (Washington, DC: Overseas Development Council).

Frankel, J. (2000) The Asian Model, The Miracle, The Crisis, and the Fund, in Krugman, P. (ed.) *Currency Crises* (Chicago: University of Chicago Press for National Bureau of Economic Research).

Freeman, C. and Hagedoorn, J. (1995) Convergence and Divergence in the Internationalization of Technology, in Hagedoorn, J. (ed.) *Technical Change and the World Economy: Convergence and Divergence in Technology Strategies* (Cheltenham: Edward Elgar).

Grunwald, J. and K. Flamm (1985) *The Global Factory* (Washington, DC: Brookings Institution).

Henderson, J. (1989) *The Globalization of High Technology Production* (London: Routledge).

Hobsbawm, E.J. (1979) The Development of the World Economy, *Cambridge Journal of Economics* 3, pp. 39–54.

Hou, C.M. and S. Gee (1993) National Systems Supporting Technical Advance in Industry: The Case of Taiwan, in Nelson, R.R. (ed.) *National Innovation Systems: A Comparative Analysis* (Oxford: Oxford University Press).

Huff, W.G. (1994) *The Economic Growth of Singapore: Trade and Development in the Twentieth Century* (Cambridge University Press).

Johnston, R.J. (1982) *Geography and the State* (London: Macmillan).

Julius, D. (1990) *Global Companies and Public Policy: The Growing Challenge of Foreign Direct Investment* (London: Pinter).

Kenwood, A.G and A.L. Lougheed (1994) *The Growth of the International Economy, 1829–1990*, third edition (London: Routledge).

Lall, S. (1994a), "The East Asian Miracle" Study: Does the Bell Toll for Industrial Strategy? *World Development* 22/4, pp. 645–54.

Lee, Kwan Yew (2000) *From Third to First World: the Singapore story, 1965–2000* (Singapore: Singapore Press Holdings).

Lipsey, R.G. (1997) Globalization and National Government Policies: An Economist's View, in Dunning, J.H. (ed.) *Governments, Globalization, and International Business* (Oxford: Oxford University Press).

Low, L. (1998) *The Political Economy of a City-State: Government-made Singapore* (Oxford: Oxford University Press).

Mirza, H. (1986) *Multinationals and Growth of the Singapore Economy* (New York: St Martin's Press).

National Science and Technology Board (NSTB) *National Survey of R&D in Singapore,* various issues

Park, Won-Am (1996) Financial Liberalization: The Korean Experience, in T. Ito and A. Krueger (eds) *Financial Deregulation and Integration in East Asia* (Chicago: University of Chicago Press).

Pavitt, Keith and Parimal Patel (1999) Global Corporations and National Systems of Innovation: Who Dominates Whom? in Archibugi, D., *et al.* (eds) *Innovation Policy in a Global World* (Cambridge: Cambridge University Press).

Schein, Edgar H. (1996) *Strategic Pragmatism: The Culture of Singapore's Economic Development Board* (Singapore: Toppman Company and MIT Press).

Science and Technology Policy Institute (STEPI) website www.stepi.re.kr.

Singapore Department of Statistics, *National Accounts*, various years.

Shin, Jang-Sup (2002) The Role of the State in an Increasingly Borderless World, the

first-prize winner in an essay competition organized by the Monetary Authority of Singapore and Economic Society of Singapore.

Shin, Jang-Sup (2005a) The Role of the State in an Increasingly Global Economy: Implications to Singapore, *Singapore Economic Review* 50(1), pp. 1–13.

Shin, Jang-Sup (2005b) Substituting and Complementing Models of Economic Development in East Asia, *Global Economic Review* 34(1), pp. 99–118.

Shin, Jang-Sup and Ha-Joon Chang (2003) *Restructuring Korea Inc.* (London: Routledge).

Wong, Poh-Kam (2001) Leveraging Multinational Corporations, Fostering Technopreneurship: The Changing Role of S&T Policy in Singapore, *International Journal of Technology Management* 22(5–6), pp. 539–67.

World Bank, (1993) *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press).

World Bank (2000) *World Development Report 1999/2000: Entering the Twenty-first Century* (New York: Oxford University Press).

World Bank (2001) *World Development Indicators CD-ROM* (Washington, DC: World Bank).

Yellen, Janet (1998) Lessons from the Asian Crisis, speech delivered at the meeting of Council on Foreign Relations, New York, as the Chair of Council of Economic Advisers (15 April), Roubini's Global Macroeconomic and Financial Policy website www.stern.nyu.edu/globalmacro/ (accessed 13 September 2004).

4 Globalization and local political economy

The multi-scalar approach

Bae-Gyoon Park

Introduction

In conventional understandings of "globalization", the term is often conceptualized as a powerful force from the outside that steers the social, political, and economic systems of nations or localities in a particular direction. This conventional "top-down" approach to globalization, however, has been increasingly criticized for its global–local dichotomy, which is based on a dualistic separation of globalization as being "out there", and of nations or localities as being "in here"; hence, globalization is understood as an external force that impinges on specific nations or localities. On the basis of this critique, an alternative view has been suggested that emphasizes multi-scalar processes of globalization. Emphasizing the spatiality of globalization, for example, Dicken *et al.* (1997) suggest that globalization processes are intrinsically heterogeneous rather than homogeneous in their forms and effects; they involve highly intricate interactions among a whole variety of social, political, and economic practices and institutions across a spectrum of geographical scales. In this sense, it has been argued that globalization is not the universal cause of contemporary social, political, and economic changes (Yeung, 2002), but an outcome of class conflict and power struggles occurring at various geographical scales (Cox, 2002).

This multi-scalar view implies that the nation state's policy of liberalization, which has been an important facilitating factor for globalization, is not simply imposed from above by global forces (e.g. TNCs, international organizations, and wealthy countries), but constituted from below by national and sub-national forces that are actively involved in the production of scale, as well as in the (re)construction and exploitation of certain discourses of globalization, in the course of power struggles within local or national communities (e.g. national bureaucrats, domestic firms, and local growth coalitions). This chapter explores how political and economic activities and processes, which are taking place at sub-national geographical scales (e.g. regional, local, urban, etc.), can contribute to the ways in which the nation state regulates trans-national flows of capital and investment. With case studies of "big deal" and the Jeju international free city project in South Korea (Korea thereafter), it elaborates on how the state's liberalization and globalization projects can be spatially and politically constructed

under the influences of: (1) inter-scalar tensions between the national and the local, and (2) politics of "jumping scale", which either local or national actors organize in order to mobilize the sources of power at different geographical scales.

A multi-scalar construction of economic globalization

Traditionally, transnational corporations (TNCs) have been seen as the primary shapers of economic globalization. Indeed, the emergence of TNCs is a basic condition for foreign direct investment (FDI) because FDI occurs only when firms try to develop international production. Thus, the flow of FDI is significantly influenced by firms' strategies in coordinating their international production activities. Especially with the increasing level of inter-firm competition, growing numbers of firms are involved in the internationalization of production through FDI. This is to take advantage of geographical differences in the distribution of factors of production (e.g. natural resources, capital, and labor) and in state policies (e.g. taxes, trade barriers, subsidies, etc.), to achieve more efficient coordination and control of various stages of individual production chains within and among different countries, to develop an ability to switch resources and operations between locations on an international scale, and to access foreign markets (Dunning, 1988). The intensification of international production by TNCs has been an important contributing factor for the rapid increase of FDI during the last few decades.

The multi-scalar view on globalization, however, tells us that the globalization of investment is not simply shaped by the activities of TNCs, but also constituted by the actions of other social actors. In particular, Dicken (1994, 1998) emphasizes the significance of the role of the nation states and their interactions with TNCs in shaping the changing geography of the global economy. Actually, the flows of FDI can be significantly influenced by the nation state's policy positions toward trans-border investments. Traditionally, nation states have regulated inward foreign direct investment within their borders by setting up various institutional barriers to cross-border flows of capital, thereby, influencing the volume, characteristics, and performance of foreign investments (Conklin and Lecraw, 1997, p. 3). Different countries may have different levels of inward and outward investments depending on state policies, and as result, the movement of capital has been geographically unequal and selective (Mauro, 2001).[1] Given this, the increasing trans-national flows of capital and investment can be better understood as an outcome of the recent liberalization tendencies in nation states than of TNCs' initiatives. Indeed, the regulatory barriers to cross-border capital movement and globalization of production have largely been removed or relaxed for the last decade as many countries implement liberalization reforms – including the liberalization of foreign investment policies, trade liberalization, deregulation, and privatization – as part of a broader, market-oriented reform of economic policy (Dicken, 1998, p. 98).

There emerged various institutional and political literature that emphasized

this significance of national political, institutional, and economic contexts that have influenced government policy positions toward liberalization (Helen and Robert, 1996; Garrett, 1998; Schamis, 1999; Appel, 2000; Bishop, 1997; Henderson, 1998). It broadly argues that social and political actors are highly unlikely to passively accept the changes driven by pressures of globalization and that the implementation of liberalization policies by the government can be influenced by domestic political, ideological, institutional, and economic conditions. However, this literature did not fully address the multi-scalar processes of globalization because it tends to reduce complex multi-scalar processes to relations between the global and the national, with little attention to processes that occur at the various sub-national scales (e.g. the regional, the local, the urban, and the neighborhood). Processes and relations at the sub-national scales cannot be considered as being subsumed under or identical with national-scale political and economic processes because there are significant local variations within nations with regard to trajectories of development and political, institutional, and economic contexts (Ettlinger, 1994). Also, different interests may be territorially constructed among the places defined at the national and sub-national scales with respect to the processes of globalization.

Accordingly, the nation state's regulatory actions on the cross-border flows of capital and investment can be significantly influenced by active interactions, negotiations and engagement among the national and local players.[2] In this sense, understanding the multi-scalar processes of globalization requires conceptualizing how agents with territorially defined interests at sub-national scales are interacting and negotiating with national players and how these inter-scalar relations can influence governmental policies on FDI and the globalization of production. For this, this chapter focuses on conceptualizing how regulatory activities can be territorially organized at different geographical scales – especially the national and the local – and how the different territorialized regulatory activities at different geographical scales can interact and negotiate with each other.

Regulation is always place-based because the creation of certain social and institutional organizations or relations, which are required for regulatory purposes, can take place only within a certain geographical boundary. According to Cox and Mair (1988), social agents (e.g. capital, labor, and the state) that are dependent on certain place-specific socio-spatial relations or organizations (e.g. product markets, localized inter-firm relations, local labor markets, and transportation networks) for their activities or reproduction may organize growth coalitions to pursue certain regulatory activities that are aimed at the economic growth of the place they are attached to. They do so because they want to secure, reproduce, or enhance the socio-spatial relations that they depend on by channeling wider flows of value into and through the place.

Since the place-dependence can be defined at various geographical scales, different kinds of regulatory activities can be organized at different geographical scales on the basis of different place-dependent interests. In Cox's (1993, 2002) concept of the scale division of labor, different growth coalitions can be formed

at different geographic scales, and they organize different kinds of regulatory activities because of the various place-dependent interests at different spatial scales. For example, the regulatory activities organized by a growth coalition within a metropolitan region that is serving local markets may be different from the goals and interests of regulatory activities that are driven by firms that are involved in "export" activities.

The different place-based regulatory activities, organized at different geographical scales, may interact with one another in the sense that regulation at a certain scale may facilitate or hinder the creation or realization of another regulatory regime on a different scale. In what ways do the inter-scalar interactions take place? How can the interactions give impacts on the ways in which the nation state regulates the trans-national flows of capital and investment? I will below answer these questions by looking at two different forms of the national–local interactions: (1) inter-scalar tensions between the national and the local and (2) cross-scalar mobilization of power through politics of "jumping scale". I will also suggest two possible mechanisms through which these different forms of national–local interactions can influence the ways in which the nation state liberalizes its regulations on the trans-national flows of capital and investment with reference to empirical examples of "big deals" and the "Jeju international free city project" in Korea.

National–local tensions and economic liberalization

Theoretical discussion

The inter-scalar interactions can occur partially with respect to the uneven spatial effects of regulation. Place-specific regulation at a certain spatial scale is supposed to draw the flows of value occurring at wider scales into and through a place. An unintended consequence of such regulatory activities, however, would be geographical inequalities within a spatial boundary (e.g. a country, a region, a city, etc.) because the efforts to establish certain socio-spatial organizations and relations, which are required for a particular regulatory project, may affect the ways in which the flows of values within the place are channeled into places that are defined at still smaller geographic scales. As a result, regulation at a particular spatial scale can either positively or adversely influence the interests of social groups in those places at smaller scales.

The inter-scalar regulatory interactions, however, do not occur in a one-way direction from the larger to smaller scales. Actors at smaller scales can influence the regulatory processes occurring at larger scales by organizing various forms of territorial politics. There are various ways in which the territorial politics organized at smaller scales may influence larger-scale regulatory activities. When regulatory projects at different scales are positively related to one another with similar interests and effects, the territorial politics organized at smaller scales may function as an intensifying force behind the bigger-scale regulatory project. In contrast, when regulatory projects at different scales are in conflict

with one another on the basis of different interests and if the territorial politics from below is powerful enough to weaken the regulatory capacity of the larger-scale actors, a regulatory deficit may occur at the larger scale and the bigger-scale regulatory project is likely to be changed. However, if the territorial politics is not powerful enough to be influential, the growth coalition formed at the bigger scale can easily ignore or suppress the voices from below and continue to push its regulatory project.[3]

The discussions provided so far, however, are made at an abstract level, so it needs to be noted that the concrete processes and outcomes of the inter-scalar tensions would be various, depending on specific social and political situations. For this, my discussion focuses on a specific process through which the national–local tension can facilitate a nation state's liberalization of policy, which was previously very restrictive to inward FDIs due to nationalistic and protectionist reasons.

A nation state's nationalist and protectionist policy is meant to protect and nurture domestic industries and firms for the sake of *national* interests. However, owing to the spatial selectivity of the state's industrial and regional policies, it is unlikely that the benefits of these protectionist policies are evenly distributed to all localities. In this context, inter-scalar tensions may emerge between the nation state and localities that are disadvantaged by the state's industrial and regional policies. As local growth coalitions organize territorial politics to challenge certain *national* industrial or regional policies in order to protect their *local* interests, inter-scalar tensions may be intensified. Furthermore, when territorial politics become highly politicized on the basis of strong local or regional identities, the tension between the national and the local may become much more acute. Severe inter-scalar tension may weaken the governing capacity and integrity of the nation state in coordinating and regulating economic activities under the principles of protectionism and nationalism.

In the face of this regulatory deficit, if forces at the national scale are not powerful enough to repress local challenges with ease, the nation state can use decentralization, deregulation, or liberalization strategies to reduce its political burden. It can transfer certain degrees of power and authority of regulation to governing bodies at local levels or/and liberalize its regulation on economic activities. In particular, when a nation state that has exercised strong regulatory authority and power on the basis of a highly centralized governmental system faces a problem of legitimacy because of highly territorialized local politics that oppose centralized regulatory practices, the national ruling elite can use the decentralization or liberalization strategy in order to maintain its political legitimacy. As the nation state liberalizes its regulation on economic activities, some restrictions on the trans-border movement of capital can be removed or relaxed, thereby facilitating the globalization of economic activities.

An empirical example: politics of "big deal" and the globalization of the South Korean automobile industry

Since the beginning of industrialization in the 1960s, the South Korean government heavily regulated inward FDI within the framework of protectionist and nationalist industrial policies. On the basis of nationalistic industrial policies, the South Korean government had strongly encouraged the development of domestic firms in the automobile industry because it considered it as one of key national industries. Since foreign firms were not allowed to own automobile assembly companies in South Korea, foreign investment in the country's automobile sector had been limited. By the eve of the financial crisis in 1997, all the dominant players in the South Korean automobile sector were domestic auto makers, such as Hyundai, Daewoo, Kia, Samsung, and Ssangyong.

However, this situation began to change dramatically after the crisis as the South Korean government changed its policy from a protectionist orientation toward liberalization and threw the doors open to foreign auto makers to take over domestic auto makers. It was in this context that Renault acquired Samsung Motors in April 2000. Furthermore, General Motors (GM) took over Daewoo in 2001. With the beginning of the new millennium, the South Korean automobile industry became more open to global capital flows.

What drove the South Korean government's policy shift from a protectionist and nationalist orientation to liberalization and globalization of its automobile industry? There had been various international and national forces that pressed the South Korean government to move away from its protectionist and nationalist policy orientation toward liberalization, including the GATT, the United States, IMF, *chaebols* (the South Korean large conglomerates), domestic scholars and bureaucrats who are oriented to neo-liberal ideologies, and so on. Since the impacts of these forces and actors on the South Korean government's policy liberalization have been widely discussed in many other studies (Bishop, 1997, 2001; Henderson, 1998; Lee, 2000; Kwon, 2004; Lim and Chung, 2003; Shin and Chang, 2003; Lim and Jang, 2005), this chapter pays attention to another important trigger for the liberalization, that is, the national–local tension: I argue below that the sudden liberalization of its regulations on inward FDI to the automobile industry was triggered by the weakening of the state's regulatory capacity, which stemmed partly from inter-scalar contestation between the nation state and a local community with respect to a state-driven regulatory project.

The South Korean government had gradually relaxed its restrictions on inward FDI since the 1980s due to increasing internal and external pressures. This general tendency toward liberalization of policy, however, had had little impact on the automobile industry because there had been various forms of resistance against a drastic liberalization of the industry, which originated from some nationalistic bureaucrats and the South Korean domestic auto makers. Even under the IMF bailout program after the financial crisis, the Kim Dae-Jung government did not totally discard nationalistic industrial policies. When some industries (e.g. automobile, steel, and petrochemicals) faced crises from

overcapacity, the government directly intervened in the economy for industrial restructuring. It made an agreement with the top five conglomerates on the so-called "Big Deal" program, which intended to make them swap their businesses in nine industrial sectors – including automobiles, semiconductors, and petrochemicals – with one another (Samsung Economic Research Institute, 2001).[4]

Ironically, however, this state-driven Big Deal program resulted in the rise of various social resistance and political challenges to the centralized top-down regulatory practices, thereby weakening the state's regulatory capacity. One of strong challenges was organized by local actors in Busan, a southeastern port city of South Korea, because the program clashed with their *local* interests (see Figure 4.1).

The Big Deal program represented interests constructed at the *national* scale and was initiated to revitalize national industries for the sake of *national* interests. In order to solve the problem of overcapacity in the automobile industry, the government pushed Samsung to give its automobile company, Samsung Motors, to Daewoo in exchange for Daewoo's electronics company, Daewoo Electronics. Regarding this business exchange, the government emphasized that both Samsung and Daewoo, as well as the national automobile industry as a whole, would likely benefit from the swap (*Korea Herald*, 1998a). This regulatory project, representing *national* interests, however, was in conflict with *local* regulatory activities, organized by actors in Busan.

Since the early 1990s, place-dependent actors in Busan, such as local governments, local chambers of commerce, local media, and business organizations had made diverse regulatory activities, which aimed at upgrading local industries and attracting high value-added industries to the region. One of the efforts was to develop the automobile industry (Kim, 1998). An outcome of such efforts was the location of Samsung Motors' automobile plant in Busan in 1994. Encouraged by this, the growth coalition in Busan attempted to develop the city as the new center of the Korean automobile industry by locating Samsung Motors' headquarters (HQ), research and development (R&D) center, and major suppliers there (*Maekyung News*, 1997). In other words, local actors in Busan wanted to use Samsung's automobile plant as an impetus for the industrial deepening of the local economy.

The two regulatory projects just discussed were clearly in conflict with each other. The main purpose of the Big Deal project was to alleviate the problems of overcapacity in the South Korean automobile industry. More specifically, it was expected that the excess of facilities and labor in the automobile sector could be reduced through a merger between Samsung Motors and Daewoo Motor. Thus, from the perspective of those who drove or supported the Big Deal project, Busan's industrialization project through the development of the automobile industry was seen to be aggravating the problems of overcapacity in the automobile industry at the *national* scale.

At the same time, local actors in Busan saw the Big Deal project as a big challenge to their local development project because a merger between Samsung Motors and Daewoo Motor meant abandoning their existing development

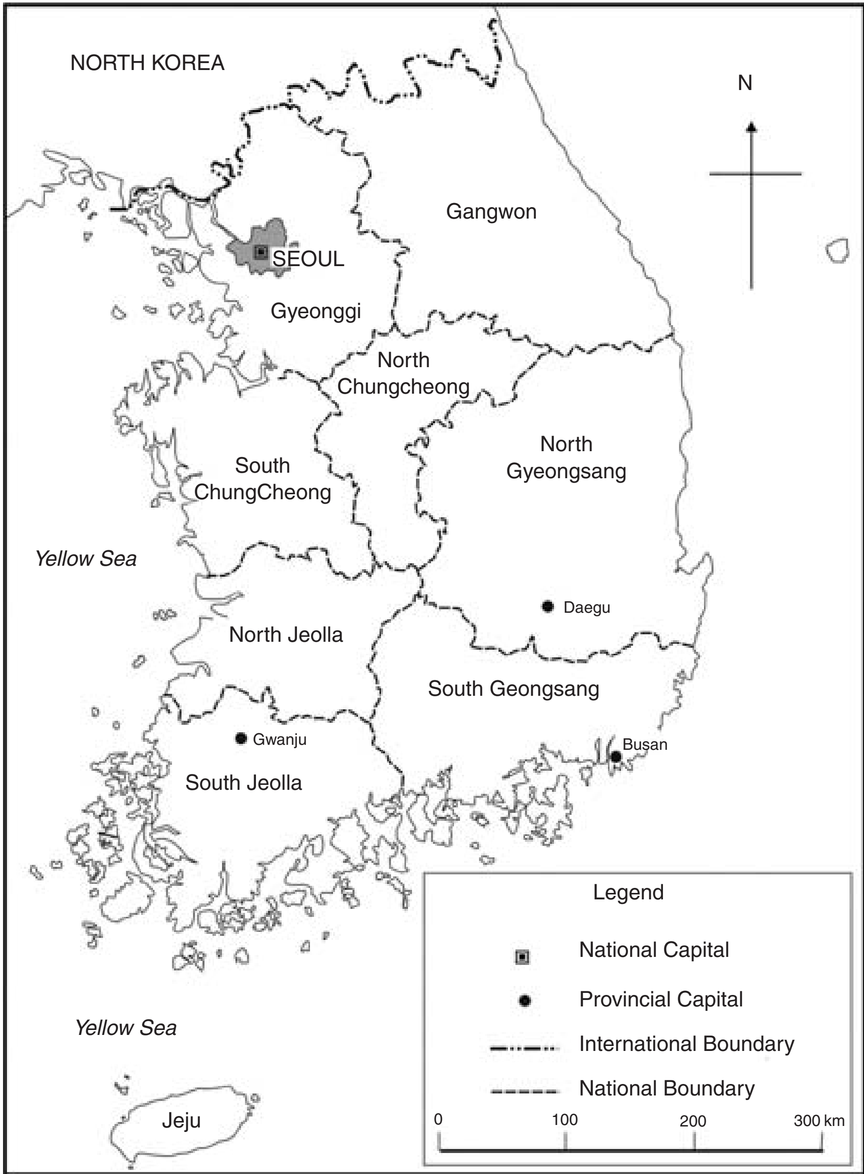

Figure 4.1 Provinces of South Korea.

project (*Korea Herald*, 1998c). The local actors also feared that, if Daewoo Motor took over Samsung Motors, it would lay off a massive number of workers in the Busan plant or even shut it down, both of which would severely damage the *local* economy (*Korea Herald*, 1998c, 1999a). Samsung Motors' suppliers

were also concerned that Daewoo Motor's suppliers would take over their contracts (*Korea Herald*, 1998b).

The conflicting interests of the two regulatory projects led to inter-scalar contestation between the local and the national. Bottom-up challenges were activated as the growth coalition in Busan began to organize political campaigns against the Big Deal project. Fearing mass layoffs, for example, workers at Samsung Motors held protest rallies against the deal, with Samsung Motors' suppliers joining in the fray. Other agents in Busan, including the mayor, the municipal council, the chamber of commerce, and civic groups, also organized political campaigns to protest against the deal (*Korea Herald*, 1998c). In response, actors at the national scale who supported the Big Deal project, especially some from the national media, showed their concern that local resistance to the deal, even if successful, would not help the nation's economic recovery. In particular, some national newspapers criticized the local activism in Busan as a "selfish regionalism" (*Korea Times*, 1999a; *Kookmin Daily*, 1999).

Furthermore, this inter-scalar tension became more intense as local politics in Busan became highly territorialized under the context of regionalist politics in South Korea. Traditionally, the primary source of cleavage in country's party politics has been regional. Major parties and political leaders have developed their support bases in particular regions. The southeastern region, including Busan, has been the hotbed for the Grand National Party, the major opposition party under the Kim Dae-Jung administration. Given this situation, the national–local tension was transformed into regionalist party politics at the national level. Legislators of the Grand National Party actively supported Busan against the deal between Samsung and Daewoo to gain more political support from that area. At the local level, strong anti-government regionalist discourses and sentiments were mobilized in Busan with respect to the government-led Big Deal program. As a result, local politics in Busan became highly territorialized, with agitated regionalist emotions, and the tension between the national and the local was highly intensified.

The territorialized politics in Busan and the intensified local–national tension placed an enormous burden on the Kim Dae-Jung government. Facing local elections in 1999, the government had to appease local discontent in Busan to generate political support there. The government publicly promised not to shut down the Busan plant in any situation and silently put pressure on Daewoo to maintain the Busan plant even after merging with Samsung Motors.

There had been a lot of difficulties in the deal between Daewoo and Samsung – since both parties disagreed on the evaluation of Samsung Motors' assets and debts – and the political situation added even more difficulties to the deal. In particular, Daewoo did not want to make any commitment to the Busan plant because the factory was surveyed in its asset evaluation at −US$ 0.91 billion (*Korea Herald*, 1999b). Therefore, the negotiations between Daewoo and Samsung did not proceed smoothly and, after long disputes, finally just broke down in 1999.

The breakdown of the deal signified that the governing capacity of the South Korean government was significantly weakened. Given the failure of the deal,

some economists suggested that the Busan plant should be shut down for the sake of the national interest, arguing that the longer the Busan plant was in operation, the higher the losses would be (*Korea Times*, 1999b). However, it was almost impossible for the government to conduct this regulatory act because of the enormous local pressure from Busan. Given this regulatory deficit, the national ruling elites began to view saving the Busan plant as much more significant for their political interests than pursuing particular regulatory projects to restructure the nation's automobile industry.

To save the Busan plant, the government decided to sell Samsung Motors through an international auction after clearing the debts of the company with public money combined with (forced) donation of private money from the Samsung family. This decision meant that it finally gave up its long-lasting nationalistic and protectionist policies for the development of the automobile industry and threw the doors open to foreign auto makers to invest in South Korea. Given this new regulatory environment, Samsung Motors was eventually acquired by Renault, the French auto maker, in 2000.

Cross-scalar mobilization of power through politics of "jumping scale" and spatially selective liberalization

Theoretical discussion

In addition to the inter-scalar interaction through political contestation, the place-based regulatory activities that are organized at different scales may interact with one another through the "politics of jumping scale". This form of inter-scalar interaction can take place in relation to the politics occurring in regulatory processes.

Even though regulation is essential for the continuity of capitalist accumulation, due to the market failure in providing all the conditions necessary to the creation or appropriation of surplus value (Aglietta, 1982; Peck and Miyamachi, 1994), it is not an inevitable, automatic, or structurally necessary process. Rather, the emergence of a successful regulatory framework is a "chance discovery" made in the course of human struggles, which involve political contestations and intentional or unintentional social practices (Lipietz, 1987; Goodwin and Painter, 1996; Park, 2001). In particular, since the benefits of regulation are not evenly distributed across agents, implementing and enforcing particular regulatory rules inevitably entails conflict and contestation among them. As a result, successful regulatory projects require resolving the tensions.

A way of resolving the tensions is building alliances (e.g. growth coalitions, public–private partnerships, etc.) with other place-dependent actors within the same "space of dependence".[5] In the process of building alliances, place-dependent actors may mobilize territorially defined identities and interests in order to secure them (Cox, 1998a). These territorial alliances organized within a space of dependence, however, are often not powerful enough to drive a certain regulatory project when there is significant internal resistance against the particular

regulatory project within the place. In this situation, the place-dependent actors may try to build alliances with sources of power outside the space of dependence. These alliances are often made through the politics of "jumping scale", which is related to the efforts to mobilize powers or resources available at different geographical scales in the course of power struggles with respect to the regulatory activities (Cox, 1998b).

There are two different forms of the politics of jumping scale, depending on to which directions actors try to jump the scale – that is, either to the bigger scales or to the smaller scales. The former is related to the efforts to build alliances with actors and forces at bigger geographical scales in order to win in the power struggle at the "space of dependence". This strategy is quite frequently used because establishing "jumping up" alliances could be more effective in power struggles due to the asymmetry in scalar power relations.

It is often the case that political actors who occupy the highest ground are more powerful than those who are constrained to lower scales. Regarding this, Peck (2002, p. 338) argues that actors who are organized at a higher scale – for example, the nation state and international organizations – typically possess the ability to shape extra-local rule regimes that constrain and channel the strategic options and tactical behavior of local actors. Especially, the nation state is very important in shaping the extra-local rule regimes due to its territorial centralization of economic, political and ideological powers. The state provides rules and regulations, ascribes categories of meaning and denotes norms universally and monopolistically within a nationally defined territorial boundary (Jones and Jones, 2004).

Given this asymmetrical power relations between scales, mobilizing the material and discursive power of those who operate at bigger spatial scales – for example, the nation state – could be very helpful for the actors at smaller scales to pursue their regulatory projects, especially when those projects are difficult to promote due to internal resistance within the locality. Through discursive practices of representing the extra-local rule regimes as an unavoidable environment, the local actors may try to resolve internal tensions that take place in the regulatory processes by justifying the regulatory projects that they are pursuing as a necessary means of securing the "space of dependence" under the unavoidable situation imposed by the extra-local actors. Economic or institutional supports from the extra-local actors – for example, financial supports from the nation state or international organizations, inward investment made by TNCs, etc. – may also enhance local actors' economic and ideological power to promote their regulatory projects.

The activities of jumping scale can take place toward the opposite direction, i.e. by building up alliances with actors at smaller geographical scales. Such politics of "jumping down" may be organized when actors who operate at a higher scale see the bottom-up supports necessary for the pursuit of certain regulatory projects. For example, when national ruling elites face difficulties in promoting particular developmental projects or regulatory changes due to oppositions from certain social actors, they may try to go through this by mobi-

lizing supports from some local actors whose place-dependent interests appear to fit into what national elites want to pursue.

The national ruling elites may use this "jumping down" strategy in relation to their globalization and liberalization drive. Actually, for the last decade, many countries have implemented liberalization reforms. However, the liberalization reform does not proceed smoothly due to various forms of resistance and counter-tendencies to the process. Especially, there could be strong resistance against the national ruling elites' liberalization drive, which stems from the legacies of inherited institutional frameworks, policy regimes and regulatory practices (Brenner and Theodore, 2002). When a full-scale shift to neo-liberalism seems impossible due to firm resistance from social forces, which insist on defending the existing regulatory framework, the nation state may utilize the strategy of "spatially selective" liberalization by imposing more liberalized regulatory frameworks only on several selected places – which may be called "special economic zones", "economic free zones", or "international free cities" – because this strategy could be more acceptable than more drastic and broader liberalization reforms on a larger scale.

In addition, this strategy can be seen as a nation state's effort for building up "jumping down" alliances with place-dependent actors in the areas selected to be the "special zones" because this special treatment given to the selected zones is expected to facilitate drawing the flows of value occurring at wider scales into and through those selected areas and hence to generate support from these areas for the state's policy orientation toward liberalization. Of course, it is possible that this strategy will generate bottom-up resistance against the liberalization drive because some local actors in the excluded areas may be critical of it due to its spatial selectivity. Furthermore, when these local forces form an alliance with the social forces opposing to the neo-liberal reforms, the nation state may face much bigger and massive social resistance against its liberalization drive. However, it is not necessary that the excluded local actors participate in the anti-liberalization campaign. It will be often the case that the local complaints about the "spatially selective liberalization" are actually reflecting the local actors' envious desire to be selected to receive the special regulatory treatment from the nation state. Thus, it is highly likely that these local actors call for the inclusion of more localities in the "spatially selective liberalization" program, instead of participating in the anti-liberalization campaign. This situation may be represented as if all regions want to jump on the "liberalization" or "globalization" bandwagon, which may facilitate the spread of pro-liberalization and pro-globalization discourses among local actors.

An empirical example: politics of "jumping scale" and "spatially selective liberalization" in South Korea

In December 2001, the National Parliament of South Korea passed the "Special Bill on Jeju International Free City", which calls for Jeju, a southern island of South Korea (see Figure 4.1), to be turned into a regional hub of international

flows of people, goods, and capital. The bill has the aims of developing Jeju as the East Asian center of tourism, logistics, and finance in the twenty-first century by guaranteeing the maximum degree of free movement of people, goods, and capital; and the facilitation of corporate activities, by relaxing various rules and regulations. The bill also aims at the creation of an exceptional environment for international investment and education by providing various incentives on taxation, land lease to attract foreign investment, and offering competent English services to foreign investors. Simply speaking, the special bill seeks to develop Jeju into another Singapore or Hong Kong.

What are the driving forces behind this project? An official reasoning of the Korean government is that, given growing competition among nations and cities for investments and technology, the interests of national development necessarily require the development of a trade and financial center for Northeast Asia within its national boundary. In this context, Jeju International Free City is expected to function as a gateway through which foreign investment will be attracted to Korea, embracing the trend of openness and globalism prevalent in the twenty-first century. This official reasoning, however, does not provide satisfactory justification of the project. One of the main criticisms of this project is related to the fact that Jeju cannot be a promising financial and commercial center in Northeast Asia because it is isolated from the major business centers of the region.

Considering the situation, one may ask following questions. Are the policymakers really confident about the feasibility of the project? If not, why has the Korean government been so eager to pursue the project? What are real driving forces behind it? Answering these questions requires understanding the politics of "jumping scale" which took place between the local actors in Jeju and the central government.

For last 40 years, the economic development of Jeju has been centered on the growth of tourism. In 2001, tourism-related economic activities accounted for 23 percent of the gross regional product in Jeju (JEICPB, 2002, p. 9). Since the early 1990s, however, Jeju has faced increasing difficulties for its continuous tourism development and its tourism growth rate has declined. Since tourism has been the main economic activity in Jeju for the last 40 years, the substantial numbers of local businesses in Jeju have been seriously dependent on the growth of tourism for their survival. The declining rate of tourism in the 1990s has posed a great threat to these businesses. Given this economic situation, local businesses and officials have promoted several mega-development projects to improve the tourism infrastructure in a bid to revitalize Jeju tourism. The attempted projects include the construction of a cable-car line in Mount Halla, the liberalization of the casino industry in Jeju, the construction of a convention center, and the development of a new port in Seogwipo, among others.

The local political landscape of Jeju, however, was not favorable for implementation of these proposed projects. Increasingly aware of negative influences of the tourism-oriented development on local environment, agriculture, fishing and identity, many local residents began to protest against those projects from

the late 1980 and these anti-development forces became politically organized in the early 1990s. As a result, a unique political landscape was shaped in Jeju on the basis of the tension between the pro-development and the anti-development forces. Since the early 1990s, the tension between the two forces has continued to exist, and the persistence of this tension was one of the main aspects of Jeju's local politics in the 1990s.

Under these local political conditions, the idea of the Jeju International Free City was proposed as a way of circumventing the anti-development sentiments of civil organizations and residents in Jeju. The adoption of this new strategy by local businesses and officials in Jeju was motivated by the social and ideological changes at the national level in the 1990s in relation to the globalization drive promoted by the Korean government. In particular, Singapore and Hong Kong have been widely used as model cases of globalization. By explaining economic prosperity of these two city-states in terms of globalization and liberalization, the Korean government and mass media actively constructed a pro-globalist discourse. On the basis of such discursive construction of "globalized Singapore and Hong Kong", the significance of freer movement of capital and people was greatly emphasized for economic growth in the era of globalization.

In this context, local businesses and officials in Jeju took a "jumping up" strategy in order to utilize the extra-local ideological environment for advantage of their developmental projects. They reshaped their previous development projects with the frame of the "international free city". More specifically, in order to make the development projects more acceptable to local residents, they attempted to justify the mega-development projects as something necessary for attracting foreign investment into the island for the purpose of building Jeju into a global city like Singapore or Hong Kong. In addition, they attempted to generate more support for the project from the central government, by linking their local development projects to the national drive for globalization.[6] Actually, these "jumping up" activities taken by the local pro-development forces in Jeju have been successful in weakening the anti-development forces within the island.

The support from the central government should not be merely seen as an outcome of successful mobilization of central forces by local actors in Jeju. The central government also had its own agenda in supporting the Jeju International Free City Project. As mentioned earlier, since the mid-1990s, the Korean government actively promoted globalization of the national economy. In particular, the state drastically shifted its policy stance from a nationalist and protectionist orientation to an internationalist and liberal one. This globalization drive, however, was not very successful due to strong social and political barriers to liberalization, which were related to the legacies of the old regulatory framework of the "developmental state". In particular, some social actors, who had benefited from – or at least grown up within the socio-political context of – the old regulatory framework (e.g. domestic capital, some bureaucrats, labor unions, NGOs, etc.) were very critical of the ideas of liberalization and deregulation.

As a result of these barriers and resistance to liberalization, some of

regulations on business activities and labor market still remained, leading foreign investors to complain about the lack of liberalization. Given this situation, the Korean government needed to find a way to attract more inward foreign investment while avoiding massive resistance against its liberalization drive. The Korean government regarded the Jeju International Free City project, initially proposed by the Jeju Provincial Government, as a solution to this dilemma. The Korean policy makers took the strategy of "spatially selective liberalization" and decided to develop several special economic zones – including the Jeju International Free City – because it was more acceptable than broader liberalization reforms on a larger scale. Under this "spatially selective liberalization" strategy, the Korean government located one "international free city" in Jeju in December 2001 and designated three other "Free Economic Zones (FEZ)" – Inchoen FEZ, Busan and Jinhae FEZ and Gwangyangman FEZ – in September 2003 (see Figure 4.2). In these special zones, the Korean government will provide various incentives and benefits to foreign firms and greatly relax its regulations on business activities in order to attract foreign investment.

In terms of the politics of "jumping down", this "spatially selective liberalization" strategy has been also successful in generating local support for the nation state's liberalization drive. It is not surprising that local actors in the selected areas became supportive of the government's selective liberalization policies. It is more surprising that local actors in other areas also showed a strong desire to participate in the "liberalization" march by urging the central government to designate more areas as Free Economic Zones or international free cities.

Conclusion

Employing the multi-scalar view of globalization, this chapter advanced an understanding of the ways how globalization is constructed through various forms of interaction between actors and forces operating at different geographical scales. In particular, it paid attention to inter-scalar interactions between national and local forces and their impacts on the ways in which the nation state regulates trans-national flows of capital and investment. Major findings of this chapter are as below.

First, with respect to the national–local tensions and their impacts on the state regulation, the chapter shows how political contestation between alliances of forces constructed at the national scale and those at the local scale can facilitate liberalization of the state regulations on trans-national flows of capital. More specifically, it suggests that, when a nation state faces a regulatory deficit from intensified national–local tensions and strong local challenges to national forces, it can use liberalization strategies to reduce its political burdens. As a supporting empirical example, the chapter examined the drastic liberalization of the South Korean automobile industry. It argued that the rapid increase in foreign investment in the industry in 2000 and 2001 was facilitated by an institutional fix by the nation state (in particular, the liberalization of foreign investment policies) to a regulatory deficit which stemmed from the inter-scalar contestation between

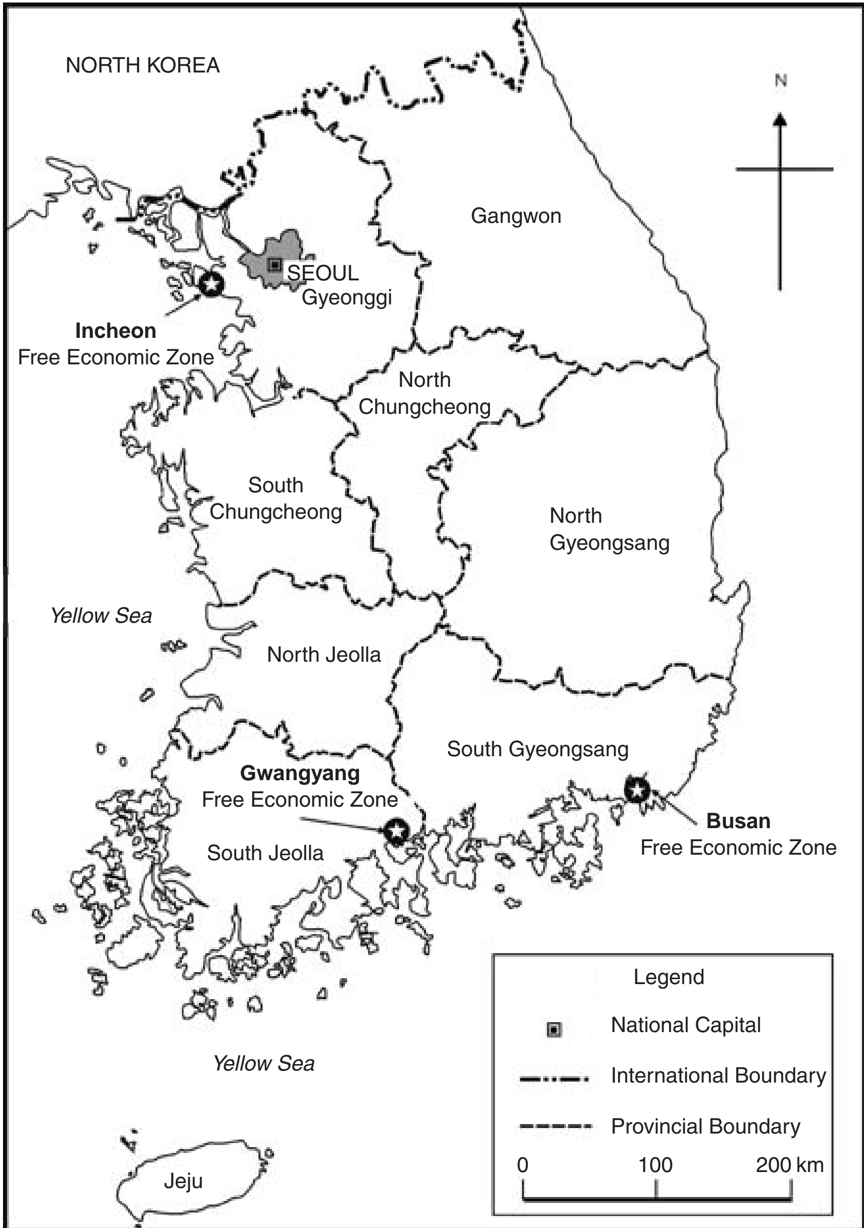

Figure 4.2 Location of free economic zones in South Korea.

the nation state and the local community in Busan with respect to the Big Deal project.

Second, this chapter examined how the forces at different geographical scales can interact with others through the politics of “jumping scale”. Especially, it argued that agents operating at a certain scale may try to mobilize the sources of power at different geographical scales in order to win in the power struggles that can happen with respect to their place-based regulatory projects and such cross-scalar mobilization of power can facilitate the development of “spatially selective liberalization” policies. By looking at the political processes taking place with respect to the construction of the Jeju International Free City project in South Korea, the chapter suggested that the “spatially selective liberalization” can be constituted by: (1) the efforts of place-dependent actors in certain localities to promote specific developmental projects by mobilizing the power of central forces, and (2) the nation state’s efforts to circumvent social resistance against, and to mobilize the bottom-up support for, the liberalization drive.

Globalization is an outcome of complex power struggles and political contestations occurring at various geographical scales. This chapter highlighted that particular national or local actors may try to construct certain forms of globalization politically and discursively in order to win in the power struggles or class conflicts at the local or national scales. It will broaden our critical understanding of globalization if we understand that not only external forces (e.g. TNCs, wealthy countries, and international organizations) but internal forces (e.g. national ruling elites, domestic firms, and local growth coalitions) are also responsible for the problems that local and national communities are facing in relation to globalization and neo-liberal reforms. As Cox (2005) argues, globalization is not a condition for the changing balance of class forces, but a product of class struggle. Neo-liberal reforms and resulting uneven development are not simply outcomes of globalization, but have been constructed out of power struggles occurring at diverse geographic scales. Globalization has been an outcome of this process.

Notes

1 For example, if the state places emphases on inward-looking development and on devoting all resources to local investment, the amount of outward investment for a given country can remain low. On the contrary, when state policies encourage domestic firms to invest abroad, the flows of outward investment can reach higher levels. In addition, countries may harbor different degrees of openness with respect to inward investment. The amount of inward investment in a country can remain low if protectionism and subsidization of domestic firms exist or if there is a preference for national private and state ownership of the productive assets in the country. In contrast, the flows of inward investment can reach higher levels when investment by foreign firms is allowed in the country.

2 MacKinnon and Phelps (2001) provided valuable insights into this process. According to them, the neo-liberal orthodoxy of economic restructuring led by foreign direct investment (FDI) in the United Kingdom is not simply imposed from above, but is constituted from below by the actions of national and sub-national actors. Especially,

they showed how the territorial politics of local economic development, organized by place-dependent actors in various localities for the purpose of attracting inward foreign direct investment there, had been facilitated and intensified by the effects of devolution, and how such territorial politics had facilitated the (re)construction of the discourses advocating the FDI-led economic restructuring at the national scale.

3 The power of territorial politics from below may be intensified when place-dependent actors at the smaller scales are able to forge wider spaces of engagement with powerful actors at the bigger scales (Cox, 1998b) or when a strong sense of territorial identity and consciousness is mobilized at smaller scales, in opposition to the larger-scale regulatory project. The mobilization of territorial identity can be facilitated under particular historical and political conditions, such as the development of a regional party centered on the locality, the history of political and economic marginalization of the locality by the central power, the geographic concentration of certain ethnic minority groups in the locality, and the like.

4 This program was a nationalistic and state-centered industrial restructuring project that was aimed at revitalizing domestic industries. It was even said that the program was similar to the industrial rationalization program that the military regime in South Korea used in the early 1980s to force the *chaebol* to interchange their business activities; however, there were differences between the two policies in the ways in which the business swaps were planned and practiced. Thus, the fact that this nationalistic and state-driven industrial restructuring project was implemented under the IMF bailout program indicates that the South Korean government's liberalization in the late 1990s cannot be solely explained as a result of external pressure from the IMF. In addition, there were more complex and diverse driving forces behind the liberalization reforms.

5 Usually, when regulatory projects are initiated by certain place-dependent social actors who want to secure or enhance their interests in certain place-specific social relations, the scales at which the regulatory activities are organized are based on the material boundaries of the "space of dependence"; within this space, the place-specific social relations that are important for realizing the interests of place-dependent actors are laid out (Cox, 1998b).

6 In addition to this strategic reason, under the centralized regulatory framework in South Korea, the Jeju Provincial Government needed to generate financial and institutional support from the central government in order to materialize the idea of international free city. In particular, since the international free city project required great relaxation of various government regulations on economic activities, land use, movement of capital and people, education, environment, etc., support from the central government was essential for successful implementation of the project.

References

Aglietta, M. (1982) *A Theory of Capitalist Regulation* (London: NLB).

Appel, H. (2000) The ideological determinants of liberal economic reform, *World Politics* 52, pp. 520–49.

Bishop, B. (1997) *Foreign Direct Investment in Korea: The Role of the State* (Aldershot: Ashgate).

Bishop, B. (2001) The liberalization of foreign direct investment policy in Korea, in O.Y. Kwon and W. Shepherd (eds) *Korea's Economic Prospects: From Financial Crisis to Prosperity* (Cheltenham: Edward Elgar).

Conklin, D., and Lecraw, D. (1997) *Foreign ownership restrictions and liberalization reforms* (Aldershot: Ashgate).

Cox, K.R. (1993) The local and the global in the new urban politics: A critical view, *Environment and Planning D: Society and Space* 11, pp. 433–48.

Cox, K.R. (1998a) Locality and community: Some conceptual issues, *European Planning Studies* 6(1), pp. 17–30.

Cox, K.R. (1998b) Spaces of dependence, spaces of engagement and the politics of scale, or: Looking for local politics, *Political Geography* 17, pp. 1–23.

Cox, K.R. (2002) "Globalization", the "regulation approach", and the politics of scale, in A. Herod and M.W. Wright (eds) *Power, politics, and geography: Placing scale* (New York: Guilford Press).

Cox, K.R. (2005) The local and the global, in P. Cloke and R.J. Johnston (eds) *Spaces of Geographical Thought: Deconstructing Human Geography's Binaries* (London: Sage).

Cox, K.R. and Mair, A.J. (1988) Locality and community in the politics of local economic development, *Annals of the Association of American Geographers* 78, pp. 307–25.

Dicken, P. (1994) Global–local tensions: firms and states in the global space-economy, *Economic Geography* 70, pp. 101–28.

Dicken, P. (1998) *Global shift: Transforming the world economy* (New York: Guilford Press).

Dicken, P., Peck, J. and Tickell, A. (1997) Unpacking the global, in R. Lee and J. Wills (eds) *Geographies of economies* (London: Arnold).

Ettlinger, N. (1994) The localization of development in comparative perspective, *Economic Geography* 70, pp. 144–66.

Garrett, G. (1998) Global markets and national politics: Collision course or virtuous circle? *International Organization* 52, pp. 787–824.

Helen, V.M. and Robers O.K. (1996) Internationalization and domestic politics: An introduction, in O.K. Robers and V.M. Helen (eds) *Internationalization and domestic politics* (Cambridge: Cambridge University Press).

Henderson, J. (1998) Uneven crises: Institutional foundations of East Asian economic turmoil. *Transnational Community Working Paper* WPTC-98–13 (Oxford: University of Oxford, Faculty of Anthropology and Geography).

Jones, M. and Jones, R. (2004) Nation states, ideological power and globalization: can geographers catch the boat? *Geoforum* 35, pp. 409–24.

Jung, Y. and Lee, Y.S. (2001) Financial crisis and industrial policy in Korea, in O.Y. Kwon and W. Shepherd (eds) *Korea's economic prospects: From financial crisis to prosperity* (Cheltenham: Edward Elgar).

Kim, S.-J. (1998) Local responses to manufacturing decline (in Korean), in G.-S. Chung *et al.* (eds) *Regional development and corporate strategy* (Gwangju, Korea: Jeonnam National University Press).

Kookmin Daily (1999) Selfish Regionalism Hurts Korean Economy (in Korean), 13 July.

Korea Herald (1998a) A Win–Win Deal, *Korea Herald*, 4 December.

Korea Herald (1998b) Big Deals to Drive Many Suppliers to Bankruptcy, 14 December.

Korea Herald (1998c) Samsung Motors Workers Protest Swap with Daewoo Electronics, 10 December.

Korea Herald (1999a) Job Security Emerges as Biggest Obstacle to "Big Deals", 26 January.

Korea Herald (1999b) Politics Clouds Outlook for Samsung Motors Plant, 6 July.

Korea Times (1999a) Regionalism Stunts Reform Drive, 8 February.

Korea Times (1999b) Samsung's Pusan Factory to be Sold, 6 July.

Kwon, E.-D. (2004) Financial Liberalization in South Korea, *Journal of Contemporary Asia* 34(1), pp. 70–101.

Lee, Y.-H. (2000) The failure of the weak state in economic liberalization: Liberalization, democratization and the financial crisis in South Korea, *Pacific Review* 13, pp. 115–31.

Lim, H.-C. and Chung, I.-J. (2003) Current Situation of Korean Democracy: *Segyehwa* Policy and Neoliberal Structural Adjustment, in C.-K. Kang (ed.) *Studies in Social Development* (Seoul: Nanam).

Lim, H.-C. and Jang, J.-H. (2005) Social Conditions and Outcomes of Swift Neoliberal Transformation: The Case of South Korea since the 1990s. Paper submitted to *Journal of Contemporary Asia*.

MacKinnon, D. and Phelps, N.A. (2001) Devolution and the territorial politics of foreign direct investment, *Political Geography* 20, pp. 353–79.

Maekyung News (1997) Discussion with Pusan mayor on local economy (in Korean), 15 February.

Park, B.-G. (2001) Labor regulation and economic change: a view on the Korean economic crisis, *Geoforum* 32, pp. 61–75.

Park, B.-G. (2003) Politics of Scale and the Globalization of the South Korean Automobile Industry, *Economic Geography* 70, pp. 173–94.

Peck, J. (2002) Political Economies of Scale: Fast Policy, Interscalar Relations, and Neoliberal Workfare, *Economic Geography* 78(3), pp. 331–60.

Peck, J. and Miyamachi, Y. (1994) Regulating Japan? Regulation theory versus the Japanese experience, *Environment and Planning D: Society and Space* 12, pp. 639–74.

Samsung Economic Research Institute (2001) *Three years after the IMF bailout: A review of the Korean economy's transformation since 1998* (Seoul: Samsung Economic Research Institute).

Schamis, H.E. (1999) Distributional coalitions and the politics of economic reform in Latin America, *World Politics* 51, pp. 236–68.

Shin, J.-S. and Chang, H.-J. (2003) *Restructuring Korea Inc.* (New York: RoutledgeCurzon).

Yeung, H.W.C. (2002) The limits to globalization theory: A geographical perspective on global economic change, *Economic Geography* 78, pp. 285–305.

Part II

Globalization and country experience

5 From East Asian “miracle” to neoliberal “mediocrity”

The effects of liberalization and financial opening on the post-crisis Korean economy

James Crotty[1] *and Kang-Kook Lee*

Introduction

Prior to late 1997, Korea’s state-guided East Asian economic model was widely admired by Western economists, the IMF and the World Bank for its exceptional long-term development record. For example, Stanley Fischer, later to become chief economist for the IMF, wrote in 1996 that “there really has been a miracle in East Asia” and that the view that government action was central to this success is “widely shared” (Fischer, 1996, pp. 345 and 347).

In the decade preceding 1997, under external pressure from G7 governments, foreign firms and banks who wanted to share in the Korean “miracle,” and internal pressure from the large family-owned conglomerates known as *chaebol* and wealthy individuals who wanted freedom from government restraint, the structures of Korea’s state-guided economy were dismantled. The state ended its traditional control of *chaebol* investment decisions, substantially reduced its regulation of domestic financial markets, and loosened control of cross-border money flows, with short-term capital flows most aggressively deregulated. Chang and Evans argue that “the dismantling of the development state was effectively finished by … 1995” (Chang and Evans, 2005, p. 115). Foreign short-term credit, which stood at $12 billion in 1993, rose to $32 billion in 1994, $47 billion in 1995, and $67 billion in 1996. These funds helped create an overheated, investment-led boom and created serious financial fragility in the economy. In 1997, after the outbreak of the Asian financial crisis, foreign banks refused to renew short-term loans, demanding payment. Illiquid Korean banks and highly leveraged firms were unable to comply. With key banks and nonfinancial corporations on the verge of default, the Korean government accepted an IMF loan to help repay their foreign debt. In return, the IMF took effective control of the Korean economy.

The post-crisis conventional wisdom asserts that the structure of Korea’s economy prior to the crisis was fatally flawed. Mainstream economists acknowledge that the liberalization of short-term capital flows created the dramatic rise

in short-term foreign debt that triggered the crisis. However, they insist that liberalization was not the fundamental cause of the crisis; it merely exposed the underlying rot within. (MOFE, 1999; Greenspan, 1999; Brittain, 1997; Hahm and Mishkin, 2000; Borensztein and Lee, 1999; Krueger and Yoo, 2001.)

There is an alternative interpretation of recent events in Korea, whose adherents include numerous heterodox scholars (Chang, 1998; Singh, 1999; Wade and Veneroso, 1998; Crotty and Dymski, 2001; Crotty and Lee, 2001) along with a few prestigious mainstream economists such as Joseph Stiglitz, former Chief Economist for the World Bank, and Harvard's Dani Rodrik. They argue that the major cause of the crisis was not *inherent* inefficiencies in the structure of the Korean development model, but rather *contingent* inefficiencies primarily created by a liberalization process that disastrously weakened the structural integrity and coherence of the traditional Korean economic system.[2] In this view, the problem in the 1990s was not too much state intervention, but the elimination of government functions essential to efficiency within the Korean model. (This thesis is defended theoretically and empirically in Crotty and Lee, 2004.) In particular, absent the deregulation of short-term capital inflows in the 1990s, there would have been no system-shaking financial crisis, no IMF takeover, and no radical neoliberal restructuring.

The IMF acknowledged in statements made both just before the crisis and several years after it that Korea faced a liquidity crisis in late 1997, not a systemic failure. The October 1997 IMF report on Korea called attention to the "absence of deeper solvency concerns." At that time, the IMF's worst-case scenario for Korea in light of the Asian crisis was a modest drop in the growth rate to 4.5 percent in 1998 (IMF, 2003, pp. 162–3). Yet in December 1997, just two months later, the IMF declared that the Korean economy was in a state of profound structural dysfunction, requiring radical emergency surgery. This was the reason it imposed what it called "extreme structural conditionality" on Korea, along with tight monetary and fiscal policy to restore foreign investor confidence (IMF, 2003, p. 179). The IMF's post-crisis evaluation report of 2003 says that if the IMF and World Bank had announced that they would provide Korea with as much foreign exchange as it needed, there would not have been a financial crisis at all.

The IMF's long-term objective was the destruction of the traditional Korean model. In its explanation of its response to the Asian crisis offered in January 1999, the IMF emphasized that "forceful, far-reaching *structural reforms* are at the heart of all [our] programs, marking an evolution in emphasis from many of the programs that the IMF has supported in the past" (emphasis in original). The structural reforms included the need to "break the close links between government and business" that define the East Asian model, "ensure the integration of the national economy with international financial markets," increase the "potential for foreign participation in domestic financial systems," and "remove impediments to growth such as monopolies [i.e. the *chaebol* system], and trade barriers …" (IMF, 1999). We are especially concerned here with IMF demands for full integration with international financial markets and open access for

foreign financial firms. The IMF acknowledged the existence of strong outside pressure on the policies it imposed on Korea. "The IMF's major shareholder governments made no secret of their view that IMF assistance should be accompanied by strong reforms. The US authorities in particular insisted that strong reforms should be a condition of IMF support" (IMF, 2003, p. 185**).**

The IMF had an enthusiastic partner in President-elect Kim Dae Jung. In a 1985 book titled *Mass-participatory Economy: a Democratic Alternative for Korea*, he stated that "maximum reliance on the market is the operating principle of my program" and that "world integration is our historic mission" (Kim, 1985, pp. 78 and 34). "I believe that the crisis will be remembered as a blessing," Kim announced in 1999, "because it is forcing essential economic changes" (*New York Times*, February 18, 1999).

The goals of the IMF–Kim team were as follows. First, to create a fully 'flexible' labor market. President-elect Kim was determined to erode the domestic market power of large *chaebol* firms and raise their efficiency through massive foreign investment, which would not take place unless Korea's militant unions were tamed. Breaking the labor movement thus became a central policy goal. For the first time in modern Korean history, firms were allowed to fire as many workers as they pleased in cases declared to be of "urgent managerial need" (which included foreign takeovers), and temporary help agencies were legalized. Second, to end government interference with the free-market allocation of finance through conversion from a state-guided, bank-based to a globally open capital market-based financial system. The government's objectives here were to drastically reduce credit flows to the *chaebol* groups and induce foreign banks to take control of much of Korea's banking system in order to improve its allocative efficiency. The stock market was to replace owning families as the controlling power of *chaebol* firms. Third, to move toward "world integration" and help break the power of *chaebol* by fully opening all Korea's markets to foreign firms. "What we need now, more than anything else, are foreign investors," Kim stated in an address to the US Congress in 1998. These goals were accepted by current President Roh, much to the regret of the trade unions and progressive activists who made his election possible.

In the next section, we briefly review economic performance in post-crisis Korea and discuss the impact of capital market opening on Korea's economy. The third section analyzes the results of financial market liberalization and foreign ownership of Korean banks, while the last section draws conclusions and discusses policy options.

Neoliberal restructuring: slow growth, high inequality, and the rising influence of foreign capital

Post-crisis economic performance

Though many Korean firms had become very financially fragile, the IMF raised the short term interest rate from 13 percent in early December 1997 to 34

percent just one month later, holding it above 20 percent through mid-1998. It imposed restrictive fiscal policy as well. Real GDP growth fell by 6.9 percent and domestic demand by 13.8 percent in 1998. Thus, the cause of the near-depression conditions of 1998 and early 1999 was the perverse policy response to the Korean crisis put in place by the IMF–Kim team.

As can be seen in Table 5.1, the economy rebounded in 1999 and 2000 due to a radical shift in macro-policy, a record trade surplus, a sharp rebound in consumer spending and a huge injection of public funds into the financial sector. It experienced a mild recession in 2001 as investment slumped and the trade surplus declined. Rapid growth returned in 2002 as consumer spending rose by an impressive 7.6 percent and investment increased. The economy slumped again in 2003 as consumption spending actually fell – its growth rate declined by 7.9 percentage points from a year earlier, and capital formation slowed. The 3.1 percent GDP growth rate in 2003 was the lowest in the past two decades, 1998 excepted. Strong growth in net exports raised economic growth modestly in 2004 even in the face of stagnant consumption and investment spending. Most projections for GDP growth in 2005 are below 4 percent. Post-crisis performance is thus far inferior to pre-crisis achievements: the average rate of GDP growth from 1998 to 2004, at 4.2 percent, is much lower than the 8 percent averaged in the entire pre-crisis regime and the 7.1 percent in 1993–97.

In 1999 the government decided to strengthen domestic demand and reduce Korea's excessive dependence on export growth. The only way to achieve this admirable goal on a long-term basis would be to increase jobs and real wages, while stimulating domestic investment. The government chose instead to deregulate consumer lending and provide tax incentives for consumer credit. This policy was a short-term success; the average growth in consumer spending was a spectacular 7.4 percent from 1999 to 2002. A residential real estate boom took place at the same time that added to household indebtedness. This government policy left a crushing household debt problem in its wake. Household debt as a share of GDP rose spectacularly – from 41 percent in 1998 to 74 percent in 2002. This share is now as high as in the low-saving US, but the situation is more precarious because the ratio of financial assets to debts is only about half the US value. An outbreak of defaults that devastated the credit card industry combined with an end to government borrowing incentives brought consumption spending to a stop in 2003 and 2004. On average, consumption, which grew at annual rate of 6.5 percent in 1993–97, inched ahead at 2.3 percent a year from 1997 to 2004.

Most important, post-crisis investment spending stagnated. Gross investment ranged from 35 percent to 40 percent of GDP from 1990 to 1997, but has been between 25 percent to 31 percent since then. A BOK survey shows that private sector equipment investment, a key foundation for productivity growth and the future competitiveness of Korean firms, which collapsed in the crisis of 1998 and rebounded in 1999 and 2000, has failed to grow since then (BOK, 2004). Equipment investment was lower in 2004 than in 1996. Investment problems are most serious in small and medium companies.[3] Investment stagnation poses a serious threat to future prosperity.

Table 5.1 Economic performance after the crisis in Korea (%, $ billion)

Measure	*1993–97*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Real GDP growth	7.1	4.7	−6.9	9.5	8.5	3.8	7.0	3.1	4.6
Consumption growth	6.5	3.2	−10.6	9.7	7.1	4.9	7.6	−0.3	0.2
Fixed investment growth	12.3	−2.3	−22.9	8.3	12.2	−0.2	6.6	4.0	1.9
Net export/GDP	−1.1	−0.6	12.9	6.7	3.2	2.3	1.4	2.4	4.4
Government deficit/GDP	−0.0	−1.4	−3.9	−2.5	1.1	1.2	3.3	1.1	0.7
Household debt/GDP	40.5[a]	46.6	41.3	44.3	51.1	62.0	73.6	–[b]	
Foreign reserves ($ billion)	21.7	8.9	48.5	74.1	96.2	102.8	121.4	155.4	199.1
Debt ratio in manufacturing	319.5	396.3	303.0	214.7	210.6	182.2	135.4	123.4	104.2
Ordinary profit/Sales in manufacturing	1.7	−0.3	−1.8	1.7	1.3	0.4	4.7	4.7	7.8

Source: BOK, National Accounts, based on 2000 prices.

Notes

a Household debt is average from 1994 to 1997.

b Due to the change of GDP statistics, direct calculation is impossible.

Investment has been constrained by several forces. Domestic demand growth has slowed significantly while volatility and uncertainty have risen. Profits were low through 2001, hindering investment. Starting in 2002, corporate profitability improved due to a fall in interest payments (as debt declined and interest rates fell) as well as a drop in labor's share of income, but investment did not respond.[4] In the new Korean economy, profits are increasingly used to raise dividends, buy back shares, and create a cash stockpile, rather than finance investment. Foreign-controlled banks have led a strategic shift in banking away from corporate to consumer lending, drying up a major source of investment finance. An increase in outward FDI that began in the mid-1990s also contributed to the investment malaise. While inward FDI was about $13 billion in 2004, outward FDI hit $8 billion, almost half of which went to China. Sixty-three percent of outward FDI was by manufacturing firms, raising fear of a "hollowing out" of Korean manufacturing (*Korea Herald*, "Korea's overseas investment jumped in 2004," January 26, 2005). In the first half of 2005, outward FDI exceeded inward FDI.

Thus, the only buoyant demand category in the past two years was net exports. How ironic! Government policy tried to shift demand from exports to domestic spending, yet domestic demand is sluggish while export dependence grows. Export plus imports as a percent of GDP rose from 65 percent in 1997 to 84 percent in 2004 – when the ratio of net exports to GDP hit 4.4 percent. However, the export boom is itself unsustainable: the won has appreciated recently, imported energy prices are rising, firms continue to rely on imported intermediate goods, and export growth increasingly depends on a superheated Chinese economy. Moreover, such heavy export dependence is irrational because the terms of trade have collapsed since the crisis.

Neoliberalism exacerbated the fragmentation of Korea's economy and society. The gap between large *chaebol* firms in the export sector and small and medium firms in the domestic sector has been increasing; many of the former are doing well while the latter suffer. The link between the export and domestic sectors appears to be weakening; fast-growing export-oriented ICT industries such as semiconductors and mobile phones rely heavily on imported intermediate goods. Thus, export growth does not trigger as much domestic spending as before (Lee *et al.*, 2004).

Social fragmentation also increased. The share of workers with "irregular" jobs, including workers with temporary contracts and part-time jobs, is, at 56 percent, the highest in the OECD. Wages and working conditions for irregular workers are much worse than for those with permanent jobs. "Nonregular workers are paid lower wages [about half], are entitled to fewer benefits and are not well covered by the safety net ... less than 8 percent of nonregular workers are covered by unemployment insurance, medical insurance or the national pension" (IMF, 2004, p. 36). Labor's share of income fell significantly, from 62.3 percent in 1997 to 58.8 percent in 2004. Since the share of employed persons categorized as "workers" increased from 61.7 percent in 1998 to 66 percent in 2004, the erosion of labor's economic share is serious. Meanwhile, the percent of workers who belong to unions is declining steadily.

Indices of inequality increased substantially in the aftermath of the crisis and remained high since then. The Gini coefficient for urban workers' families is about 10 percent higher now than in 1997, while the ratio of the income of the top 20 percent of working families to the bottom 20 percent rose from 4.5 in 1997 to 5.9 in the first quarter of 2005 – a record high for Korea.[5] The rise in the ratio of the top to the bottom 10 percent rose by a third. Government policy does little to ameliorate rising inequality. In contrast to developed countries, Gini coefficients calculated with and without the inclusion of government transfers and taxes are not significantly different. The poverty rate more than doubled since the crisis, but the welfare system, while improved, remains inadequate to deal with the social problems created by neoliberal policies. Social welfare spending is just 10 percent of total government spending. Unemployment compensation is technically available to more workers in the new Korea, but in 2003 only 19 percent of the unemployed actually received benefits (IMF, 2004, p. 39). Even the research institute of the conservative Bank of Korea published a report calling for efforts to establish a virtuous cycle between the export and domestic sectors and reduce income inequality (Lee *et al.*, 2004).

Economic opening and capital inflows

Capital account liberalization was the proximate cause of the crisis, yet in response, the Kim government, under pressure from the IMF and the G8, dramatically accelerated the pace of financial opening. In May 1998 the government abolished limits on the percent of corporate stock that foreigners could own. Regulations on foreign investment in most corporate bonds, in the forward market and in commercial paper were eased or abolished. The government permitted hostile M&As by foreign investors after 1997 and made a concerted effort to sell important financial institutions to foreign buyers (MOFE, 1999, pp. 137–51). Restrictions on foreign borrowing by domestic firms were further liberalized in 1998. In April 1999 the government permitted nonresidents to hold long-term deposits in domestic financial institutions, further deregulated firms' short-term foreign borrowing, accelerated deregulation of real estate investment abroad, and permitted all Korean financial institutions and individuals to engage in foreign currency transactions. In 2001 regulations on individuals' purchases of foreign currency and spending abroad were repealed, and domestic deposits by foreign financial institutions and the purchase of foreign bonds by Koreans were deregulated (*Korea Economic Daily*, April 23, 2000; MOFE, 2000). Regulations on nonresidents' bond issuance and borrowing in domestic currency were repealed in 2002, as were foreign exchange transactions of financial institutions, including derivatives trading. By 2006, remaining restrictions on foreign capital transactions will be lifted (MOFE, 2002).

Capital flows increased rapidly in response. As can be seen in Table 5.2, though net portfolio inflows have been modest, both inflows and outflows have grown rapidly, and are now very large (both exceeded $100 billion in 2004) and extremely unstable. In 2004 portfolio inflows were almost nine times as large as

Table 5.2 Foreign capital flows in Korea after the crisis ($ billion)

Capital flow	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
FDI inflows	3.2	6.9	8.8	15.5	15.2	11.3	9.1	6.5	12.8
Portfolio									
Inflows	12.6	13.2	16.5	41.7	60.1	43.9	65.4	81.6	116.2
Outflows	8.0	12.1	11.7	36.2	48.8	36.4	66.2	68.1	106.8
Net inflows	4.6	1.1	4.8	5.5	11.3	7.5	−0.8	13.5	9.4
Total (portfolio inflows + outflows)	20.6	25.3	28.2	78.0	108.9	80.4	131.6	149.6	222.9

Source: Bank of Korea and Ministry of Commerce, Industry and Energy.

in 1998. Large and volatile short-term capital flows have created substantial instability in stock prices and the exchange rate. Korean stock prices now respond primarily to changes in US investor sentiment: the correlation between US and Korean stock prices is high (BOK, 1999). The Korean stock market has become a gambling casino for foreigners. In just three weeks in May of 2004 "massive withdrawals of investment funds by foreign investors" caused the KOSPI stock market index to fall by 22 percent (*Korea Herald*, "Foreign funds outflow from bourse easing," June 10, 2004).

In recent years the Bank of Korea has been forced to "sterilize" the inflow of foreign funds (created by capital inflows and huge trade surpluses) by issuing "Monetary Stability Bonds" (MSB) to ensure that the trade surplus is not destroyed by a rapidly appreciating won. The BOK sold large quantities of won in exchange for foreign currencies, creating a $200 billion pool of foreign reserves in the process, and simultaneously issued won-denominated bonds to limit the supply of won in public hands. The supply of MSB increased from 23.4 trillion won in 1997 to 105.5 trillion in 2003 and 142.8 trillion won in 2004. The increasing interest burden associated with this aggressive sterilization policy recently pushed the BOK into deficit for the first time in a decade. The ever-rising foreign reserve hoard comforts those who remember Korea's vulnerability in the 1997–98 crisis, but excessive exchange reserves are a costly form of protection, and they could not prevent financial instability in the event of another bout of exceptionally rapid capital outflows. It would be far more effective to reinstitute effective controls over short-term capital flows (a thesis defended in Rodrik, 1999).

Korea's capital market opening also led to a surge of inward FDI. President Kim forced Korea's highly indebted *chaebol* conglomerates to put key assets on the market after 1997 by demanding that they cut their debt-to-equity ratios in half – in just two years. Thus, only foreign firms could afford to bid for the assets they disgorged. (See Crotty and Lee, 2001, for a detailed description of this process.) Moreover, capital flight in late 1997 and early 1998 caused the value of the won to collapse – from 844 won per US dollar in 1996 to 1,415 at the end of 1997. Korean assets were thus offered to foreign capital in a fire sale not open to domestic bidders. Encouraged by deregulation, fallen asset prices and a collapse in the value of the won, cumulative FDI inflows from 1998 to 2000 were two-thirds larger then total inward FDI from 1962 to 1997. Korea got little in return. The lion's share of asset sales were in the form of M&As. New capital assets were not created, existing assets merely changed ownership.[6] There is no convincing evidence that FDI inflows were helpful to the recovery process in Korea or in East Asia (Mody and Negishi, 2001).

Is foreign capital helping Korea's economy?

Foreign stock ownership, especially of important *chaebol* firms, increased dramatically post-crisis. The share of foreign ownership of Korea's publicly held stock increased from 15 percent in 1997 to 22 percent in 1999, 37 percent in

2001 and 43 percent in early 2004. Foreigners have gained strong influence in important industries such as semiconductors, autos, petrochemicals, and finance. The foreign ownership share of the ten firms with the largest market capitalization has risen to an astounding 54 percent (*Korea Herald*, "Foreign investors flock to Korean stock market," January 19, 2005). Control of most *chaebol* conglomerates by their domestic owners has been sustained in the face of rising foreign ownership through interlocking ownership among *chaebol* firms and controlling-family ownership of unlisted shares.[7] However, foreigner owners have tried to control the investment policy and corporate governance structures of the firms they hold stock in. A foreign equity fund tried on several occasions to take control of the SK group, the third largest *chaebol* in Korea. Even Samsung, Korea's largest and most profitable company, appears vulnerable to a foreign takeover. The corporations precariously controlled by domestic insiders have begun to incorporate fear of foreign takeover into their strategic decision making. This reinforced the investment-constraining behavior mentioned above. These firms hold more cash, pay more dividends (dividend payments to foreigners rose from $0.4 billion in 1998 to $3.1 billion in 2003), and make more stock buybacks than they did previously. "This trend has spurred the largest shareholders of Korea's listed companies to increase ownership in their companies to defend managerial control against what they perceive as increasing takeover threats, raising concerns about already sagging corporate investment" (*Korea Herald*, "Foreign investors increase stakes to gain more input," June 21, 2005).

It is not clear that the transfer of advanced technology by foreign firms sought by President Kim has taken place. Foreign ICT companies repatriated 98 percent of profit in 2002 with almost no domestic investment or R&D spending (*Seoul Kyoungje Sinmun*, November 23, 2003). Worse yet, Korea's top *chaebol* firms never did require a technology transfer from abroad to remain competitive in their domestic and global markets, as the success of Samsung, Hyundai, POSCO and LG demonstrates.

Curiously, as the costs of foreign portfolio and FDI inflows and outflows become clearer and the benefits less certain, the government has increased its efforts to attract foreign capital. Given Korea's experience with foreign capital since the crisis, this continued hunt for yet more FDI is astonishing, and demonstrates the utter futility of economic policy-making since 1997.[8]

The most troubling problems created by rising foreign ownership have taken place in the financial sector. They are analyzed in the next section.

Financial liberalization and the effects of foreign bank ownership

Global shareholder capitalism

The neoliberal model that has guided Korean restructuring envisions a world in which efficient capital markets decide how much is invested in each country and what the allocation of finance across competing uses will be. Those who own

financial capital are free to send it to whatever country offers the best expected returns. Supporters of neoliberalism argued that financial capital would flow from the capital-rich advanced countries to the capital-poor but opportunity-rich developing world, accelerating poor-country growth. To benefit fully from the new system, it was argued, Korea would have to open its financial markets to foreign firms. World-class foreign banks would bring state of the art technology and managerial systems to Korea's dysfunctional financial system. This is *global shareholder capitalism*, a system in which efficient stock and bond markets are supposed to shift financial capital from poorly run firms to those most efficiently managed. A vigorous market for corporate control is essential to its operation: stock markets must punish inefficient companies by slashing their market value, making them attractive takeover targets for more capable domestic or foreign management teams.

We believe this guiding vision is fatally flawed; adopting its policies is a recipe for instability, economic stagnation, and rising inequality. No country that trusted lightly regulated financial markets to make its saving and investment decisions has ever had a successful development experience (Chang 2002; Amsden, 2001). To take one example of its shortcomings, in recent years capital has moved from developing countries, especially in Asia, to the US – not the other way around. America currently receives about three-quarters of all the capital that crosses national borders. Most of the money that does go to developing nations is concentrated in a few countries, with the state-guided Chinese economy getting the lion's share. Because capital flows have become so volatile in the neoliberal era, many countries have been hit by devastating currency and banking crises.[9] In response to such crises, countries in Asia have built absurdly large stocks of dollar reserves to protect against runs on their currencies. It has been estimated that the cost of holding excessive reserves in East Asia is between 1 and 2 percent of GDP (Baker and Walentin, 2001).

As noted, managements are under increasing pressure to keep stock prices high even in the shortest of runs to avoid hostile foreign takeover. Managers also seek rising short-term stock prices in order to maximize the value of management stock options, a form of compensation that dominates the top echelons of US companies and has begun to penetrate Korea. Samsung executives made almost one trillion won in capital gains on their stock options in 2004 (*Korea Herald*, "Samsung execs stock-option gains put at W1 tril," September 24, 2004). Using stock price as the main index of managerial competence might be reasonable if stock prices reflected long-term enterprise "fundamentals" – as in efficient markets theory. But as Keynes stressed decades ago, lightly regulated financial markets are prone to bubbles and herd behavior. The stock turnover ratio in Korea is among the world's highest. In 1999 the "average" Korean stock was sold about 3.5 times, convincing evidence that stock prices cannot possibly reflect long-term "fundamentals" (*The Economist*, June 24, 2000, p. 122) It would be irrational for the average investor – who will own a stock for less than four months – to be concerned with long-term prospects. Moreover, pressure to use the firm's internal funds to raise dividends and buy back stock reduces the

internally generated funds available to finance investment spending, as it has done in the US (Crotty, 2002). Shareholder capitalism thus imposes a short-term planning horizon on managements that, in concert with increased uncertainty and decreased internal and external sources of finance, constrains and distorts long-term investment.[10]

No country is in practice willing to put its economic future completely in the hands of domestic and foreign stock and bond speculators – no matter how deep its ideological commitment to neoliberalism. Rapid stock price declines, which in neoliberal theory are rational signals to cut investment, have triggered government efforts to push prices up again. In late 2004, for example, the government announced a "plan to mobilize public funds, including the national pension fund, to prop up the stock market" (*Korea Herald*, "Plan to mobilize pension funds faces criticism," November 20, 2004). Such policies clearly indicate that the government believes it is a better judge of the optimal rate of capital investment than financial markets – an implicit rejection of shareholder capitalism.

The foreign takeover of Korea's banking system

Opening Korea's financial markets was a central component of the strategy to move rapidly from a highly regulated and "repressed" financial system to a lightly regulated and globally open one. President Kim and the IMF believed that domestic banks were too backward to lead the financial revolution. Designed for a radically different purpose, domestic banks had neither the managerial skills, the experience, the technology, the organizational structure, the strategic orientation nor the access to capital required to replicate sophisticated financial markets in North America and Europe. As President Kim put it: "Under the strategy of government-led economic development, the government used the financial industry as a tool to implement its industrial policies … Consequently, Korean financial institutions have been significantly less sound and profitable than their foreign counterparts" (MOFE, 1999, p. 87). Foreign institutions were thought to be required to change the structure and efficiency of Korea's financial markets quickly. Domestic banks would be forced to compete with them – on their terms – or fade into oblivion. Since the government had effectively nationalized many Korean financial institutions in the process of absorbing their bad debts – at an enormous cost of some $140 billion – it was in position to sell these firms to whoever it wanted. Kim wanted foreign buyers. There was a subsidiary advantage: foreign firms had no commitment to existing stakeholders, whereas domestic firms had implicit contracts with their workers as well as with the domestic firms that were their long-standing customers. Thus, outsiders could be counted on to immediately slash both labor costs (employment in finance dropped by 40 percent from 1997 to 2002) and corporate lending, which would help achieve the rapid reduction of *chaebol* indebtedness demanded by President Kim.

The initial buyers were private equity firms. Their strategy was to buy troubled firms cheap, then sell them quickly for substantial capital gain. The process

started with the sale of Korea First Bank to Newbridge Capital in 1999, followed quickly by Lone Star's takeover of the Korea Exchange Bank. The Korean government gave Newbridge a sweetheart deal. After spending 12.6 trillion won to clean up the bank's bad debts, it sold the bank to Newbridge for 0.5 trillion won. But it also agreed to buy any assets that turned sour in the next three years, which cost the government an additional 5.1 trillion won – ten times the sale value! Newbridge sold Korea First to London-based Standard Chartered Bank for 3.4 trillion won in early 2005 – almost seven times its purchase price. Carlyle's sale of the Korean-American bank generated a 250 percent return on investment, while Lone Star made 1.5 trillion won on the sale of Korea Exchange Bank. None of these banks paid any capital gains tax, which infuriated the public.

Under these conditions, any foreign private equity firm that could hold on to its newly acquired Korean bank until financial markets were restored to some degree of health was bound to make a substantial profit at resale, whether it improved efficiency or not. Instead of investing large sums to modernize their banks, foreign owners extracted capital through dividends and a reduction in the bank's capital base. BOK researchers concluded in a recent study that "foreign private-equity firms … focused on stabilizing the banks, rather than improving efficiency, with the goal of quickly selling their holdings" (*Wall Street Journal*, "Foreign Investors Induce Anxiety in South Korea," May 11, 2005).

Foreign ownership of Korea's large commercial banks has skyrocketed since the crisis, and giant multinational banks have begun to purchase banks initially taken by private equity funds. The foreign ownership share of the eight large urban banks grew from 12 percent in 1998 to 39 percent in late 2003 and 64 percent in late 2004. Foreign firms own more than half the shares of seven of the eight large commercial banks, totally dominating commercial banking in an economy in which corporate investment funding depends heavily on commercial bank loans. By mid-2005, the share of foreign ownership in major Korean banks included: Korea Exchange Bank 74 percent, Korea-America 100 percent (owned by Citibank); Korea First 100 percent (owned by Standard Chartered), Hana 76 percent, Kookmin, 84 percent; and Shinhan 63 percent. Publicly owned Woori Bank is the only major bank not owned primarily by foreigners, and it is soon to be privatized. Foreign-owned banks are thus in position to strongly influence the pace of capital accumulation. A World Bank study (based on the share of assets held by banks in which foreigners owned more than half the stock) showed that as early as 2001 Korea had much higher foreign bank ownership than most Asian countries: while Korea's share was then 30 percent, Malaysia had 19 percent, Thailand 7 percent, Japan 7 percent and China 2 percent (World Bank, 2003). By mid-2005, Korea had higher foreign bank ownership than almost all Latin American countries.[11]

The most important question is: what are the likely long-term effects of letting large foreign banks gain substantial control over Korea's banking system? To answer, we need to consider the strategies that guide giant financial firms such as Citigroup and Standard Chartered. These banks are likely to

concentrate on three major market segments. First, they will service Korea's and Asia's growing wealthy elites – a strategy Gary Dymski calls "upscale retail" banking. Second, they will operate in the residential mortgage and household loan markets. *The Economist* noted that across Asia: "There has been a sea change in the attitude of banks [after the Asian crisis] which moved away from their beloved corporations toward consumers ("Asia's banks have been shored up after the crisis – but business is still precarious," May 2, 2005). Third, they will specialize in fee-generating services for large corporations, especially those that are foreign owned, and trading on their own account.

By creating rising inequality, neoliberal restructuring is enlarging the "upscale retail" market that foreign banks see as their most important profit center. Korea already has $215 billion of wealthy household assets under private management, while all of Asia has $6.2 trillion.

> Asia is the new battleground for the world's private banks ... Rapid economic expansion across the region is creating wealth at an astonishing pace. And more of that money is coming into the orbit of professional managers as Asia's rich diversify from property and gold into bonds, equities and hedge funds.... Rich Asians generally demand a global service because the region's financial crisis in 1997–98 taught them to spread their risks.
> (*The Economist*, "Private Banking in Asia: Striking it Rich," June 12, 2004)

Banks like Citi, which has 200 million customers in 100 countries, can offer every financial asset and service imaginable anywhere in the world – including investment options in off-shore tax havens, access to private equity funds and exclusive hedge funds – and have vast experience catering to the rich in the advanced countries. It is hard to imagine domestically owned banks offering Citi serious competition. "Citibank seems particularly intent on going after the wealthy individual segment ... With its array of services and strong reputation, the US company could provide unmatched one-stop shopping services. They have expertise in private banking service and can use their global franchise ... to provide more products and services to clients" (*Korea Herald*, "US financial giant Citigroup seen targeting wealth consumer segment," February 23, 2004). Still, having suffered large losses in credit card lending, local firms will have to try to compete for elite money: "Handicapped by millions of unprofitable customers, credit card companies are chasing the moneyed elite, who are immune to the nation's economic malaise" (*Korea Herald*, "Credit card companies chase the rich," August 11, 2004).

Dominant foreign banks have huge investments in the software and hardware needed to efficiently assess the risk-return characteristics of mortgage and consumer credit applications as well as experience with securitization operations that provide the capital needed to operate in these markets. It will take time to create the credit information base required to maximize returns in this market, but eventually giant foreign banks will dominate, leaving only the bad risk applicants for domestic banks. "A bank with the systems and expertise of Citi

will be able to pick and choose the best customers in Korea, leaving domestic banks with lower-grade ones" (*Financial Times*, "Asia's banks have been shored up after the crisis – but business is still precarious," May 2, 2005, p. 13).

Foreign banks and brokerage houses are also likely to dominate such fee-generating income sources as derivatives trading and hedge fund operations. They are the firms that are helping turn Korea's financial markets into casinos for the global rich, financial institutions, and large corporations operating in Korea. They are responsible for the explosion in international gambling on Korea's stock market. In 2003, there were more futures and options contracts written on the KOSPI stock price index than on any other financial asset in the world (Dodd, 2004). How can this possibly be "efficient"? Moreover, "the local currency market is turning into one of the most popular playgrounds for hedge funds, with the won becoming the main target by the international speculative funds aimed at short-term gains (*Korea Times*, "Won under Attack from Hedge Funds, February 24, 2005). It would also be reasonable to assume that foreign banks, who have important long-term relations with many of the multinationals that have taken over large Korean firms, will favor these firms in any conflicts they may have with domestic competitors.

Foreign banks are likely to help large domestic and foreign corporations in Korea fool regulators and tax collectors, and defraud investors, as they did for Enron, WorldCom and other large US corporations in the late 1990s. Citi was forced to pay $2 billion to Enron investors and $2.7 billion to WorldCom shareholders for helping these firms conduct colossal fraud. It was also punished for serious regulatory violations in Japan, China, and Europe. According to Japanese regulators, Citi "failed to prevent transactions linked to money laundering, extended loans to manipulate publicly traded stocks, routinely misled customers about the risk involved in financial products and tied loans to the purchase of specific securities" (*Wall Street Journal*, "Japan Orders Citibank to Halt Private Banking," September 20, 2004). Citi was fined by Britain's financial regulatory agency for trying to game the European government bond market using a strategy its traders called "Dr Evil." It executed a $13.5 billion sale on its own account in August 2, 2004 in just 18 seconds. This volume, equal to an average day's trading, overwhelmed the electronic trading platform, causing a steep drop in prices. Less than an hour later, Cite purchased bonds at a large capital gain. (It also bought bond futures in anticipation of these trades.) Korea's Financial Supervisory Service announced it was going to investigate Citi "for possible links to money laundering and [illegal] domestic funds outflows through the US bank" (*Financial Times*, "Seoul to investigate Citigroup operations," October 5, 2004). The Korean government also initiated an investigation of foreign private equity funds for tax evasion, and is considering suspending derivatives trading by Deutsche Bank because it failed to inform several government-run companies of the risks involved in the derivatives it sold them (*Financial Times*, "S Korea set to suspend Deutsche," June 25–26, 2005).

Giant financial conglomerates have helped companies and wealthy families around the world evade financial and tax regulations for decades. As vividly

described by James Henry, leading international banks have created and fueled high-growth global markets for: recycling foreign aid money stolen by Third World politicians, illegal capital flight, money laundering, tax evasion, and illicit weapons traffic (Henry, 2005). William Grieder, one of America's most astute economic observers, commented that "Citi's criminal behavior is so far flung and ambidextrous it seems to be [an integral] part of the profit structure" (Greider, 2005).

The effects of foreign financial firms on Korea's economy

One thing foreign banks will not do is fund long-term investment by Korea's nonfinancial enterprises. Financial market funding for corporate investment in Korea is evaporating in the new foreign-dominated regime. According to a 2003 BOK study, between 1998 and late 2003 foreign banks slashed corporate loans as a percent of total loans by 33 percentage points, while domestic banks, following their lead, cut such loans by 25 percentage points. Foreign banks also cut loans to small and medium enterprises more deeply than did domestic banks. The share of corporate lending in total bank lending decreased from about 75 percent in 1996 to 43.5 percent in 2004. External funds provided by all financial institutions to the corporate sector decreased from about 118 trillion won in 1997 to an average of 65 trillion from 1999 to 2004 – *a drop of 45 percent.* Foreign banks also shifted bond holdings from corporate to government bonds, weakening a secure long-term source of finance for private investment. The share of government bonds in all securities held by foreign banks increased from 50 percent in 1998 to 68 percent in late 2003. The BOK report concludes that foreign banks have a powerful and growing influence in banking and that foreign control has reduced Korea's growth potential by leading the shift away from corporate lending toward consumer loans and the purchase of government bonds (BOK, 2003, p. 18).

Whenever foreign firms take control of a developing country's banking market, investment funding suffers, with small and medium businesses, which employ most workers, hit hardest. Consider the case of Mexico. Large foreign banks, including Citi, own 85 percent of local banking assets, the highest rate in Latin America. As was the case in Korea, foreign banks gained their stranglehold on Mexican banking by acquiring banks that were devastated by a crisis. They got them cheap, but only after bad assets had been cleaned up by the government at a cost of $105 billion – about 14 percent of GDP ("Mexico's banking sector is bouncing back" Knowledge@Wharton, March 10, 2004). Foreign banks have starved Mexican companies of needed credit. "These banks are turning gigantic profits," because "instead of providing credit to companies that could become engines for economic growth, banks have profited by charging expensive commissions for services such as credit card use and by filling loan portfolios with government bonds. The lack of available credit is a key obstacle to economic growth" (*Wall Street Journal*, "Mexico's Foreign Banks Grow Uneasy," March 17, 2004). Credit card lending has increased, but, as in the case

of Korea, the rise in consumer spending it generated is unsustainable: unless there is faster growth in jobs and real wages, debt burdens will constrain future consumption spending.

Given that foreign banks are not likely to contribute to widespread prosperity in Korea over the long run, it is important that domestic banks win the competition created by large-scale foreign entry because, if leaned on aggressively by the government, they might be induced to do so. However, domestic banks have yet to formulate a viable long-term defensive strategy. According to Dymski, Korea's banks "are simultaneously engaged in a strategic shift away from long-term lending relationships with large firms (especially *chaebol*), while moving toward alternative financial products and relationships. The problem is that Korean banks … have just been burned in their efforts to move toward one alternative; that is, consumer lending. They do not yet have a well-defined strategic option" (Dymski, 2004, p. 22).

Post-crisis data fail to provide evidence that foreign-controlled financial institutions have been more efficient than domestic ones. Domestic banks had higher return on asset and return on equity performance in each year from 2001 to 2003. However, over the longer run, it seems likely that foreign banks will dominate the most profitable segments of Korea's financial markets. Domestic firms may be left to compete with each other in marginally profitable segments. Dymski is pessimistic about the future of domestic banks: "If Citibank and other potential foreign competitors are permitted to enter the Korean market on their own terms and in pursuit of their own banking strategies, maintaining a competitive domestic banking system will be difficult or impossible" (Dymski, 2004, p. 24).

Another problem is that the success of foreign banks is not closely tied to the general health of the Korean economy. Since their highest priority is catering to Korea's wealthy elite, as long as income distribution remains highly unequal and the economy stumbles forward, however slowly, foreign banks will make money. Moreover, we should expect to see an increasing proportion of the financial assets of Korean elites moved offshore, which will further erode the link between foreign bank profits and Korean economic growth.

Foreign banks are also more insulated from pressure to cooperate with government economic policies than are domestic institutions. Korea Exchange Bank and KorAm, both foreign-owned, were the only creditor banks that refused the government's request to participate in its $4.2 billion bailout of LC Card, the nation's largest credit card issuer, when it faced bankruptcy in 2003. As one major newspaper put it: the arrival of "Citigroup may also signal a defining loss of influence by the government in banking decisions, with foreign institutions seen as less willing to succumb to government pressures" (*Korea Herald*, "US financial giant Citigroup seen targeting wealth consumer segment," February 23, 2004) In 2001, Kim Jung Tae, president of the foreign-owned Kookmin bank, famously declared his unwillingness to be guided by government policy: "I want to make my way even if the government doesn't like the idea" (*Far Eastern Economic Review*, "Punching above his weight,"August 23, 2001).

As a result of these problems, the Korean people have become increasingly resistant to further encroachment by foreign economic interests, especially in financial markets. An article in the *Financial Times* noted the rising resentment against foreign investment: "Far from being welcomed for helping to rehabilitate its shattered economy, foreign investors are being demonized in the local press" ("If Korea is so cool, why is Seoul in a lather?" September 14, 2005). A public opinion poll done in May 2005 showed that 94 percent of Koreans support the government's tax investigation of private equity funds, while 70 percent believe that foreign capital seeks short-term speculative profit rather than long-term growth. A majority believe the government should more tightly regulate foreign capital, should limit foreign entry in industries important to national security, and expel foreign firms that "distort the economic order" (*Jose Ilbo*, May 17, 2005) "Foreign investors are becoming increasingly concerned that financial authorities, fuelled by popular outrage at the profits foreign funds are making, are trying to make life harder for foreign investors … The spotlight has been on foreign takeovers of banks in particular" (*Financial Times*, "S Korea feels draught as doors open to foreigners," April 11, 2005). The government has threatened to eliminate the ability of foreign private equity funds to evade Korean taxes, and to impose residence requirements on non-Korean directors. A bill requiring that half of all directors of Korean banks be Korean has been submitted to the legislature. The government also passed a law legalizing domestic private equity funds in Korea, and has pledged to invest $3 billion in public money to such funds. Its purpose is "to keep foreigners at bay, amid growing unease over the profit foreign private equity investors have been making" (*Financial Times*, "South Korea to keep foreign funds at bay," February 10, 2005, p. 19). Korea's central bank issued a report (Jeon *et al.*, 2004) "calling on regulators to encourage domestic investment in local banks and other Korean financial institutions, underscoring a growing wariness in the country about the role of foreign investors … The recommendations appear as the government prepares to divest its 78 percent stake in Woori Finance Holdings," one of the three largest banks in Korea (*Wall Street Journal*, "Foreign Investors Induce Anxiety in South Korea," May 11, 2005).

There is nothing that prevents government restriction of foreign ownership of key banks. France and Germany made it quite clear that they will not tolerate foreign takeovers of "national champion" companies. For example, the German government announced it would not allow Deutsche Bank to be sold to foreigners. The French government warned Pepsi in mid-2005 not to launch a hostile takeover bid for Danone, the publicly owned French food company. In September 2005 the Prime Minister "urged his compatriots to rally behind his concept of "economic patriotism"; meanwhile "the government is drawing up a list of 10 strategic industries to be shielded from foreign ownership" (*Financial Times*, "French PM firm on calls for 'economic patriotism'," September 23, 2005). China tightly controls its financial markets. Nevertheless, Korea's current government remains determined to pursue its plan to make Korea the "Northeast Asian Financial Hub," which will require even greater efforts to woo foreign

financial firms. Thus, at the moment, there is no effective roadblock to further foreign domination of Korea's banking system even as the public backlash against it intensifies.

Conclusion

After rising rapidly in the three and one-half decades leading up to the crisis, corporate investment has not grown at all in the post-crisis period. Real GDP growth substantially slowed, and may well decline further, since the debt-fueled consumption bubble of 1999–2003 has run its course, and the rapid increase in net exports in 2003 and 2004 cannot be sustained. A 2005 World Bank research paper on Korea concluded that "the national economy is now suffering from weak investment, slow growth and slow job creation and rising unemployment" and suggests that the neoliberal or "Anglo-Saxon" model may have been the wrong "blueprint" for post-crisis Korea (Lee *et al.*, 2005, p. 38).

Inequality and poverty have increased substantially, and labor's condition is deteriorating. The radical deregulation of cross-border capital flows brought very large costs and negligible benefits. The rising power of foreign financial firms contributed to investment stagnation, a dramatic increase in household indebtedness, and the conversion of Korea's stock and foreign exchange markets into global gambling casinos. Giant global banks are poised to complete their conquest of Korea's banking market, which means continued problems for investment finance, an increasing disconnect between banking profits and economic prosperity, and tightening constraints on more effective or more progressive government policies. The US, the IMF, global corporations and Korea's rich imposed radical neoliberalism on a Korean people who did not want it, not because of its development success record – it doesn't have one – but because it was in their own self-interest to do so. The eight-year experiment has worked well for them, but is a dismal failure for the majority of Korea's people.

A radical rethinking of economic institutions and policies is thus in order, based on a careful analysis of relevant history, not on neoliberal fairy tales. At a bare minimum, the government should reestablish effective regulation of domestic financial markets, reimpose adequate control of short-term capital flows and FDI, and create a structure of incentives, penalties and controls that will shift financial flows away from speculation and excessive consumer credit, toward capital accumulation and productive pubic investment. Social welfare spending must be increased substantially and the tax system reformed to help reverse the rise in inequality, a goal that also requires a cease-fire in the one-sided war waged by domestic and foreign capital and the government against the labor movement. Faster growth in employment and real wages is an essential component of healthy growth in domestic demand, and history suggests that this normally requires strong unions. What is needed now are the policies that should have been implemented in 1998, designed to modernize the state-guided system that achieved the 35 year Korean economic "miracle" and thoroughly democratize the economic planning process to eliminate its non-representative, anti-labor character.

Unfortunately, these are not the lessons drawn by the Roh government. Faced with stagnant domestic demand, the government has turned outward, banking on its ambitious plan to make Korea the "hub" for economic activity in East Asia. "President Roh has made turning the country into the financial, manufacturing and logistics hub of the region a key component of his long-term economic plan" (*Financial Times*, "Aiming to create a regional hub," December 1, 2004). There are a number of serious flaws in this plan, not least of which is the hubris involved in trying to make Korea the key economic force in an area with far stronger economic powers. The financial component of the plan could not possibly succeed without a qualitative increase in the power of foreign capital in Korea. To seriously enter the competition to become Asia's dominant financial center would necessitate giving global financial institutions control of virtually all of Korea's financial markets and the dismantling of most regulatory controls. The hub plan will not succeed; the growing political backlash against foreign financial institutions in Korea as well as competition from more developed Asian financial centers will prevent that. Our purpose in mentioning this plan is to demonstrate again the bankruptcy of economic policy-making in post-crisis Korea, and to point out that the Korea government is not yet ready to learn the appropriate lessons from its failed experiment with neoliberalism.

Notes

1 James Crotty is grateful to the Political Economy Research Institute of the University of Massachusetts, Amherst, for generous research support

2 We do not deny that the Korean "model" had developed serious problems prior to the crisis and was therefore in need of substantial reform.

3 According to a survey by the Korea Industrial Bank, large firms' equipment investment started to increase in 2004 while that of small and medium firms shrank by 34 percent. These companies have lower profitability than most giant firms and cannot get adequate bank funding.

4 Operating profits/sales have been lower than in the pre-crisis era, which suggests that allocative efficiency has not improved. (Operating profits are measured before the deduction of interest payments and certain other expenses.) However, a dramatic reduction in financial expenses/sales substantially raised ordinary profits/sales after 2001.

5 This survey covers workers' families living in cities. For all families in cities, the top 20 percent/bottom 20 percent ratio is 8.2.

6 Foreign takeovers were "Purchase and Assumption" deals in which foreign investors bought only the good assets of the firms while bad assets and debts were shifted on to newly created public institutions. When this was accomplished, foreign owners established a new firm and bought its stock. Thus, M&A-type FDI is greater than the total acquisition of outstanding stock. In 2000, the share of greenfield investment was reported to be less than 10 percent of total FDI (*Hankook Kyoungje Shinmun*, April 12, 2000). According to a UN report, M&As were the dominant form of FDI in East Asia since the crisis, a finding confirmed by Mody and Negeshi (2001).

7 Listed firms account for about 61 percent of the 30 top *chaebols'* capital. Insiders, such as owner families and affiliate firms, controlled 65 percent of unlisted firms and 32 percent of listed firms in 2001, suggesting an insiders' total share of 45 percent in 2001. In 2004, the total insiders' share of the top 15 private *chaebol* (excluding public firms) was 46.4 percent.

8 The fact that total investment was a higher share of GDP than domestic saving provided a superficial defense of the need for foreign investment before the crisis. However, saving has exceeded investment in the post-crisis years; in 2004 gross saving exceeded domestic investment by 4.6 percent of GDP.

9 Advanced countries are not immune to these dangers. In the early 1990s, several Scandinavian countries experienced financial crises following financial liberalization. In the late 1990s, rising US stock prices, inflated by massive accounting fraud in such companies as Enron and WorldCom, made possible by excessive deregulation, led to over-investment in ICT industries. An ICT spending collapse ensued, leaving three-quarters of a million workers idle.

10 The *Wall Street Journal* explains the problem in the US as follows. "Even companies enjoying strong profits and cash flow are building cash hoards, reducing debt and buying back their own shares – instead of making investment bets" ("Global Economy Depends on Investment," July 21, 2005).

11 Combining Financial Supervisory Service data on bank assets as of late 2004 with foreign ownership data from mid-2005, the foreign share of all bank assets, including public banks, is about 60 percent. However, the share for private commercial banks is about 80 percent in 2005, which is as high as in Mexico, and higher than in most other developing countries.

References

Amsden, A. (2001) *The Rise of "the Rest,"* Oxford: Oxford University Press.

Baker, D. and Walentin, K. (2001) Money for Nothing: the Increasing Cost of Foreign Reserve Holdings to Developing Nations, CEPR briefing paper.

Bank of Korea (BOK) (1999) The Effect of Foreign Investment on Domestic Stock Prices (Korean).

—— (2003) The Effect of Foreign Capital in the Banking Industry and its Implications (Korean).

—— (2004) The Trend and Characteristics of Recent Equipment Investment (Korean).

Borensztein E.R. and Lee J.W. (1999) Credit Allocation and Financial Crisis in Korea, IMF Working Paper WP/99/20.

Brittan, S. (1997) Asian Model R.I.P, *Financial Times,* 4 December 1997.

Chang H.-J. (1998) Korea: The Misunderstood Crisis, *World Development* 26(8).

—— (2002). *Kicking away the Ladder – Development Strategy in Historical Perspective*, London: Anthem Press.

Chang, H.-J. and Evans, P. (2005) The Role of Institutions in Economic Change, in S. DePaula and G. Dymski (eds) *Reimagining Growth – Towards a Renewal of Development Theory*, London: Zed Press.

Crotty, J. (2002) The Effects of Increased Product Market Competition and Changes in Financial Markets on the Performance of Nonfinancial Corporations in the Neoliberal Era, Political Economy Research Institute website www.umass.edu/peri/pdfs/WP44.pdf.

Crotty, J. and Dymski, G. (2001) Can the global neoliberal regime survive victory in Asia? in: Philip Arestis and Malcolm Sawyer (eds) *Money, Finance and Capitalist Development*, Northampton MA: Edward Elgar.

Crotty, J. and Lee, K.-K. (2001) Economic Performance in Post-crisis Korea: A Critical Perspective on Neo-liberal Restructuring, Political Economy Research Institute, University of Massachusetts, Working Paper 23.

—— (2004) Was the IMF Imposition of Economic Regime Change in Korea Justified? A

Critique of the IMF's Economic and Political Role before and after the Crisis, Political Economy Research Institute, University of Massachusetts, Working Paper 77.

Dodd, R. 2004 Developing Countries Lead Growth in Global Derivatives Market, Special Policy Brief 15, Financial Policy Forum, www.financialpolicy.org.

Dymski, G. (2004) Korea's Post-crisis Banking Crisis and the Global Bank Merger Wave. Mimeo.

Fischer, S. (1996) Lessons from East Asia and the Pacific Rim, *Brookings Papers*, 2

Greenspan, A. (1999) Lessons from Global Crises, Before the World Bank and the IMF, Program of Seminars, 27 September, Washington, DC.

Greider, W. (2005) Sins and the Citi, *Nation*, 4 July.

Hahm, J. and Mishkin, F.S. (2000) Causes of the Korean Financial Crisis: Lessons for Policy, NBER Working Paper 7483.

Henry, J. (2005) *The Blood Bankers*, New York: Thunder's Mouth Press.

IMF (1999) The IMF's Response to the Asian Crisis, 17 January 1999, www.imf.org.

—— (2003) *Evaluation Report: IMF and Recent Capital Account Crises – Indonesia, Korea, Brazil*.

—— (2004) Republic of Korea: Selected Issues, Country Report 04/45.

Jeon, S.-C. *et al.* (2004) Problems of Speculative Foreign Capital and Policy Agenda (Korean), Seoul: Bank of Korea Financial Research Institute.

Kim, D.-J. (1985) *Mass Participatory Economy*, Cambridge MA: Harvard University Press.

Krueger, A. and Yoo, J.H. (2001) *Chaebol* Capitalism and the Currency–Financial Crisis in Korea. Presented at NBER conference.

Lee, K., Kim, B., Lee, C. and J. Lee (2005) Visible Success and Invisible Failure in Post-crisis Reform in the Republic of Korea, World Bank Policy Research Working Paper 3651.

Lee, Nae-Hwang *et al.* (2004) The Issue of Economic Dualization and Policy Agenda (Korean), Seoul: Bank of Korea Financial Research Institute.

MOFE (Ministry of Finance and Economy) (1999) *Djnomics – A new foundation for the Korean economy*, Seoul: KDI.

—— (2000) Performance of Capital Account Liberalization (Korean).

—— (2002) Long-term Measures for Development of the Foreign Exchange Market (Korean).

Mody, A. and Negishi, S. (2001) Cross-border Mergers and Acquistions in East Asia: Trends and Implications, *Finance and Development* 38 (1).

Rodrik, D. (1999) Governing the Global Economy: Does One Architectural Style Fit All? Mimeo, Harvard University.

Singh, A. (1999) Asian Capitalism and Financial Crisis, in John Grieve Smith and Jonathan Michie (eds) *Global Instability and World Economic Governance*, London: Routledge.

Wade, R. and Veneroso, F. (1998) The Gathering World Slump and the Battle over Capital Controls, *New Left Review* 231.

World Bank (2003) World Bank Survey of Bank Regulation and Supervision.

6 The Chinese response to globalization

Accession to the WTO and its challenges

Ding Lu

Globalization and China's rise

For over 20 years, China experienced hyper economic growth, with its per capita income rising six times as fast as the world average. By the end of 2005, China became the world's third largest trading nation with total trade of over US$1.4 trillion. With the annual inflow of foreign capital over US$60 billion, it is the largest developing-country recipient of foreign direct investment. It also held US$818.9 billion in foreign reserves, set to overtake Japan's as the world's largest. China has become the world's fourth-largest economy by total nominal GDP. If measured by purchasing power, China's total GDP is already the second largest economy only after the US.[1]

With rapid economic growth, China was able to raise its per capita annual income from about $250 twenty years ago to $1,290 by 2004. By purchasing power parity, its per capita annual income reached about $5,530 by 2004. In both terms, China has upgraded itself from the rank of "low income countries" to the rank of "lower middle income countries" by the World Bank's classification. Thanks to wealth accumulation, China has made tremendous progress in reducing poverty: the share of its population living on less than $1 a day fell from 64 per cent in 1981 to less than 17 per cent by 2001 (World Bank, 2005, 2006).

China's successful economic takeoff in two and half decades has been driven by market-oriented institutional reforms and active participation in international transactions. Institutional reforms in this formerly centrally planned socialist economy have unleashed enormous market forces that breathe life into a literate, aspiring, and thrifty labour force, awakening the vigour and creativity of a nation with legacies of an ancient civilization. Opening to international trade and investment has allowed China to extract huge benefits by exploiting its comparative advantages, utilizing foreign capital and talents, and learning modern management and technologies.

At the turn of the century, China became a new member of the World Trade Organization. In exchange for WTO membership, China has made a series of concessions and commitments to further open up its domestic industries to

foreign imports and investment. Most of these market opening conditions are more stringent than those ever imposed on other developing countries by the WTO or its predecessor GATT. The willingness of China to make these concessions is based on rational calculations. One is institutional, which reflects "an attempt by reformers to lock economic policies on to a course for further marketization and internationalization that is costly to reverse" (Woo, 2001). Or, in other words, the WTO accession is China's public recognition of marketization and internationalization as the primary sources of its great success in growth since the 1980s. The other consideration relates to China's strong desire to secure access to its major export markets. Without WTO membership, for instance, the continuity of China's normal trading relationship with the United States was subject to annual reviews by the US Congress, leaving China's export trade vulnerable to the vagaries of American domestic politics. The WTO membership guarantees that this engine of growth would no longer be unilaterally shut off by the US without the action being a major violation of US international commitments (Sachs and Woo, 2002).

As China harmonizes its domestic institutions with the international standards in line with WTO requirements, it faces a series of challenges arising from tensions between economic globalization and domestic social-economic stability.

Intermediate concerns in the post-WTO years

China's participation in globalization has been greatly enhanced by its accession to the WTO. In the intermediate period after its accession to the WTO, there are several concerns about the challenges of globalization.

Employment and market opening

One of the concerns is about employment. WTO membership might promote a flood of imports that could compete with domestic industries and aggravate unemployment in the urban and rural areas. That might provoke the social unrest that could interrupt economic growth. Several years after the WTO accession, the concern of such a challenge appears to have somewhat receded. As the WTO membership removed a major uncertainty about China's growth prospects by securing the country's access to its major export markets, investors' confidence in the economy has been greatly boosted. The resulting surge of inward investment has created more jobs for the economy. In 2004, foreign funded enterprises and businesses with funds from Hong Kong, Macao and Taiwan provided 7.2 million jobs, equivalent to 6.8 per cent of the total number of staff and workers in all sectors.[2] GDP growth accelerated from 7.5 per cent per annum in 2001 to around 10 per cent in 2004 and 2005, lifting the economy from a deflationary underemployment slowdown to a boom (Figure 6.1).

Unemployment nevertheless remains serious. China's official statistics suggest that the urban registered unemployment rate increased from 3.0–3.1 per cent in 1996–2000 to 4.0–4.3 per cent in 2002–05. Meanwhile reports of wide-

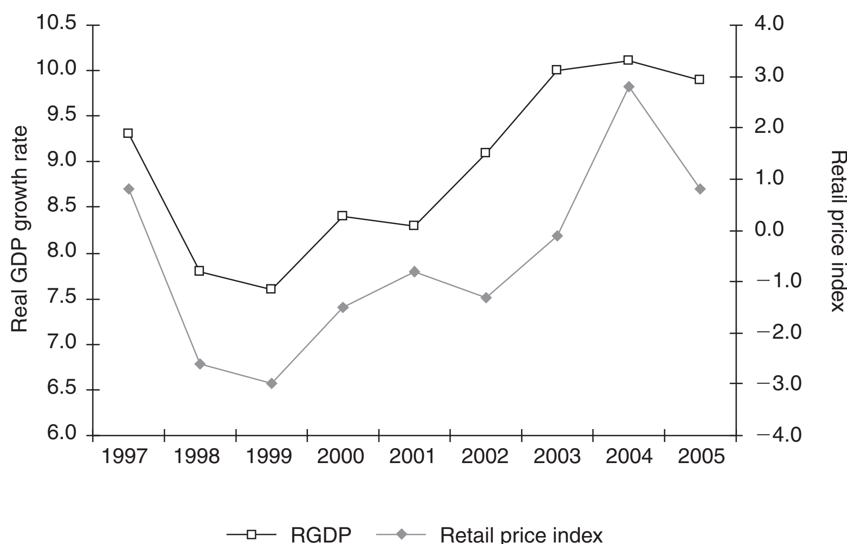

Figure 6.1 China's real GDP growth and inflation, 1997–2005 (source: National Bureau of Statistics of China (NBSC)).

spread underemployment of rural workers are plenty. The serious unemployment problem, however, cannot be attributed to WTO-related market opening, since this also has been a period when China speeded up its reforms of state-owned enterprises by imposing more budget discipline on these firms. The rising unemployment is partially due to demographic change in it, too, as a generation of baby boomers who were born in the early 1980s are entering the job market.[3]

The impact of market opening on employment opportunities should be seen in the light of the foreign trade situation. It is notable in Figure 6.2 that China's international trade has increased by leaps and bounds in the past few years, with annual growth rates of both exports and imports above 20 per cent since 2002. Despite opening up more domestic markets for surging imports, export growth has continued to keep in pace with the import growth (Figure 6.2). That has enabled China to maintain a trade surplus and a rising surplus on current account (Figure 6.3). This boom in trade is a sign of further integration of China into the world economy.

Given the country's abundance of low-cost labour, China's deeper participation in international specialization should have a positive net effect on job creation in the early stage of globalization. In fact, since the early 1990s, the Chinese economy has become increasingly dependent on exports and fixed capital investment as the two major growth engines (Figure 6.4). This, however, mirrors another problem in the economy: the over-dependence on external demand for economic growth.

Figure 6.2 Growth rates of exports and imports (1996–2005) (source: China Statistical Bureau).

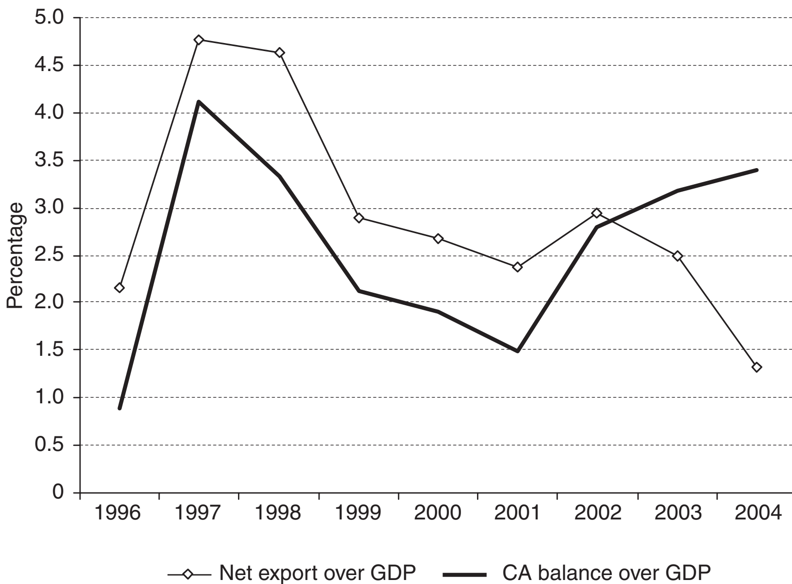

Figure 6.3 China's net export and current account balance over GDP (1996–2004) (source: National Bureau of Statistics of China (NBSC)).

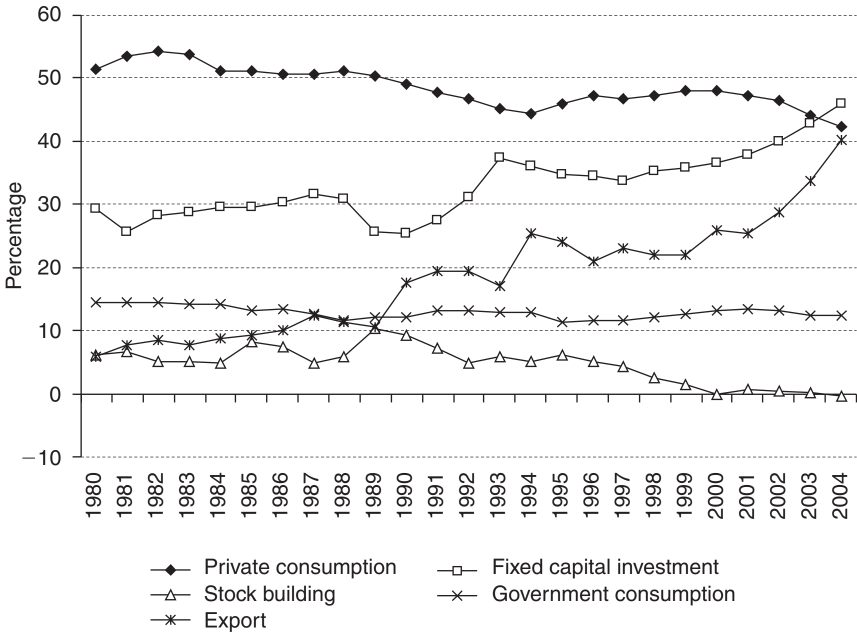

Figure 6.4 Components of GDP (%) (source: EIU database).

Internal demand for growth

Since the second half of the 1990s, the share of private consumption in GDP has slid to an unprecedented low level while exports' share has risen significantly (Figure 6.4). Lack of a domestic growth engine prompted the government to adopt an "active fiscal policy" after 1997, which resorts to deficit fiscal spending to pump prime the economy. The consequence is an immediate jump in the share of public debt in GDP from about 8 per cent to over 30 per cent from 1999 to 2004. Meanwhile government outlay in GDP increased sharply from less than 13 per cent in 1996 to over 20 per cent in recent years (Figure 6.5). Most of the increased government spending has gone to fixed capital investment, which has rapidly increased its share in GDP since the mid-1990s.

While some government-financed investment in infrastructure building is necessary at the current stage of China's economic development, the sudden rise of the government share of spending to over one-fifth of GDP certainly counters the market-oriented transition of the economy. In particular, the fiscal pump priming has raised government's share of fixed capital investment from about 5 per cent in 1996 to over 30 per cent in recent years (Figure 6.6). This remarkable increase in government finance of fixed capital investment sharply contrasts with the fact that the non-state sector had already accounted for more than 70 per cent of total output and an even greater share of employment by 2004.

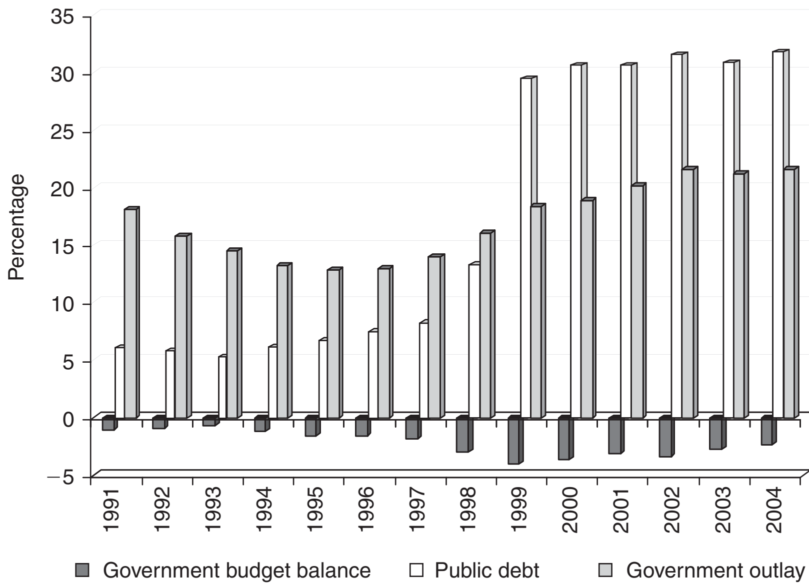

Figure 6.5 Government budget balance, public debt, and government outlay as percentage shares of GDP (1991–2004) (source: EIU database).

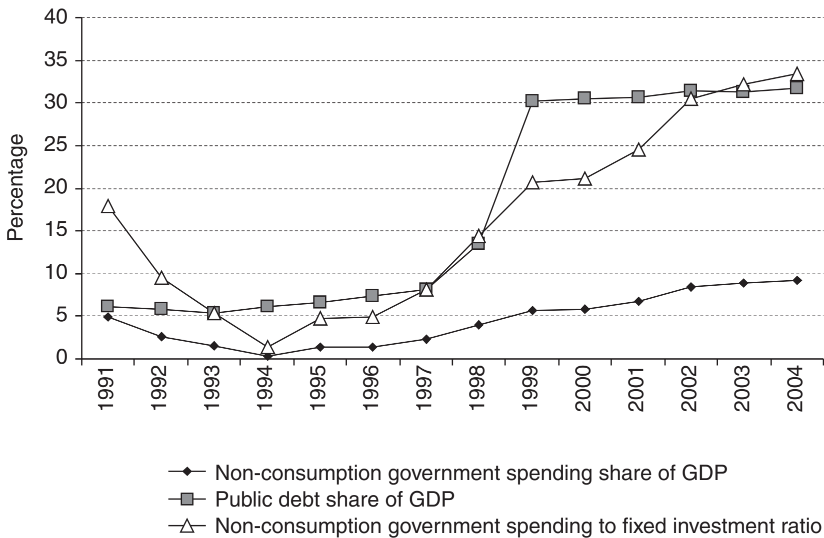

Figure 6.6 Non-consumption government spending share of GDP, public debt share of GDP, and non-consumption government spending to fixed investment ratio (1991–2004) (source: EIU database).

Table 6.1 Incremental capital to output ratio (ICOR): China compared with Japan, South Korea, and Taiwan in their high-growth periods

Country	*Period*	*Investment share of GDP*		*GDP growth rate*		*ICOR*	
China	1991–95	33.2	*32.6*	12.0	*12.2*	2.8	*2.7*
	1996–2000	35.1	*32.6*	8.3	*8.6*	4.3	*3.8*
	2001–05	45.1	*40.4*	8.7	*9.5*	5.1	*4.3*
Japan	1961–70	32.6		10.2		3.2	
S. Korea	1981–90	29.6		9.2		3.2	
Taiwan	1981–90	21.9		8.0		2.7	

Source: NBSC (varies issues); NBSC (2006a); Kwan (2004).

Note
Numbers in italics are based on adjusted GDP statistics in NBSC (2006a).

For economies experiencing fast industrialization, infrastructure building and fast capital accumulation are normally reflected in a high incremental capital to output ratio (ICOR). It is, however, rather worrying that China's ICOR has gone up substantially since the early 1990s and has been considerably higher than those of Japan, South Korea, and Taiwan during latter's high-growth periods (Table 6.1).[4] The rising ICOR implies that China has to pump in increasingly more capital investment to generate the same amount of output in more recent years. The mostly plausible causes behind this phenomenal rise of ICOR are the less efficient investment financed by the pump-priming fiscal money and the state banks' low-quality lending.

The relatively slow growth of domestic consumption, which prompted government's "active fiscal policy", is largely due to the incomplete reforms of the social security and welfare system. As China transformed itself from a centrally planned economy to a market-based one, its old socialist-style, egalitarian social security system was dismantled in the urban areas and collapsed in the rural areas. Although great efforts have been made to rebuild a new social security and welfare system compatible with a modern market economy, their success has been limited and uneven (Zhou, 2002; Gu, 2005). The uncertainty about retirement-age welfare, health care coverage, and the availability of other elements of the social safety net has prevented individuals from spending on contemporary consumption.

Meanwhile, a series of institutional reforms since the 1990s have converted some previously free or low-cost goods and services into major expenditures to households. Privatization of housing has led to booms in the real estate market and escalation of housing prices; marketization of healthcare provision has multiplied the cost of medical services; education reforms allow schools of all levels to charge and raise tuitions, quasi-tuitions and all kinds of fees from students and their parents. The magnitude, scale and speed of these cost increases have drastically changed households' expectations for lifelong spending and prompted them to save more for these expenditures.

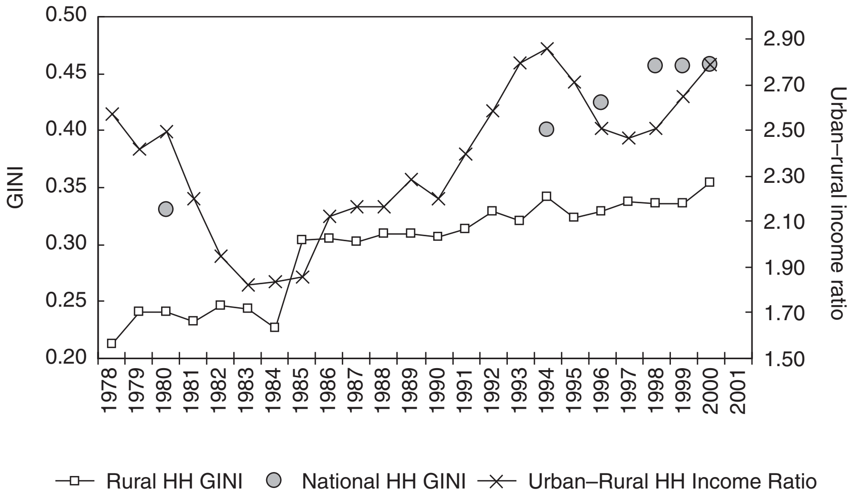

Figure 6.7 Urban-to-rural household income ratio, rural household GINI coefficient, and national household GINI coefficient (1978–2001) (source: National Bureau of Statistics of China (NBSC)).

Private consumption may also have been deterred by rising disparity of income distribution. Since the mid-1980s the urban–rural per capita income gap has been yawning and, among urban and rural households, the income inequality measured by GINI coefficient has risen sharply (Figure 6.7).

According to China's state media, the overall GINI coefficient in 2004 rose further to 0.47, even higher than the US level of 0.45. A survey of 54,000 households by National Bureau of Statistics revealed that the richest 10 per cent controlled 45 per cent of urban wealth while the poorest 10 per cent owned just 1.4 per cent of the assets. These figures suggest that rich–poor gap has reached alarming levels.[5]

On top of that, income disparity across regions has been growing (Figure 6.8). The polarization of income distribution has constrained the consumption ability of those who have been left behind by the economic growth. The inability of the poor to consume has dragged down private consumption as a whole and led to a phenomenal concurrence of aggravation in income disparity and relative slow growth of private consumption since the early 1990s (Kwan, 2004b).

Financial opening and financial risks

The pool of savings has provided cheap funds that have fuelled investment booms in recent years through a fragile banking–financial sector. This issue has been complicated by China's WTO-bound commitment to speed up the opening of this sector. According to WTO agreements, China has to allow foreign banks to conduct RMB corporate banking business with Chinese companies within two

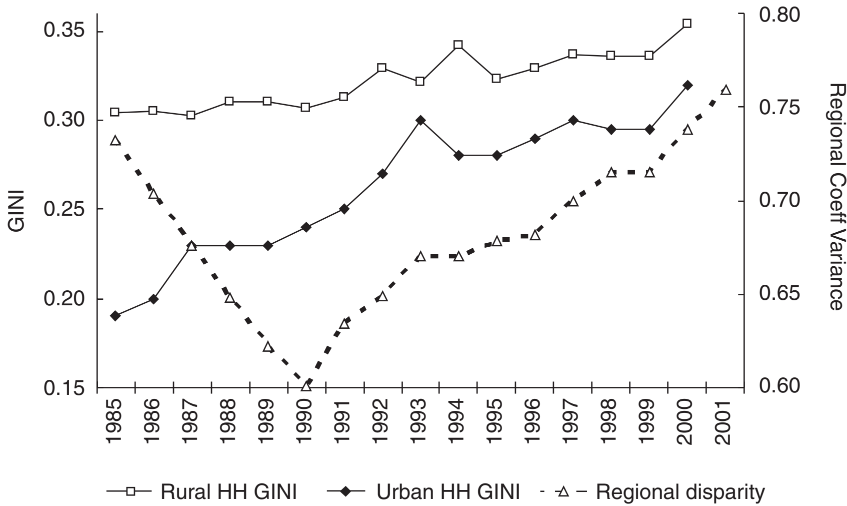

Figure 6.8 Rural and urban household GINI coefficients and regional per capita income disparity, measured by coefficient variance (1985–2001) (source: Chang (2002), Asian Development Bank (2004)).

years after WTO entry (by end of 2003) and retail banking with Chinese individuals five years after WTO entry (by the end of 2006). All geographic restrictions are also to be removed. The entry of foreign banks could divert deposits from the already insolvent domestic banks, and the resulting shutdown of the credit system would disrupt production economy-wide (Sachs and Woo, 2002).

In the past few years, Chinese monetary–financial authorities have made great efforts to beef up the fragile banking sector to prepare it for full opening to foreign competition. These include:

1 Started the procedure to liberalize commercial banks interest rates by lifting the controls on foreign currency rates for deposits larger than US$3 million in 2000 and implemented a plan to deregulate all foreign currency and RMB interest rates since then. In July 2004, the PBOC increased the allowed range of lending rate float from the original 0.9 to 1.3 times the official benchmark rate (5.31 per cent for one-year corporate lending in 2004) to 0.9 to 1.7 times.[6]
2 Recapitalized major state banks to give them a fresh start. In 1998, the Ministry of Finance issued RMB270 billion (US$33 billion) in bank restructuring bonds to double the capital base of the "big four" state commercial banks. In 1999 and 2000, RMB1.4 trillion (US$169 billion) worth of nonperforming loans from four state commercial banks were transferred to the four state-owned Asset Management Companies at face value. In January 2004, the government injected $45 billion, or one-tenth of China's foreign-currency reserves, into the best (or the least bad) two of the "big four" state

banks, CCB and BOC, to boost their capital adequacy ratios and thus to support new, supposedly more profitable, lending.

3 Restructured the management, improved the asset quality of the four major state-owned banks, and prepared them for Initial Public Offering (IPO) at the stock market in 2005 and 2006. In September 2004, the CCB successfully launched its IPO on the Hong Kong stock exchange on October 27, 2005, raising US$8 billion from foreign investors for 12 per cent of its shares. The BOC plans a US$5 billion IPO in early 2006.
4 A major effort has been to reduce the proportion of non-performing loans (NPLs) in total bank assets (which stood over 25 per cent in 2001) by 2–3 per cent per year during 2001–05 to below 15 per cent by 2005. The effort has been greatly beefed up since the founding of the China Banking Regulatory Commission (CBRC) in April 2003. Under the supervision of CBRC, all the commercial banks have been pressed to meet the Basel I capital ratio by January 2007 or face severe sanctions, including the removal of senior management.[7]

These reform efforts have been only partially successful, for the following reasons. Although the overall NPL ratio of the banking sector was successfully driven down to below 10 per cent in 2005, this was first achieved mainly by the transfer of the NPLs to the state-owned asset management corporations and the injection of public funds. However, the repeated injection of public money to clear up the banks' balance sheets in the past few years might have encouraged moral hazard behaviour of the banks to continue the reckless lending in anticipation of future government-financed bailout (Lu *et al*., 2005). The consequence is a new surge of bank credit expansion after 2002. This wave of new lending boom since then has helped suppress the NPL ratio by enlarging the overall bank credit base. The lending boom, however, may have a serious impact on the health of the banking sector in the coming years. The immediate outcome of macroeconomic overheating in 2003–04 already signalled many problematic loans ahead.

China's financial risk in opening up the fragile banking sector to foreign competition has been compounded by another related issue: the exchange rate regime of RMB. When foreign banks gain full access to China's banking market, their behaviour tends to be a type of "cream-skimming", i.e. focusing on the coastal cities, the most lucrative part of the Chinese market.[8] Without official deposit insurance, it is an open question whether depositors will start a bank run on the state-owned commercial banks in the fear that they would be driven into open bankruptcy by foreign competition. As observed by Sachs and Woo (2002), this dismal scenario of crisis is unlikely to happen since the central bank will be able to issue currency to the state banks to meet the withdrawals. This expansion of high-power money cannot be easily translated into a loss of foreign reserves thanks to the capital controls.

The safeguard of capital controls, however, has been substantially weakened since then. China maintained a de facto peg of the renminbi to the US dollar for

over a decade and after 1997–98 Asian Financial Crisis the controlled band was narrowed to a rather rigid one. In more recent years, China has faced mounting international pressure to revalue its currency. Such pressures, which China had resisted for a couple of years until July 2005 (when it allowed the renminbi to appreciate marginally by 2 per cent), led to an influx of hot money into the economy. To offset the impact, from late 2003 to mid-2005, China took a series of measures to relax its capital controls to make it easier for money to flow out of the economy (Lu, 2004). The rationale is to release some pressure on the renminbi's appreciation and to prepare for a flexible exchange rate regime by making the renminbi more convertible. As pointed out by Prasad *et al*. (2005), this strategy is conceptually wrong since capital-account liberalization is not a prerequisite for greater exchange-rate flexibility but rather the other way round. Further dismantling capital controls only increases China's exposure to global financial market risks in the imminence of banking sector opening by end of 2006.

Long-term challenges and opportunities

Income inequality

For China, further participation in globalization brings in new challenges as well as opportunities in the coming decades. First, as observed by Kuznets (1955), international development experience suggests an inverted U-shaped relationship between per capita income increase and income disparity. As China upgrades itself from a low-income country to a middle-income country, income inequality is likely to deteriorate further in coming years.

Deeper participation in international transactions, arguably, could serve as an ameliorating factor. It is well understood in the literature of international economics that market opening to international trade will increase the demand for the production factor that is relative abundant in the country involved. That will eventually raise the returns to the owners of the abundant production factor and benefit them. In China, where labour is abundant and low-paid, economic globalization will certainly have a factor price equalization effect and thus benefit the workers more than the owners of other production factors in the society.

However, before that long-term effect can take place, the highly elastic supply of China's abundant rural surplus labour, highlighted by a "floating population" of migrant workers (estimated to be 140 million or over 18 per cent of rural population), will continue to keep wages of many migrant workers at the "sweatshop level" for some years to come. Meanwhile, rising incomes of successful entrepreneurs and those with skills and talents in high demand in a fast globalizing economy will continue to enlarge the overall income disparity.

Deeper participation in globalization also has significant implications for interregional disparity. Literature of economic development has shown that the distribution of the wealth of nations falls along two geographical divides. One is the temperate zone versus the tropical zone and the other is the coast versus

interior, which determines opportunities to participate in global trade. Over 90 per cent of the world's poor live between the Tropic of Cancer and the Tropic of Capricorn. Being close to maritime transport routes for the coastal region also provides great advantages in development from low-cost access to international markets. As China is further integrated in the world economy, the coastal regions' advantage in geographic location will be multiplied. The coast–inland disparity is therefore likely to be aggravated as the variety in geographic conditions between the coast and interior becomes more crucial in trade-related growth performance.

In a larger social-political context, the sharply polarized income and wealth distributions have fermented growing tensions in the one-party-ruling society. The increasing frequency of local protests and riots since the turn of the century has alarmed the so-called fourth-generation Communist Party leaders.[9] Chinese President Hu Jintao has made "building a harmonious society" a top priority on his work agenda. He noted that China, after its per capita income surpassed US$1,000, has entered "a crucial stage for the economic and social development of a country in the process of modernization, as proven by experiences of many countries in the world". He also acknowledged that "the problems and contradictions China will face in the next decades may be even more complicated and thorny than others."[10]

To buffer the impact of globalization on domestic interregional disparity and urban–rural disparity, reforms to facilitate labour and capital flows across regions and between rural and urban areas must be carried out. In particular, institutional changes must be implemented to speed up urbanization so as to catch up with the economy's industrialization progress. In recent years, China has started to reform a major barrier to rural–urban and interregional labour mobility, the Household Registration (*hukou*) System. The System, established in the late 1950s, confines people, especially those in the rural areas, to the place of their birth and has been a major institutional barrier to labour mobility.[11] In China's Tenth Five-year Plan of National Economic and Social Development (2001–05), it was explicitly stated that the institutions segregating the urban and rural areas should be broken up and the Household Registration System should be reformed to allow orderly flows of population between urban and rural areas. It also called for the abandonment of unreasonable restrictions on rural workers' entry into the urban labour market.[12] A major reform was launched in October 2001 when the *hukou* system was officially relaxed to allow rural people the freedom to relocate to more than 20,000 cities and towns nationwide.[13] In 2003, China's State Council terminated the Act of Compulsory Deportation, which had allowed the police to arrest and deport people who did not have a legal permit to live and work in the cities.[14]

More reforms are needed to facilitate urbanization and internal migration of rural surplus labour. There still exist rules and regulations that discriminate against migrant workers and deny them access to urban public goods and services. On top of that, a major obstacle is the existing farmland acquisition and appropriation procedures that severely under-compensate the rural residents who

lose their lands to urban development. Without secured, well defined rights to their land, many Chinese farmers are condemned to join the impoverished urban underclass living in city slums. In fact, since China started to reform its *hukou* system a few years ago, a massive influx of rural migrants has already given birth to a sudden emergence of urban slums and rural shanty towns in many parts of the country.[15] To avoid falling into the same trap of slum-tainted urbanization as in other developing economies, China must overhaul its land appropriation laws and regulations to give farmers well defined rights to land, restructure local governments' fiscal revenue to be less dependent on land sales, strengthen long-term urban planning, and have more checks and balances on land acquisition procedures.

Moving up the value chains

Thanks to substantial reductions in costs of transport and telecommunications, the world has witnessed profound changes in the global production system in the recent two decades. The nature of the value chain has undergone a "business revolution" as described by Nolan (2000, p. 15):

> In the epoch of the global business revolution, there has been a dramatic process of "retreat" by the successful globalising businesses into the higher value-added, "brain" activities, with a large range of non-core functions undertaken by other firms. At the centre of this kind of business system is the agent that is the integrator and orchestrator of the activities of a myriad of other business activities. A large number of businesses upstream and downstream are dependent on the success of the "core" firm in generating sales through its "brain" activities, including developing and enhancing brand image, product development, and effectively "knitting together" all the other elements in the value chain. The myriad of related upstream and downstream firms cannot do this independently. Their connection to the final consumer is reliant on the success of the global partner with which they are working.

This global overhaul of value chains has important implications for developing countries such as China and India. In the past, developing countries had to import predominantly finished products from advanced economies. Otherwise, if they chose to produce by themselves, they had to compete with the much more integrated manufacturers of finished products from the developed world. Since the 1990s, however, the process of "unpacking" the large firm into an extended value chain has opened up a myriad of new opportunities for small and medium-sized firms across the world to enter the value chain at lower levels and work their way up into larger and more complex businesses. This has created unprecedented opportunities for small and medium sized firms within developing countries to become a part of the "external firm" of large global corporations, and to grow into larger suppliers of goods and services as their competencies develop.

In this context, China's opening up since the mid-1980s has coincided with this business revolution and China's abundant cheap labour supply has made the economy extremely successful in joining the global value chain of multinational business by receiving large amounts of jobs outsourced from advanced economies.

On the other hand, the emergence of this new business model has led to

> a dramatic growth in the business strength of firms based in advanced economies compared to those based in developing countries.... The high income economies contain just 16% of the world's total population. In 1997 they accounted for 91% of the total world's total stock market capitalisation, 95% of the *Fortune* 500 companies which ranks companies by value of sales, 97% of the FT 500 which ranks companies by value of stock market capitalisation and 99% of the world's top 300 companies by value of R&D spending.
>
> (Nolan, 2000, p. 15)

China's success in becoming a manufacturing base and exporter is featured by its position in the low-value-adding parts of the value chains. For instance, of $325 billion of exports in 2002, China's Ministry of Commerce rated only 20 per cent as genuinely high-tech, which were mostly mature commodities, such as DVD players and laser printers. "The brains of these machines, namely their semiconductor chips, were almost all imported – reflected in China's high-tech trade deficit of around $15 billion. What's more, 85 per cent of its high-tech exports between January and August 2003 were accounted for by foreign enterprises in China."[16] The result is that "while more and more high-tech goods are made in China, almost all the value is being captured by foreign companies".[17]

As summarized by Nolan (2000), for firms in late developing countries, although the possibility to enter the value chain as a small business and progress up the chain in partnership with a leading global firm has never been greater, their possibility to compete directly with global giant system integrators is much less than ever before. "This raises challenging issues about the meaning of 'catch-up' at both the national and the firm level in those vast parts of the world that contain a large share of the world's population and future markets" (Nolan, 2000, p. 18).

This issue has become trickier with the stringent intellectual property right regime created by advanced countries through the WTO negotiations in the early 1990s. In the past, when intellectual property right protection was less enforceable across international borders, firms in late developing economies such as Japan in the last century were able to "catch up" by imitating products and technologies from more advanced economies and win their place in world markets with their low-labour-cost advantages. In the post-1990s global production system, the "core" firms in advanced countries can easily beat the firms in the developing economies by outsourcing their labour-intensive chains of production to the latter's land while applying their well guarded core technologies.

Concerns about late developing countries being trapped in the low end of the value chain of production in the Age of Globalization have been aired by some renowned economists. Wade (2005), for instance, warns that the WTO-based trade liberalization with rising protection of core technologies is consolidating the dominance of "a hereditary world oligarchy" of the industrialized North. Stiglitz (2005) points out that the current international rules of intellectual property right protection reflect the interests of advanced industrial countries more than the interests of the developing world. He advocates developing countries' right to develop the appropriate intellectual property regime for their own industrialization needs.

Facing the challenge, China has to take necessary domestic reforms and smart strategies to participate in globalization. First, it should fully utilize its advantage in human capital, which contains one of the world's largest pools of engineers and scientists. The numbers of university graduates from science and engineering subjects have been half a million per annum in recent years, three times the Japanese number. To release the power of its human capital, China needs to develop its venture capital market among other reforms to improve the efficiency of the financial sector.

So far, the government has played an active role in sponsoring research and development. There are two distinct types of programmes organized and planned by the government: those that focus on supporting basic and frontier research – such as the "Climbing up" Program (*Pandeng*), the "863" Program (*Baliusan*) – and those with a primary objective to promote the diffusion of applied technologies – such as the "Key Projects" Program (*Gongguan*), the "Torch" Program (*Huoju*), the "Spark" Program (*Xinghuo*) and the "Dissemination" Program (*Tuiguang*). Especially in the latter category of the programmes, the government acts as an agent between enterprises and research institutes and universities to encourage applied research and commercialization of research outputs. Thanks to these programmes and other reforms, research fund uses have experienced sharp rises in recent years.

Apart from domestic reforms, China needs to use its increasing economic clout to play a more proactive role in rule-making of international games. This means to lead a coalition of developing countries in pressing for more "developing space" in multinational negotiations in international organizations. This has happened in China's role in the G20, a group of developing countries that includes India, China, South Africa, and Brazil, in the Doha round of WTO negotiations.

A notable strategy taken by China recently is to boost technology and enhance brand power by buying foreign companies as a producer of sophisticated goods. Chinese companies (mostly state-owned) have drawn global attention with a series of high-profile acquisitions and mergers of foreign firms, including China's top oil company CNOOC's (failed) $18.5 billion bid to take over US Unocal, China's Lenovo Group's $1.25 billion purchase of the PC business of IBM, etc. While this strategy to capture the "core businesses" may help China's firms leapfrog certain stages of brand building and product

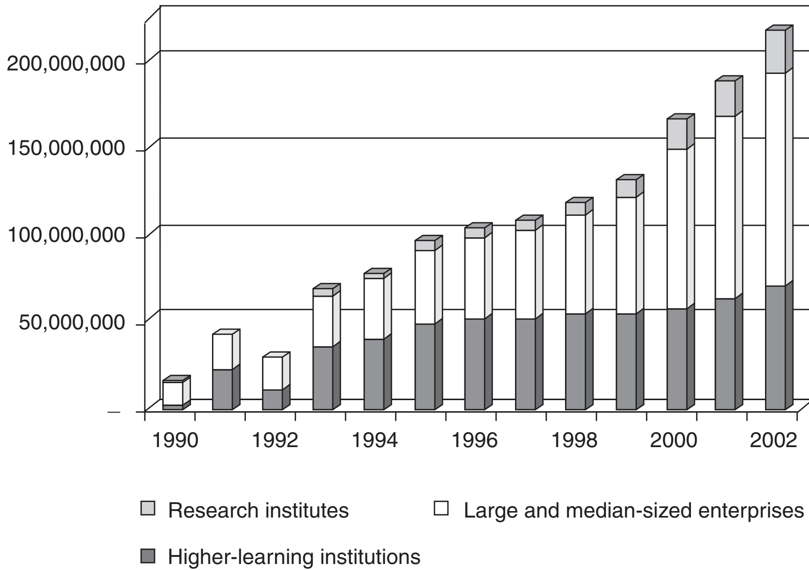

Figure 6.9 Users of science and technology research funds (source: NBS/MOST, various years).

development, its effectiveness to lift China from the "low-value-chain trap" remains to be seen in future.

Ecological constraints: environment and energy

China's remarkable economic growth in the recent history has been highly costly in terms of environmental deterioration and energy use. China's GDP accounted for 4 per cent of the world's total GDP in 2003, but it consumed 7.5 per cent of global oil output, 27 per cent of the world's output of steel, 34 per cent of coal, and 40 per cent of cement. China's top eight energy-guzzling industries account for 73 per cent of the entire industrial sector's energy use and use nearly 50 per cent more energy per unit of output compared with the global average. To produce one dollar of gross national product, China consumes seven times more energy than Japan and six times more energy than US.[18] The energy demand from China's heated growth has been one of the major driving forces behind the soaring world oil price in recent years.

China has paid a high environmental price for its breakneck growth in the past two decades. The country's Vice-minister for the Environment Pan Yue warned that the amount of liveable land in China had been halved from six million sq km to three million sq km in the past 50 years due to severe soil erosion. Acid rain already affects 298 cities, or 56.5 per cent of cities monitored by the ministry. A clear blue sky has now become a rare sight in major cities

like Beijing. The pollution load is expected to quadruple by 2020 if current trends continue.[19] Around the turn of the century, sand and dust storms not only repeatedly swept through vast areas of northern China but also polluted the air in neighbouring countries. Meanwhile, total sales of vehicles have increased two and a half times to over five million per annum since 2000.

By all these accounts, and considering the sheer size of its 1.3 billion population (or 22 per cent of the world's total), China's current extensive mode of growth is unsustainable for long not only for its own geographic territory but also for the global ecological system. To overcome this constraint, the country needs to introduce domestic reforms to its growth model. China must revamp its unrealistic pricing structure of key resources, such as the low price for water in cities (one-third of that in South Africa and one-tenth of that in Germany) and fuel prices (a quarter of that in the US).[20] Government initiatives in providing incentives for waste and water recycling, energy conservation, use of new energy sources and pollution reduction need to be introduced and strengthened through a combination of public policies and institutional innovations.

On the international front, so far the main initiative China has taken is to strike deals with oil and gas-rich countries such as Russia, Sudan and Venezuela to secure supplies of these strategic energy resources. Given its weight in the international energy market, China can take a more proactive role in pivoting the world towards new energy sources. For instance, research and development of biofuel has already reached the commercialization stage for some of its products. Brazil is now able to supply the world with ethanol (a form of alcohol distilled from sugar cane) at a price of $25 per barrel, less than half of the cost of crude oil. According to some energy experts, since conventional engines can run on such biofuel products, producing ethanol from developing countries like Brazil and India could replace 10 per cent of global gasoline fuel "without too much effort".[21] However, farm lobbies in the developed nations have raised protectionist barriers to worldwide exports of ethanol from developing countries. If China could open itself up to biofuel supplies, it would help these biofuel-producing countries overcome the political resistance and benefit the whole world.

Conclusion

From the above analyses, we can see that the challenges of globalization are intertwined with the domestic challenges. To answer the challenges of globalization, China has to engage an increasingly integrated world economy with proper strategies as well as carefully designed domestic reforms. In China's experience in trade liberalization, that started in the early 1980s, dismantling the monopoly of state-owned trading agency on export and import business, delegating trading rights to local governments, and allowing non-state enterprises to participate in international trade, have all helped China extract great benefits from opening up its economy.

Proper strategies to engage in globalization also help domestic reforms to succeed. Again China's past experience provides valuable lessons. Policies to

attract foreign direct investment into Chinese industries have brought in not only much-needed capital and technology but also new models of doing business. Foreign companies have exhibited demonstrative effects on Chinese counterparts, be they state-owned or not. Evidence has shown that the spill-over efficiency of foreign businesses in Chinese industry was large and significant (Liu, 2002). The opening to foreign investment has been a great stimulus to reforms of domestic firms.

Such a relationship between promoting domestic reforms and engaging globalization can be illustrated by the issue of fully opening up the banking sector by end of 2006 according to China's WTO deal. On the one hand, the sector's exposure to international financial risks is complicated by the fragility of the state-owned commercial banks. To minimize tomorrow's risks of opening up the banking sector, domestic reforms of state-owned banks and state-owned enterprises must proceed forward. On the other hand, if the opening is handled properly, one can expect the entry of foreign banks to press the domestic (state-owned) banks to improve loan quality and adapt themselves to market rules more quickly. In this juncture, the government policy since 2005 to encourage Chinese banks to sell their shares to foreign "strategic investors" is a remarkable move.[22] Under this policy, foreign financial institutions are invited to become key shareholders of Chinese banks (subject to a 20–25 per cent share cap) and participate in the latter's management. The policy offers potential benefits to foreign banks by providing immediate access to the Chinese banks' vast domestic network and customer base. To the Chinese, selling the stakes not only pluralizes the ownership of their banks but also creates a short cut for introducing foreign management, technology and financial products. Direct involving well established foreign financial institutions as strategic investors is also set to boost public confidence in China's banking sector as it opens up according the WTO accession agenda.

To prepare the banking sector for the imminent full opening to foreign entry, China has to proceed carefully with the reform of its foreign exchange regime. Due to the inaction of the renminbi's exchange rate reform up to July 2005, market expectations of the currency's appreciation drove the influx of hot money in the period of 2002–05, adding fuel to macroeconomic overheating and investment bubbles in certain sectors (especially the real estate market). The negative impact on the quality of bank lending has not been helpful to the reform of the banking sector. On top of that, the dissembling of some capital controls in a bid to release RMB's appreciation pressure may have left the banking sector more vulnerable to the financial risks involving post-WTO opening to foreign banks.

Facing these risks, China should introduce deposit insurance to reduce the risk of bank runs. Selective capital controls may be reinforced in some areas to pre-empt a sudden reversal of hot money flows that may destabilize the financial sector. China may also play a more proactive role in regional monetary cooperation, in particular, pushing for a more powerful Asian currency cooperation mechanism based on the existing Chiang Mai Initiative scheme.[23] China may

even take the initiative to form a sub-regional currency union including the renminbi, the Hong Kong dollar, and the Macau pataca, by developing a *de jure* link among these currencies. Such a move will immediately minimize the uncertainty about RMB's exchange rate mechanism and substantially reduce the risk of capital reversal while enhancing RMB's convertibility.[24]

Notes

1 Based on National Bureau of Statistics of China (2006), Wong (2005), and "China's economy as the world's No. 4", *Huanqiu Huabao* (*Global Chinese Press,* Canada), 3 February 2006.
2 National Bureau of Statistics of China (2004).
3 Around 1979–81, the Chinese government reversed the state-sponsored "urban-to-rural" and "coast-to-inland" migration policy in the Mao era, allowing millions of previously rusticated urban youth and persecuted cadres, officials, and intelligentsia to return to their home towns (Kam, 1992). The consequent reunion of millions of families resulted in a baby boom in the early 1980s, despite the enforcement of the "one-child" policy.
4 China carried out a nationwide census of its secondary and tertiary industries in 2004. Based on the survey results, the National Bureau of Statistics of China adjusted the country's GDP upward in 2004 by 16.8 per cent and recalculated GDP statistics for years back to 1993 (NBSC, 2006a).
5 Chua, C., "Impressive numbers, but what's the real story?" *Straits Times* (Singapore), 27 July 2005.
6 "PBOC governor: speeding up interest rate reform", *Lianhe Zaobao (United Mornings*, Singapore), 9 July 2004.
7 "Liu Mingkang at media conference", www.cbrc.gov.cn/, 1 December 2004.
8 According to Sachs and Woo (2002), the big four banks extract about 95 per cent of their profits from about half a dozen coastal cities.
9 In contemporary Chinese political terminology, the "first generation" refers to the leadership headed by Mao Zedong, who ruled China from 1949 to 1976. The "second generation" refers to the ruling elite in which Deng Xiaoping was the paramount leader, who dominated Chinese politics from end 1970s to early 1990s. The "third-generation" leadership was headed by Jiang Zemin, who was the party's general secretary through the 1990s to 2002. The "fourth generation" has had Hu Jintao at the helm since the end of Jiang's era.
10 "Hu: harmonious society crucial for progress", *Xinhuanet*, 28 June 2005.
11 For a more detailed discussion on the *Hukou* system, see Chan and Zhang (1999).
12 *Guidelines for the Tenth Five-year Plan of National Economic and Social Development of the People's Republic of China (2001–05)*, approved by the Ninth People's National Congress at its fourth assembly, 15 March 2001.
13 "*Hukou* system relaxation", *Straits Times* (Singapore), 10 October 2001; "Household registration reform in 20,000 cities and towns", *Beijing Qingnianbao (Beijing Youth News)*, 28 August 2001.
14 "The Sunzhi Gang incident and reform of household registration system", www.rdyj.com.cn/2003/rdqk-12-10.html.
15 Simons, C. "This is really home", *Newsweek* (US), 8 August 2005.
16 "The allure of low technology", *The Economist* (UK), 18 December 2003.
17 Ibid.
18 Chua, C.H. "China's uphill task in conserving energy", *Straits Times* (Singapore), 6 July 2005.

19 Chua, C.H. "Impressive numbers, but what's the real story?" *Straits Times* (Singapore), 27 July 2005.
20 Ibid.
21 Theil, S. "The next petroleum", *Newsweek,* 8 August 2005.
22 "Liu Mingkang's answers to correspondents", www.cbrc.gov.cn/, 5 December 2005.
23 Chiang Mai Initiative is a multinational agreement reached in 2000 to develop a network of bilateral/multilateral swap transactions among the monetary authorities of the ASEAN+3 countries, i.e. members of the Association of Southeast Asian Nations plus China, Japan, and South Korea.
24 For more discussions- on the feasibility and benefits for China to initiate an Asian Monetary Union, see Lu (2005).

References

Asian Development Bank (2004) *Poverty Profile of the People's Republic of China.* Manila, ADB.

Chang, G. (2002) The cause and cure of China's widening income disparity. *China Economic Review* 13: 335–40.

Gu, X. (2005) From Labour Insurance to Social Safety Net: Welfare Regime Change in China. Paper presented at International Conference on "China under Hu Jintao: Policy Initiatives and Challenges", Singapore, 15–16 August.

Kam, Wing Chan (1992) Post-1949 urbanization trends and policies: an overview, in Gregory E. Guildin (ed.) *Urbanizing China*. New York: Greenwood Press, pp. 41–63.

Kuznets, Simon (1955) Economic growth and income inequality. *American Economic Review* (Nashville) 45(1): 1–28.

Kwan, Chi Hung (2004a) Why China's Investment Efficiency is Low – Financial Reforms are Lagging Behind, www.rieti.go.jp/users/kan-si-yu/, 18 June.

Kwan, Chi Hung (2004b) Can Consumption Replace Investment as a Growth Engine? www.rieti.go.jp/users/kan-si-yu/, 4 August.

Liu, Zhiqiang (2002) Foreign Direct Investment and Technology Spillover: Evidence from China. *Journal of Comparative Economics* 30: 579–602.

Lu, Ding (2004) China's Capability to Control its Exchange Rate. *China Economic Review* 15(3): 343–7.

Lu, Ding (2005) East Asia Monetary Cooperation: Progress and Prospects. Paper presented at Shanghai Forum, Shanghai, 15–17 May.

Lu, Ding, S.M. Thangavelu and Q. Hu (2005) Biased Lending and Non-performing Loans in China's Banking Sector. *Journal of Development Studies* 41(6): 1071–91.

National Bureau of Statistics of China (various years). *China Statistical Yearbook*. Beijing: NBSC.

National Bureau of Statistics of China (2006a) Announcement of adjustments to historical statistics of China's GDP, 9 January, www.stats.gov.cn.

National Bureau of Statistics of China (2006b) The National Economy Kept Steady and Fast Growth in 2005, 25 January, www.stats.gov.cn.

NBS/MOST (National Bureau of Statistics and Ministry of Science and Technology) (various years). *China Statistical Yearbook on Science and Technology.* Beijing: China Statistics Press.

Nolan, Peter (2000) Global Business, Value Chains and Developing Countries. *ECR Academic Report*, pp. 14–20.

Prasad, Eswar, T. Rumbaugh and Q. Wang (2005) Putting the Cart before the Horse?

Capital Account Liberalization and Exchange Rate Flexibility in China. *IMF Policy Discussion Paper* 05/1.

Sachs, Jeffery and Wing T. Woo (2002) China's Economic Growth after WTO Membership. *Journal of Chinese Economic and Business Studies* 1(1): 1–32.

Stiglitz, Joseph E. (2005) Intellectual Property Rights: Why They are so Wrong. *Straits Times* (Singapore), 13 August.

Wade, Robert H. (2005) Beyond Asian Horizons: Neoliberalism and the Emergence of a Hereditary World Oligarchy. Paper for NUS Centennial Conference on "Asian Horizons: Cities, States and Societies", 1–3 August, Singapore.

World Bank. (1997) *China 2020*. Washington, DC: World Bank.

World Bank. (2005) *World Development Report 2005: A Better Investment Climate for Everyone*. Washington, DC: Oxford University Press.

World Bank. (2006) *World Development Report 2006: Equity and Development.* Washington, DC: Oxford University Press.

Wong, John (2005) China's economy in 2004: stability over growth. *Straits Times* (Singapore), 23 January.

Woo, Wing T. (2001) Recent Claims of China's Economic Exceptionalism: Reflections inspired by WTO Accession, *China Economic Review* 12(2/3): 107–36.

Zhou, Xiaochuan. (2002) China's Social Security Reforms: The Institutional Arrangements, www.ccer.edu.cn/download/1431–1.pdf.

7 Reassessing the Japanese response to globalization

Causes and consequences of the Japanese financial crisis

Masao Ishikura

Introduction

The Japanese responses to globalization can be understood in terms of the interaction between the strategy of the hegemon, i.e. the US, to induce other countries to open and deregulate their markets and the responses of domestic economic agents to this foreign pressure, which caused socio-economic imbalances. The measures to deal with these imbalances brought about further imbalances and resulted in a financial crisis in the late 1990s.

From the early 1980s, the Japanese economy accelerated financial deregulation and globalization, encouraged by pressure from the US to liberalize its capital markets. The ensuing liberalization of inflows and outflows of capital permitted Japanese firms to raise funds through the issuance of Euro-yen bonds on more favorable conditions than on the domestic capital markets. Along with that, further deregulation of the domestic capital markets enabled non-financial firms with sufficient creditworthiness to raise funds through the issuance of commercial paper, corporate bonds and other financial instruments on more favorable conditions than bank loans. Consequently, large non-financial firms became less dependent on bank debts, and the banking sector faced increasing difficulties in finding good borrowers with sound financial conditions.

Structural changes in the loan market following the deregulation of the capital markets can be evidenced by the dependence of industries on bank debts during the 1980s: in the manufacturing sector, the dependence of large firms on bank debts declined by half, while that of small and medium-sized firms continued to rise gradually; in the non-manufacturing sector (especially in real estate, construction, wholesale and retail) the dependence of small and medium-sized firms rose significantly in the second half the 1980s, while that of large firms remained at a higher level than in the manufacturing sector. Against the background of aggressive monetary easing policy after the Plaza Accord in September 1985 and the resulting run-up of stock and land prices, the Japanese banking sector extended credit to borrowers, including those without promising projects, with expectation of the rising price of land as collateral.

However, as the collapse of stock prices in 1990 put an end to the bubble

economy, the Japanese economy faced financial imbalances such as huge non-performing loans in the banking sector and debt overhang in the non-financial corporate sector, which intensified the economic downturn of the 1990s. Following the successive failures of large financial institutions in 1997–98 and the resulting pressure from global financial markets, the Japanese economy was forced to arrange an institutional framework to deal with the failed financial institutions and their non-performing loans, and to further reorganize the banking sector. Between 1998 and 2000, public funds were successively injected into the banking sector in order to deal with the failed financial institutions and to increase the capital base of major banks.

This chapter investigates these Japanese responses to economic globalization and their socio-economic implications. The next section overviews the deregulation of the capital markets since the mid-1970s, and examines the impact of that deregulation on Japanese financial and corporate sectors and the resulting credit expansion in the late 1980s. The following section examines the processes in which the financial imbalances of the late 1980s manifested themselves as the non-performing loan problem in the banking sector since the early 1990s, and the measures that had been taken to deal with that problem before the financial crisis in 1997–98. The fourth section investigates the process in which the non-performing loan problem evolved into the successive failure of large financial institutions in 1997–98, and the measures that were taken to reshuffle the financial sector following the Financial Big Bang initiative. The fifth section overviews the reorganization of the financial sector following the financial crisis in 1997–98 and its consequences. The conclusion summarizes the main findings.

The credit expansion in the bubble economy of the 1980s

This section overviews the deregulation process of the capital markets, which was accelerated by pressure from the US on Japan to open its financial markets, and investigates the responses of Japanese financial and corporate sectors to that deregulation, and the resulting huge credit expansion in the late 1980s. The mechanism for accumulating financial imbalances during the bubble economy of the late 1980s is critical to investigating the causes and consequences of the long downturn and financial crisis of the late 1990s.

The deregulation of capital markets in Japan

Until the mid-1980s, the Japanese economy was characterized by a bank-centered financial system (for details, refer to Bank of Japan 1995: ch. 3). Before the 1970s, the issuance of corporate bonds in Japan was strictly restricted. As most corporate bonds were underwritten and held by financial institutions, the secondary bond market was quite small. Until the mid-1970s, the Committee on Bond Issue (Kisai-Kai), which was composed of commissioned banks and underwriting brokerage houses, determined the eligibility criteria for issuance of bonds, including the upper limits of issuance, the financial conditions to be met

by issuers, and so on. The issuance of government bonds and municipal bonds was prioritized over corporate bonds. Except for the bonds issued by the Electric Power Corporation and the bank debentures issued by long-term credit banks, the issuance of corporate bonds in general was strictly restricted in those institutional contexts.

The first step toward deregulating the capital markets was motivated by an increase in the issuance of government bonds from 1975, which was due to the government deficits resulting from the slower economic growth and concomitant shortage of tax revenue following the first oil shock of 1973–74. The secondary bond market expanded rapidly following an increase in the amount of outstanding government bonds. In April 1977, restrictions on the secondary trading of government bonds were relaxed for the first time. Along with the deregulation in the secondary bond market, restrictions on the primary bond market, such as the requirement to be secured and the eligibility criteria for issuance of bonds, were relaxed gradually. Unsecured convertible bonds and unsecured straight bonds were issued for the first time, in 1979 and 1985, respectively. The eligibility of bond issuance was authorized in accordance with credit ratings from the early 1980s. Some rating agencies were established from the late 1970s. And bonds with warrants were issued for the first time in December 1981.

The second step toward deregulation of the capital markets was the internationalization of the yen from the early 1980s. The Foreign Exchange and Trade Control Law enacted in 1949, which prohibited foreign exchange transactions in principle, was revised in December 1980 to allow Japanese residents to buy and sell foreign currencies through authorized foreign exchange banks. However, under the revised law, forward foreign exchange transactions were permitted only if they were based on actual imports and exports. In other words, the real demand principles for forward foreign exchange transactions were maintained.

Along with the above revision of the foreign exchange law in 1980, the US increased pressure on Japan to open its financial markets. US manufacturers lobbied the US government to force Japan to open its financial markets, on the grounds that the closed nature of Japanese financial markets discouraged foreign investors from holding the yen, leading to an excessive rise in the dollar against the yen. US-based multinational financial institutions also hoped to expand their business into the Japanese financial market. The Japanese government conceded the US demands, so as to secure continued access to the US market for Japanese producers in the face of the external trade conflict. In November 1983, the "Japan–US Yen–Dollar Committee" was established. After several task forces under the committee, its final report titled "the Japan–US Yen Dollar Committee Report" was released in May 1984.[1]

The measures agreed to encourage further deregulation of Japanese financial markets were as follows. First, the real demand principle for forward foreign exchange transactions was abolished in April 1984. This enabled non-financial corporations to take the opportunity of risk hedging through forward foreign exchange contracts. Second, the regulation on the conversion of funds denominated in

foreign currencies into the yen was lifted in June 1984. This included the removal of the ceilings on the amount of yen that Japanese banks could secure through the conversion into foreign currencies. Third, regulations regarding the Euro-yen market were relaxed successively. In April 1984, the guidelines on the issuance of Euro-yen bonds by residents were relaxed. Since December 1984, foreign institutions have been allowed to become lead managers in issuing Euro-yen bonds. In April 1986, the guidelines on the issuance of Euro-yen bonds by non-residents (for example, overseas subsidiaries of Japanese corporations) were relaxed to determine the eligibility criteria for bond issuance based on credit ratings. In July 1993, the eligibility for the issuance of Euro-yen bonds by non-residents was lifted. The eligibility criteria for the issuance of Euro-yen bonds by residents were completely abolished in January 1996. The "lock-up period," during which the sale of Euro-yen bonds issued by residents was prohibited, was gradually reduced and was completely abolished in April 1998.

The third step toward capital market liberalization was a further deregulation of domestic capital markets from the late 1980s. The domestic commercial paper market was established in November 1987. Financial conditions such as credit ratings and the net assets required to issue unsecured straight bonds were gradually relaxed from 1987. As a measure to simplify the procedures of corporate bond issuance, the system of shelf registration[2] was introduced in 1988. The commission on underwriting corporate bonds was reduced in March 1992. The ceiling on the issuance of corporate bonds was abolished, in accordance with the revision of the Commercial Code in April 1993. And finally, in January 1996, the eligibility criteria for corporate bond issuance were completely removed and concomitantly the requirement of covenants related to unsecured corporate bonds was lifted.

The impact of the deregulation of capital markets on the banking sector

Following the deregulation of the capital markets as mentioned above, the fund raising of the Japanese non-financial corporate sector through the capital markets at home and abroad rapidly increased.

As shown in Figure 7.1, the issuance of straight corporate bonds abroad increased significantly since the mid-1980s, when regulations on the issuance of the Eurobond began to be relaxed, from 370 billion yen on average in 1980–84 to 1,157 billion yen on average in 1985–89, and further to 2,506 billion yen on average in 1990–94. Issuance of straight bonds at home significantly increased from the mid-1990s, when the eligibility criteria for issuing corporate bonds and Euroyen bonds were completely abolished, from 2,728 billion yen on average in 1990–94 to 7,370 billion yen on average in 1995–2000.

As shown in Figure 7.2, the issuance of convertible bonds increased rapidly during the second half of the 1980s, in expectation that debts would be promptly converted into equity with the help of rising stock prices, from 1,463 billion yen on average in 1980–84 to 5,734 billion yen on average in 1985–89, as a total of those issued abroad and at home.

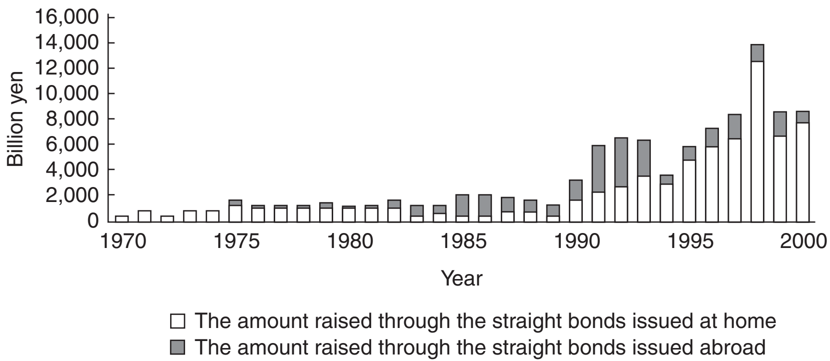

Figure 7.1 Funds raised through the capital market (straight bonds) (source: Tokyo Stock Exchange (2002: Table 46-1)).

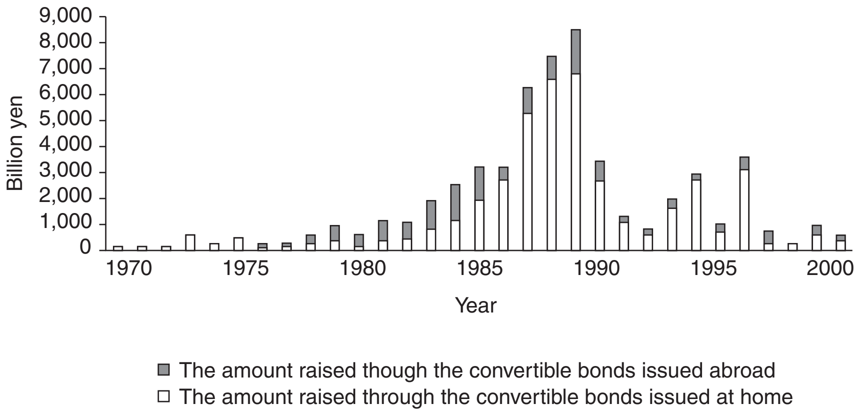

Figure 7.2 Funds raised through the capital market (convertible bonds) (source: Tokyo Stock Exchange (2002: Table 46-1)).

As a consequence of the deregulation of capital markets, large non-financial corporations with sufficient creditworthiness became less dependent for their funds on bank debts, and the banking sector faced increasing difficulties in finding sound borrowers.

Figure 7.3 shows the proportion of bank debts to total assets for non-financial corporations, by the size of their capital, for the manufacturing and real estate sector from 1970 to 2004. The proportion of bank debts to total assets in the Japanese corporate sector shows how the deregulation of the capital markets affected the dependence on bank debts in different ways. In the manufacturing sector, the proportion of bank debts to total assets for large firms fell from 30.9 percent in 1980 to 15.2 percent in 1990 while the same proportion for small and

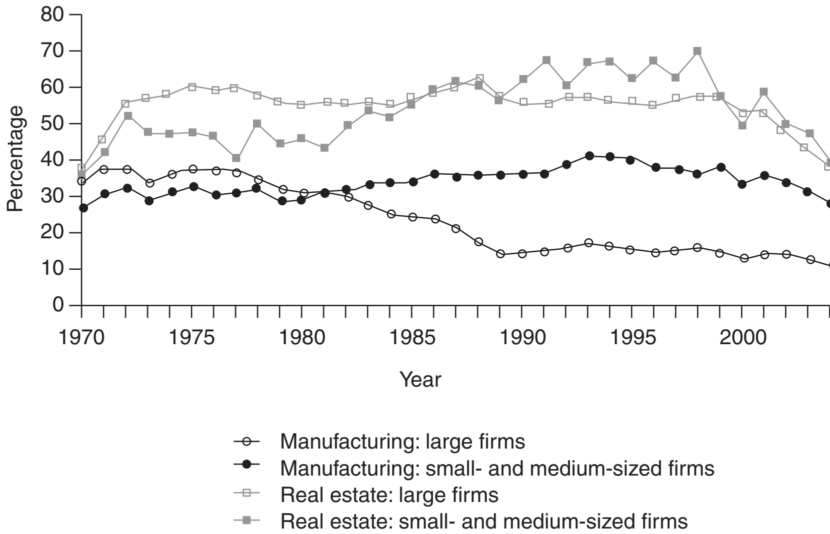

Figure 7.3 The proportion of bank debts to total assets in Japanese corporate sector (source: Ministry of Finance, Policy Research Institute 2005).

Note
This figure defines bank debts as the sum of borrowings from financial institutions both in current and fixed liabilities, and calculates their proportion to total assets. Firms with a capital of one billion yen or more are defined as large firms, and the remaining ones as small and medium-sized firms.

medium-sized firms rose from 30.3 percent in 1980 to 36.1 percent in 1990. On the other hand, in the real estate industry, the proportion of bank debts to total assets for small and medium-sized firms rose significantly from 45.9 percent in 1980 to 62.2 percent in 1990, and the same proportion for large real estate firms remained at a higher level (about 57 percent on average) than that in the manufacturing industry.

The declining dependence of large manufacturing firms on bank debts during the second half of the 1980s implies that large firms with relatively high creditworthiness had greater opportunities to raise funds through the issuance of corporate bonds at home and abroad. At the same time, it turned out that increasing real estate firms, even with little promising projects, obtained loans from banks in the expectation of rising values of collateral, fueled by the bubble in stock and land prices.

Meanwhile, the run-up of asset prices in the late 1980s led to the unprecedented credit expansion, and caused the accumulation of financial imbalances. With the help of the monetary easing implemented following the Plaza Accord of September 1985 and the Louvre Accord of February 1987, there occurred a rapid rise in Japanese land and stock prices, at a pace far greater than the growth rate of nominal GDP.

As shown in Figure 7.4, the ratio of the index of land prices to that of nominal

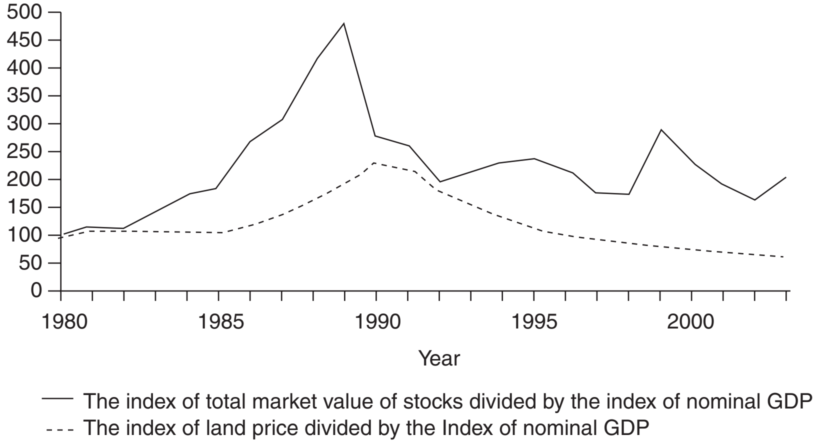

Figure 7.4 The land prices and the total market value of stocks, relative to the nominal GDP (the year 1980 = 100) (source: Japan Real Estate Institute (2005), Economic and Social Research Institute (2005), Tokyo Stock Exchange (2005)).

Note
This figure shows the behavior of the ratio of land prices (that is, the price indexes averaged for land in commercial, residential and industrial uses) and the total market value of stocks (on the first section of Tokyo Stock Exchange) to nominal GDP from 1980 through 2003, as indexes (the benchmark year of 1980).

GDP rose from 102.1 in 1985 to 223.2 in 1990, with the benchmark year of 1980, implying that the land prices rose at a pace 2.2 times faster than nominal GDP during the same period. The ratio of the index of the total market value of stocks to that of nominal GDP rose 185.8 in 1985 to 476.0 in 1989, implying that the total market value of stocks increased at a pace 2.6 times faster than nominal GDP during the same period.[3]

Against the backdrop of such an unprecedented run-up of land and stock prices in the late 1980s, most banks increased lending to real estate, construction, and other retail firms, with optimistic expectations of their business prospects and the rising value of their collateral. Relying on the appreciation of collateral, Japanese banks extended loans to borrowers, even with less promising projects, in order to survive the competition over the volume of lending. As a result, there emerged a big change in the proportion of loans outstanding by industry. As Figure 7.5 shows, the proportion of loans to the manufacturing industry fell from 32.0 percent in 1980 to 15.7 percent in 1990, while that of loans to the real estate industry rose from 5.6 percent to 11.3 percent during the same period.

While the share of bank loans to the manufacturing sector decreased rapidly, overall bank loans increased sharply. As Figure 7.6 shows, the proportion of total loans to nominal GDP rose from 56.6 percent in 1980 to 73.3 percent in 1985, and further rose to a peak of 100.9 percent in 1989, and 100.7 percent in

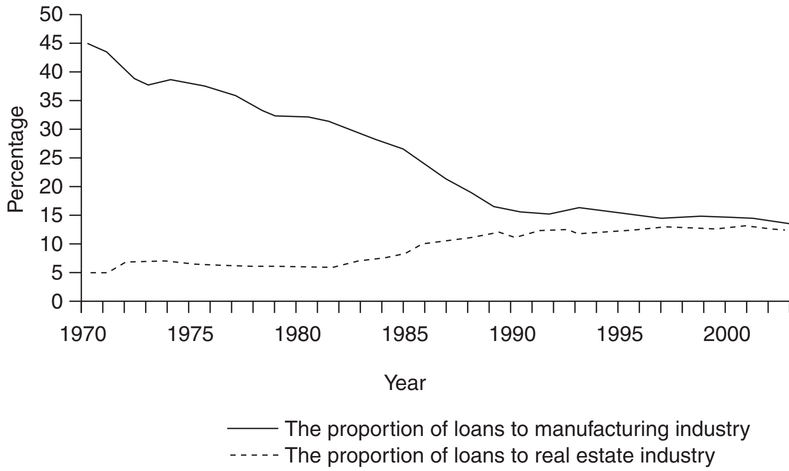

Figure 7.5 Outstanding loans by industry (source: Bank of Japan (2003; 2005)).

Note
Figures are from the banking account of domestically licensed banks.

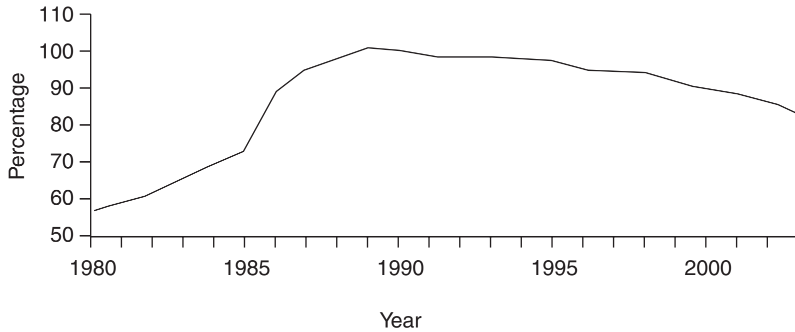

Figure 7.6 Outstanding loans as a percentage of nominal GDP (source: Economic and Social Research Institute (2005), Bank of Japan (2003) and Bank of Japan (2005a)).

Note
Loans from domestically licensed banks.

1990, implying that in the second half of the 1980s the credit expansion was generated with the help of the deregulation of the capital markets and the bubble in stock and land prices. The credit expansion of the late 1980s was accompanied by deterioration in the quality of loan assets. The same proportion fell slowly from 98.8 percent in 1991 to 94.6 percent in 1997, the year in which the economy experienced successive failures of large financial institutions. The

credit expansion of the late 1980s caused prolonged and deepening financial imbalances during the 1990s.

The emergence of non-performing loan problem in the Japanese banking sector

This section examines the process in which the financial imbalances accumulated in the late 1980s had manifested themselves as the non-performing loan problem in the Japanese banking sector and the measures that had been taken to address that problem before the outbreak of financial crisis in 1997–98.

The collapse of asset prices since 1990 and the non-performing loan problem

Even after the end of monetary easing in May 1989, Japanese stock and land prices continued to rise, and the Nikkei Stock Average peaked at 38,915.87 yen on December 29, 1989. However, the continued rise in long-term interest rates triggered a plunge in stock prices.[4] The Nikkei Stock Average fell to 20,221.86 yen on October 1, 1990, and to 14,309.41 yen on August 18, 1992, a 63 percent drop from the peak at the end of 1989. Following the collapse of stock and land prices (as shown in Figure 7.4 above), the Japanese banking sector faced a sudden fall in the value of collateral it held. However, most banks agreed to roll over existing loans, with the expectation that the value of collateral would recover soon.

The Japanese banks and financial authorities as yet did not regard the problem of non-performing loans as a serious threat. The scale of non-performing loans held by the Japanese financial institutions was not disclosed until 1992. In the financial statements as of the end of March 1993, major banks (composed of city banks, long-term credit banks and trust banks) were obliged for the first time to disclose the loans to borrowers who went bankrupt and the past due loans (that is, the loans on which interest payments were overdue more than six months). Their disclosure, however, did not cover the loans on which interest payments were reduced below the official discount rate. The remaining banks (composed of regional banks, second-tier regional banks) were required to disclose only the loans to those who went bankrupt, and the cooperative-type financial institutions (composed of agricultural financial institutions, credit cooperatives) were not obliged to disclose their non-performing loans. As late as the end of March 1998, the Federation of Banking Associations of Japan required all banks to disclose Risk Management Loans, which were composed of the loans to borrowers who had gone bankrupt, the past due loans in arrears three months or more, and the restructured loans, including loans whose interest payments were within a period of grace in order for the lending bank to help the borrowers reconstruct.

The failure of credit cooperatives and the revision of the Deposit Insurance Law in 1996

Following the failure of small-sized financial institutions since the end of 1994, the Japanese financial authorities were forced to establish the institutional framework to deal with failed financial institutions and their non-performing loans. Since the mid-1990s, the Japanese economy had experienced the successive failure of financial institutions, ranging from credit cooperatives, housing loan companies, regional banks, even to major banks with international operations.

In December 1994, two Tokyo-based credit cooperatives (Tokyo Kyowa Credit Cooperatives and Anzen Credit Cooperative) failed. This was the first case in which the Japanese economy actually experienced the failure of financial institutions. As neither the Deposit Insurance Corporation of Japan (DIC) nor the federation of credit cooperatives had sufficient funds to repay the deposits of these failed institutions, the Tokyo Kyodo Bank was newly established to purchase the assets and liabilities of the failed financial institutions, sponsored by the Bank of Japan (20,000 million yen) and private financial institutions (20,000 million yen). In July–August 1995, another two credit cooperatives failed and the DIC extended financial assistance to the Tokyo Kyodo Bank that assumed the assets and liabilities of those failed institutions. By the end of March 1996, the financial assistance extended by the DIC far exceeded the annual insurance premiums (for details, refer to DIC 1996).

Along with the successive failures of credit cooperatives since the end of 1994, there arose problems to deal with failing housing loan companies (*Jusen*).[5] Against the background of ever greater anxiety over financial instability, in June 1996, the following special measures were implemented to maintain the stability of the financial system (DIC 1997):

1. The Banking Law was amended to introduce the system of Prompt Corrective Action, which empowered financial authorities to order financial institutions to improve their business in cases where their capital adequacy ratio fell below a certain standard.
2. The Deposit Insurance Law was amended to postpone the implementation of the cap on deposit insurance (the maximum of insurance payment), and to extend the full protection of deposits until the end of March 2001, in the light of an inadequate disclosure of non-performing loans in the banking sector.
3. Under the revised law, the DIC was allowed to extend financial assistance (referred to as the Special Financial Assistance) in excess of the estimated costs required to make deposit insurance payments (often referred to as the "pay-off costs") to financial institutions that acquired assets and liabilities (other than non-performing loans) of failing and failed financial institutions. The Special Financial Assistance was a temporary measure with the expiration of the end of March 2001, corresponding to the time limit for the full protection of deposits.

4 In September 1996, the Tokyo Kyodo Bank was restructured to become the Resolution and Collection Bank (RCB), as the institution to acquire and assume the operations of failed credit cooperatives, and to undertake the resolution of their businesses including the repayment of deposits and the collection of loans. The DIC was allowed to entrust the purchase and collection of non-performing loans held by failed credit cooperatives to the RCB.
5 The DIC established two new special accounts (the Special Account for Non-credit Cooperative Financial Institutions and the Special Account for Credit Cooperative Financial Institutions), on which the Special Financial Assistance mentioned above could be implemented. These two special accounts (for special financial assistance exceeding the pay-off costs) were temporary ones to expire at the end of March 2001.
6 The government was empowered to guarantee the DIC's borrowings from the Bank of Japan and other financial institutions to finance the special operations to deal with failed credit cooperatives.

These measures provided the basic scheme for dealing with failed financial institutions. The temporary suspension of the cap on deposit protection implied that the financial authorities had come to better recognize the importance of financial stability than ever before. However, the Japanese economy subsequently experienced more difficulties than the scheme had anticipated, and was forced to restructure the banking sector under the pressure from global financial markets.

The financial crisis of 1997–98 and the subsequent restructuring of the Japanese banking sector

This section investigates the process in which the non-performing loan problem evolved into the successive failures of large financial institutions in 1997–98, and the Japanese economy was forced to restructure the banking sector under the pressure from financial markets at home and abroad.

Further deregulation of the financial system following the Financial Big Bang initiative

In the face of the growing anxiety regarding financial instability following the collapse of asset prices, and in response to the negative impact of the rapid appreciation of the yen in 1994–95 on the manufacturing sector, a series of stimulus packages were implemented between 1992 and 1995 to support the domestic demand. The Japanese economy recovered from the recession in the fourth quarter of 1993, and accelerated investment growth between 1996 and early 1997. With an improvement in business confidence, the Hashimoto administration, in office from January 1996 to July 1998, implemented austerity measures such as a rise in consumption tax and a government spending cut, which brought the Japanese economy into recession in the second quarter of 1997.

Along with the austerity measures, the Hashimoto administration launched a

comprehensive reform of the financial system, the Japanese version of the Financial Big Bang, whose outline was announced on June 13, 1997 under the slogan of "free" (i.e. liberal market under market principle), "fair" (i.e. transparent and reliable market) and "global" (i.e. international and advanced market) (Ministry of Finance 1997). The Financial Big Bang initiative implied the decision of the Japanese financial authorities to keep pace with the globalization of financial markets, and to embark on the system-wide restructuring of the financial sector through the following measures.

First, the front runner of the reform initiative was the amendment of the Foreign Exchange and Foreign Trade Control Law to allow free entry and exit into the foreign exchange business, and to completely liberalize cross-border capital transactions. The revised law, renamed the Foreign Exchange and Foreign Trade Law, took effect on April 1, 1998.

Second, the Financial Big Bang also facilitated the restructuring of the Japanese financial sector by permitting the establishment of financial holding companies (defined as holding companies, the subsidiaries of which are financial institutions such as banks, insurers, brokerages). Following the amendment of the Anti-monopoly Law in June 1996 to permit holding companies,[6] and the deliberation by the Financial System Research Council, the applicable law concerning the establishment of bank holding companies (defined as holding companies, the subsidiaries of which were banks) was approved by the Diet in December 1997. Under the law, the subsidiaries of bank holding companies may include banks, long-term credit banks, trust and banking companies, security houses, and other financial institutions, other than business companies in manufacturing, real estate, and so on, in order to maintain the sound operation of the banking subsidiaries. The lifting of the ban on financial holding companies, as shown below, facilitated major financial institutions to develop into financial conglomerates offering a full range of financial services.

Third, along with the restructuring of major financial institutions, the Financial Big Bang initiative committed itself to deal promptly with non-performing loans and to maintain the sound operation of financial institutions, through an implementation of Prompt Corrective Action, and through more accurate disclosure of their operations. In the post-war Japanese economy, the financial sector was protected by the "convoy system" of financial regulation, where the Ministry of Finance arranged for an insolvent bank to be merged with another bank to protect the interests of depositors and borrowers. Following the Financial Big Bang initiative, the Japanese financial authorities were forced to abandon the "convoy system" of financial regulation to facilitate the restructuring of the financial sector, forcing even major banks to leave the market in case of their insolvency.

The failure of large financial institutions in November 1997 and the subsequent pressure from the global financial markets

Following the commitment by the financial authorities to abandon the "convoy system" of regulation, the ailing financial institutions, including large ones,

faced financial difficulties in global financial markets and were forced to leave the market.

On November 3, 1997, Sanyo Securities, one of the mid-sized broker houses, filed for relief under the Corporate Rehabilitation Law owing to the huge amount of non-performing assets held by its affiliate financial companies, becoming the first Japanese financial institution to default on the repayment of funds raised on the call market. On November 17 of the same year, Hokkaido Takushoku Bank, the tenth largest bank, announced that it had become insolvent due to its huge irrecoverable loans and severe funding difficulties. Subsequently, on November 24, Yamaichi Securities, one of the four largest brokerage houses, went out of business, as it was faced with severe funding difficulties due to greater anxiety in the short-term money market about its huge amount of "off-balance sheet" (concealed) liabilities.

The abandonment of the "convoy system" of financial regulation was evidenced by the fact that the Ministry of Finance had allowed such large and influential financial institutions to leave the financial market. This policy shift put the Japanese financial sector under the pressure of global financial markets. Growing concern over the instability of the Japanese financial system caused serious shrinkage and disturbance of the short-term money market at home and abroad. Following the successive failure of large financial institutions in November 1997, Japanese banks saw their creditworthiness in the overseas financial markets suddenly deteriorate. As Figure 7.7 shows, the Japan premium, which is the interest rate premium that Japanese financial institutions had to pay for raising funds in US dollars, suddenly expanded in November 1997, and the Japanese banking sector came to have difficulties in raising short-term funds in the global financial market. The Japan premium persisted up to 1999, when the measures were implemented to deal with the non-performing loans of failed financial institutions with the help of public funds.

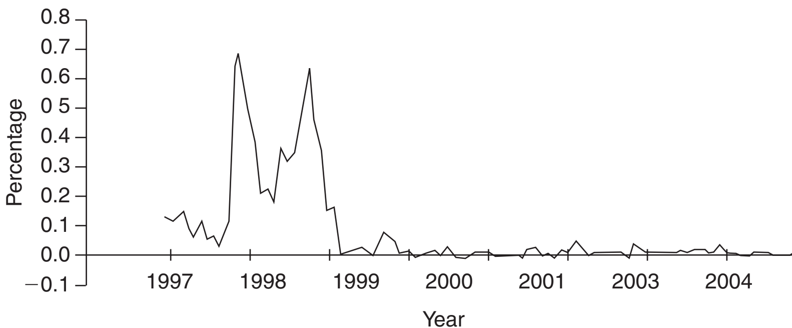

Figure 7.7 The Japan Premium (source: Bank of Japan (2005b)).

Note
The Japan premium is calculated as a difference between the rate quoted by Bank of Tokyo–Mitsubishi and the rate quoted by Barclays Bank in the Eurodollar market.

The measures taken to deal with failed financial institutions in 1998–99

In the wake of the successive failure of large financial institutions since November 1997, the Japanese financial authorities took measures to deal with large failed banks and to increase the capital base of major banks, with the help of public funds. The estimated costs incurred in dealing with such a large failed bank far exceeded the financial basis of the deposit insurance system then available. Against the background of the deteriorating confidence in the creditworthiness of the Japanese financial sector in the international financial market, in February 1998, the Deposit Insurance Law was revised to prepare public funds to deal with the non-performing loans of failed financial institutions. The revision of the law in February 1998 led to the following measures (DIC 1999, 2000).

1. Two special accounts (established in the DIC to finance the special financial assistance exceeding the pay-off costs) were integrated to establish the Special Operations Account, to expire at the end of March 2001.
2. The function of the RCB was extended to include the resolution of businesses and the collection of non-performing loans related to failed financial institutions other than failed credit cooperatives.
3. The DIC was authorized to lend funds necessary to purchase the non-performing loans of failed financial institutions to the RCB.
4. Government bonds of seven trillion yen were granted to the Special Operations Account in the DIC to establish the Special Operations Fund. This fund could be used (through the redemption of the government bonds granted to the DIC) to finance special financial assistance to the relieving financial institutions that would acquire and assume the assets and liabilities of failed institutions.[7]
5. The limit at which the government could guarantee the DIC's liabilities (including borrowings from the Bank of Japan or private financial institutions) in the Special Operations Account was set at ten trillion yen.

Along with the use of public funds to deal with failed financial institutions, in February 1998, the Financial Stabilization Law was enacted to prepare public funds to increase the capital base of major banks. Following the same law and the related revision of the Deposit Insurance Law, the Financial Crisis Management Account was newly established in the DIC, and government bonds of three trillion yen were granted to the DIC to establish the Financial Crisis Management Fund in that account. In March 1998, the DIC borrowed 1,818,100 million yen from the Bank of Japan and other financial institutions to lend to the RCB. Then, the DIC entrusted the RCB to underwrite the preferred shares and subordinated loans of 17 major financial institutions totaling 1,815,600 million yen.

However, the measures to boost the capital base of major banks failed to recover the soundness of the banking sector. The preferred shares and subordinated loans

underwritten by the RCB included those issued by the Long Term Credit Bank of Japan (LTCB) and the Nippon Credit Bank (NCB), both of which failed and were placed under temporary nationalization in October–December 1998, as detailed below. The public fund injection into major banks that was implemented in March 1998 lacked a strict assessment of the quality of their assets.

The temporary nationalization of two long-term credit banks

The successive failure of large financial institutions since November 1997 opened the way for the restructuring of large banks including ten city banks[8] and three long-term credit banks.

Since June 1998, there has been growing anxiety regarding the financial condition of the LTCB, one of the three long-term credit banks,[9] as the soundness of the whole banking sector was increasingly suspected by the market. How to deal with failing and failed large financial institutions (including the LTCB and the NCB) became political issues and the Financial Reconstruction Law was enacted in October 1998. It stipulates the measures for the temporary nationalization of failed financial institutions, and the role of financial administrators in dealing with failed institutions. Under the same law, it was determined that the operation and management of financial institutions judged by the Financial Reconstruction Commission (FRC) to be inappropriate and irrecoverable should not be allowed to continue. Following the enactment of the Financial Reconstruction Law and the related revision of the Deposit Insurance Law in October 1998, the Financial Reconstruction Account was newly established in the DIC in order to cover the losses arising from the temporary government control of failed financial institutions as well as to purchase non-performing loans from financial institutions. This account could be financed by the DIC's borrowings from the Bank of Japan and private financial institutions, and the issuance of DIC bonds, with a government guarantee up to 18 trillion yen.[10]

In October 1998, the LTCB was placed under special public management (temporary nationalization) in accordance with the Financial Reconstruction Law, and the DIC acquired all the shares of the LTCB. Following the assessment of the LTCB's assets and liabilities by the FRC, the Stock Price Evaluation Commission (established within the FRC) judged that the LTCB had been in excess liability at the time when its temporary government control was publicly announced. In August 1999, the DIC extended loans of 493,900 million yen to the Resolution and Collection Corporation (RCC)[11] in order to entrust it to purchase the non-performing loans held by the LTCB. Then, in February 2000, following the Financial Reconstruction Law, the DIC extended to the LTCB the exceptional financial assistance[12] of 3,239,100 million yen, which was financed by the disbursement from the Special Operations Fund (public funds) of seven trillion yen.

Along with the above measures to deal with the non-performing loans, the FRC was engaged in screening the preferred candidate for the acquisition of the LTCB. In September 1999, the FRC decided to give the New LTCB Partners

(NLP), an investment consortium organized by Ripplewood Holdings (in New York), the preferential negotiating rights to purchase the LTCB. In February 2000, the agreement regarding the acquisition of LTCB by the NLP was signed among the NLP, the DIC, and the LTCB. This agreement included several clauses favorable to the purchaser. The purchaser, NLP, was able to avert the losses that could occur after the purchase of loan assets, under the contract on the liability for defects that could be detected in the loan assets purchased from the LTCB.[13] On March 1, 2000, the FRC decided to terminate the special public management of the LTCB. In June 2000, the LTCB was renamed Shinsei Bank, which was converted into an ordinary commercial bank in April 2004. The Nippon Credit Bank (NCB), another long-term credit bank, was also placed under temporary nationalization in December 1998, having been saddled with huge irrecoverable loans. In June 1999, the Stock Price Evaluation Commission within the FRC judged that the NCB had been in excess liability at the time when its temporary nationalization was announced.[14] In November 1999, the DIC extended loans of 298,700 million yen to the RCC, in order to entrust it to the purchase of non-performing loans from the NCB. Then, in August 2000, the DIC extended the exceptional financial assistance of 3,149,700 million yen, which was financed by disbursements from the Special Operations Fund (public funds). In February 2000, the FRC announced that it would give priority negotiation rights for the purchase of the NCB under temporary nationalization to the consortium led by Softbank Corporation, Orix Corporation and Tokyo Marine & Fire Insurance Company. In June 2000, the acquisition of the NCB by the consortium was signed, and in August 2000 the FRC decided to terminate the special public management of the NCB. In January 2001, the NCB was renamed Aozora Bank.[15]

The Industrial Bank of Japan (IBJ), another long-term credit bank, was not placed under nationalization, but was converted into a financial holding company with other major banks. In September 2000, the IBJ, the Dai-Ichi Kangyo Bank and the Fuji Bank established Mizuho Holdings. Under the same holding company, in April 2002, these three banks were reorganized into the Mizuho Bank (specialized in serving individuals as well as small to medium sized companies) and the Mizuho Corporate Bank (MCB) (specialized in serving large corporations). The IBJ was dissolved into the MCB. Then, in January 2003, the Mizuho Financial Group (MFG) was established and Mizuho Holdings became a wholly owned subsidiary of the MFG. The MFG also provides various financial services including securities business (Mizuho Securities), trust and asset management business (Mizuho Trust and Banking). The establishment of the MFG was followed by, as shown below, the emergence of another financial groups.

Further reorganization of the financial sector

The comprehensive financial deregulation led by the Financial Big Bang and the subsequent failures of large financial institutions in the late 1990s facilitated the

reorganization of major financial institutions into mega financial groups and the shakeout of small to medium-sized financial institutions, leading to the increasing disparity between large and small corporations and the stagnating regional economy.

Reorganization of major financial institutions into mega financial groups and the shakeout of small to medium-sized financial institutions

Following the lifting of the ban on financial holding companies in 1997, Japanese major financial institutions (including those formerly classified as ten "city banks") were reorganized under bank holding companies, such as Mizuho Financial Group (MFG), Mitsubishi UFJ Financial Group (MUFG), Sumitomo Mitsui Financial Group (SMFG), Resona Holdings.[16] Further reorganization of major financial institutions into mega financial groups may lead to the formation of financial conglomerates as experienced in the US and the UK.[17] While the financial conglomerates can bring about synergy effects on the related areas of business, the integration of major financial institutions into mega financial groups may lead to greater credit exposure to certain industries. Under the Financial Revitalization Program launched in 2002, as shown below, major banks were forced to accelerate the disposal of non-performing loans. In May 2003, the Resona Bank was placed under temporary nationalization and forced to remove non-performing loans from its balance sheets.

In contrast to the reorganization of major financial institutions into mega groups, an increasing number of small and medium-sized financial institutions with relatively weak business base, such as regional banks, credit cooperatives, were shaken out or consolidated. More rigorous inspection of credit cooperatives has been conducted, since April 2000, when the authority of inspection and supervision over credit cooperatives was transferred from prefectural governments to the Financial Supervisory Agency (reorganized into the Financial Services Agency in July 2000). Between October 1996 and March 2003, the DIC extended the financial assistance of 6,418.2 billion yen in total to deal with 127 cases of failed credit cooperatives. In most cases, the DIC entrusted to the RCC to collect the non-performing loans of failed credit cooperatives.[18] The RCC's accelerated debt collection forced some debtor firms into bankruptcy and had negative effects on local economies, where the employment situation deteriorated due to the shift of manufacturing base to foreign countries.

The accelerated disposal of non-performing loans following the Financial Revitalization Program

Major banks, which were reorganized into new financial groups, were still saddled with non-performing loans in the early 2000s. There was growing political pressure for the disposal of non-performing loans of banks. In June 2001, the Council on Economic and Fiscal Policy, under the Koizumi administration,

suggested that major banks should accelerate the removal of non-performing loans from their balance sheets, in the belief that the disposal of non-performing loans would help reallocate resources away from inefficient industries to more promising ones (Council on Economic and Fiscal Policy 2001).

In October 2002, the government adopted the Financial Revitalization Program, which aimed at the reduction of the ratio of non-performing loans to the total loans of major banks to half the current level by the end of March 2005 through stricter assessment of assets, and the restructuring of both financial and industrial sectors with the help of a new body, the Industrial Revitalization Corporation of Japan (IRCJ) (Financial Services Agency 2002). The Financial Revitalization Program forced major banks to assess the creditworthiness of borrowers with stricter criteria, where the borrowers with debts greater than ten times the annual cash flow of the business were judged insolvent. Major banks increased their capital base through the issuance of preferred shares, and segregated the loans to problematic borrowers to their subsidiary companies for corporate revitalization, in preparation for further disposal of non-performing loans from their balance sheets.[19] From the end of March 2003 on, the ratio of non-performing loans to total credit of major banks steadily declined.

Table 7.1 shows the outstanding amount of non-performing loans disclosed under the Financial Reconstruction Law and its ratio to total credit, for major banks and regional banks, between the end of March 2002 and the end of March 2005. The ratio of non-performing loans to total loans for major banks declined from 8.42 percent at the end of March 2002 to 4.65 percent at the end of September 2004, and to 2.93 percent at the end of March 2005. The Minister of Financial Services stated that "the goal of the 'Financial Revival Program,' i.e. 'to normalize the NPLs problems in FY2004 by reducing major banks' NPL ratio to about half of the ratio as of March 2002 (8.4 percent),' has thus been achieved."[20] The ratio of non-performing loans to total loans of regional banks declined from 8.01 percent to 5.55 percent in the same period, at a slower rate than that of major banks, as shown in Table 7.1.

The disposal of non-performing loans at different paces between major banks and regional banks shows the different features between the loans to large firms and those to small-to-medium firms. The Financial Revitalization Program suggested the restructuring of heavily indebted firms in different ways for large firms and small and medium-sized firms. The IRCJ was established in April 2003 as a fully-owned subsidiary of the DIC, with the aim to facilitate the restructuring of heavily indebted large firms. The IRCJ was designed to facilitate the restructuring of large firms by purchasing the loan assets held by the non-main banks (that is, banks other than the main financing bank) at their market value. There was often disagreement among creditors over debt forgiveness in the process of corporate restructuring. The IRCJ was expected to mitigate conflicts among creditor banks, facilitating the procedures for private liquidation. In fact, as shown in the restructuring of the Daiei Group, one of the largest retailers in Japan, there was disagreement between the main-financing banks and the indebted firm over the reorganization plan proposed by the IRCJ. Eventually, the

Table 7.1 Non-performing loans disclosed under the Financial Reconstruction Law

Half-year ending	*Major banks*		*Regional banks*	
	NPLs (million yen)	*NPLs/total credit (%)*	*NPLs (million yen)*	*NPLs/total credit (%)*
March 2002	26,801,700	8.42	14,822,000	8.01
September 2002	23,948,000	8.09	15,002,000	8.26
March 2003	20,244,000	7.23	14,660,000	7.83
September 2003	17,458,000	6.45	13,893,000	7.51
March 2004	13,616,000	5.18	12,792,000	6.87
September 2004	12,073,000	4.65	11,573,000	6.30
March 2005	7,410,000	2.93	10,367,000	5.55

Source: The data at the end of March and September of each year from 2002 through 2005 are based on "Status of non-performing loans (NPLs) based on the Financial Reconstruction Law" for financial institutions in the categories of major banks (composed of City Banks, Long-Term Credit Banks, and Trust and Banking) and regional banks, released on the website of the Financial Services Agency (www.fsa.go.jp/en/regulated/ npl.html).

Notes
The outstanding amount of non-performing loans is calculated as the total of three categories disclosed: (1) bankrupt or de facto bankrupt loans; (2) doubtful loans; (3) loans in need of special attention. As of the end of March 2005, "major banks" indicate the following eleven institutions: Mizuho Bank; Mizuho Corporate Bank; Mizuho Trust & Banking; Tokyo Mitsubishi Bank; Mitsubishi Trust & Banking; UFJ Bank; UFJ Trust & Banking; Mitsui Sumitomo Bank; Resona Bank; Chuo Mitsui Trust & Banking; and Sumitomo Trust & Banking.

Daiei Group was urged to apply for the financial assistance to the IRCJ and accept the reorganization plan including the replacement of management, the downsizing of employee numbers and the closure of unprofitable stores, under the pressure of the main-financing banks.[21] The restructuring of indebted large firms mediated by the IRCJ facilitated the disposal of unprofitable business and reduced the losses of creditor banks.[22] However, the corporate restructuring along those lines was not applicable to the restructuring of small and medium-sized firms with lower creditworthiness.

The FSA suggested the restructuring of small and medium-sized firms with the help of the functions of Relationship Banking, as a solution to the non-performing loan problem facing the small and medium-sized and regional financial institutions (Financial Services Agency 2003). Relationship Banking is defined as the way of lending, based on a long-run relationship between lenders and borrowers and shared information on the quality of management and future prospects of debtors. The regional financial institutions were expected to contribute to better management of debtor companies by providing the guidance to improved management practices and through closer monitoring of their creditworthiness. The FSA required financial institutions to keep a close relationship with debtors by reinforcing the function of management consultation, and to take particular consideration of qualitative information on the creditworthiness of debtors. Meanwhile, the FSA required the small and medium-sized and regional financial institutions to more strictly assess the quality of loan assets, and urged them to promptly remove non-performing loans from the balance sheet. The Relationship Banking initiative has failed to provide a solution to revitalize local economies, which had suffered from the deteriorating business confidence following the economic globalization. The contribution of regional financial institutions to the improved management of debtor companies was quite limited due to specific circumstances of local economies.

Conclusion

The successive attempts of the financial authorities to keep pace with financial globalization and their impact on the behavior of economic agents are the key to understanding the causes and consequences of the Japanese financial crisis in the late 1990s. Under the pressure from the US on Japan to open its financial markets, the Japanese financial authorities were forced to further deregulate the capital market at home and abroad since 1984, leading to further decline in the dependence of non-financial large corporations on bank debt and the concomitant deterioration of bank assets (second section). Following the successive failures of credit cooperatives and housing loan companies in 1994–95, the Deposit Insurance Law was revised in 1996 to establish the basic scheme for dealing with failed financial institutions (third section). The commitment by the financial authorities to abandon the “convoy system” of regulation under the Financial Big Bang initiative forced the ailing financial institutions including major ones to leave the market. The successive failures of large financial institutions opened

the way for the reorganization of the financial sector (fourth section). The comprehensive financial deregulation facilitated the reorganization of major financial institutions into mega financial groups and the shakeout of small and medium-sized ones. Such reorganization of the financial sector exposed the limited capacity of financial institutions to improve the management of debtor companies and to revitalize the local economies affected by the globalization of corporate activity (fifth section).

Notes

1 For the political background underlying the "Japan–US Yen–Dollar Committee," see Frankel (1984), pp. 1–4.
2 The system of shelf registration permits eligible companies to issue their securities at any time within a period of one or two years after filing supplements to their securities registration statements for specifying the conditions of issuance. The eligibility of corporations for shelf registration includes their listing on the Japanese stock exchanges, continuous disclosure of their financial condition, a certain level of their credit rating, sufficient trading volume and market capitalization of their shares.
3 The rise in the ratio of the index of total market value of stocks to that of nominal GDP in 1998–99 and 2002–03 was due to the appreciating market value of stocks combined with the decrease in nominal GDP, which was an expression of the deflationary pressure facing the Japanese economy.
4 According to the monthly data of the "government bond futures listed yield on Tokyo Stock Exchange (ten years)" released by the Bank of Japan (www.boj.or.jp/stat/stat_f.htm), the yield rose from 5.05 percent in July 1989 to the latest peak of 8.36 percent in September 1990.
5 In the early 1970s, private financial institutions and cooperative-type financial institutions jointly established the eight housing loan companies as entities specialized in housing loans for individuals, which are referred to as *Jusen* companies. Until the early 1980s, they performed well in the area of personal housing loans. However, since the mid-1980s, most private financial institutions including the founder of *Jusen* companies had turned to retail banking, including housing loans for individuals, against the background of declining dependence of large firms on bank debts. This forced *Jusen* companies to turn to business other than housing loans, such as loans to real estate firms. The collapse of land and stock prices from the early 1990s rendered the loan assets held by *Jusen* companies irrecoverable.
6 In Japan, the Anti-monopoly Law (enacted in 1947) had prohibited the establishment of holding companies. On June 11, 1996, almost one year before the announcement of the Financial Big Bang initiative, the law was amended to lift the ban on holding companies.
7 In November 1998, financial assistance of 1,794,700 million yen was extended out of the Special Operations Fund (public funds) to the relieving financial institutions (Hokuyo Bank and Chuo Trust Bank) that assumed the assets and liabilities of the failed bank (Hokkaido Takushoku Bank).
8 The ten city banks, Daiichi-Kangyo Bank, Sakura Bank, Fuji Bank, Bank of Tokyo-Mitsubishi, Asahi Bank, Sanwa Bank, Sumitomo Bank, Daiwa Bank, Tokai Bank and the Hokkaido-Takushoku Bank (as of November 1997), had head offices in major cities and a nationwide network of branches.
9 In the 1950s, three long-term credit banks (Industrial Bank of Japan, Long Term Credit Bank of Japan, Japan Real Estate Bank (renamed Nippon Credit Bank in 1977)) were established to promote the development of capital-intensive heavy industries. Long-term credit banks were granted a privilege to issue bank debentures for

fund raising. After the high growth era of the Japanese economy (from 1955 to 1973), large firms in the manufacturing sector became less dependent on bank borrowing following deregulation of the capital market (as shown in the second section). Under such structural change in a domestic loan market, those long-term credit banks turned to loans to real estate firms, instead of large firms in the manufacturing sector, which had been good clients.

10 Following the enactment of the Financial Reconstruction Law, the Financial Stabilization Law (enacted in February 1998) and the Financial Crisis Management Account in the DIC were abolished, with the Financial Crisis Management Fund of three trillion yen retuned to the government.

11 Following the revision of the Deposit Insurance Law in October 1998, the RCB and the Housing Loan Administration Corporation (established in June 1996) were merged to establish the Resolution and Collection Corporation (RCC) in April 1999.

12 Under the Financial Reconstruction Law, the Exceptional Financial Assistance was defined as the financial assistance that the DIC was allowed to extend in excess of the estimated costs required to make deposit insurance payments to the financial institutions placed under temporary government control.

13 Under the contract on the liability for defects, the renewed LTCB could cancel the sell-off of loan assets and the DIC should pay back to the renewed bank the amount of their initial book value, in case of defects being detected. For details, see "Outline of the Basic Agreement for Acquisition of LTCB," released by the Financial Reconstruction Commission on December 24, 1999 (www.fsa.go.jp/frc/newse/ne014a.html).

14 Stock Price Evaluation Commission, "Nihon-Saiken-Shinyo-Ginko ni kakaru Kabuka-Santei no Gaiyo" (On the price of the acquired shares relating to Nippon Credit Bank, in Japanese), released on June 14, 1999 (www.fsa.go.jp/frc/news/036.pdf).

15 In January 2006, the Aozora Bank decided to make an application for conversion from a long-term credit bank to an ordinary commercial bank on April 1, 2006 (www.aozorabank.co.jp/en/company/newsrelease/2006/article/06012001_n.pdf).

16 UFG Holdings was a bank holding company (established in January 2001), which held the UFJ Bank (created in January 2002 by the merger of Sanwa Bank and Tokai Bank) and UFJ Trust and Banking (renamed in January 2002 from the Toyo Trust and Banking Corporation). The Mitsubishi Tokyo Financial Group (MTFG) was a bank holding company (established in April 2001), which held the Bank of Tokyo-Mitsubishi (BTM) and the Mitsubishi Trust and Banking Corporation. In October 2005, the MTFG and UFJ Holdings were merged into the Mitsubishi UFJ Financial Holdings (MUFG), which held the Bank of Tokyo-Mitsubishi UFJ (created in January 2006 from the merger of the BTM and the UFJ Bank) and the Mitsubishi UFJ Trust and Banking Corporation (created in October 2005 by the merger of the Mitsubishi Trust and Banking Corporation and the UFJ Trust and Banking Corporation). The Sumitomo Mitsui Financial Group (SMFG) was a bank holding company (established in December 2002), which held the Sumitomo Mitsui Banking Corporation (SMBC), the Sumitomo Mitsui Card Company, the SMBC Leasing and the Japan Research Institute. Resona Holdings was a bank holding company (established in March 2003), which held the Resona Bank (created in March 2003 by the merger of the Daiwa Bank and the Asahi Bank), and two banks and one trust and banking corporation.

17 A financial conglomerate is defined as "a conglomerate whose primary business is financial and whose regulated entities engage to a significant extent in at least two of the banking, securities and insurance sectors" (The Joint Forum, 1999).

18 DIC (2003). During the same period, the DIC extended the financial assistance of 16,345.9 billion yen in total to deal with 17 cases of failed banks, including Hokkaido Takushoku Bank, the LTCB, and the NCB.

19 For example, on February 6, 2003, Mizuho Holdings announced the issuance of pre-

ferred shares of 650 billion yen by allocation to third parties (namely, customers of Mizuho Bank and Mizuho Corporate Bank), and on February 25, 2003, the issuance of preferred shares of 150 billion yen by allocation to overseas investors. For details, see the press release by Mizuho Holdings (www.mizuho-fg.co.jp/english/release/2003/index.html). On May 23, 2003, three banks within the Mizuho Financial Group established the financial subsidiaries specializing in corporate revitalization. The same group segregated 4.6 trillion yen of loans (to approximately 1,000 companies) and stocks to those financial subsidiaries. For more details, see the press release "Corporate Revitalization Project initiated by the Mizuho Financial Group," May 14, 2003 (www.mizuho-fg.co.jp/english/release/2003/index.html).

20 "Statement by the Minister for Financial Services: Normalization of the NPLs Problems of Major Banks," released on May 25, 2005 (www.fsa.go.jp/danwa/danwae/20050525–1e.html).

21 On December 28, 2004, the IRCJ approved the application for assistance that had been submitted by The Daiei (one of the largest retailers in Japan) and related group companies (Daiei Group) and their main financing banks, UFJ Bank, Mizuho Corporate Bank and Sumitomo Mitsui Bank, with the revitalization plan for the Daiei Group ("IRCJ Approves Application for Assistance for Daiei Group Companies," released by the IRCJ on December 28, 2004). Then, on March 7, 2005, Advantage Partners (AP) and Marubeni Corporation were selected as the business sponsors of the Daiei Group. Under the new capital structure composed of the business sponsors (AP and Marubeni) and the IRCJ, the Daiei Group companies embarked on the restructuring process aiming to eliminate the following four causes of the group's distressed condition, namely "the strategies of owning its retail locations, insisting on a nation network, diversifying and expanding, and depending unduly on low prices to compete" (ibid., p. 2).

22 The IRCJ had approved applications of 41 companies for assistance, between its establishment in April 2003 and the end of March 2005, when it completed the purchase of loan claims from financial institutions. During the same period, the IRCJ purchased loans totaled 962,041 million yen from financial institutions ("companies currently approved for assistance," released on IRCJ's website: www.ircj.co.jp/english/press/index.html).

References

Bank of Japan (1995) *Waga-Kuni no Kin'yu-Seido* (Financial System of Japan), Tokyo: Nihon Shinyo Chosa.

—— (2000) *Annual Review 2000* (www.boj.or.jp/en/about/00/ar2000.htm).

—— (2003) *Economic and Financial Data on CD-ROM*, Tokyo: Tokiwa Sougo Service.

—— (2005a) "Loans and Discounts Outstanding by Sector (by Type of Major Industries)" (www.boj.or.jp/stat/stat_f.htm).

—— (2005b) "JapanPremium (through December 2004)," (www.boj.or.jp/en/theme/research/stat/stop/premium/index.htm).

Council on Economic and Fiscal Policy (2001) "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" (the English summary of "Basic Policies for Future Economic and Fiscal Management and Structural Reform of Economic Society"), released on 26 June (www.keizai-shimon.go.jp/cabinet/2001/pamphlet-e.pdf).

Deposit Insurance Corporation of Japan (1996–2004) *Annual Report*, Tokyo: Deposit Insurance Corporation of Japan. (The issues since 2000 are available on the website: www.dic.go.jp/english/.)

—— (2003) “Financial assistances under blanket guarantee system,” released on March 6 (www.dic.go.jp/english/e_new/2003/2003.3.26a.pdf).

Economic and Social Research Institute, Cabinet Office (2005) “Annual Report on National Accounts of 2005,” (www.esri.cao.go.jp/en/sna/h17-nenpou/n90a1_en.xls).

Financial Services Agency (2002) “Program for Financial Revival: Revival of the Japanese Economy through Resolving Non-performing Loans Problems of Major Banks,” released on October 30 (www.mofa.go.jp/policy/economy/japan/program0210.html).

—— (2003) “Action program concerning enhancement of relationship banking functions,” released on March 28 (www.fsa.go.jp/news/newse/e20030328–1a.pdf).

Frankel, Jeffrey A. (1984) *The Yen/Dollar Agreement: Liberalizing Japanese Capital Markets*, Washington, DC: Institute for International Economics, Cambridge MA: MIT Press.

Japan Real Estate Institute (2005) “Urban Land Price Index” (www.reinet.or.jp/e/jrei-data/a_shi/im/0505_2.gif).

The Joint Forum (1999) “Intra-group Transactions and Exposures Principles,” Basel Committee on Banking Supervision, International Organization of Securities Commissions and International Association of Insurance Supervisors, Basel (www.bis.org/publ/bcbs62.pdf).

Ministry of Finance (1997) “Financial System Reform: Toward the early Achievement of Reform” (www.mof.go.jp/english/big-bang/ebb32.htm), released on June 13.

Ministry of Finance, Policy Research Institute (2005) *Houjin Kigyou Toukei Chousa* (Financial Statements Statistics of Corporations by Industry), annual data available on the website (www.fabnet2.mof.go.jp/fsc/index.htm).

Tokyo Stock Exchange (2002). *Shoken Tokei Nempo 2002* (Annual Securities Statistics 2002), CD-ROM, Tokyo: Tokyo Stock Exchange.

—— (2005) *Tosho Tokei Geppo* (Monthly Statistics Report), Tokyo: Tokyo Stock Exchange.

8 Globalization and the Malaysian response

Trade-related investment liberalization under the WTO

Rajah Rasiah[1]

Introduction

Capitalist civilization has historically been dominated by the contest for control over markets. Rapid technological change from the Age of the Renaissance facilitated the integration of markets as the instruments of technical change transformed localized individual firms to large scale globalized production and distribution networks – both intra-firm and inter-firm division of labour. The exponential leap in synergies that followed technological breakthroughs helped quicken globalization. Economies endowed with little resources and lacking a clear policy framework to strengthen domestic accumulation have hardly achieved long-term growth. The struggle to dominate markets – both factor and product markets – has seen the replacement of the General Agreement on Tariffs and Trade (GATT), which had interfaced with macroeconomic management under the World Bank and the International Monetary Fund (IMF), with the World Trade Organization (WTO) in 1995.

The GATT was replaced with the World Trade Organization when it became obvious that its instruments were no longer effective but more important were failing to prevent the successful expansion of exports from the fast-growing developing economies. Although the dominant nations have continued to argue that the WTO was inevitable to prevent a collapse in global trade, it is also a fact that several developing economies are merely being absorbed into the new institution without their voices being sufficiently heard. The history of modern economic development shows that the quest to break away from the tentacles of unequal exploitation requires nations to pursue pro-active development policies to stimulate domestic firms' participation in innovative and competitive activities. While the evolutionary processes of learning from technology acquisition and the appropriation of new knowledge form the fulcrum to power competitive advantage, the requisite institutional and systemic environment must be created to initiate and drive this process.

As documented lucidly by Gerschenkron (1962), Kitching (1982), Kaldor (1989), Reinert (2003), Chang (2002) and Malhotra *et al.* (2003) technological development in all developed economies followed an interventionist path where

national governments introduced distortions to quicken learning and innovation. Despite the apparently less successful examples recorded than Korea and Taiwan, Malaysia's investment policy has also been defined selectively to stimulate technological broadening and deepening since the 1990s. Although many of these interventionist policies have been liberalized since 1998, a number of controls – particularly involving services – still exist to protect national interests that are important for development.

This chapter examines the implications of the WTO instruments of TRIMs and GATS for industrial upgrading in Malaysia. This chapter is organized as follows. The next section examines the economic arguments for investment regulations. The following section discusses the multilateral commitments embodied in the TRIMs Agreement and GATS, which restrict the scope of Malaysia's investment policy. The fourth section analyses the implications of these agreements for industrial upgrading in Malaysia. The fifth section finishes with conclusions and policy implications.

Economic arguments for investment regulation

There are three major approaches advocating the introduction of international investment agreements that currently dominate intellectual and policy debate. The first assumes that individual economies should be left with the autonomy to frame their own trade policies, as that would be best suited to address particular country needs especially because of the absence of a link with trade rules that could entail penalties in the form of trade sanctions (Kaldor, 1984; Singh, 1997; Chang, 2003). The second calls for the removal of trade regulations to promote free trade (Bhagwati, 1988). The third assumes that a multilateral framework is better, as it would streamline and rationalize transactions across nations, and enable smaller economies to engage more actively and equally with larger economies (WTO, 1999).

All three approaches face problems. The first is promoted by heterodox economists, but has increasingly run out of space owing to the limits imposed by larger trading nations under global trade organizations such as the WTO. The second is simply bereft of reality as national strategies have evolved in a dynamic framework where successful economies have taken advantage of synergies arising from complementarities and increasing returns to expand exports over the long run in global markets. Despite the promise multilateral frameworks offer, bigger powers generally use dirty lobbying tactics to cultivate asymmetric power relations. The institutionalization of such a framework under the WTO would subject investment policy measures to the dispute settlement mechanism, with the possibility of punitive compensating retaliation when individual members are found not to comply. The asymmetric relationships often entail unequal consequences. The measures meted out to compensate for delinquent trade practice will be far more severe for a smaller economy than for a bigger economy, since the effects of retaliatory compensation will be extremely unequal. Yet, developing economies had attempted to negotiate a multilateral

instrument on investment in the 1970s by calling for a code of conduct within the United Nations to regulate transnational corporations to shield them from their harmful practices such as predatory monopolistic conduct on pricing and development, as well as the unnecessary inflation of incentives. Some developing countries have indicated that they could support an MFI if such obligations on host countries and their investors were included.

Whilst the globe is increasingly facing liberalization there are powerful reasons to argue for industrial policy (IP) to drive learning, innovation and competitiveness in especially latecomer economies so that the role of government policy is allowed to go beyond the provision of basic infrastructure (e.g. primary schooling, health and sanitation, roads and telecommunications and basic utilities). Industrial policy and national innovation system (NIS) exponents are quick to emphasize the public good characteristics of high-tech infrastructure such as R&D, training and ICT and hence contend that government support is necessary to stimulate learning and innovation. Institutions associated with human resource development and R&D often face collective action problems. Private agents are unlikely to participate in market-driven activities when the risks involved are not matched by the returns. Schumpeter (1934), Abramovitz (1956), Kaldor (1957) and Arrow (1962) had argued that interventions in markets are necessary to stimulate participation in welfare enhancing public good activities.[2] Training and R&D institutions involve considerable acquisition and diffusion of knowledge, which is a public good in that its consumption by one does not exclude that by others. Hence, knowledge-appropriating institutions such as universities, R&D labs and technical schools come under the category of public goods. It is acknowledged that strong government support initiated technological progress in the Western economies and Japan (see Gerschenkron, 1962; Kaldor, 1967; Johnson, 1982; Chang, 1994; Chang, 2002). Rodrik (2001) and Malhotra *et al.* (2003) compiled convincing evidence to argue that macroeconomic stability and human development rather than liberalization have been the basis of rapid economic growth across the world.[3] Importantly, as noted earlier, the environment deemed conducive to attract strong private investment in increasing returns activities require strong support from the government.

Although some costly experiments have produced a negative image for industrial policy (e.g. India and Indonesia), it is widely acknowledged to have anchored the expansion of the successful industrializers, e.g. the United Kingdom (Reinert, 2003),[4] the United States (Hamilton, 1791; Gerschenkron, 1962), Germany (List, 1885; Geschenkron, 1962; Kaldor, 1967), France, Japan (Johnson, 1982), Korea (Amsden, 1989) and Taiwan (Wade, 1990; Amden, 2001; Lall, 2001).[5] Restrictionist practices were an integral part of discriminatory policies pursued by these economies to catch up and leapfrog over their competitors. Nevertheless, industrial policy is not just characterized by the adoption of protectionist policies, it is more about fostering capability development in infants to become global competitors (Kaldor, 1957; Kalecki, 1976; Lewis, 1955; Myrdal, 1957; Palma, 2003; Katz, 1987). Protection has just been a fiscal

instrument, which was often used selectively, sparingly and sequentially – in addition to the core instrument of building a dynamic national innovation system – so that it fitted the overall plan of building technologically competitive industries. Global developments – especially the World Trade Organization (WTO) agreements – have effectively required the removal of non-tariff barriers and eventually tariff barriers and hence reduced the extent to which developing economies can use tariff and non-tariff measures and ownership conditions as policy instruments.

The consequences of legally agreeing to common multilateral rules governing investment measures will also be particularly severe for developing economies owing to the dynamics of government intervention, which varies as economies develop. A poor economy may attract investment with broader developmental considerations at the bottom of the development trajectory when few local firms exist to compete. As infant firms evolve governments may seek to introduce selective instruments to shield infant firms from being crowded out by foreign firms, or may prefer to stimulate upgrading and structural connections to promote differentiation and division of labour by targeting incentives to related industries. At a later phase governments may target incentives to promote R&D more openly without any targeting. Succumbing to a formal one-size-fits-all agreement would deny developing economies the flexibility to change investment regulations in the interest of promoting upgrading.

The two WTO instruments examined here address these issues. TRIMs prohibits both local content requirements for goods and trade balancing obligations, including those affected through foreign exchange restrictions. Although no direct ownership implications are involved, the TRIMs agreement has ramifications for investment policies targeted at stimulating domestic upgrading. Empirical work on investment measures – e.g. import quotas and bans and local content requirements – are mixed. Arguments against investment measures point to the distortions such measures create, which provide oligopolistic rents to the beneficiaries at the expense of consumer welfare (WTO, 1999; Moran, 2002; Reddy, 2003). Arguments in support of investment measures make the point that some amount of protection is necessary to stimulate potentially viable and essential industries that offer economies strong backward linkages (Lewis, 1955; Kaldor, 1967; Chang, 1994). The latter is also consistent with new growth exponents who make the point that free trade is not the welfare-optimizing alternative in the presence of dynamic and increasing returns (Romer, 1986; Lucas, 1988). Although there is extensive evidence of investment measures that have arguably drained developing economies of their resources, no country actually developed its heavy industry initially without investment measures (see Chang, 2002). Chang and Green (2003) and Chang (2003) in fact quote extensive historical evidence to show how various so-called distorting measures were adopted by the developed economies to stimulate the growth of industry, which they tell developing economies now not to follow.

The GATS agreement has already undergone considerable negotiations but despite disputes over its implementation, it is already being implemented by a

number of economies. GATS has direct implications for investment, as restrictions on foreign ownership are defined as barriers to trade in services, which along with limitations on national treatment are the subject of multilateral commitments. Meanwhile a multilateral framework on investment is still being courted by several nations – the Doha and Cancun Meetings being the major platforms where serious discussion on the matter took place. Although the MFI received a serious blow at the Cancun Meeting in 2003, because the issue has returned again and again, this chapter seeks to re-examine it using Malaysia as a case of liberalization initiatives.

There is convincing evidence that regulation of ownership conditions cannot simply be viewed to be inversely correlated with technological capability building. There is little evidence to suggest that foreign firms will relocate substantial innovation-related activities in developing economies even in economies considered to offer equal treatment to local and foreign firms. The OECD (1998) noted that even among OECD economies, the share of R&D undertaken by multinationals outside their home base averaged no more than 12 per cent of their total R&D expenditure: the share being higher for European economies, about the average for the United States and around 2 per cent for Japan (see also Amsden *et al.*, 2001). The OECD report also reported that where subsidiaries undertake R&D more often than not the subsidiary originated as an acquisition.

The evidence is clear that much of the learning from foreign direct investment (FDI) that has benefited host economies has come from knowledge of operational activities and training of human resource and modifications and adaptations of plant and equipment (Hughes and You, 1969; Lall, 1978). The latest features of FDI-related learning in developing economies include the absorption of cutting-edge inventory and quality control systems – through both intra- and inter-industry diffusion (see Rasiah, 1994, 1995, 2003a, b). The diffusion of such knowledge has been stronger in regions where the embedding national innovation system is equipped to ease absorption. Hence, developing economies should not specifically target foreign firms to undertake R&D activities. Singapore, Ireland and Israel are exceptions that have managed to promote a shift from confinement of R&D activities to only production-related activities to applied R&D activities, but not only interventionist policies were instrumental in effecting the change, these countries remain outliers when compared with the poorer economies.

Although several aspects of technological capability building in firms (e.g. acquisition of patented technologies for in-house use, organizational and process technologies, human capital and marketing and customer service know-how) remain outside global governance instruments, the removal of controls on goods and services by governments will deny developing economies the capacity to coordinate actively the development of national firms when the developed economies had already raised and seen to maturity their national firms. Herein lies a major problem – what TRIMs and GATS-consistent alternatives, if any, do developing economies have? – to support the development of investment targeted to stimulate domestic upgrading, whether under foreign or local owner-

ship. TRIMs do not concern themselves with local equity conditions, while GATS does but only when countries obligate themselves. Malhotra *et al.* (2003) produced an interesting work that argues convincingly that many countries have achieved economic development on the basis of macroeconomic stability and human development, rather than trade liberalization.

Chang (2003) compiled an impressive account of historical evidence from the successful industrializers, the United States, the United Kingdom, France, Germany, Finland, Ireland, Japan, Korea and Taiwan, to show discriminatory FDI regulations to promote domestic accumulation. Even in the leading innovation-driven economy (measured by the number of new products innovated), i.e. the United States, its National Research Council still advocates strong government support for R&D activities (see Wessner, 2003). Even the FDI-friendly economies of Singapore and Ireland used leveraging strategies to govern industrial upgrading (see Mytelka and Rasiah, 2003). Similar experiences albeit limited to specific industries and regions can be observed in Brazil (see Rasiah, 2003). What is clear about successful industrial policy is that it has anchored technological capability building for economies to compete historically. Protection was only an instrument used to shield firms in their infantile period until they reached maturity. Welfare and distributive instruments have also been used to coordinate the provision of public goods, utilities and basic necessities with important distributive consequences. Liberalization that calls for the removal of national treatment obviously opens developing economies vulnerable to foreign interests who may not share the same welfaristic goals and paths. The financial turmoil that gripped East Asia following the deregulation of currency and capital markets is just one example in point (see Krugman, 1999).

Trade-related investment regulations

The Working Group on Trade and Investment set up at the 1996 Singapore Ministerial Conference was instructed to clarify the scope and definition of the issues of transparency, non-discrimination, preparation of negotiated commitments, development of provisions, exceptions, balance of payments safeguards, consultation and dispute settlement (WTO, 2003: 14). This work continued up to the Doha Conference, where the decision was taken to commence negotiations at the fifth Ministerial Meeting. The negotiated commitments were to be modelled in line with the framework for services.

In addition to the obligations and commitments in the TRIM as and GATS Agreements, the Agreement on Subsidies and Countervailing Measures also provides controls on investment policy. As discussed below, incentives (such as tax breaks) based on export performance are prohibited, although export performance requirements are not prohibited under the TRIMs Agreement. Specific subsidies targeted at selected industries are actionable, i.e. potentially subject to countervailing action if found to injure industries in other countries) but not prohibited. Subsidies that are generally available subject to objective criteria are non-actionable. Governments can offer subsidies on a general level to R&D,

training and SMEs without specifically tying them to exports, and particular industries and regions.

The General Agreement on Trade in Services (GATS) requires governments to undertake negotiations on specific issues and to enter into successive rounds of negotiations to progressively liberalize trade in services (WTO, 2003: 5). Negotiations were started officially in early 2000 under the Council for Trade in Services. The Services Council fulfilled a key element in the negotiating mandate by establishing the guidelines and procedures in 2001. The Doha Declaration endorses the work already done, reaffirms the negotiating guidelines and procedures, and establishes some key elements of the timetable including, most important, the deadline for the conclusion of the negotiations as part of a single undertaking by 1 January 2005.

Most countries consider that any future Multilateral Framework of Investment (MFI) may be defined along the lines of GATS. Work is currently focusing on modalities of negotiations (Malhotra *et al.*, 2003). Although the Doha declaration spelled out a number of issues (e.g. the interests of members affected by foreign investment inflows and outflows, their right to regulate foreign investment, taking account of the level of development of public interest and specific circumstances, and the special support offered to least developed countries), there is still no consensus on a fair MFI. Hence, this chapter avoids discussion on this topic. Owing to the dominance of the developed economies in production and innovation involving services, the further liberalization of services could seriously aggravate balance of payment problems and undermine national preferences. The East Asian financial crisis is a good reminder of what the liberalization of currency and capital markets can do to some of the most dynamic economies. The claim of poor corporate governance practices as the basis of the crisis was convincingly dismissed by Doraisami's (2004) statistical analysis, vindicating Stiglietz's (1998) argument that even the best steered small boats can capsize when hit by strong waves.

The Malaysian experience

Although the extent of controls used has been much less than what has been observed even in the developed economies during their expansionary phase, Malaysia has used investment regulations to promote national interests and as well as those conditional on exports. This section examines some critical instruments related to TRIMs and GATS in Malaysia.

The TRIMs Agreement

As of December 2004 Malaysia had not become a signatory of the TRIMs Agreement. This section examines the instruments that would have been affected had Malaysia acceded to this agreement. Three major instruments of Malaysian industrial policy relate to the TRIMs Agreement. The first involve ownership conditions on the basis of export shares: local ownership require-

ments rise with domestic sales. The second deal with the local content policy introduced in automobile assembly. The third relate to local sourcing requirements (value added plus local purchases) in export-oriented manufacturing to access financial incentives that were in place from 1991 but abandoned following the 1997 financial crisis.

Trade-related ownership conditions

National ownership conditions in Malaysia became explicit following the promulgation of the Industrial Coordination Act in 1975, which sought to regulate investment by ethnicity and by the criterion of foreign/local – but only on new investment and when the capital involved exceeded RM250,000 paid-up capital and the employment of over 25 initially. These figures rose subsequently to eventually reach RM2.5million and 75 employees in 1986, and eventually the employee criterion was dropped. Firms producing for the export market – with exports of a minimum 80 per cent – did not face any control on ownership regulation, which was initially introduced in 1975 and subsequently restated in the 1986 Promotion of Investment Act.

Given that export-oriented foreign firms generally bypassed national ownership regulations under the Industrial Coordination Act, investment trends in related industries such as electronics and textiles and garments were influenced more by external events. Textiles and garments attracted strong foreign investment until the late 1980s, but tightening regulations under the Multi Fibre Agreement (MFA) and rising relative production costs in Malaysia reduced investment inflows in the industry. Electronics investment was influenced strongly by external business swings, with a significant fall experienced during cyclical downswings in the late 1970s, mid-1980s and late 1990s. Also, the growth in significance of other economies – especially China – has been instrumental in slicing away FDI inflows in both industries. Inward-oriented industries generally faced scrutiny from ownership conditions and consequently local ownership dominated in steel, cement and transport equipment. It can be argued that the selective imposition of ownership controls on the basis of trade orientation hardly affected the overall inflow of FDI into Malaysia.

Following the financial crisis of 1997–98, the government abandoned its regulations to target incentives for strategic and technologically advanced industries that were introduced in 1991 following the adoption of the Action Plan for Industrial Technology Development (APITD). Hence, foreign investment enjoyed access to financial incentives irrespective of industrial specification from the late 1990s. Hence, equity ownership regulations were made liberal from 31 July 1998 (MIDA, 2004), but with the exception of paper packaging, plastic packaging, plastic injection-moulded components, metal stamping and metal fabrication, wire harness, printing and steel service centres. Given that the TRIMs agreement is not concerned with ownership controls unrelated to trade, these conditions are not expected to attract complaints from other WTO members.

The Malaysian government has retained several incentives to stimulate investment, upgrading and exports in prioritized areas. Special incentives are targeted at manufacturing, agriculture, tourism, shipping and transport, and services (MIDA, 2004). Other incentives include specifically defined instruments for environmental protection, promotion of R&D, training, the use of information communication technology, the multi-media super-corridor, inducements to start or relocate operational headquarters, regional distribution centres, international procurement centres, and general incentives. Most of these incentives violate neither the subsidies agreement nor the TRIMs Agreement. Whereas the promotion of SMEs, training, R&D and exports without sectoral emphasis is unlikely to face problems, incentives to promote upgrading in specially defined industries such as automotive components and specialized machinery and equipment may attract complaints in future. Yet, these instruments are important for the maturization of Malaysia's automotive component and capital goods industries.

A number of the incentives stated above played important roles in boosting the relocation of foreign firms in export-oriented manufacturing. The Malaysian government offered Pioneer Status and Investment Tax Allowance (previously known as Investment Tax Credit) to firms locating in export processing zones – Free Trade Zones (renamed Free Industrial Zones in the 1990s) and Licensed Manufacturing Warehouses. Firms with a large investment and employment levels but exporting 80 per cent or more of their sales qualified for such incentives, which are believed to have been instrumental in attracting the first large wave of FDI in the early 1970s (see Rasiah, 1995: chapter 5). The employment conditions were removed in the 1990s when serious labour shortages gripped the western industrial corridor of peninsular Malaysia. The focus on incentives shifted to high-tech and strategic industries from the early 1990s, until 1998 when FDI levels in GFCF declined considerably. These incentives were also given from 1991 until the late 1990s to exporting firms that showed local sourcing amounting to 50 per cent of inputs purchased (inclusive of percentage value added).

Exporting firms have also been offered double deduction on expenses and preferential warehousing and credit refinancing benefits since the Promotion of Investment Act of 1986 (see 1995: chapter 4). Apart from local sourcing conditions, which do not apply any more in industrial products other than transport equipment, the tax allowance conditions do not violate the current TRIMs Agreement. These instruments nevertheless show the government preference to introduce particular incentives to guide investment differently as economies develop.

Local content requirement

As with most industrializing economies that pursued import substitution policies, Malaysia has a local content policy to stimulate localization of the automobile industry. There were other local content instruments in Malaysia earlier,

but they were generally removed following efforts to deregulate the economy since 1986. The use of the local content policy became stronger following the opening of local-foreign joint-venture car assemblies with strong local control. Proton was the first national car company launched and the first cars rolled out in 1985, followed by Perodua in 1995. Although Mitsubishi was the main partner, Proton has had deals with Renault and acquired Lotus in the mid-1990s. Perodua has a joint-venture partnership with Daihatsu.

Malaysia introduced import restrictions on both completely built up (CBU) and completely knocked down (CKD) – tariffs and quotas to limit imports of foreign cars. Local content stipulations, which obviously violate the TRIMs agreement, are scheduled to be phased out in 2005, after Malaysia obtained a delay from AFTA members, as well as from the WTO. Affected parties – Thailand in particular – have voiced concern over the local content policy involving automobiles, but the Malaysian government managed to defer its phasing out until 2005. Malaysia has agreed to lower tariffs on automobiles under the AFTA agreement to 20 per cent on 1 January 2005, and subsequently reducing it by 5 per cent annually until it reaches 5 per cent in 2008. Although sales taxes are expected to hold tax revenues to pre-liberalization levels, the creation of a more level playing field is expected cause imports to cut sharply into Malaysia's car market. Sales taxes and environmental taxes – so long as they respect the national treatment obligation– are allowed. Also, subsidies – e.g. through preferential rates – are allowed for R&D, training and on the basis of size categories so long as they are not defined on the basis of sector and region.

Whilst considerable deregulation of the automotive sector has been under way under the AFTA programme, the Minister of MITI has insisted that the government of Malaysia will not scrap the use of Approval Permits (APs), which requires that all car imports can be handled only by authorized *Bumiputera* firms. Although in principle this instrument should not contravene the TRIMs agreement, in practice the authorized dealers remain subjected to government regulation of car imports. Despite the lack of evidence of Malaysia's initiatives to develop an efficient car industry (see Jomo *et al.*, 2003), the use of local content and preferences for the domestic producer was a critical driver of automobile assembly in all economies. China has also benefited considerably from the diffusion of foreign technology, but like Korea preferential policies were central to the development of its domestic firms. The significance of scale in car manufacturing has made this option unavoidable. If domestic car assemblers are to be supported further preferential policies will remain unavoidable although the government must re-examine the performance of domestic producers in the country where high tariffs and subsidies have been a serious burden on domestic consumers.

GATS

Malaysia's offer under the General Agreement on Trade in Services (GATS) in 2003 is shown in Appendix 8.1. It can be seen that Malaysia's commitments to

GATS maintain a high degree of policy space for discretion on the part of the government to impose national preferences on foreign investors. In its horizontal commitments Malaysia has scheduled the requirement that foreign investors seek approval for any acquisition of assets or interest that will result in ownership/control of Malaysian companies. The approval may be denied in cases of conflict with the interest of the state. Malaysia also included a series of limitations in National Treatment on land ownership, incentives and government procurement. Malaysia has thus maintained a large degree of freedom to use investment measures to pursue human development goals.

Malaysia made Mode 3 commitments in Business Services, Telecommunications, Construction, Financial, Health, Tourism and Recreational, Cultural and Sporting Services. Distribution, Education, Environmental Services and Transport (except for a very limited liberalization in Maritime Transport) were not included. With the exception of Professional and Recreational Services, all are subject to joint-venture requirements/foreign equity ceilings of up to 30 per cent, therefore subject to limitations in the form of establishment and ownership/control limitations. For Professional Services and Recreational Services only natural persons can provide the service. In the Financial and Health Sector, this limited form of foreign participation is conditional on an Economic Need test (under specific criteria). Furthermore, Malaysia maintained unbound the granting of new licences in the Telecommunications, Insurance and Banking sectors.

Under the National Treatment on Sectoral Commitments, apart from the Horizontal restrictions already mentioned, Malaysia did not include further restrictions, and scheduled simply ‘none’, except in the following sectors:

1 Local content of 80 per cent in Advertising services.
2 In the Financial sector:
   a Limitations on branching for local companies exceeding a threshold of foreign equity stake.
   b Exemptions in national treatment in terms of subsidies and incentives.

It is difficult to assess the impact of GATS so far on upgrading in Malaysia, since whatever minimal deregulation on ownership has taken place has been fairly new. Nevertheless, regulations imposed to govern sectors deregulated are expected to retain the government’s control of key service sectors in the interest of the nation. Malaysia has a blanket MFN exemption for policies limiting foreign equity and interests to permit differentiation in favour of those companies that match Malaysia’s ‘specific development requirements’, with the objective of maximizing the economic benefits of foreign participation in the Malaysian economy. At the sectoral level local content requirements on advertising services are waived for ASEAN countries.

In summary, there is no clear foreign equity ceiling at the horizontal level. However, the government retains discretion for approval for acquisition of stakes in local companies, Moreover, the sectors where acquisitions are allowed

are subject to strict foreign equity ceilings, while the rest are simply not scheduled. In effect, Malaysia has the freedom to impose control limitations across the schedule. In Telecoms and Financial Services, limitations on the number of market agents are strict (unbound for new licences), as well as Economic Need tests on the latter. While national treatment is normally granted at the sectoral level, it is subject to exceptions for subsidies, *Bumiputera* policies and government procurement included in the horizontal commitments.

As with most economies, regulation of ownership in the services sector was strong in Malaysia since the end of the 1960s, but particularly since the introduction of the New Economic Policy (NEP) in 1971. However, it can be argued that the level was still low compared with the record of even developed economies during their expansionary phase. In addition, there were still interventionist measures applied to achieve greater equality as between ethnic groups. Many of these constraints have been liberalized since the mid-1980s. However, as indicated above, the government has retained a very large policy space, which it can exploit if considered necessary.

Implications of investment regulations for upgrading

Investment regulations bring different implications depending on the motive behind their introduction. The room for implementing import substitution-style protection is no longer available under the WTO. Nevertheless, the continued use of investment measures and regulation of services has provided the Malaysian government room for engendering upgrading. Although government intervention can cause severe economic inefficiencies if ill coordinated, latecomers such as Malaysia do require control over critical economic activities to quicken learning and innovation in firms. Efforts to stimulate local capability building will involve efforts to shield local firms and hence controls on foreign capital in selected sectors have often characterized government policy – especially with consequent participation of local firms in R&D activities.

Whilst there are arguments that regulatory controls will undermine Malaysia's ability to attract FDI, the evidence suggests otherwise. FDI levels – both net and gross as a proportion of GDP – rose significantly in the first half of the 1970s and the second half of the 1980s and early 1990s when regulatory controls on trade orientation were in place (see Figure 8.1). The share of net FDI in Gross Fixed Capital Formation (GFCF) and gross FDI in GDP in Malaysia reached its peak in 1992 before declining quite severely since. It recovered marginally before falling again following the financial crisis in 1997–98 (see Figure 8.1). The share of net FDI in GFCF, and gross FDI in GDP, 2000 was obviously close to its historic low since 1970. Unlike the late 1980s and early 1990s when the Endaka effect from the Plaza Accord of 1985 and the withdrawal of the Generalized System of Preferences (GSP) from the East Asian NIEs in February 1988 triggered a massive relocation of FDI to Southeast Asia and China, the trends of net FDI in GFCF and gross FDI in GDP this time seem destined to remain low unless there is s successful attempt to resolve growing skill deficits –

through domestic capacity development and immigration. This will be a tall order, given similar efforts by China. Under the circumstances unless Malaysia orientates its FDI policy alongside a proactive policy to raise human capital levels in the country in relation to quickening technical change and upgrading it will be difficult prevent the current slide in foreign direct investment in the country.

Malaysia has obviously targeted some industries for development, which should not infringe WTO obligations so long as the provision of tax exemptions or subsidies does not cause injury in export markets owing to the preferential treatment accorded. Injured parties may seek redress using the dispute mechanism if this occurs. Given the importance the Malaysian government attaches to technology development as the vehicle for achieving developed status by 2020, the economic rationale supporting subsidies and other forms of government intervention to spur innovative activities,[6] the Doha negotiations should address these points.

The application of TRIMs-related liberalization through the AFTA deregulation process – which is to take effect in 2005–08 – has already raised concern among local brand manufacturers and policy makers in Malaysia. Removing local content regulations involving automobiles may initially aggravate balance of payment problems, even if the government keeps the overall tax at the same rate – substituting tariffs that differentiate value added recorded in Malaysia with a sales or value added tax. The sale of cars in Malaysia would not be expected to rise too much given the same level of tax incidence but the composition of cars sold in the domestic market may be dominated by imports – both automobiles and components. Given that benchmarking studies show that Malaysia's supplier industries are not as competitive as the ones in Brazil, Mexico, South Africa and even Thailand (World Bank, 2001; Quadros, 2003; Justin and Lorentzen, 2003), a hollowing-out effect can be expected. A few auto

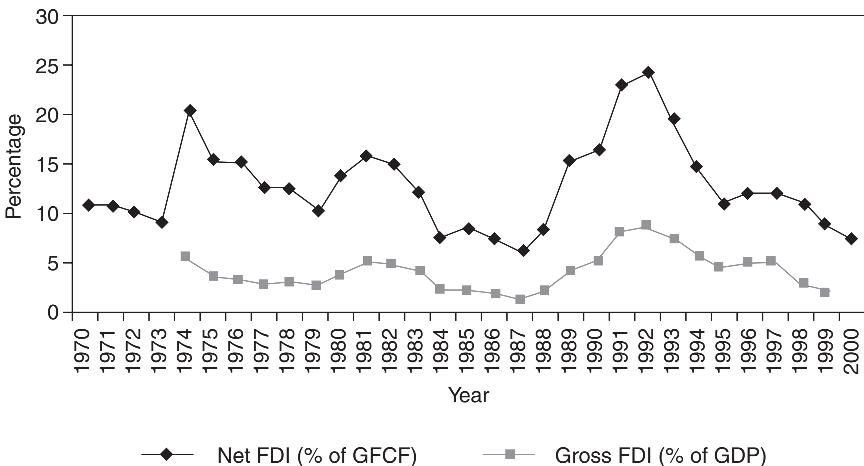

Figure 8.1 Foreign Direct Investment inflows, Malaysia, 1970–2000.

parts manufacturers – especially involving precision engineering and electronics control – are expected to remain (Ganesh, 2003). These segments have already been deregulated.[7] Despite Malaysia's car market being the largest in Southeast Asia, Thailand may become the biggest beneficiary if the Malaysian government implements the TRIMs agreement (see Rasiah, 2001). Despite questionable policies that have hampered upgrading, liberalization will not help build capabilities in the automobile industry. While government failures in promotion have sapped a number of countries of their resources, no country in the world has successfully developed the automobile industry without selective interventions in markets.

Given the public good characteristics of a number of services – e.g. education – it is important for Malaysia to retain a number of conditions to ensure greater control so that national interests will be protected. Unless the Malaysian government decides or is forced to adopt more liberalization than it has already committed to under GATS, the service sector can be expected to retain national preferences and stability. While the learning and innovation policies of Malaysia – despite strong government support – have not succeeded in stimulating synergies comparable to China Taipei, Korea and Singapore, it is still necessary to avert the exposure of critical sectors that embody basic and public good characteristics to the vicissitudes of external forces. As mentioned earlier, the Asian financial crisis is a classic example of how over-exposure to external vulnerability can harm the very macroeconomic fundamentals which are necessary for capability development. Malhotra *et al.* (2003) make these points lucidly.

Efforts to establish a liberal environment in the service sector will bring considerable implications for human development in Malaysia. Development plans in Malaysia have deliberately attempted to introduce instruments to ensure that economic growth does not undermine social equity and stability (Malaysia, 1971, 1981, 2001). The transition from the New Economic Policy (NEP) to the New Development Policy (NDP) has called for greater focus on human development but still retaining an ethnic distribution focus. Several services providing public goods (e.g. educational institutions and ownership of public utilities) are still heavily governed to ensure that they are more accessible to the masses. The government continues to pursue distributive goals along ethnic lines, even declaring its willingness to intervene sectorally to increase *Bumiputera* participation in the economy (Malaysia, 2003a).[8] The government retains considerable discretion on equity and ownership matters – between foreign–domestic ownership as well as ethnically within domestic ownership – related to the services industry. Unless governments have control over critical public goods, private interests seeking profits will undermine distribution.

Although investment measures or investment guidelines along ethnic lines may not be the best means of protecting domestic interests, efforts to impose restrictions on foreign ownership to shield the critical services obviously allow governments to address human development issues more broadly. As noted earlier, interviews showed that the government when addressing the issue of GATS will be unlikely to compromise its ethnic-oriented distributional

strategies and hence will continue to restrict foreign equity ownership in critical service sectors such as business services, telecommunications, construction, financial, health and cultural and sporting services in the country.[9] Even if ethnic policies are the wrong framework to follow, this issue should be resolved nationally rather than under a multilateral global body. This is more so when Malaysia's capacity to reverse policies with binding commitments to the WTO will be far less than the developed economies. Arbitration involving the dispute settlement mechanism under the WTO faces highly asymmetric consequences. Retaliatory measures by small economies on larger economies will have little impact compared to the converse.

Conclusion and policy implications

Malaysia is generally a very liberal economy. Despite some government failures Malaysia's efforts to quicken technological capability building and strengthen its macroeconomic fundamentals has obviously required keeping some of the instruments that impede liberalization. The government committed to remove local content policies that infringe the TRIMs Agreement by 2005, which may bring some adverse balance of payment consequences. In spite of the protectionist nature of industrial promotion that characterized all countries that stimulated the development of the automobile industry, deregulation involving the industry might very well be useful given the lack of evidence supporting its successful growth (see Jomo *et al.*, 2003). However, the same mode of liberalization could be dangerous when involving the service sector, especially those enjoying public good properties where at least some amount of government intervention is necessary to stimulate access and participation by the underprivileged. Hence, Malaysia has retained significant control over them, imposing an equity ceiling of 30 per cent on foreigners in such strategic sectors such as business services, health and telecommunications. In addition, Malaysia still maintains several non-TRIMs-violating instruments to govern upgrading in the country. Tax incentives to stimulate exports, and a mandatory levy of 1 per cent to force training in manufacturing firms with employment size exceeding 50 employees have played important roles to stimulate exports and training.

Malaysia should retain the controls it still has in place to ensure that its national human development policies are not affected by foreign agents. Far from taking an anti-foreign stance, this approach is necessary to keep critical instruments of control from being destroyed by unfettered short-term profit-seeking interests. The restrictions it has imposed on its commitments to GATS should be retained to ensure that sufficient safeguards exist to prevent increases in its vulnerability to external business swings. This is necessary to prevent the painful lesson of the 1997–98 financial crisis recurring in future. It is important for Malaysia to seek consensus among Asian and other developing economies to retain control over domestic policy options that are necessary to promote human development. After all development is the ultimate goal members of the WTO purportedly seek to promote.

Despite its generally liberal stance, Malaysia's investment policies have evolved considerably and have often been adapted to meet domestic circumstances. Unless a more serious attempt is made to re-examine the efforts to establish codes of conduct for transnationals, the pursuit of an investment-oriented multilateral framework should be treated with caution. The former invoked developmentalist objectives and hence offers the best possible steer for a fair and balanced approach to the framing of multilateral investment umbrella. However, given that development involves trajectories and specificities, binding legal commitments will do little to help the poorer developing economies.

Appendix 8.1

Malaysia's service sector offer under the GATS
Malaysia's offer schedule under services in 2003, involved a wide coverage of sectors, substantive bindings of current policies and in several important sectors. Further liberalization in modes of supply and activities were made.
Malaysia's *horizontal commitments* are as follows:

1 Foreign service suppliers may set up as joint-venture companies, subsidiaries, branches, representative offices, regional offices, depending on the sectors these suppliers wish to participate in.
2 Binding of Malaysia's Guidelines for Regulations of Acquisition of Assets, Mergers and Takeovers.
3 Commitments on the movement of intra-corporate personnel, including senior managers and other categories such as professionals, experts, specialist and business visitors. No commitments offered to unskilled and semi-skilled labour.

With respect to *sectoral commitments*, a total of 64 service activities have been in Malaysia's Final Offer. In the non-financial services sector, Malaysia made specific commitments in 44 sectors and sub-sectors. In financial services, commitments were made in 20 financial services activities. These are:

1 *Business services.* Covering mostly consultancies, management services (for example, covention and exhibition services) and other specialized services such as crop and fisheries management, skills training and translation services. Horizontal measures apply.
2 *Professional services.* Horizontal measures apply. Additionally, specific ruling on qualifications, residence requirements, experience and accreditation procedures need to be met. Legal services only limited to offshore-related activities in Labuan. The commitments in this sector are safeguarded by ensuring potential service suppliers take qualifying examinations and English language criteria.
3 *Telecommunications services.* Basic telecommunication is closed. Enhanced

value added services are controlled by way of licensing (in order to limit the numbers). Horizontal measures also apply.

4 *Sea transport.* Only international shipping services and shipping agency services are open; the latter has been liberalized further to permit foreign share of up to 49 percent. Other horizontal measures apply; however, multimodal transport operations (MTOs or door-to-door services) are not permitted.
5 *Audiovisual and broadcasting services.* Horizontal measures apply. Local content policy applies. The number of entrants is limited through licensing.
6 *Construction services*, including integrated engineering services (turnkey activities). Horizontal measures apply. No other limitations.
7 *Financial services.* No new entrants in the banking sub-sector, except through share acquisition of existing firms. Existing foreign banks accorded Tier 1 status. Some relaxation in equity limits allowed in the insurance industry, but is subject to criteria and is time-bound. Some sub-sectors under the capital market sector to be further liberalized in the year 2000.
8 *Health services.* Horizontal measures apply. Only private hospitals and specialist services committed. The number of hospitals and specialists permitted is also subject to Economic Need test.
9 *Tourism services.* No limits on management of hotels Ownership of property subject to investment rules, FIC rules. Restaurants must be 'exotic'.
10 *Travel services.* Horizontal measures apply. Only inward-bound tourism permitted. Ticketing/sales reserved for Malaysian companies, unless it is airline's office.
11 *Computer services* (software implementation included). Horizontal measures apply except for equity limits, which can be up to 70 per cent foreign.
12 *Rental and leasing services.* Horizontal policies apply. No other limits.
13 *Entertainment services.* Horizontal measures apply. No other limits.

Source: *Malaysia's Obligations and Potential Benefits under Uruguay Round*, 2003 (Kuala Lumpur: MITI)

Notes

1 This chapter was originally prepared for the United Nations Development Programme (UNDP) in 2003. I am grateful for helpful comments from Chang Ha Joon, Shin Jang Sup, Kamal Malhotra and Murray Gibbs.
2 New growth economists such as Romer (1986) and Lucas (1988) demonstrated these ideas using elegant models.
3 See Rodrik (2001) for statistical evidence to demonstrate this point.
4 Henry the 7th is believed to be the first ruler to have promoted industrial policy in 1485.
5 The dynamics of these points was articulated lucidly by Smith (1776), Mill (1848) and Young (1928).
6 Of course a number instruments that entail government failure exists – which is not uncommon in a number of countries as governments learn and interact with the private sector to improve institutional coordination. The failures should not constitute a basis to end government support since all the successful economies industrialised on the

basis of government support. Governments should weed out government failure and other forms of inefficient interventions, but should not deregulate to become mere passive followers of relative prices.

7 Interviews with an official of the Federation of Malaysian Manufacturers (8 August 2003).

8 This point was also confirmed from author's interviews with an officer from the Economic Planning Unit of the Prime Minister's Department and another from the Ministry of International Trade and Industry on August 2003.

9 Author interviews with officials from the Economic Planning Unit and the Ministry of International Trade and Industry conducted in August 2003.

References

Abramovitz M. (1956) Resource and Output Trends in the United States since 1870, *American Economic Review*, 46, pp. 5–23.

Amsden A.O. (1989) *South Korea and Late Industrialization* (New York: Oxford University Press).

Amsden A., Tschang T. and Goto A. (2001) Do Foreign Companies Conduct R&D in Developing Countries? ADB Institute Working Paper 14.

Arrow K. (1962) The Economic Implications of Learning by Doing, *Review of Economic Studies*, 29(3), pp. 155–73.

Barnes J. and Lorentzen J. (2003) Learning, Upgrading, and Innovation in the South African Automotive Industry, paper presented at the international workshop FDI-assisted Development, Oslo, 22–24 May.

Best M. and Rasiah R. (2003) *Malaysia's Electronics Industry in Transition* (Vienna: UNIDO).

Chang H.J. (1994) *Political Economy of Industrial Policy* (Basingstoke: Macmillan).

Chang H.J. (2002) *Kicking away the Ladder* (London: Anthem Press).

Chang H.J. (2003) Regulation of Foreign Investment in Historical Perspective, FDI-assisted Development, Oslo, 22–24 May.

Chang H.J. and Green D. (2003) The Northern WTO Agenda on Investment: Do as we say, Not as we Did (Geneva: South Centre).

Deyo F.C. (ed.) (1987) *The Political Economy of the New Asian Industrialism* (Ithaca NY: Cornell University Press).

Doraisami A. (2004) Trade Causes of the Asian Crisis: The Malaysian Experience, *World Economy*, 27(5), pp. 715–26.

Ganesh R. (2003) Transnationals, Innovation and Technological Spillovers: A Case Study of Malaysian Firms, paper presented at the International UNU–INTECH Workshop, Transnational Corporations, Technological Capabilities and Economic Performance: Evidence from Africa, Asia and Latin America, Maastricht, 19–20 June.

Gerschenkron A. (1962) *Economic Backwardness in Historical Perspective* (Cambridge MA: Harvard University Press).

Hamilton A. (1791) Report on manufactures, reprinted in H.C. Syrett (ed.), *The Papers of Alexander Hamilton*, vol. 1 (New York: Columbia University Press).

Hughes H. and You P.S. (eds) (1969) *Foreign Investment and Industrialisation in Singapore* (Canberra: Australian National University Press).

Jaya Gopal (2001) The Development of Oil Palm Processing in Malaysia, PhD thesis, Imperial College, London.

Johnson C. (1982) *MITI and the Japanese Miracle* (Stanford CA: Stanford University Press).

Jomo K.S. (1986) *A Question of Class* (Singapore: Oxford University Press).

Jomo K.S, Rasiah R., Alavi R. and Jaya Gopal (2003) Industrial Policy and the Emergence of Internationally Competitive Manufacturing Firms in Malaysia, in Jomo K.S. and Ken Togo (eds), *Manufacturing Competitiveness: How Internationally Competitive Nations, Firms and Industries Developed in East Asia* (London: Routledge).

Jomo K.S. and Todd P. (1994) *Trade Unions and the State in Peninsular Malaysia* (Kuala Lumpur: Oxford University Press).

Kaldor N. (1957) A Model of Economic Growth, *Economic Journal*, 67, pp. 591–624.

Kaldor N. (1967) *Strategic Factors in Economic Development* (Ithaca NY: Cornell University Press).

Kaldor N. (1989) *The Essential Kaldor*, in Targetti F. and Thirlwall A.P. (eds) (London: Duckworth).

Kalecki M. (1976) *Essays on Developing Economies* (Hassocks: Harvester).

Katz J. (ed.) (1987) *Technology Generation in Latin American Manufacturing Industries* (Basingstoke: Macmillan).

Kitching G. (1982) *Development and Underdevelopment in Historical Perspective* (London: Methuen).

Krugman P. (1999) *Return of Depression Economics* (New York: Norton).

Lall S. (1978) Transnationals, Domestic Enterprises, and Industrial Structure in Host LDCs: A Survey, *Oxford Economic Papers*, 30, pp. 217–48.

Lall S. (2001) *Competitiveness, Technology and Skills* (Cheltenham: Edward Elgar).

Lewis A. (1955) *The Theory of Economic Growth* (London: Allen & Unwin).

List F. (1885) *The National System of Political Economy* (London: Longmans, Green).

Lucas R.E. (1988) On the Mechanics of Economic Development, *Journal of Monetary Economics*, 22, pp. 3–22.

Malaysia (1971) *Second Malaysia Plan 1971–75* (Kuala Lumpur: Government Printer).

Malaysia (1981) *Fourth Malaysia Plan 1981–85* (Kuala Lumpur: Government Printer).

Malaysia (1991) *Fifth Malaysia Plan 1991–95* (Kuala Lumpur: Government Printer).

Malaysia (2001) *Eighth Malaysia Plan 2001–2005* (Kuala Lumpur: Government Printers).

Malaysia (2003) *Malaysia's Obligations and Potential Benefits under Uruguay Round* (Kuala Lumpur: Ministry of International Trade and Industry (MITI)).

Malaysia (2003a) Motion to table the Mid-term Review of the Eighth Malaysia Plan by Dato, Dr Mahathir Mohamad, Prime Minister and Finance Minister at Parliament on 30 October, Kuala Lumpur.

MIDA (2003) Statistics on the Manufacturing Sector (Kuala Lumpur: Malaysian Industrial Development Authority).

MIDA (2004) Available at www.mida.gov.my/guide_03.html.

Malhotra K. *et al.* (2003) *Making Global Trade Work for People* (London: Earthscan Publications).

Mansfield E., Teece D.J. and Romeo A. (1979) Overseas Research and Development by US-based Firms, *Economica*, 46, pp. 187–96.

Mansfield E. (1985) How Fast Does New Industrial Technology Leak Out? *Journal of Industrial Economics*, 34(2), pp. 217–24.

Mill J.S. (1848) *The Principles of Political Economy with some of their Applications to Social Policy* (London: John Parker).

Moran T. (2002) The Relationship between Trade, Foreign Direct Investment and Development: New Evidence, Strategy and Tactics under the Doha Development Agenda Negotiations, paper prepared for ADB, Manila.

Murray R. (1973) The Internationalisation of Capital and the Nation State, *New Left Review*, 67, pp. 84–109.

Myrdal G. (1957) Economic Theory and Underdeveloped Regions (New York: Methuen).

Mytelka L. and Rasiah R. (2003) FDI-related Technological Capability Building in Developing Economies: Towards a Strategic Framework for Government Policy, policy paper presented at the UNCTAD Conference on Preparing for Liberalisation, 16–18 July.

OECD (1998) The Global Research Village: How Information and Communication Technology Affect the Science System (Paris: Organization for Economic Cooperation and Development).

Palma G. (2003) Four sources of 'de-industrialisation' and a new concept of the 'Dutch Disease', paper prepared for UNU–INTECH Seminar, Maastricht, 13 November.

Prasada R. (2003) TRIMs and Technological Capacity Building, *UNU–INTECH Technology Brief*, 2(1), pp. 1–4.

Quadros R. (2003) TRIMs, TNCs, Technology Policy and the Brazilian Automobile Industry, *UNU–INTECH Technology Brief*, 2(1), pp. 10–12.

Rasiah R. (1994) Flexible Production Systems and Local Machine Tool Subcontracting: Electronics Transnationals in Malaysia, *Cambridge Journal of Economics*, 18(3), pp. 279–98.

Rasiah R. (1995) *Foreign Capital and Industrialization in Malaysia* (Basingstoke: Macmillan).

Rasiah R. (2001) Market, Government and Malaysia's New Economic Policy, *Cambridge Journal of Economics*, 25(1), pp. 57–78.

Rasiah R. (2003a) FDI, Technological Capabilities and Export Performance, *Development Engineering*, 9(1), pp. 21–44.

Rasiah R. (2003b) Foreign Ownership, Technological Capabilities and Exports in Electronics Firms in Malaysia and Thailand, *Journal of Asian Economics*, 14(5), 786–811.

Rasiah R. (2003c) Industrial Technology Transition in Malaysia, in Sanjaya Lall and Shujiro Urata (eds), *Technology Development in East Asia* (Cheltenham: Edward Elgar).

Reddy P.R. (2003) TRIMs and Technological Capacity Building, *UNU–INTECH Technology Policy Briefs*, 2(1), pp. 2–5.

Reinert E. (2003) Discussion Comments, International Workshop, FDI-assisted Development, Oslo, 22–24 May.

Rodrick D. (2001) The Global Governance of Trade as if Development Really Mattered, report submitted to United Nations Development Program, New York: UNDP.

Romer P.M. (1986) Increasing Returns and Long Run Growth, *Journal of Political Economy*, 94, pp. 1002–37.

Schumpeter J.A. (1934) *The Theory of Economic Development* (Cambridge MA: MIT Press).

Singh A. (1997) Financial liberalisation, stock markets and economic development, *Economic Journal*, 107(442), pp. 771–82.

Smith A. (1776) *The Wealth of Nations* (London: Strahan & Cardell).

Stiglitz J. (1998) More Instruments and Broader Goals: Moving toward the post-Washington Consensus, The WIDER Annual Lecture, Helsinki.

Wade R. (1990) *Governing the Market* (Princeton NJ: Princeton University Press).

Warren B. (1973) Imperialism and Capitalist Industrialization, *New Left Review*, 81, pp. 3–44.

Wessner C.W. (ed.) (2003) *Government–Industry Partnerships for the Development of New Technologies* (Washington, DC: National Academic Press).
World Bank (2001) *World Development Indicators* (Washington, DC: World Bank Institute).
WTO (1999) Proposals Regarding the Agreement on Trade-related Investment Measures, Documents WT/GC/W, 203, 271, 311, 351, Geneva.
WTO (2003) *Opening World Markets for Services* (Geneva: World Trade Organisation).
Young A. (1928) Increasing Returns and Economic Progress, *Economic Journal*, 38(152), pp. 527–42.

Part III

Sectoral and regional responses to globalization

9 Globalization and trade unions

Transformation of automobile trade unions in Korea and Malaysia

Peter Wad[1]

Trade union experience is national, but the challenge is global!
(Peter Unterweger, International Metalworkers' Federation, Bangkok, 2002)

Introduction

In the literature on economic globalization and restructuring in East Asia, few studies have addressed the reactions and impacts of trade unions on these changes. This chapter aims to analyze how trade unions in the Korean and Malaysian automobile industries (auto industries hereafter) respond to industrial changes and act collectively in order to influence employment conditions, industrial relations, corporate restructuring and broader social transformations before, during and after the East Asian financial crisis 1997–99.

Entering the crisis from different structural and strategic positions and being exposed to different national policies and corporate strategies of crisis management, the Korean automobile unions overall adopted a more radical and militant strategy while their Malaysian counterparts employed a more pragmatic and moderate strategy. This chapter argues that this difference was mainly due to the fact that actual opportunities for increasing benefits through unionization and industrial action were different between the Korean and Malaysian auto industries. Above all, they were located in very different positions in the global value chain: Korean auto companies were much more internationalized and had already reached a higher global value chain position than their Malaysian counterpart. Moreover, the Korean unions enjoyed more political space than Malaysian unions due to the consolidation of political democracy in Korea since the beginning of democratization in 1987. However, this chapter also argues that both types of union strategy made sense in their own institutional and historical contexts, and that they eventually contributed to converging the industrial relations of the industry and probably also sustaining or improving nominal wages and working conditions, yet without affecting the corporate structure of the industry and the level of employer organization.

The chapter relies on primary empirical studies done in 1999 on national auto industries in Korea and Malaysia with Hyundai Motor Company (HMC) and

Daewoo Motor (DMC) in Korea and Proton and Perodua in Malaysia, and in 2001–03 on auto workers' trade unions and federations in both countries, including Korean Metal Workers Federation (KMWF), Korean Metal Workers Union (KMWU), and the Malaysian National Union of Transport Equipment and Allied Industry Workers (NUTEAIW). In the next section, the global and local dimensions of the Korean and Malaysian auto industries are outlined. The following section deals with the industrial relations of the auto industries in Korea and Malaysia before, under and after the Asian Financial Crisis. In the fourth section the dynamics of the trade unionism in the Korean and Malaysian auto industries are explained by investigating its interface with the political economic aspects of globalization and the interaction between labor and capital in the auto industry in a broader context of labor organization and mobilization. The final section winds up the arguments and findings of this chapter.

Automobile industries and firms in Korea and Malaysia

The Asian-Pacific region (excluding Japan) makes up the world's fourth largest area of LV (passenger cars and commercial vans) manufacturing and sales. In 2002, Korea's auto market registered 1,240,000 LVs, more than three times the number of Malaysia's 375,000 LVs. Korea produced 3,096,000 LVs in the same year, nearly eight times Malaysia's 395,000, due to its formidable export production. The Korean auto industry employed 368,000 workers in 2001 while the Malaysian ditto was 45,000 in 2002; The Korean work force was more than eight times as large as the Malaysian (IMFmetal 2003; OICA 2002; Jeong 2003, table 6; Wad 2004b, p. 13).

The beginning of the auto industries in the two countries was similar: auto assembling firms were established in the 1960s through foreign direct investment (FDI), technological alliances or joint ventures (JVs) from Japanese and Western firms. In Korea, Daewoo Motors Company (DMC) was formed in cooperation with Toyota from 1965 to 1972, and in a 50/50 joint venture with General Motors (GM) from 1972 to 1992. The company became independent from GM in 1992 by purchasing GM's shares and maintained its autonomy till 1999. After it went bankrupt, GM acquired a controlling share of DMC in 2002. Hyundai Motor Company (HMC) began in 1967 and allied technologically with Ford to assemble Ford completely knocked down (CKD) sets of components, then in a joint venture with Mitsubishi Motor Corporation (MMC) (12 percent), and later with DaimlerChrysler (DC) (10 percent) in 2000, when HMC was spun off from the Huyndai Group (KARI 2001, p. 97).

The Korean state intervened heavily in its auto industry in the mid-1970s and forced Korean auto firms to develop their own product and process technology, and to start exporting. HMC was the first to succeed in following the government policy and, when it participated in the export drive, its ties with Ford broke. It turned to Mitsubishi and became very successful in its exports to the US and later in other parts of the world. It experienced failure in overseas investment when it established a transplant in Canada in 1989 (Chung 2003, p.

190). However, HMC continued its export drive and shifted its FDI strategy to targeting developing countries – it formed JVs with several local firms in East Asia, one in Africa, and one in Latin America. In 1998, HMC began production in India with its first wholly owned subsidiary. DMC targeted the emerging market economies of Eastern Europe, and selected Asian countries (India, China, Vietnam, the Philippines). By 2000, HMC, DMC and Kia Motors (KMC), the third largest auto company, which was acquired by HMC in 1998, had an overseas production capacity of 1,659,000 units, of which DMC took 55 percent and HMC 30 percent (Chung 2003, p. 195). The Korean auto industry produced nearly three million vehicles in 2001, of which more than half were exported (46 percent to the US and 28 percent to Western Europe) (KARI 2002). HMC and KMC, an affiliate of HMC, made 51 percent and 29 percent of total Korean output respectively in 2001. HMC and KMC took 49 percent and 27 percent of total domestic sales, and 53 percent and 31 percent of total exports.

The 1997–98 financial crisis and the subsequent reform policies of the International Monetary Fund (IMF) and the President Kim Dae Jung government (1998–2003) represented a watershed in the Korean auto industry in two ways. First, export sales had surpassed domestic sales for the first time. Second, it paved the way for waves of domestic consolidation among Korean auto manufacturers (HMC took over Kia and DMC acquired Ssangyong Motors) and subsequent waves of FDI and foreign acquisitions (Samsung Motor was acquired by Renault, and DMC by GM). The Korean auto components suppliers rose and fell with the Korean auto manufacturers. Foreign first-tier MNC system suppliers like Visteon, Delphi, Bosch and Valeo took control of Korean first-tier auto component suppliers like Halla and Duckyang Industry. In sum, processes of outward and inward internationalization of the Korean auto industry took place before and after the East Asian financial crisis respectively.

The Malaysian auto industry began from 1967 with Western models being assembled through franchising and licensing arrangements, JVs or transplants. Due to a small market and the lavish license policy, the Malaysian auto industry was fragmented and the market was overburdened with many brands and models, making it difficult to localize component production profitably. In the 1970s, Western models were ousted by Japanese models, with Nissan and Toyota becoming the market leaders, and with the Japanese companies forming JV assembly plants with ethnic Chinese-Malaysians. The Malaysian government, in pursuing a Malay-enhancing policy (*Bumiputra*), decided to start a national auto project by allying with the weakest Japanese link, Mitsubishi Motor Corporation (MMC), and set up Proton, a national car manufacturer. Proton targeted the mid-size car market, leaving the luxury market to foreign-controlled makers for a while, and began exporting without much technological advancement despite having sales agents in 50 countries. Proton entered into JVs in the Philippines (disbanded again), Vietnam (with MMC) and in China to begin production in 2005 (Proton 2003). Proton consciously went ahead with technology development, acquiring Lotus Group International, a UK design and consultancy firm, and allying with another foreign firm to develop an engine.

The success of the first national car project made the Malaysian government pursue a second national car project with Daihatsu, an affiliate of Toyota, to target the small-size car market. Perodua, which started production in 1994, saw the small-size car market enjoying a boom. This was followed by state-sponsored projects for a national motorcycle company and a truck and bus company, with the aim of complete dominance of the Malaysian automotive market by national manufacturers.

The 1997–98 financial crisis changed this planned path of the Malaysian auto industry. The Malaysian government rescued the national auto companies and then proceeded to do the same for the non-national auto companies in 1998. The Malaysian auto industry bottomed out in 1998 and recovered as of 1999. Proton, however, was unable to increase exports during and after the crisis[2] and was rescued by Petronas, a national oil company. It was 're-nationalized' in 2002 when the government's investment company (Khazanah Nasional Berhad) increased its share to 33 percent followed by new expansion of capacity and corporate restructuring. Meanwhile, new FDI flowed into the auto industry and further re-organized the industry: Daihatsu obtained 51 percent of Perodua Manufacturing Company after the national car maker was restructured; Honda Motor substituted its main local partner for another and established a new JV manufacturing facility; HMC established a JV production facility; Toyota Motor gained 51 percent equity control of UMW-Toyota, its domestic JV; Ford increased its equity in AMIM from 30 percent to 49 percent. In the auto supplier industry, foreign auto supplier firms acquired Malaysian firms; for example, German Continental took a 51 percent interest in the Sime Group's tire division (*The Star*, 14 October 2003).

Overall, the Malaysian industry failed to become a major exporter, though it made huge advances in increasing production volume and sales in the protected domestic market in the last two decades, while the Korean counterpart emerged as a major exporter as well as an investor in the world market. In the global value chain, the Korean industry takes an overall middle position due to its indigenous brand manufacturing, economies of scale and export performance, while the Malaysian industry holds a position in the low end due to export failure, weak indigenous brand manufacturing and protected home market. The lead manufacturers in their respective home markets are HMC and Proton, but Proton's domestic market share has been declining (*Asian Automotive Business Review*, July 2002; Proton 2003, p. 34). Moreover, both the Korean and the Malaysian auto industries started as internationally subordinate industries, based on MNC equity or technology control, but they both underwent a process of indigenization, building national auto firms, before they entered a process of outward internationalization through export and FDI. Since the Asian crisis in 1997–98, a new phase of inward internationalization began, driven by foreign companies' acquisition of local firms or setting up new JVs.

Trade unionism in Korean and Malaysian auto industries and firms

The watershed in Korean trade unionism was the 'Great Labor Struggle' in 1987, when new democratic trade unions emerged in the manufacturing sector, including the auto industry (Koo 2001). Although unions were founded at KMC and DMC from as early as the late 1960s, they were compliant: the DCM union was controlled by the company and the KMC union was collaborating with the company (Lee 2003, p. 327). From 1987, new democratic unions, including the HMC union, went on to form wider alliances, networks, federations and ultimately a national labor center. In 1990, the democratic unions in the Hyundai Group formed the Alliance of Trade Unions in Hyundai (ATU Hyundai), inspiring other *chaebol* unions to follow suit (Sohn 2002). At the same time, the National Alliance of Trade Unions (NATU) was formed based on 17 regional associations of trade unions. This was initiated by unions in the southern part of Korea, comprising enterprise unions in small and medium-size enterprises (SMEs). The General Union Federation of Metal Working Industry (GUCMI) and the National Federation of Shipbuilding Trade Unions were established in 1994. In 1995, the National Federation of Auto Assembly Industry Trade Unions (NFATU) emerged; it included unions in assembly companies of Hyundai, Kia, Daewoo, Ssangyong and Asia Motor. In 1996, the GUCMI and NFATU established the National Democratic Metal Industry Trade Unions (NDMTUA).[3] These three federations were all affiliated to the democratic labor center, Korean Confederation of Trade Unions (KCTU), when it was established 1995. KCTU had a radical, class-oriented program for the establishment of a democratic socialist labor movement, based on industrial unions on the one hand and a democratic labor party on the other hand (KCTU 2000).

It took a national general strike from December 1996 to January 1997 against labor reform and a financial crisis during 1997–98 for the labor unions to return to the center stage of Korean politics (Lee and Lee 2001). These events also created a strong momentum to organize an encompassing federation of metal industry unions, including the auto manufacturing unions. The various union organizations emerged from the plant level and then associated into two different, looser organizations – one for large firms and another for SMEs. In order to bridge the gap between different trade union organizations, ATU Hyundai proposed to unite the NATU, NFATU and NDMTUA in a single Korean Metal Workers Federation (KMWF). This occurred in February 1998 at the peak of the financial crisis when the new government formed the Tripartite Commission among government, employers and trade unions. The KMWF numbered around 200,000 employees and aimed at consolidation of scattered unions into one industrial union with industry-wide collective bargaining authority.

The formal centralization of (radical) trade unions in the metal industry took place in 2001 with the establishment of the Korean Metal Workers Union (KMWU). However, this time the big assembler unions were not driving the unification process. Instead, it was carried out by the KMWF leadership and

SME unions. The big assembler unions stood outside the industrial union – even when all auto worker unions went on strike in solidarity with the DMC union as it struggled against the downsizing and imminent take-over of bankrupt DMC by a foreign auto maker (KMWF-KCTU, undated).

The KMWU initiated regional collective bargaining and supported enterprise-based bargaining, but the counterpart was missing, i.e. an employers' association among auto manufacturers and suppliers. In Hyundai, the federation of Hyundai unions undertook for the first time common collective negotiation with HMC in 2001 but they did not coordinate with KMWU. In DMC, the union leaders were expelled from the factory site during the industrial dispute, and the union leadership was handed over to the new group who finally accepted GM's acquisition of DMC (Lee 2005). Samsung Motor was the only auto manufacturer without any kind of independent union organization, being isolated from the auto workers' movement by a vigorous anti-union management.

In sum, there emerged a divide between the big unions in big auto companies like HMC and DMC and the SME unions in the auto component supplier and wider metal industry unions, although the overall union structure in the Korean auto industry has moved towards a more unified and centralized form with regional collective bargaining. The HMC union holds the central key to this situation. It has been at the forefront of radical unionism several times, organizing, mobilizing and acting militantly, but the HMC union has been divided into several factions, which have different opinions about the costs and benefits of giving up its autonomy and transferring it to the KMWU. At one end of the spectrum, there are the KCTU-inclined activists believing in class solidarity and centralization, and, at the other end of the spectrum, there are the unionists criticizing the leaders of KCTU and KMWU for calling strikes all the time for political purposes, without any insight into workplace issues or facing their members in daily working life. The latter maintains that the top union leaders in KCTU and KMWU are taking an academic approach to industrial issues. It requires a two-thirds majority for giving up autonomy, and the result of a vote in the HMC union in June 2003 did not cross this threshold although a majority of 62 percent voted in favor of joining the KMWU (IMF *Metal World* 2003, No. 3, p. 11). Meanwhile, the HMC union kept control of union resources and used them to fight for the interests of the HMC union members quite successfully. At HMC, the annual wages increased 4.5 percent in 1999, 8 percent in 2000, and 12.9 percent in 2001.[4]

In Malaysia, auto workers were organized in an industrial union in 1971. The National Union of Transport Equipment and Allied Industries Workers (NUTEAIW)[5] rapidly turned into a radical union after an internal fight by which grass-roots-oriented activists from a car assembler of Ford (AMI) took over the leadership (Das 1991, p. 129). The new union leadership prompted employers to organize an association of assemblers and enter into a common, centralized mode of collective bargaining in 1973. Centralized collective bargaining expanded in 1975 but never did include the Nissan assembler (Tan Chong), the

market leader. Collective bargaining was contracted again in 1982 when an important employer (UMW–Toyota) withdrew from the employers' association and undertook bilateral negotiation with the industrial union in the same way as Tan Chong (Wad 2004a). Hence, a weakened centralized IR system prevailed in the Malaysian auto assembly industry in the 1980s.

This system began to be decentralized in three ways (Wad 2004a, pp. 246–59). First, the non-national auto employers' association was disbanded in the 1990s, and the industrial union undertook bilateral bargaining with individual employers. Second, enterprise unions emerged in the national sector of state-owned enterprises (SOEs) and JV enterprises, began negotiation and concluded collective agreements with their individual employers. Third, two of the larger assemblers' work forces broke away from the industrial union to form or join enterprise unions in collaboration with their employers. The industrial union counteracted this movement by driving unionization of the emerging auto supplier industry, and even succeeded in making some smaller enterprise unions in auto component supplier firms join the NUTEAIW.

During the financial crisis of 1997–99, the Malaysian auto industry faced a dramatic decline in sales followed by reductions of production and employment in 1998: Proton's sales fell 52 percent, Perodua's dropped by 35 percent, and non-national assemblers' declined by 78 percent; their production fell by 57 percent, 43 percent and 85 percent respectively; and their employment declined by 14 percent, 11 percent and 38 percent, respectively (Wad 2004a, p. 243).

Although the decline in employment was slower than that of production, the reduction of remuneration was very sharp. Overtime was abolished and working hours were reduced. Collective agreements (CAs), which were running for at least three years by law, were not renewed but extended unchanged for one year or more. While the industrial union concluded CAs with 10–15 percent wage increases across the board during the period of 1994–97, the NUTEAIW managed to get 5–10 percent salary adjustments in 1998–99 (NUTEAIW 1997, 2000; Jomo & Lee 2001, p. 236). The overall wage increase was less than the inflation rate during and after the crisis, hence real wages were declining. The severe damage to take-home pay was caused by the reduction in overtime, which had generated a lot of extra income in the boom years before the crisis.

Yet, no legal or illegal strikes at the industry level happened in the Malaysian auto industry. During and after the financial crisis, only a few wildcat strikes occurred in the unionized sector. Management and unions in general collaborated in order to save jobs both in the national and the non-national sectors. Based on field research on three auto manufacturers and two auto suppliers in March 1999, Peetz and Todd (2000, p. 72) reported that the auto manufacturers attempted to adjust in a worker-friendly way during the crisis while outright retrenchment was carried out among auto component suppliers. During the crisis, enterprise unions began networking with one another, and a few also met with the industrial union. The NUTEAIW feared that the in-house unions would give in and lower the terms of employment during the financial crisis. Although

the attempt at collective networking faded with economic recovery, the industrial union saw the need to form in the future a federation of auto unions as the auto workers faced a free trade area among the ASEAN countries (AFTA), which would include liberalization of the automobile market. The issue was restated in 2002 and set a mandate for the industrial union to be the secretariat in charge of the formation of a federation of auto workers' unions. An agreement was reached in 2004 to form a federation constituted by NUTEAIW and the two important enterprise unions in the auto assembling industry (Proton and Perodua), but the final decision has to be taken by the governing bodies of the unions.

In sum, the Malaysian auto workers began with an industrial union (NUTEAIW) and established fairly quickly centralized collective bargaining with auto assembly companies in the 1970s. The state-induced restructuring of the industry helped the formation of enterprise unions in new and dominant assembly companies in the 1980s. In the early 1990s, the industrial union shifted to pragmatic unionism, halting union decline by organizing the auto supplier industry, recapturing enterprise unions, and adopting bilateral collective negotiations with employers. The Malaysian auto workers were now divided into a radical-turned-pragmatic industrial union and conservative enterprise unions, and this divide was sustained by their alliances with the opposition and the leadership, respectively, in the national labor center, the Malaysian Trades Union Congress (MTUC). The financial crisis and the emerging free trade area of the ASEAN countries forged a new alliance between the Malaysian industrial union and the key enterprise unions agreeing in principle, but not yet in practice, on the formation of a federation of Malaysian auto unions.

While the Korean auto unions adopted a common radical conception of unionism, the Malaysian auto unions were divided in terms of union ideology (union pragmatism versus conservatism). While Korean auto unions began as enterprise unions and Malaysian auto workers formed an industrial union from the outset, both Korean and Malaysian unions ended up with a pluralistic union structure which is composed of an industrial union, enterprise unions and a federation (established or agreed upon) and with unions which by and large undertake bilateral collective bargaining with individual employers. While the Korean auto workers are an integrated part of a metal industry-based federation and union, the Malaysian auto workers are part of a narrower organization of employees within the motor vehicle and component manufacturing industry and join hands with other metal industry workers' unions in the IMF (metal)–Malaysia Council. In actual numbers and union density, the KMWU had 126,000 members (2002) within the metal industry, of which most were from the auto industry, while Malaysian auto workers' unions had 21,300 members (2002) (Jeong and Wad 2004; Wad 2004b). In terms of union density, the Korean auto workers stayed around 34 percent in 2001 (124,500 union members relative to a work force around 368,000, Jeong 2003, table 6), while the Malaysian auto workers were as high as 47 percent in 2002, up from 39 percent in 2000 (Wad 2004b, p. 13). (See Appendix 9.1 for a summary of the historical changes.)

Explaining the dynamics of Korean and Malaysian auto unionism

What explains this divergence in union ideology and apparent convergence in IR patterns between Korea and Malaysia at the dawn of the twenty-first century? In order to answer this general question, we need to be more specific and ask five questions and relate them to industry development, state policies and key features of trade unionism.

The first question has to do with relative performance between the auto industries in the two countries. Why did the independent Malaysian auto workers' union arise much earlier than the independent Korean auto worker unions although the Malaysian auto industry was slower than its Korean counterpart in expanding and technologically upgrading?

The states of Korea and Malaysia similarly established protectionist trading regimes in the 1960s to facilitate import substitution (IS) in the auto industry, at first aiming at achieving higher levels of localization of auto production and later on attempting to indigenize ownership, develop the industry technologically, and capture the domestic market. The authoritarian Korean government was, however, more successful in IS policies than its Malaysian counterpart. It quickly turned the private Korean auto firms towards indigenous management, technological upgrading and export orientation. It secured domestic expansion in the 1970s and export competitiveness in the 1980s while keeping wages down through state corporatism, that is, through state-directed tight wage policy, enforcing discipline, and suppressing independent labor union activists. The policies were successful as regards industrial development but generated a mass of repressed and angry workers. Auto workers had been prevented from forming independent unions and suppressed by management and the state. Therefore, labor activists became part of the broader democratization movement. The 'Great Labor Struggle' of 1987 to 1990 changed the shopfloor power and social status of labor for the better, and workers in the automobile and other heavy industries initiated a radical and militant trade union movement in opposition to the conservative trade unions which had been organized in the Federation of Korean Trade Unions (FKTU) and co-opted to be subordinated by the former authoritarian repressive developmental state.

In Malaysia, the auto industry was established and dominated by Western MNCs during the 1970s through wholly owned subsidiaries, JVs or franchising and licensing arrangements with local firms. The work force of the non-national auto industry consisted primarily of Indians and Chinese and so did the membership and leadership of the auto worker union. The newly formed auto worker industrial union was taken over by grass-roots union leaders who challenged the hegemony of the employers and also left the pragmatic trade union center (MTUC) in order to build a new radical trade union movement together with other radical unions (Wad 1988; Das 1991). This happened in a conjuncture of intra-Malaysian tensions (ethnic cleavages), regional conflict (the Vietnam War) and an IR system of sector unions and centralized collective bargaining in key

export and infrastructure industries which dated back to colonialism and the anti-communist battle in the 1950s. Hence, the Malaysian auto workers formed a radical trade union very quickly after the start of the Malaysian auto industry, and this industry consisted of low-technology OEM firms assembling imported completely knocked down (CKD) kits of components. A component supplier industry did not yet exist.

This analysis does not answer the second question, i.e. why the independent Malaysian and Korean auto worker unions adopted a radical line from the outset yet diverged in terms of organizational structure and forms of collective bargaining? The Malaysian auto worker union arose in an IR system where centralized collective bargaining was known in the large plantation industry and in commerce, including companies which traded in automobiles. Managers of auto assemblers were more or less familiar with centralized bargaining from the Western countries, so it did not take long for the employers to counteract the radical industrial union by establishing their own association of motor vehicle assemblers and accept collective bargaining and agreements. Finally, the state prohibited industry-wide and class-based unionization, not allowing the establishment of a metal industry union.

In Korea, the situation was different. The Korean government and *chaebols* insisted from the very beginning on the control of auto firms by Korean managers, who were rather despotic and anti-unionistic. Korean workers were only provided with a state co-opted union, which by law had to be industry-wide before 1980 (Lindström 1993). The Korean workplace was commanded like a garrison, and this militaristic managerial ideology suppressed the individual freedom of workers and made them feel like second-class citizens. At the same time, the auto workers formed a concentrated, huge work force of male workers in a strategic capital-intensive industry while living in urban areas, and this structural location made them potentially strong as a socio-economic and political force.

When the mobilization began in the middle of the 1980s, triggered off by police brutality, the flood of militant workers overtook shopfloors for a while. With the state's retreat from the workplace, employers were left with few means of control against a militant and angry working-class community. Enterprise unions multiplied in *chaebol* groups and beyond, supported by sympathy strikes and civic groups. They forced employers to undertake enterprise-based collective negotiations although the employers were very much against giving up their management prerogative to lead the companies in an authoritarian way. Hence, the radicalism of Korean and Malaysian auto worker unions was rooted in different circumstances and their choices of different types of union structure (enterprise union versus industrial union) were conditioned by the institutional options and experiences.

The third question is the following. Why did the Malaysian auto worker unions during the 1980s turn to a more pragmatic and conservative unionism while accepting rather decentralized collective bargaining when the Malaysian auto industry emphasized indigenization; and why did the Korean auto worker

unions on the contrary maintain a radical ideology while favoring centralized IR institutions, when their industry was taking part in the process of globalization more vigorously?

In Malaysia, the government restructured the auto industry into Malaysian-owned firms and Japanese-oriented firms because it wanted to rectify ethno-economic imbalances, especially between the Malay and Chinese populations, and to rectify the lack of localization of auto component production controlled by MNCs. A state–MNC alliance for the benefit of the Malays emerged, creating an ethno-political framework for the first 'national' auto project in the early 1980s. The Malaysian government aimed to control the industry by adopting the 'Look East' policy, which takes Japan and partly Korea as developmental models, and promoted enterprise unionism in pursuit of corporate harmony and increased productivity (Wad 1988). The trend towards a more decentralized IR system was already initiated by the JVs between Japanese firms and Chinese Malaysian families. The Nissan OEM stayed outside the association of assemblers from the beginning, although it was unionized by the industrial union. But when a new JV between Toyota and a Chinese Malaysian-owned company emerged in the early 1980s and decided to leave the employers' association in favor of bilateral negotiations with the industrial union, the centralized Malaysian IR system made a decisive shift towards enterprise-level bargaining. The strength of the industrial union was reduced when it lost membership control of these important, non-national assembly firms (Nissan and Toyota) in the early 1990s. This happened due to a dispute among union leaders in the wake of the imprisonment of the general secretary, together with other critics of the government, in 1987 and the decision to elect new union leaders. In this situation, the industrial union switched to a more pragmatic strategy and improved cooperation with employers. It also began organizing the auto component firms which had emerged due to the indigenization of the auto industry. The union leadership did also believe that bilateral negotiations with individual employers provided it with a better bargaining position than when it faced a united front of auto assemblers.

When the Korean state and capital struck back during the economic recession in the early 1990s – motivated by unstable business environments and rising labor costs – workers and unions found themselves on the defensive, and this continued with the globalization policy of the President Kim Yong Sam administration (1992–97) which adopted 'globalization (*segewha* in Korean) as its major economic agenda (Wad 2002). The authorities continued to suppress illegal industrial action, arresting and imprisoning labor activists; employers started collaborating with moderate unionists, forming micro-coalitions of productivity improvements (company production compromises). Radical union activists concluded that a process of centralization was necessary if they were to sustain and progress with their labor movement (Jeong 2001b). This took time and many debates but did eventually produce the KCTU, which was born as a radical and illegal labor center in 1995 and finally legalized with the Tripartite concord and 'Grand Compromise' between the government, employers associations and labor centers in 1998 (Lee and Lee 2001; Wad 2002). Yet, the KCTU

abandoned this instance of social corporatism immediately when the leadership was ousted after accepting the deal (Kim 2004).

The KCTU believed that the employer offensive in the 1990s disclosed the weaknesses of enterprise unionism, and promoted the alternative industry-level bargaining. It thought a consolidation of thousands of enterprise unions, which had sprung up in the late 1980s, was necessary if the trade union movement were to progress. The ongoing confrontations between radical enterprise unions and employers, facing increasing competition in the domestic and export markets on the one hand, and rising labor and other production costs in Korea on the other hand, sustained the radicalism of the independent and democratic Korean unions, including the unions in the heavy metal industries. However, the process did not facilitate the establishment of centralized collective bargaining because the Korean employers did not want centralized employer associations empowered with bargaining authority with labor unions.

The discussion above takes us to the fourth question. Why did the auto worker unions in Korea and Malaysia end up with a rather similar union structure at the industry level in spite of their differences in union ideology and strategy and differences in the level of internationalization and technological development? The industrial development of the auto industries in Korea and Malaysia had created a rather similar structure of larger auto manufacturing firms and smaller auto component supplier companies. But they were positioned differently in the global auto value chain. The stratification of the domestic auto industry in quite different firms with different levels of productivity, profitability and wages created different interest groups among the auto workers, which were again maintained by enterprise-based unions. In spite of the radical ideology of the auto workers and their leaders, factionalism evolved in the larger assembly firms, and some groups were not eager to completely give up union autonomy and join the industrial union.

In Korea, the metal industrial federation was led by former student-turned-worker leaders whom some worker groups judged to be without enough workplace experience and insight to understand and support the workplace struggle for better wages and working conditions. Hence, the development of the industrial union was driven by the leadership of the federation (KMWF) and the unions in the smaller supplier firms, with no active participation of large enterprise-level unions in *chaebol* firms. A similar situation arose in Malaysia, but from a different starting point: the auto worker industrial unions began in the assembly industry, and with the national auto program it was pushed away from the dominant assemblers and into the component supplier industry, where it created a new union stronghold.

Korean and Malaysian auto industrial unions differed in a strategic sense. While the Malaysian industrial union once did bargain with an employer association, it did not consider the industry-level bargaining as of strategic importance. Contrary to Korean metal workers' unions, it perceived bilateral negotiation between the industrial union and individual employers as to its advantage. The union leadership is confident that time will prove that the industrial union is

stronger than enterprise unions. This relative strength, the union contends, is confirmed by the fact that the industrial union has been determining the trend in collective bargaining and agreements, and that some in-house unions joined the industrial union in the 1990s. But bilateral negotiations between an industrial union and an individual employer emphasize the enterprise level, and the industrial union risks that the management makes use of eventual opportunities to support a breakaway faction, which wants to establish an in-house union. Such a situation appeared in the past, and it emerged again in one of the biggest Malaysian auto component supplier firms in 2004.

The Korean industrial union's strategy towards centralized collective bargaining seems to be founded in a commitment to equalize the very unequal terms of employment among assembly and supplier firms. But as long as employers are not forced to unite and convinced that there would be no net benefits of organizing centralized bargaining, the KMWU does not have a reliable counterpart for such industry-level or region-level negotiations. With increasing foreign FDI and MNC involvement in Korea's auto industry, the ownership structure gets closer to the Malaysian one, and the prospect for a centralized association of auto industry employers is bleak. Foreign auto MNCs do not seem to join hands with local employers, and with the new adherence to human resource management strategies, flexibility and decentralized IR are emphasized.

It is interesting to notice that the establishment of a federation of auto worker unions in Korea and Malaysia seems to target different objectives. In Korea, the objective was to use the federation as a mechanism to create an industrial union and increase the pressure on employers to enter centralized bargaining (KCTU 2000). In Malaysia, the objective has been political first and foremost; the federation wanted to be a 'voice' of workers to the Malaysian government. This became important as the industry was making the transition from a protected market to an open market due to the conclusion of AFTA and increasing competitive pressure from Thailand. These differences show that the key drivers of the auto industry in Korea and Malaysia are not similar. In Korea, the private local and foreign auto firms are now fully established with little need of help from the government. In Malaysia, by contrast, the state is still seen as the protector of the auto industry. The Malaysian conception of the state as a 'protector' was corroborated during the financial crisis, when the government introduced capital controls in combination with policy measures to boost domestic demand to save the economy in general and the auto industry in particular from collapse. Although the ASEAN countries have agreed upon a free trade agreement (AFTA), the actual implementation is still up to political negotiations, and will continue to be so for several years to come.

The fifth question concerns the future. Will industrial relations in Korea and Malaysia diverge in the future, that is, will the Korean auto unions strengthen their trend towards a radical industrial union and a centralized bargaining system while the Malaysian unions evolve into conservative unions dominated by enterprise unions and a decentralized bargaining system? The answer hinges on the

'union effect' – the achievements of the unions in the past – and lessons to be learned from these experiences. Two aspects will suffice to illustrate this issue.

First, the Korean 'Great Labor Struggle' in 1987 caused a sustained increase in wages and had potential to undermine the export competitiveness of Korean auto industries. This prospect forced Korean firms to rationalize their organization and invest in technology, quality and training. Hence, the militancy of the new independent and democratic unions generated dynamic efficiency in the Korean auto industry. However, the efficiency was mainly achieved by the Fordist way of exploiting economies of scale through standardized mass production (Jeong 2001a). Around the financial crisis, Korean auto workers earned a net hourly wage of US$6.67 in 1997, which increased to US$7.12 in 2001 and US$9.40 in 2003/04, while their Malaysian counterparts earned US$1.81 in 1997, which fell to US$0.94 in 2001 (IMFmetal 1998, 2002, 2004). The Korean auto workers earned 3.7 times as much as the Malaysian auto workers in 1997 and this difference widened to 7.5 times in 2001.

Second, the HMC union's battle for the 40 hour, five-day work week in 2003 ended with a victory for the union, thus setting a benchmark for other unions. In August 2003, the HMC union extracted an agreement from its employer on a 40 hour, five-day work week, an 8.6 percent wage increase for the next year, a performance-based incentive worth two months' wages, an immediate incentive worth one month's wages, job security, and a labor–management panel to handle the concerns of employees. The collective agreement was approved by 81 percent of the members, the highest majority in the history of the HMC union.[6]

In Malaysia, the claim for a 40 hour work week has not been on the agenda in the auto industry since the 1970s. The best hourly working conditions are a 42½ hour work week, practiced in a few auto assemblers in both the national and non-national sectors. On the contrary, a new situation evolved when Honda Motors instituted employment conditions, calling upon employees to work 48 hours per week. Proton's management took up the idea and demanded that working hours should be increased at the new factory in 'greenfield' Proton City. Moreover, Proton also demanded that Proton employees who had volunteered to be relocated to the new workplace should do so without transfer benefits. This move by the management came in a situation where Proton was losing market share in Malaysia to Honda, Toyota and HMC, and facing increased competition within the regional free trade area (AFTA).

Hence, the effectiveness of the auto worker unions was stronger in Korea than in Malaysia. The Korean unions pursued a radical and militant strategy, which has paid off so far, while the Korean auto industry was globalized rapidly. The KTCU and its supporters are in favor of establishing a centralized IR system within the metal industry, although factions within the key enterprise unions in the large auto manufacturing firms are hesitant to give up their autonomy. The Malaysian auto worker unions have also secured higher than average wages in the protected auto industry, which again is in line with the trend in the Malaysian manufacturing sector that unionized companies pay better than non-

unionized companies (Standing 1992; Wad 1997). But with creeping regionalization of the Malaysian automobile market, the benefits, achieved through a long process of unionization and collective bargaining led by the industrial union, are now under pressure. While the industrial union has adopted a more pragmatic ideology, the larger enterprise unions have been under attack from their management, and these pressures may turn the big in-house unions away from a conservative stance towards a more pragmatic ideology.

Moreover, the advance of the Democratic Labor Party in Korea indicates that the radical Korean trade unions have succeeded in gaining political ground in the parliament. This kind of political advancement of labor unions has not materialized in Malaysia. Hence, it is likely that the Korean auto worker unions will continue to be radical and militant to achieve centralized unionization while the Malaysian auto worker unions will remain more pragmatic and stay pluralistic at the industry level.

Conclusion

We face two paradoxes in interpreting the experience of Korea and Malaysia. The first paradox is that in spite of the differences in union ideology during the 1990s and 2000s, the outcome in terms of the IR system was rather similar in the sense that the auto industries in the two countries contained a mixture of industrial and enterprise unions and formal/informal federations of these unions, and that collective bargaining was by and large undertaken bilaterally at the enterprise level. In Malaysia, a semi-centralized IR system is dominant in the low-technology assembly industry (the globally subordinated local OEMs) and a decentralized IR system is prevalent in the SOE-MNC-controlled industry. In Korea, the centralization of enterprise unions has undergone in the process of the confrontations between militant unionists and authoritarian employers while its industry become much more technologically advanced and export-oriented over time and indigenized, until foreign acquisitions followed in the wake of the East Asian financial crisis. Yet, while some employers gave in and undertook regional collective bargaining with KMWU, large auto enterprise unions in both countries resisted organizational and bargaining centralization.

The second paradox is that the radicalism of the Korean auto worker unions was maintained during the 1990s when the globalization of the auto industry was accelerated, while radicalism was abandoned by the Malaysian auto worker unions in favor of union pragmatism from the early 1990s when the indigenization of the Malaysian auto industry unfolded and the local auto supplier industry had been formed. Union ideologies, strategies, organizational structures and forms of collective bargaining made sense in the context of the respective countries, and they changed with changes in the circumstances they faced. The union wage effectiveness was above average in both countries in comparison with other industries, but the Korean auto workers rapidly achieved a much higher level of wages and working conditions than their Malaysian counterpart.

The difference between the auto industries of Korea and Malaysia can be

partly explained by their different positions in the global and local auto value chain. The radicalism and effectiveness of Korean auto worker unions sustained the development of dynamic efficiency among Korean auto manufacturing firms, which again sustained and improved export competitiveness and later on outward FDI. In the same way, the intra-industry differences in wages and working conditions among auto manufacturing firms and component suppliers were also related to the stratification of the domestic auto value chain, and this uneven distribution of benefits created obstacles of centralized unionization and collective bargaining. The early centralized IR system in Malaysia evolved in an auto industry composed primarily of firms assembling imported CKD kits of components, while the semi-centralized IR system was a result of the state-driven indigenization of auto manufacturing insulating the SOE work forces from the unionization drive of the industrial union, and increasing preference among employers for bilateral and enterprise-level collective bargaining. The inequality of employment conditions between auto assemblers and component suppliers was a driver of the strategy to centralized unionism and collective bargaining in Korea, while the inequality was not perceived as that significant by the Malaysian industrial union, probably because it has been dealing with these problems since the early 1990s. Yet, the workers of the component suppliers became the social base of the industrial unions in both Korea and Malaysia, indicating that industrial unions are better organizational devices than enterprise unions in the pursuit of organizing small and medium-size companies.

Finally, the Korean auto worker unions became part of a new, independent and democratic labor movement in the 'Great Labor Struggle' in the late 1980s, and they have stayed with this labor movement, which also spun off a democratic labor party. The Malaysian auto worker unions arose in a labor market which already carried centralized IR institutions, established under late colonialism to counteract the eventual return of a defeated communist labor movement, and which was transformed in accordance with a new ethno-political policy of indigenization. The radical industrial union tried to create an alternative, radical trade union movement, but failed and became the internal opposition after returning to the labor center (MTUC).[7] The Malaysian unions stayed united in a pragmatic-conservative trade union center, while the Korean unions have been divided into a radical labor center (KCTU) and a conservative-turned-pragmatic trade union center (FKTU). But in spite of this difference in trade union unity, the Korean unions held more political leverage due to their militancy and larger political space in comparison with Malaysian unions, which have to risk immediate deregistration if they adopt an illegal, militant strategy or engage in partisan political struggles.

Appendix 9.1 Evolution of the Korean and Malaysian auto industries, state (GO) policies and the auto worker unions

Appendix 9.1 Evolution of the Korean and Malaysian auto industries, state (GO) policies and the auto worker unions

Period	*Korea*		*Malaysia*	
	Industry structure and GO's auto and labor policies	*IR system of automobile industry*	*Industry structure and GO's auto and labor policies*	*IR system of automobile industry*
1950s	Import of CBUs; state corporatism and anti-communism (until today)	–	Import of CBUs; sector-wise IR corporatism and anti-communism (until fall of USSR)	–
1960s	Home market OEM; IS policy for CBUs; state corporatism	Unorganized	Home market OEM; IS policy for CBUs; legalistic labor policy	Unorganized
1970s	Home market ODM; IS policy for CBU and components; repressive state corporatism	Company union at HMC	Home market OEM; IS policy for CBUs; ethno-labor policy and weak sector corporatism	Radical industrial union and centralized CB
1980s	Home/export OBM; IS and EO policy; repressive micro-corporatism and then retreat of the state during 'Great Labor Struggle'	KIA with cooperative management–union relations Radical enterprise unions and plant CB DMC from 1985 and HMC from 1987, etc.	Home OEM and OEM(B); IS policy for CBU and components with national car project and localization; ethno-micro corporatism (in-house unionism)	Radical industrial union and weak centralized CB; Conservative enterprise union and enterprise CB
1990s	Home/export and FDI by OBMs; IS and EO policy; legalistic and repressive labor policy with liberal reform before financial crisis and social corporatism during the crisis	Radical enterprise unions and enterprise/group CB; federations at group, industry and national levels	Home/weak export and FDI ODM(B); expanded national motor vehicle program and localization; (ethno) micro corporatism and rudimentary state corporatism during financial crisis	Pragmatic industrial union into OES and enterprise CB; Conservative enterprise unions and enterprise CB

continued

Appendix 9.1 Continued

Period	*Korea*		*Malaysia*	
	Industry structure and GO's auto and labor policies	*IR system of automobile industry*	*Industry structure and GO's auto and labor policies*	*IR system of automobile industry*
2000s	Export and FDI by OBMs; free trade and FDI regime; legalistic labor policy.	Radical enterprise unions and enterprise/group CB; Federations at group, industry and national levels; Industrial union with OES and attempts at regional CB	Home/weak export and FDI by OBM; regional free trade area (AFTA) policy; (ethno) micro-corporatism	Pragmatic industrial union and enterprise CB; Conservative enterprise unions and enterprise CB; federation agreed by industrial and key enterprise unions in OBM and OEM but stalled in practice

Notes

IR industrial relations, that is, the relations between workers and trade unions, employers and employers' associations and the government and state agencies involved in labor market and workplace issues. CB collective bargaining. CBU completely built-up automobile. OEM original equipment manufacturer. ODM original design manufacturer. OBM original brand manufacturer. OEM(B): OEM with own marketing brand. OBM(B): OBM with own marketing brand. Home market, export market and FDI mean that the manufacturer is oriented towards the home market, the export market and undertakes foreign direct investment. OES original equipment supplier of auto components.

Notes

1 This chapter is a product of my collaboration with Jooyeon Jeong, Korea University and enduring interviews and discussions with trade unionists in the Korea and Malaysia. The recent research from 2001 to 2003 on trade unions in Korea and Malaysia was supported financially by the Danish Research Council for Social Sciences (SSF). Moreover, research on automobile global value chains and foreign–local linkages in Malaysia, India and South Africa 2003–04 has been supported by the Danish Council for Development Research (RUF) in relation to the research project 'Globalization, Competitiveness and Third World Enterprises' 2001–04. The usual disclaimers prevail.
2 Proton exported 8,648 units in 2002 and 7,929 units in 2003 (Proton Annual Report 2003, p. 34).
3 Koo (2001) uses slightly different English names for these unions.
4 Interview with HMC union officers by Jeong and Wad, June 2001.
5 The industrial union was originally named the Transport Equipment and Allied Industries Employees Union (TEAIEU) and shifted name in early 1990s to differentiate itself from the Transport Workers Union, unionizing drivers, etc.
6 *IMF News* 2003, No. 3.
7 In the tri-annual MTUC election by the end of 2004, the executive secretary of the NUTEAIW won the presidency of the MTUC due to an election alliance between two pragmatic coalitions of unions against the conservative coalition presided over by the former MTUC president.

References

Chung, M.-K. (2003) The Chance for a Peripheral Market Player: The Internationalization Strategies of the Korean Automobile Industry, in Freyssenet, M., Shimizu, K., and Volpato, G. (eds) *Globalization or Regionalization of the American and Asian Car Industry?*, New York: Palgrave Macmillan.

Das, A. (1991) *Not beyond Repair. Reflections of a Malaysian Trade Unionist*, Hong Kong: Asia Monitor Resource Center.

Gereffi, G. (1999) International Trade and Industrial Upgrading in the Apparel Commodity Chain, *Journal of International Economics*, 48: 37–70.

IMF(Metal) (1998, 2002) *The Purchasing Power of Working Time. An International Comparison*, Geneva: IMF(Metal).

—— (2003) *Global and Regional Auto Industry Trends & Challenges for Unions*, Asia-Pacific Auto Conference, Bangkok, October 6–8 (*dias* by R. Blum).

Jeong, J. (2001a) Assembler–supplier relations in the Korean auto industry: An economic sociological analysis, *Business and Society*, 2(1): 76–98.

—— (2001b) Pursuing centralised bargaining in an era of decentralisation? A progressive union goal in Korea from a comparative perspective, *Industrial Relations Journal,* 32 (1): 55–70.

—— (2003) 'A Socio-economic Analysis of Union Densities and Bargaining Structures: The Korean Case from a Cross-National Comparative Perspective', paper presented at the 15th annual SASE meeting, Aix-en-Provence, France, June 26–28.

Jeong, J. and Wad, P. (2004) 'Diversity and Dynamism of Union and Bargaining Structures in Korea and Malaysia from a Comparative, Multi-level Perspective', conference paper, IRRA 56th annual meeting, San Diego CA, January 3–5.

Jomo, K.S. and Lee H.A. (2001) 'Social Impacts', in Jomo, K.S. (ed.) (2001) *Malaysian Eclipse. Economic Crisis and Recovery*, London: Zed Books, 216–55.

KCTU (2000) *The strategy of building industry-wide union in KCTU* (2000.3), document. Seoul: KCTU (translated from Korean).

Korea Automotive Research Institute (KARI) (various years) *Korea Automotive Industry*, Seoul: KARI.

Kelly, J. (1998) *Rethinking Industrial Relations. Mobilization, collectivism and long waves*, London: Routledge.

Kim, D.-O. (2004) 'Neither Authoritarian Corporatism nor Democratic Corporatism: The Rise and Decline of the Korea Tripartite Commission', conference paper, IRRA annual meeting, San Diego CA, January 3–5.

KMWF–KCTU (undated) *No sale to GM. Daewoo Auto Workers' Union, KMWF–KCTU*. Seoul: KMWF–KCTU.

Koo, H. (2001) *Korean Workers. The Culture and Politics of Class Formation*, Ithaca NY, Cornell University Press.

Korean Automotive Research Institute (KARI) (1998, 2000, 2001, 2002) *Korean Automotive Industry*, Seoul: KIRA (formerly Kia Economic Research Institute).

Lee, Y.-S. (2003) 'Lean Production Systems, Labor Unions, and Greenfield Locations of the Korean New Auto Assembly Plants and their Suppliers', *Economic Geography*, 79(1): 321–39.

—— (2005) 'Debt Restructuring and the Politics of Exclusion: A Case Study of the Daewoo Motor Bupyeong Plants in Incheon, South Korea', paper, USRP, ARI, NUS.

Lee, W. and Lee, J. (2001) 'Will the Model of Uncoordinated Decentralization Persist? Changes in Korean Industrial Relations after the Financial Crisis', conference paper, ILR-Cornell University, October 5–7.

Lindström, L. (1993) Accumulation, Regulation, and Political Struggles. Manufacturing Workers in South Korea, PhD dissertation, Stockholm University.

National Union of Transport Equipment and Allied Industries Workers (NUTEAIW) (1997, 2000), *Triennial Report*, Shah Alam: NUTEAIW.

OICA (2002) *Correspondents Survey 2001–2002* (www.oica.net/htdocs/Main.htm).

Peetz, D. and Todd, T. (2000) *Globalization and Industrial Relations in Malaysia*, Bangkok: ILO ROAP.

Proton (2003) *Annual Report 2003* (www.proton.com).

Sohn (2003) *The history of KMWF (Korea Metal Workers' Federation) and KMFU (Korea Metal Workers' Union)*, Mimeo, Seoul, Korea University.

Standing, G. (1992) 'Do unions impede or accelerate structural adjustment? Industrial versus company unions in an industrialising labour market', *Cambridge Journal of Economics*, 16: 327–54.

Wad, P. (1988) 'The Japanization of the Malaysian Trade Union Movement', in Southall, R. (ed.) *Trade Unions and the New Industrialization of the Third World,* London: Zed Books, 210–29.

—— (1997) 'Enterprise Unions and Structural Change in Malaysia', final research report, Copenhagen: DICM, CBS.

—— (2001) 'Making and Unmaking Viable National Auto Manufacturers in South Korea and Malaysia: The Net Holder Approach', *Business and Society*, 2(1): 24–55.

—— (2002) 'The political business of development in South Korea', in Gomez, E.T. (ed.) *Political Business in East Asia*, London: Routledge, 182–215.

—— (2004a) 'Transforming Industrial Relations: the Case of the Malaysian Auto Industry', in Elmhirst, R. and Saptari, R. (eds) *Labour in Southeast Asia. Local processes in a globalised world*, London: RoutledgeCurzon, 235–64.

—— (2004b) 'Auto workers in ASEAN-4', in Chang Dae-oup and Ed Shepherd (eds) *Automobile workers and industry in globalising Asia*, Hong Kong: AMRC &CEC, 3–27.

List of abbreviations

AFTA	ASEAN Free Trade Area
CB	Collective bargaining
CBU	Completely build up (automobile)
CKD	Completely knocked down (set of automobile components)
DMC	Daewoo Motors
FDI	Foreign direct investment
FKTU	Federation of Korean Trade Unions
GERPISA	Permanent group for the study of the automobile industry and its employees
GM	General Motors
HMC	Hyundai Motor Co.
IMFmetal	International Metalworkers' Federation (IMF, yet here called IMFmetal to distinguish it from the International Financial Fund, IMF)
IMVP	International Motor Vehicle Program
IR	Industrial relations, i.e. relations between employers' associations, employees' unions and state agencies
ISA	Internal Security Act, Malaysia
JV	Joint venture
KCTU	Korean Confederation of Trade Unions
KMC	Kia Motors
KMWF	Korean Metal Workers Federation
KMWU	Korean Metal Workers Union
LV	Light vehicle
MMC	Mitsubishi Motor Co.
MNC	Multinational corporation
MTUC	Malaysian Trades Union Congress
NUTEAIW	National Union of Transport Equipment and Allied Industries Workers (before 1990 called TEAIEU: Transport Equipment and Allied Industries Employees Union)
OBM	Original brand manufacturing
ODM	Original design manufacturing
ODS	Original design supplier
OEM	Original equipment manufacturing
OES	Original equipment supplier
SOE	State-owned enterprise
TRIM	Trade-related investment measures

10 Globalization and labor market restructuring

Regional discrimination in the Korean labor market

Changhui Kang[1]

Introduction

At the end of 1997, Korea was hit by a massive financial crisis on its path toward transformation into a more globalized economy. The Korean economy then found itself facing a variety of tasks to overcome the urgent situation, and to restructure the economic system in the manner required by "global standards". As part of the International Monetary Fund (IMF)-sponsored rescue program, the Korean government implemented radical economic restructuring measures by pursuing a high interest-rate policy and by allowing for "flexible" employment practices in the labour market. These policies resulted in a severe economic recession, which was accompanied by large-scale bankruptcies among firms, together with massive job displacements.

This study investigates how those policies to embrace challenges from globalization were hijacked by regional politics at the local level by looking into the Korean labour market during the post-crisis era (1997–2001). It specifically examines the process whereby workers suffered job displacement during this period, which revealed one of the social problems that had been lying deep at the heart of the Korean society – regional discrimination.

In Korea, regional discrimination signifies two different but closely related views of regional economic development and its consequences. First, like the geographically uneven economic development that other countries experience domestically (for example, the problem of Italy's Mezzogiorno, or southern Italy), it refers to contemporary economic gaps that exist among different regions within the country. In the course of economic development, some regions have lagged behind others in Korea, and such regional economic disparities still persist. Second, regional discrimination in Korea also refers to discrimination in social and economic status of people due to differences in birth regions. Since the 1960s when economic development started in earnest in Korea, it has been believed that people from one region, namely, the Jolla provinces in the southwestern part of the Korean peninsula, have been disadvantaged or discriminated against relative to those from another region, the Kyongsang provinces in the southeastern part of the country. This notion

becomes more pronounced among residents of the Seoul–Kyongki metropolitan area, who largely consist of immigrant population from other regions: in Seoul–Kyongki, those born in the Jolla provinces were believed to be discriminated against in favor of those born in the Kyongsang provinces. According to the latter view, regional discrimination is believed to be embedded in an individual's birth region.

Although the first view of regional discrimination (i.e. contemporary regional economic gaps) has been studied extensively by Western scholars interested in regional inequality, Korean researchers have more often emphasized the second view when they discuss regional discrimination. This chapter also primarily deals with the second view in examining the process of job displacement.

Previous studies on regional discrimination in Korea have usually focused on the regional bias in the composition of high-ranking government officials, or in the elite groups within large private firms or government-owned companies. Kim (1991a), Kim (1991b) and Kim and Lew (1996) report the pre-1997 situation of regional discrimination, and Kim and Lee (2001) and Kim and Park (2001) investigate the recent changes in the regional composition of the power-elite groups in private large firms. Findings of these studies are that, before 1998, the bias was in favor of those from the Kyongsang provinces, whereas it shifted toward those from the Jolla provinces after 1998, when the new Jolla-based political power led by Kim Dae-Jung stepped in the administration. Although these studies give some indication of the operation of regional discrimination, they are limited to certain elite groups. Studies of regional discrimination in Korea in general have lacked the breadth of scope and depth of analysis. In particular, there have been few studies to confirm that the regional discrimination also operates at the level of ordinary Koreans.

This study investigates regional discrimination among individual workers, using a data set from a household survey that is representative of the entire population of the country. The findings of the empirical analysis show that regional discrimination did function in the process of job displacement and significantly affected the economic status of individual workers in the post-crisis era of economic restructuring. Given that regional discrimination is a very sensitive social issue in Korea, this finding per se deserves much attention. The latter section of this chapter presents plausible causes that explain such empirical findings. In addition, the chapter shows the changes in the effects of birth region on job displacement in the period of economic recovery, about two years after the financial crisis.

This chapter is organized as follows: in the next section, the historical background of regional discrimination in Korea is presented. Then, the data used in the empirical analysis are discussed with their descriptive statistics. In subsequent sections, the statistical model and the empirical findings, respectively, are explained. The final section concludes the chapter.

Background to regional discrimination in Korea

Regionally uneven economic development

It is often pointed out that Korea's successful economic growth in the past four decades has been accompanied by geographically uneven development in the following two respects: (1) the concentration of industrial activities in the Seoul–Kyongki metropolitan area in the northwest; and (2) unbalanced development between the Jolla provinces in the southwest and the Kyongsang provinces in the southeast (see Figure 10.1).

First, the concentration of industrial activities in the Seoul–Kyongki region is very evident when we look at some indicators of employment and industrial production by region.[2] Table 10.1 shows the regional distribution of population and

Figure 10.1 South Korea.

Table 10.1 Regional distribution of population and value added in the mining and manufacturing industries (%)

Year	*Population*					*Value added*				
	Seoul–Kyongki	*Kyong-sang*	*Jolla*	*CJK*	*Total*	*Seoul–Kyongki*	*Kyong-sang*	*Jolla*	*CJK*	*Total*
1960	–	–	–	–	–	36.8	33.6	8.5	21.2	100
						(31.8)	(35.9)	(11.9)	(20.4)	(100)
1966	–	–	–	–	–	37.9	34.0	8.5	19.5	100
						(37.5)	(34.2)	(11.1)	(17.3)	(100)
1970	28.3	30.4	20.4	20.9	100	42.0	34.8	7.2	16.0	100
						(43.4)	(32.8)	(10.0)	(12.4)	(100)
1975	31.5	30.5	18.1	19.1	100	44.4	35.7	8.9	11.1	100
						(46.1)	(36.3)	(6.6)	(11.0)	(100)
1980	35.5	30.5	16.2	17.7	100	40.8	39.6	9.2	10.3	100
						(44.3)	(39.4)	(6.3)	(10.0)	(100)
1985	39.1	29.8	14.7	16.3	100	42.3	39.8	7.4	10.4	100
						(45.9)	(33.4)	(5.7)	(9.1)	(100)
1990	42.8	28.9	13.2	15.1	100	45.1	37.1	7.9	9.9	100
						(47.0)	(32.2)	(6.4)	(9.2)	(100)
1995	45.3	28.6	11.7	14.4	100	44.4	34.0	8.9	12.7	100
						(46.4)	(30.0)	(7.2)	(10.9)	(100)
1998	45.8	28.2	11.5	14.5	100	38.9	38.2	9.7	13.2	100
						(44.0)	(31.5)	(7.6)	(12.0)	(100)

Source: Korea National Statistical Office, Statistics Database.

Note
Numbers in parentheses indicate the share of the average number of employees per month. *CJK* refers to the Chungchong–Jeju–Kangwon provinces.

value added of the mining and manufacturing industries, from the year 1960 to 1998. The share of the population residing in the Seoul–Kyongki region rapidly increased from 28.3 percent in 1970 to 45.8 percent in 1998. The regional distribution of value-added also shows the concentration of industrial production in the Seoul–Kyongki region. In 1960, the region accounted for 36.8 percent of value added and 31.8 percent of employment in the mining and manufacturing industries. In 1995, these numbers had grown to 44.4 percent and 46.4 percent, respectively.

Second, even in the economic development of regions outside Seoul–Kyongki, regional bias has existed between the Kyongsang provinces and the Jolla provinces. A variety of indicators show that, relative to the Kyongsang provinces, the Jolla provinces have been underdeveloped. As Table 10.1 shows, in 1998, the Kyongsang provinces were occupied by 28.2 percent of the total South Korean population, and the Jolla provinces were occupied by 11.5 percent. In contrast to these recent figures, the Kyongsang provinces in 1970 accounted for 30.4 percent of the total population while the Jolla provinces accounted for 20.4 percent. While the Kyongsang provinces show only a slight fall in population, the Jolla provinces reveal a dramatic decline in population during the last three decades. In terms of industrial output, the gap is also evident between the Kyongsang and Jolla provinces. During the period of economic development since the early 1960s, the Kyongsang provinces have outgrown the Jolla provinces in terms of value added and employment in the mining and manufacturing industries.[3] Such uneven economic development between the Kyongsang provinces and Jolla provinces is closely related to the regional discrimination in economic and social status by birth region, which is a primary interest of this chapter.

Data from a Korean household survey ("Korean Labor and Income Panel Study"[4]) also provides evidence of the two aspects of geographically uneven development in Korea. Table 10.2 reports the number of survey respondents at the time of the survey in 1998, by residence and birth regions. The Seoul–Kyongki region accounts for 49 percent of the total number of respondents, while the other regions account for 51 percent. About 45 percent of the respondents currently residing in the Seoul–Kyongki region are emigrants of other regions. When we look at the geographical immigration patterns of the Kyongsang-born and Jolla-born respondents in Table 10.2, we find that 23 percent of those born in the Kyongsang provinces have left their birth region in search of new residences in other regions (mainly, the Seoul–Kyongki region), while as much as 57 percent of those born in the Jolla province have left their home region for other regions.

Historical context of regional discrimination

It is often believed that the geographically uneven distribution of economic development was accelerated by the authoritarian government and its political power elites, which had based their regional and political support in the

Table 10.2 Number of survey respondents by residence and birth regions

Birth regions	*Residence regions*				
	Seoul–Kyongki	*Kyongsang*	*Jolla*	*CJK*	*Row sum*
Seoul–Kyongki	2,915 (0.92)	100 (0.03)	29 (0.01)	111 (0.04)	3,155 (1.00)
Kyongsang	881 (0.20)	3,427 (0.77)	21 (0.00)	129 (0.03)	4,458 (1.00)
Jolla	1,280 (0.46)	213 (0.08)	1,219 (0.43)	97 (0.03)	2,809 (1.00)
CJK	1,468 (0.51)	270 (0.09)	47 (0.02)	1,098 (0.38)	2,883 (1.00)
Total	6,544 (0.49)	4,010 (0.30)	1,316 (0.10)	1,435 (0.11)	13,305 (1.00)

Note
Those born in foreign countries are included in the CJK provinces. Numbers in parentheses indicate the proportions within each row.

Kyongsang provinces. On the other hand, the Jolla provinces and their regional political power (led by the former president, Kim Dae-Jung) had remained as the major political opponent to the incumbent governments from the late 1960s. These facts explain that in economic, social, and political respects, the Kyongsang provinces had been a favored region together with the Seoul–Kyongki region, while the Jolla provinces had been a disadvantaged region. Although some argue that Seoul–Kyongsang-based economic development was an inevitable by-product of the government's strategy of economic development – which had to follow what the previous Japanese colonial strategy that favored industrial development in the Kyongsang area, and which also paid more attention to the Kyongsang area due to reliance on imports from Japan and exporting products to the US – the incumbent governments have ignored (or at least, failed to take seriously) the underdevelopment of the Jolla provinces.

As a result of regional bias in political and economic decision-making, the public perception grew that people in the Kyongsang provinces had been favored in comparison with those in other regions. The impression of unfavored Jolla versus favored Kyongsang is held to be valid for residents in Seoul–Kyongki from both regions, let alone in the Kyongsang provinces into which many Jolla-born people have immigrated. Historically, this strain of public perception on regional division has very often played a dominant role in Korea's general and presidential elections in the past decade and a half.[5]

The traditional political situation, however, changed dramatically in February 1998, when a new political power group took over the administration as a result of the presidential election in December 1997. This new government and ruling political party led by Kim Dae-Jung, a long-time political opponent to the Kyongsang-based political power, had based its regional and political support on

the Jolla provinces – the main victims of traditional regional discrimination. Interestingly, the coming of the new government coincided with the unprecedented economic crisis and the subsequent large scale of job displacements.

In the new political and economic environment, we would expect two scenarios of changes in the system of regional discrimination that the new government might bring to the process of job displacements in the post-crisis period. First, the mechanism of regional discrimination could die out altogether with the dismantling of the Kyongsang-driven discrimination system. If this is the case, we would not expect to find any discriminatory (to the Kyongsang-born) or favorable (to the Jolla-born) outcomes. Second, it is equally possible that the old system of regional discrimination may be reversed in favor of the Jolla-born and against the Kyongsang-born, if the mechanism of regional discrimination persists, only changing who is in the driver's seat. If this happens, the outcome will be favorable to the Jolla-born and unfavorable to the Kyongsang-born.

In our empirical analyses, we examine the process of job displacements for individual workers after the 1997 economic crisis, and find evidence which supports the second scenario, especially during the recession period of 1997 to 1999. We find that workers' birth regions constituted one of the determinants of job displacements during this period, and that Kyongsang-born workers faced a significantly higher likelihood of job displacements (especially, layoffs) relative to Jolla-born workers with similar characteristics.[6]

Empirical data

For empirical analyses, we use an annual national household survey entitled Korean Labor and Income Panel Study (KLIPS) for the survey years 1998 to 2001. KLIPS is a longitudinal survey administered by the Korea Labor Institute, a government-sponsored research organization. From 1998, it annually conducts longitudinal surveys of 5,000 Korean households and 13,783 household members over 15 years of age. The respondents to the KLIPS survey are selected to represent the population of South Korea. The survey collects a wide range of information regarding households and individuals, such as household income and expenditure, information on individual demographics and the status of the labor market, including current and previous employments, and labor or non-labor income. The calendar date on which an individual left his/her most recent job turns out to be very useful in constructing the sample of individuals who were affected by the post-crisis employment restructuring. We use the survey years 1998 and 1999 of KLIPS to investigate the effect of birth regions on job displacements during the recession period. To compare the results from the recession period with those after it, we also examine job displacements that occurred during the recovery period of 2000 and 2001.[7]

When we examine job displacements during the economic recession, we identify the date and the reason that a worker left his/her job in order to construct a sample of workers who left their most recent jobs between December 1997 and the survey date of 1999 for involuntary reasons.[8] These workers are

defined as "separators", that is, those who were displaced from their jobs during the process of restructuring that was forced on firms by the economic recession.[9] In contrast, those who retained their employment with the same employer between December 1997 and the survey date of 1999 are defined as "stayers". They include those who survived downsizing during the relevant period. In a similar way, when we investigate job displacements during the period of economic recovery in 2000 and 2001, we construct a group of "separators" as those who were displaced after the 1999 survey date and before the 2001 survey date, while we define "stayers" as those who retained the employment with the same employer during the same time period. We refer to the group of separators and stayers from the 1998 and 1999 data as the "recession sample"; that from the 2000 and 2001 data is referred to as the "recovery sample".

Since job displacements during the economic recession constitute our primary interest in this chapter, we report the characteristics of the stayers and separators in the recession sample in Table 10.3, and show those of the recovery sample in Appendix 10.1. According to Table 10.3, the separators during the recession period are more likely to be females, non-household heads who are older workers with less education, smaller monthly earnings and shorter tenure in non-full-time employments. The separators are mostly service workers or laborers, and there are fewer professional and technical workers, or sales and administrative support workers.

The likelihood of displacement is higher in the construction, light manufacturing and non-professional service industries, while it is lower in the professional services industry.[10] The likelihood of displacement is higher in small-sized firms. It is substantially high in firms with less than ten employees, while it is substantially low in firms with more than 1,000 employees. This implies a possibility that the effect of overall economic deterioration on the likelihood of job displacement varied across firms of different size. These varying effects are also observed when the cause of a displacement is identified. While the likelihood of separation because of plant closure and by layoffs is relatively close in firms with less than 1,000 employees, the picture is quite different in firms with more than 1,000 employees. In these larger firms, the likelihood of a displacement due to plant closure is much smaller than displacement due to layoffs.

Systematic significant differences do not appear to exist in the unconditional likelihood of job displacement between Jolla-born and Kyongsang-born workers. The higher proportion of Kyongsang-born workers among the separators as well as among the stayers simply reflects their larger population size. Similar differences in population size can be observed among the largest proportion of the workers residing in the Seoul-Kyongki region. In contrast to the unconditional analysis, a statistical model that highlights the marginal effect of interesting variables shows fairly differential impacts that birth regions can have on the likelihood of displacement.

Table 10.3 Descriptive statistics of the recession sample

	Stayers	*Separators*		
		Total	*Plant closure*	*Layoffs*
Means				
Age	36.65	38.85	38.00	39.53
	(9.71)	(11.06)	(10.13)	(11.71)
Years of schooling	12.77	11.03	11.40	10.74
	(3.29)	(3.56)	(3.28)	(3.75)
Monthly earnings	1,298.64	1,112.63	1,154.96	1,081.83
(W1,000)	(727.83)	(717.86)	(713.41)	(711.43)
Tenure (year)	6.28	5.06	4.28	5.67
	(7.13)	(6.66)	(5.43)	(7.43)
Proportion (%)				
Male	65.70	61.45	62.62	60.51
Married	73.27	75.68	76.04	75.38
Head of the household	58.59	53.34	54.95	52.05
Full-time occupation	87.58	73.65	81.46	67.53
Professional and technical	30.41	14.50	13.21	15.52
Sales and administrative	26.42	13.50	13.21	13.73
Support service	10.85	21.67	26.04	18.21
Crafts, operatives, laborers	32.31	50.33	47.55	52.54
Industry				
Construction	6.26	16.25	16.96	15.70
Light manufacturing	13.27	21.05	20.85	21.21
Heavy manufacturing	16.33	15.02	15.19	14.88
Non-professional services	27.92	34.98	38.16	32.51
Professional services	36.22	12.69	8.83	15.70
Firm employment size				
1~10	21.59	41.64	43.82	39.76
11~30	16.39	17.21	19.08	15.60
31~100	16.55	15.74	19.08	12.84
101~300	10.12	9.02	10.25	9.75
301~1,000	10.61	5.41	4.24	6.42
1,000+	24.75	10.98	3.53	17.43
Birth region				
Seoul–Kyongki region	22.76	22.19	22.04	22.31
Kyongsang provinces	33.89	33.29	37.38	30.00
Jolla provinces	21.17	23.22	22.36	21.28
CJK provinces	22.18	22.76	18.21	26.41
Region of residence				
Seoul–Kyongki region	49.10	52.22	48.87	54.90
Kyongsang provinces	30.61	29.76	33.44	26.80
Jolla provinces	9.91	9.01	9.97	8.25
CJK provinces	10.37	9.01	7.72	13.49
Number	2,391	703	313	390

Note
Variables are measured at time of displacement risks. Individuals over 60 years of age are excluded. Numbers in parentheses are standard deviations.

Estimation model for job displacements

Basically, our empirical analysis of job displacements compares the personal and job-related characteristics of those who were displaced and those who were not. The control group is made up of those workers who retained their jobs during the recession period (1997–99) or during the recovery period (2000–01), and the experimental group comprises those who experienced displacement during the same periods. In our micro-analyses of regional discrimination, the main explanatory variable of interest is an individual's birth region. A probit model is implemented for the statistical analysis. The probit model is specified, as follows.

Define D_i as a dummy variable that indicates whether a worker (i) had been displaced from his/her employer during a period of interest. A worker takes a value of 1 for D_i if he/she was displaced during the valid period, and 0 if he/she managed to retain employment during the same period. The likelihood that one may be displaced is specified by

$$\Pr(D_i = 1) = \Phi(X_i \beta)$$

where X_i is a $(1 \times K)$ vector of the worker i's personal and job-related characteristics at the risk of displacement, b is a $(K \times 1)$ parameter vector and $\Phi(\cdot)$ is a cumulative distribution function of the standard normal distribution. In contrast, the likelihood that one retained employment during the same period is specified by

$$\Pr(D_i = 0) = 1 - \Phi(X_i \beta)$$

Taking a derivative of $\Pr(D_i = 1)$ with respect to X_{ik} $(k = 1,2, \ldots, K)$ to interpret the estimates, we have

$$\frac{\partial \Pr(D_i = 1)}{\partial X_{ik}} = \frac{\partial \Phi(X_i \beta)}{\partial X_{ik}} = \phi(X_i \beta) \times \beta_k$$

where $\phi(\cdot)$ is a probability density function of the standard normal distribution. Since $\phi(\cdot)$ always remains positive, a characteristic X_{ik} increases (or decreases) the displacement likelihood if β_k is positive (or negative, respectively), other explanatory variables being kept constant.

The effect of birth regions on job displacement

Probit estimates

Tables 10.4 and 10.5 show the estimation results of the probit model on the likelihood of a displacement from both the recession and the recovery sample, respectively.[11] Each model of estimation has three different specifications.

Table 10.4 Probit estimates for displacement likelihood: effect of birth region, 1997–99

Explanatory variables	*Overall displacement*			*Layoffs*			*Plant closure*		
	(1)	*(2)*	*(3)*	*(1)*	*(2)*	*(3)*	*(1)*	*(2)*	*(3)*
Birth region effects in Seoul–Kyongki region									
Seoul–Kyongki	0.215	0.267*	0.287*	0.179	0.218	0.235	0.271	0.327	0.312
	(0.133)	(0.136)	(0.144)	(0.156)	(0.158)	(0.173)	(0.173)	(0.179)	(0.184)
Kyongsang	0.329*	0.374*	0.385*	0.389*	0.434*	0.446*	0.214	0.230	0.239
	(0.163)	(0.167)	(0.172)	(0.187)	(0.189)	(0.202)	(0.218)	(0.228)	(0.228)
CJK	0.142	0.178	0.135	0.212	0.237	0.232	0.080	0.128	0.026
	(0.146)	(0.149)	(0.161)	(0.168)	(0.170)	(0.188)	(0.191)	(0.199)	(0.213)
Birth region effects in areas outside Seoul–Kyongki region									
Seoul–Kyongki	0.318	0.250	0.169	0.391	0.366	0.223	0.194	0.064	0.143
	(0.292)	(0.299)	(0.344)	(0.343)	(0.346)	(0.414)	(0.367)	(0.396)	(0.412)
Kyongsang	0.228	0.210	0.327	0.142	0.122	0.505*	0.348	0.341	0.202
	(0.202)	(0.202)	(0.229)	(0.235)	(0.237)	(0.241)	(0.247)	(0.27)	(0.281)
CJK	0.210	0.179	0.245	0.424	0.401	0.625*	−0.025	−0.098	−0.146
	(0.229)	(0.232)	(0.260)	(0.264)	(0.267)	(0.271)	(0.310)	(0.35)	(0.350)
Region of residence									
Seoul–Kyongki	0.021	−0.035	0.060	0.055	0.002	0.088	−0.098	−0.172	−0.015
	(0.155)	(0.157)	(0.174)	(0.179)	(0.181)	(0.206)	(0.200)	(0.205)	(0.224)
Kyongsang	−0.064	−0.057	−0.009	−0.025	−0.034	−0.221	−0.168	−0.164	0.112
	(0.212)	(0.213)	(0.240)	(0.245)	(0.246)	(0.250)	(0.263)	(0.265)	(0.306)
CJK	−0.045	−0.020	−0.043	−0.109	−0.098	−0.208	−0.105	−0.066	0.040
	(0.244)	(0.247)	(0.280)	(0.284)	(0.288)	(0.294)	(0.322)	(0.328)	(0.381)

Other controls									
Log (monthly earnings)	No	Yes	No	No	Yes	No	No	Yes	No
Job designation	No	No	Yes	No	No	Yes	No	No	Yes
Log-likelihood	−980.8	−957.4	−800.4	−509.8	−685.6	−558.7	−544.6	−522.3	−437.8
No. in sample	1,994	1,968	1,789	1,835	1,821	1,678	1,724	1,702	1,597
No. of separators	470	454	343	273	269	195	200	188	151

Notes
The reference group comprises females who are unmarried, non-household heads, part-time laborers born and residing in the Jolla provinces, while employed in a firm with less than ten employees in light manufacturing industry. The estimates for personal characteristics, occupations, industries and firm sizes have been suppressed. They are available from the author upon request. Numbers in parentheses are standard errors. * Significant at the 5% level.

Table 10.5 Probit estimates for displacement likelihood: effect of birth region, 2000–01

Explanatory variables	*Overall displacement*			*Layoffs*			*Plant closure*		
	(1)	*(2)*	*(3)*	*(1)*	*(2)*	*(3)*	*(1)*	*(2)*	*(3)*
Birth region effects in Seoul–Kyongki region									
Seoul–Kyongki	0.229	0.215	0.287	0.149	0.140	0.165	0.389	0.374	0.506*
	(0.155)	(0.156)	(0.166)	(0.178)	(0.179)	(0.190)	(0.221)	(0.222)	(0.235)
Kyongsang	0.148	0.097	−0.046	0.190	0.190	−0.073	0.185	0.006	0.158
	(0.187)	(0.189)	(0.220)	(0.210)	(0.211)	(0.253)	(0.277)	(0.280)	(0.302)
CJK	−0.086	−0.149	−0.060	−0.144	−0.218	−0.168	0.055	0.028	0.163
	(0.176)	(0.178)	(0.191)	(0.203)	(0.208)	(0.224)	(0.246)	(0.248)	(0.259)
Birth region effects in areas outside Seoul–Kyongki region									
Seoul–Kyongki	0.313	0.312	0.364	0.113	0.138	0.199	0.537	0.486	0.522
	(0.387)	(0.388)	(0.395)	(0.479)	(0.478)	(0.486)	(0.489)	(0.498)	(0.492)
Kyongsang	0.254	0.240	0.391	0.201	0.201	0.340	0.388	0.348	0.365
	(0.261)	(0.254)	(0.283)	(0.309)	(0.301)	(0.350)	(0.314)	(0.323)	(0.317)
CJK	0.054	0.055	0.003	−0.148	−0.150	−0.198	0.398	0.387	0.254
	(0.321)	(0.319)	(0.355)	(0.410)	(0.407)	(0.449)	(0.443)	(0.462)	(0.453)
Region of residence									
Seoul–Kyongki	−0.250	−0.211	−0.226	−0.074	−0.069	−0.053	−0.535*	−0.473	−0.517
	(0.197)	(0.203)	(0.213)	(0.230)	(0.232)	(0.246)	(0.270)	(0.282)	(0.288)
Kyongsang	−0.293	−0.286	−0.390	−0.115	−0.145	−0.234	−0.619	−0.569	−0.540
	(0.291)	(0.287)	(0.317)	(0.355)	(0.348)	(0.399)	(0.336)	(0.351)	(0.344)
CJK	0.009	0.004	0.102	0.240	0.202	0.287	−0.438	−0.418	−0.235
	(0.346)	(0.346)	(0.376)	(0.449)	(0.445)	(0.483)	(0.476)	(0.499)	(0.481)

Other controls									
Log (monthly earnings)	No	Yes	No	No	Yes	No	No	Yes	No
Job designation	No	No	Yes	No	No	Yes	No	No	Yes
Log-likelihood	−601.0	−586.4	−498.9	−434.1	−424.9	−350.8	−272.7	−264.5	−237.2
No. in sample	1,882	1,878	1,654	1,803	1,801	1,584	1,739	1,736	1,542
No. of separators	222	219	182	143	142	112	79	77	70

Notes
The reference group comprises females who are unmarried, non-household heads, part-time laborers born and residing in the Jolla provinces, while employed in a firm with less than ten employees in light manufacturing industry. The estimates for personal characteristics, occupations, industries and firm sizes have been suppressed. They are available from the author upon request. Numbers in parentheses are standard errors. * Significant at the 5% level.

Column (1) is a specification that controls for a worker's birth region as well as other personal and firm characteristics, whose estimates are suppressed for expositional simplicity. Columns (2) and (3) additionally control for monthly earnings and job designation, respectively. They are employed to verify the robustness of estimates in column (1). In each model and specification, workers' regions of residence are also included with the birth regions in order to control the contemporary regional differences in industrial activities and other regional attributes. To control for the region of residence is important for pinpointing the effect of the birth region on displacement. Without the regions of residence, it would be impossible to distinguish between the residence region effect and birth region effect for those who chose never to migrate.

In examining the effect of birth regions on the likelihood of displacement, a possibility should be noted that birth regions function differently between the Seoul–Kyongki region and other regions. While the areas outside Seoul–Kyongki have mainly been populated by those born and staying in the respective regions, the Seoul–Kyongki region has been the main area to which people from all over the country have migrated; these immigrants make up about 55 percent of the area's current residents (See Table 10.2). It is suspected, therefore, that the effect of birth regions may be more pronounced in the Seoul–Kyongki region, but may either not exist or be weaker in the areas outside Seoul–Kyongki. To address this possibility, we have interacted a worker's birth region with the Seoul–Kyongki residence region, and report separate estimates of birth regions Seoul–Kyongki and areas outside Seoul–Kyongki.

According to the results in column (1) of Table 10.4, the regions of residence did not make a significant difference to the likelihood of worker displacement during the recession period, in terms of either overall displacement, or displacement due to plant closure or layoffs. It suggests that the economic recession of 1997 to 1999 was nationwide, hence worker displacement was geographically uniformly distributed. In contrast, birth regions had significant effects on the likelihood of displacement. Those workers born in the Kyongsang provinces were more likely to get displaced than those born in the Jolla provinces, especially in the Seoul–Kyongki region. When the causes for a displacement are further divided into the two categories, we find that the Kyongsang-born workers in the Seoul–Kyongki regional firms were more likely to get laid off than those born in the Jolla provinces. The finding is statistically significant at the 5 percent level. However, the layoff rates do not vary significantly in the areas outside Seoul–Kyongki.

Note that the regions of residence are considered in this estimation. As a result, the possibility is already taken into account that a greater degree of industrial activity in the Seoul–Kyongki region and Kyongsang provinces leads to a greater likelihood of displacement for those born and staying in the respective regions. Even after controlling for the regions of residence, Kyongsang-born workers faced a greater likelihood of displacement and layoffs than Jolla-born workers, in the Seoul–Kyongki region. The empirical result of the significant Kyongsang–Jolla gap in layoff rates is quite surprising in itself. A seemingly

non-economic factor of workers' birth regions generates a significant gap in the layoff rates between the Kyongsang-born and Jolla-born workers in the Seoul–Kyongki region. We interpret this finding as evidence that a mechanism of regional discrimination (against Kyongsang-born workers) was in place for ordinary workers in the post-crisis recession period in South Korea.

This empirical result remains robust against a possible omission of relevant variables. To confirm the robustness of the results, we add monthly earnings and job designations at the risk of displacement to the basic specification (1). In columns (2) and (3), these two variables attempt to measure worker attributes that are not controlled for in the specification (1).[12] When we include monthly earnings and job designation in the estimation, the significant gap in overall displacements and layoff rates remains unchanged. In fact, the layoff gap between the Kyongsang-born and Jolla-born workers widens. The layoff estimates for the Kyongsang-born (relative to the Jolla-born) increase from 0.389 (s.e. 0.187) in column (1) to 0.446 (s.e. 0.202) in column (3).

In contrast to the results of the recession sample, the birth regions fail to have any significant association with job displacement during the recovery period (2000–01) (see Table 10.5). With the exception that the Seoul–Kyongki region displays some significant effects as a region of birth and residence in the case of plant closure, none of the regional variables has a significant impact on a worker's likelihood of displacement in the recovery period. We fail to find any significant gaps in the overall likelihood of displacement and layoff rates between Jolla-born and Kyongsang-born workers.

Although it may be interpreted as the mechanism of regional discrimination weakening during the recovery period, the result from the recovery sample does not necessarily contradict our main findings for the recession sample. First, in the recovery period, it was highly likely that workers were not actually at risk of job displacement. Including those who are not at risk can lead to the biased results as discussed in note 11. Second, in the recovery period, job displacement might have failed to serve as a means to discriminate any longer. To the extent that employers firmly wish to cut off their employees while employees want as firmly to remain employed, displacement operates as an efficient tool of discrimination. These two conditions are well satisfied during the recession period of 1997 to 1999, but not as well maintained during the recovery period after the second half of 1999.

Predicted probabilities of job displacement

To give more concrete pictures of the estimation results, we calculate the expected probabilities of three types of displacement of a representative median worker[13] for the recession and recovery period, using the estimates of column (1) of each model. These are reported in Table 10.6. According to the table, the Kyongsang-born workers were more likely than the Jolla-born workers to get displaced during the recession period, especially in the Seoul–Kyongki region. However, the Kyongsang–Jolla gap in the likelihood of displacement is not

statistically significant in the areas outside Seoul–Kyongki. A Kyongsang-born worker who had the median personal characteristics and who was employed in a Seoul–Kyongki regional firm faced a 0.332 probability of overall displacement, while a hypothetically similar worker born in the Jolla provinces faced a 0.161 probability. A Kyongsang-born worker faced twice as high a displacement rate in the Seoul–Kyongki region as a Jolla-born worker with the same personal and job-related characteristics. This difference in the overall probability of displacement is statistically significant at the 5 percent level. However, if a worker was employed in a firm located in an area outside Seoul–Kyongki, the Kyongsang-born worker had a 0.206 probability of overall displacement, while a similar worker born in the Jolla provinces had a 0.147 probability; the difference here is insignificant.

When the cause of a displacement is separated, in the Seoul–Kyongki region, a Kyongsang-born median worker faced a 0.138 probability of layoff, while a similar Jolla-born worker faced a 0.070 probability. The difference here is statistically significant. In areas outside Seoul–Kyongki, the Kyongsang-born worker had a 0.076 probability of layoff, while the Jolla-born worker had a 0.057 probability. In contrast, the likelihood of plant closure shows different patterns. In the Seoul–Kyongki region, a Kyongsang-born median worker faced a 0.153 probability of experiencing plant closure, while a similar Jolla-born worker faced a 0.108 probability. In areas outside Seoul–Kyongki, the Kyongsang-born worker had a 0.189 probability, while the Jolla-born worker had a 0.109 probability. This suggests that the Kyongsang–Jolla gap in the overall displacement

Table 10.6 The probability of a median worker's displacement, 1997–99 and 2000–01

Birth region	*Region of residence*			
	Period 1997–99		*Period 2000–01*	
	Seoul–Kyongki	*Non-Seoul–Kyongki*	*Seoul–Kyongki*	*Non-Seoul–Kyongki*
Overall displacement				
Kyongsang	0.332*	0.206	0.094	0.146
Jolla	0.061	0.147	0.071	0.095
Layoff				
Kyongsang	0.138*	0.076	0.078	0.098
Jolla	0.070	0.057	0.054	0.068
Plant closure				
Kyongsang	0.153	0.189	0.024	0.055
Jolla	0.108	0.109	0.015	0.024

Notes

The median worker here is a male, married, household head who is 36 years old and has had 12 years of education, with W1.1 million in earnings and three years of tenure while employed on a full-time basis as a laborer in a firm with more than 1,000 employees in the heavy manufacturing industry. * The estimated probability for a Kyongsang-born worker is significantly different from that for a Jolla-born counterpart at the 5% level.

probability can be mainly explained by the gap in the layoff probability, rather than by the plant closure probability in the recession period.

When we take a look at the expected probabilities of each displacement type during the recovery period, however, we fail to find significant gaps of the overall displacement, layoffs or plant closure among those born in the Kyongsang and Jolla provinces. Compared with the recession period, the probabilities of the overall displacement, layoffs and plant closure decrease during the recovery period, except for the probabilities of layoffs in areas outside Seoul–Kyongki. No statistically significant gaps between Kyongsang-born and Jolla-born workers are found to exist in the Seoul–Kyongki region, nor in areas outside Seoul–Kyongki. A Kyongsang-born median worker's probabilities of the overall displacement, layoff and plant closure are 0.094, 0.078, and 0.024 in the Seoul–Kyongki regions, respectively. The corresponding probabilities of a Jolla-born median worker are at 0.071, 0.054, and 0.015, respectively. The Kyongsang–Jolla gaps are not statistically significant. As stated in the previous section, insignificant Kyongsang–Jolla gaps in the likelihood of displacement for the recovery period does not conflict with the main findings for the recession period.

Implications to regional discrimination

From the above findings, it is clear that in the post-crisis recession period in Korea, Kyongsang-born workers faced a significantly higher likelihood of layoffs in Seoul–Kyongki region firms. The overall displacement rate gap between Kyongsang and Jolla workers is mainly due to the gap in layoff rates between the two groups. We believe that these findings per se deserve much attention. In the Korean labor market during the economic crash, a regional factor (and a seemingly non-economic factor) played a significant role in the process of worker layoffs. This implies that the economic effects of workers' birth regions and the functioning of regional discrimination were more deeply rooted and widespread in Korea than has been reported by previous studies, which had looked at relatively smaller groups.

We interpret the finding as the continuation of the mechanism of regional discrimination only with positions between Jolla provinces and Kyongsang provinces upside down. Since the political and social power that might affect firms' economic decisions shifted from the Kyongsang provinces to the Jolla provinces with the launch of the new Jolla-based administration at the beginning of 1998, the regional discrimination that had earlier favored the Kyongsang provinces was reversed; it was turned against the previous benefactors and began to benefit the Jolla provinces.

Some studies (Kim and Lee, 2001; Kim and Park, 2001) of the changes in composition of birth regions of the power elite groups in private large firms (for example, the firms listed on the Korean Stock Exchange) and in government organizations provide macro-level evidence to support our main findings. These studies show a clear pattern that, more often than was the case previously, those

Table 10.7 Distribution of birth regions of management staff in the firms listed on the Korean Stock Exchange

Birth region	*1988*[a]	*1997*	*1998*	*1999*	*2000*
Seoul–Kyongki region	352 (44.6)	2,202 (40.7)	1,488 (39.8)	1,244 (39.6)	1,050 (38.9)
Kyongsang provinces	258 (32.8)	1,825 (33.7)	1,301 (34.8)	1,047 (33.3)	923 (34.2)
Jolla provinces	50 (6.3)	420 (7.8)	308 (8.2)	290 (9.2)	249 (9.2)
CJK provinces	130 (16.5)	967 (17.9)	642 (17.2)	560 (17.8)	476 (17.6)
Total	790 (100)	5,414 (100)	3,739 (100)	3,141 (100)	2,698 (100)

Source: Recreated from tables 2 and 3 of Kim and Lee (2001).

Notes
Numbers in parentheses are percentages.
a Management staff of the 50 largest chaebol-affiliated firms.

born in Jolla advanced to high-ranking positions in these organizations under the new political regime (see Table 10.7 for reorganized findings of the two studies cited earlier). This shift in decision-making power may have had an effect on firms' decisions regarding who they would displace.[14]

Conclusion

In this chapter, we have examined the incidence of job displacements in the Korean labor market during the period of post-crisis economic restructuring. The empirical findings reveal striking evidence of the operation of regional discrimination in Korea. Probit analysis shows that workers' birth regions played a key role in the decisions concerning displacement (particularly, in layoffs) during the recession period of 1997 to 1999. Those born in the Kyongsang provinces had faced a significantly higher likelihood of layoffs in Seoul–Kyongki region firms than those born in the Jolla provinces.

Our findings about individual workers bring us a step closer towards understanding regional discrimination in Korean society. According to our results, regional discrimination is not only a concern among high-ranking government officials and power elite groups in the private sector, as shown by the previous Korean studies, but is also an issue among ordinary individuals at the workplace. This suggests that regional discrimination is even more deeply rooted and widespread in the country than was previously believed. Regional discrimination in Korea also presents an example of a revelation of a local issue in the process of globalization. It can be said that the forces of globalization do not change the mechanism that gives rise to local issues: rather, the rhetoric of globalization is employed only to change the positions of actors within the mechanism.

Appendix 10.1 Descriptive statistics of the recovery sample

	Separators			
	Stayers	*Total*	*Plant closure*	*Layoffs*
Means				
Age	37.77	40.15	39.90	40.27
	(9.72)	(10.74)	(9.59)	(11.25)
Years of schooling	12.14	10.87	10.69	10.69
	(3.77)	(3.46)	(3.55)	(3.42)
Monthly earnings	1,164.33	796.84	848.67	772.96
(W1,000)	(611.38)	(441.67)	(455.58)	(434.17)
Tenure (year)	6.49	4.11	4.51	3.93
	(6.30)	(5.37)	(5.60)	(5.51)
Proportions (%)				
Male	65.60	52.11	47.57	54.15
Married	74.16	77.23	79.00	76.44
Household head	58.72	49.70	42.72	52.84
Full-time	80.31	56.94	73.91	48.68
occupation				
Professional and technical	24.26	13.62	13.29	13.83
Sales and administrative	15.28	8.96	10.99	7.98
Support				
service	9.96	16.13	24.18	12.23
Crafts, operatives,	49.82	59.86	50.55	64.36
laborers				
Industry				
Construction	12.70	16.42	12.22	18.48
Light manufacturing	16.68	19.34	24.44	16.85
Heavy manufacturing	17.25	14.20	13.33	14.67
Non-professional services	28.96	29.56	41.10	23.91
Professional services	24.41	20.44	8.89	26.09
Firm employment size				
1~10	24.80	41.26	49.50	36.76
11~30	17.61	21.33	25.74	18.92
31~100	18.85	16.78	12.87	18.92
101~300	9.89	9.09	6.93	10.27
301~1,000	8.75	3.50	1.98	4.32
1,000+	20.10	8.04	2.97	10.81
Birth region				
Seoul–Kyongki region	23.01	19.87	23.23	18.35
Kyongsang provinces	34.35	38.49	33.33	40.83
Jolla provinces	20.58	22.08	19.19	23.39
CJK provinces	22.06	19.56	24.24	17.43
Region of residence				
Seoul–Kyongki region	53.87	44.58	45.63	44.10
Kyongsang provinces	30.84	36.14	33.01	37.55
Jolla provinces	7.03	9.04	9.71	8.73
CJK provinces	8.26	10.2	11.65	9.61
Number	2,294	332	103	229

Notes

Variables are measured at the time of displacement risks. Individuals over 60 years of age are excluded. Numbers in parentheses are standard deviations.

Notes

1 A more extensive analysis is available in Kang and Lee (2007), Regional ties and discrimination: Political change, economic crisis, and job displacements in Korea, 1997–1999. *The Developing Economies* 45 (1), 63–96. Some analysis of the current chapter overlaps with that paper. The author thanks Jang-sup Shin and other participants of the workshop on “Global Challenges and Local Responses: A Comparison between Singapore, Malaysia, and South Korea” for helpful discussions and comments. The research was supported by the National University of Singapore (R-122-000-060-112).

2 In our analysis, we divide the entire nation into four broad regions that are mutually exclusive and that are believed to be the basis of regional discrimination: they are the Seoul–Kyongki region, the Kyongsang provinces, the Jolla provinces, and the Chungchong–Jeju–Kangwon provinces. Seoul–Kyongki region includes Seoul and Inchon City, and the Kyongki Province. The Kyongsang provinces include the North Kyongsang and South Kyongsang Provinces, and Taegu, Pusan and Ulsan City. The Jolla provinces include the North Jolla and South Jolla Provinces, and Kwangju City. The Chungchong–Jeju–Kangwon (or CJK) provinces include the Kangwon Province, the North Chungchong and South Chungchong Provinces, and the Jeju Province. This demarcation system of the cities and provinces has been employed (with slight occasional modifications) ever since the First Republic in 1948. As most of the border lines between the cities and provinces are not drawn in direct association with geographical separations, they are generally blurry from non-geographical perspectives. In contrast, the separation between the Kyongsang provinces and the Jolla provinces is very pronounced, as it is actually based on geographical separation by a high mountain range lying north–south along the border.

3 See also Wessel (1997) and Cho and Kim (1991) for details of the region-biased economic development in Korea.

4 This survey is used for our main empirical analysis. Details of the survey are provided in data section.

5 See Park (2001, Tables 5.10–11) for the proportions of supporting votes for parties by region in the 1987 and 1992 presidential elections and the 1988 and 1992 national parliament elections in South Korea. The patterns of region-based voting persisted in two more recent presidential elections. In the 1997 presidential election, Kim Dae-Jung, then elected president, received about 92.9 percent of the votes from the Jolla provinces, while getting about 13.2 percent of those from the Kyongsang provinces. His then major opposition candidate, whose regional basis of political support was believed to be the Kyongsang provinces, received about 3.2 percent of their votes from the Jolla provinces, while getting about 58.1 percent of those from the Kyongsang provinces. In the 2002 presidential election, the current president (Roh Moo-Hyun) whose then regional basis of political support was believed to be the Jolla provinces (to be more exact, Jolla provinces-born voters) received about 93.6 percent of votes from the Jolla provinces, while getting about 25.8 percent of those from the Kyongsang provinces. In contrast, his major opposition candidate received about 4.9 percent of votes from the Jolla provinces, while getting about 69.5 percent of those from the Kyongsang provinces. These figures are available from the National Election Commission of South Korea Database.

6 Unlike the skin color or the gender, the birth region is not apparent at a glance. Because Korea is a very homogeneous country in terms of race and ethnicity, it is fairly difficult to distinguish between the Jolla and Kyongsang-born people by their appearance or language. Although some people speak a certain degree of dialects of their own that must have originated from the geographical division by a high mountain range lying at the border of the Jolla and Kyongsang provinces, one will have a fair amount of difficulty in discerning them without further information. One of the

most frequently used methods to identify someone's birth region would be browse a person's résumé that has information on the records of the high school that he or she attended. Unless the pupil moves between provinces in his/her teenage, the birth region will well match the region where the high school is located.

7 The KLIPS surveys have been mainly conducted during the second half of each year (June to October for the 1998 survey, August and November for the 1999 survey, and May to October for the 2000 survey). Given that the 2000 survey mainly asked what happened between the 1999 and 2000 survey dates, and that the Korean economy seemed to be back on track by the first quarter of 2000 in view of the GDP growth rate or unemployment rate, we use the years 2000 and 2001 data to examine job displacements after the recession.

8 We distinguish between two causes of job displacement: a displacement due to plant closure and a layoff. The former happens when a worker's employer goes bankrupt, and thereby it is not associated with the employer's decision regarding whom to lay off. In contrast, the latter results from an employer's decision on selective layoffs of its employees. In both cases, the control group is those workers who anyhow retain their employments despite plant closures or layoffs during the relevant period. We consider the sum of the likelihoods of two displacement events as an overall displacement likelihood that a worker becomes displaced anyway. Such distinction between displacements is made possible by a question in the survey that asks the reason why one left his/her most recent employer. We classify a worker's displacement as due to plant closure if the reason for leaving a job is "because of plant closure". In contrast, if the reason answered is "because of being laid off or because of no jobs assigned", we classify the displacement as due to a layoff. Besides, if a worker left the employer for voluntary reasons such as "because the compensation was too low", "because the job is not promising", or "because of personal matters like marriage or child care, etc.", his/her observation is excluded from the analysis.

9 Information given by the survey makes it impossible to distinguish between a shut-down of an entire firm and that of one of its establishments with the entire firm alive. The plant closure may imply a shut-down of one of establishments of an entire firm that has more than one establishment. As a result, those displaced by the plant closure may include those displaced by the parent company's decision to shut down one of its establishments and axe entire work force in it.

10 All industries are summarized by five representative industries that are put together based on three-digit industry codes. These five industries are the construction, light manufacturing, heavy manufacturing, non-professional services, and professional service industry. The construction industry is the one-digit construction industry. Light manufacturing industry consists of the industry of nondurable manufacturing, primary metals, and fabricated metals. Heavy manufacturing industry is the industry of non-electrical machinery, electrical machinery, transport equipment and other durable manufacturing. The nonprofessional service industry is made up of wholesale and retail trade, and transport, communications and public utilities. Finally, the professional service industry includes finance, insurance and real estate, and professional and business services. Those who are employed in agriculture, the mining industry and the government sector are excluded from the analysis.

11 In the statistical analysis, we assume that every worker used in the regression had *actually* been "at risk" of losing a job during the relevant period of analysis. This assumption requires us to be cautious in interpreting the empirical results. In our probit analysis, a worker who was not actually "at risk" may be (erroneously) classified as being so, since the KLIPS surveys do not explicitly ask whether one has been "at risk of losing the job" during the relevant period. If it is the case, the group of stayers not only includes those who survived employment restructuring, but those who did not actually experience the restructuring risk itself in their employment. (This possibility has been one of major concerns in the traditional US studies of job

displacement that use data only of those displaced. See Farber 1993, Fallick 1996 and Kletzer 1998, p. 130.) For better and refined analysis, one requires the distinction between the former and latter group of stayers. In our analysis of job displacement, we believe that the recession sample is relatively free from this problem. The economic recession between 1997 and 1999 was so strong that it makes sense to assume most private sector employees were actually exposed to a risk of displacement during the period. In contrast, the recovery sample can be more vulnerable to the problem of wrong assumption, since the job displacements were not so widespread during the recovery period as during the recession period. This consideration imposes some restrictions on the comparison between the recession-sample results and the recovery-sample results.

12 Suppose that the Kyongsang-born workers in the Seoul–Kyongki region firms were less productive than the Jolla-born workers who shared the same observational characteristics. If it were true, higher displacement and layoff rates of the Kyongsang workers relative to the Jolla workers would arise because unproductive workers simply faced higher layoff rates rather than because regional discrimination functioned in Seoul–Kyongki regional firms. We add a worker's monthly earnings as an extra explanatory variable for a proxy for a worker's (unobservable) productivity. Job designations attempt to control for a possibility that Kyongsang-born workers had been favored (before the new era) for promotion within firms and were more likely to be found in the mid-level positions that were more vulnerable to job displacement. If such was the case, their higher displacement rates would be due to their job designations rather than the birth region-biased decision of displacements.

13 This worker is a male married household-head worker who is 36 years of age and has had 12 years of education, KRW1.1 million of monthly earnings and three years of tenure while employed on a full-time basis as a laborer in a firm with 100–300 employees in heavy manufacturing industry.

14 One of the major Korean daily newspapers (*Donga-Ilbo*) also reported the case of job displacement in public-sector institutions (the Korea Racing Association and the Korean Cable Communications Commission) that are relevant to this study. In these two cases, an individual's birth region and political orientation constituted the major factors that influenced the job displacement decisions (by the parachuted Jolla-based management staffs) to downsize the work force in 1998. See reports on the Korea Racing Association in the *Donga-Ilbo* March 20 (2002) edition, and on the Korean Cable Communications Commission in the March 21 (2002) edition. Both were state-run non-profit organizations. The former case actually resulted in a civil lawsuit following the report. The court decided against the association and ordered the reappointment of those displaced and payment of their lost compensation. See the report in the *Donga-Ilbo* July 8 (2003) edition.

References

Cho, L.-J. and W. B. Kim (1991). The population redistribution plan (1977) and urbanization problems. In L.-J. Cho and Y. H. Kim (eds), *Economic Development in the Republic of Korea: A Policy Perspective*, pp. 349–67. Honolulu HI: East–West Center.

Fallick, B. C. (1996). A review of the recent empirical literature on displaced workers. *Industrial and Labor Relations Review* 50 (1), 5–16.

Farber, H. S. (1993). The incidence and costs of job loss: 1982–91. *Brookings Papers on Economic Activity. Microeconomics 1993* (1), 73–119.

Gibbons, R. and L. F. Katz (1991). Layoffs and lemons. *Journal of Labor Economics 9* (4), 351–80.

Kim, M. H. (1991a). The intensification of political regionalism in the period of the sixth Republic in South Korea (in Korean). In H. Kim and D. Lee (eds), *Studies of Political Regionalism*, pp. 155–67. Seoul: Hakminsa.

Kim, Y. H. (1991b). The regional disparity in inclusion and exclusion of power elites in South Korea (in Korean). In H. Kim and D. Lee (eds), *Studies of Political Regionalism*, pp. 258–88. Seoul: Hakminsa.

Kim, Y. H. and S. C. Lew (1996). A study on the movement patterns of power elites in Korea (in Korean). *Seongok nonchong 27*, 165–97.

Kim, Y.-M. and S.-I. Lee (2001). Changes in positions of the management staffs of Korean private firms under the new government (in Korean). *Proceedings of the 2001 Summer Meeting of the Korean Academic Society of Business Administration*.

Kim, Y.-M. and K.-S. Park (2001). Crony capitalism: Evidence from top managers of Korean private large firms (in Korean). *Proceedings of the 2001 Summer Meeting of the Korean Academic Society of Business Administration*.

Kletzer, L. (1998). Job displacement. *Journal of Economic Perspective 12* (1), 115–36.

Park, B.-G. (2001). The Territorial Politics of Regulation under State Capitalism: Uneven Regional Development, Regional Parties, and the Politics of Local Economic Development in South Korea. Ph.D. thesis, Ohio State University.

Wessel, K. (1997). Basic features of economic and regional development in South Korea. In L. H. Schätzl, K. Wessel, and Y.-W. Lee (eds), *Regional Development and Decentralization Policy in South Korea*, pp. 34–176. Singapore: Institute of Southeast Asian Studies.

Index

Italic page numbers indicate tables and figures not included in the text page range.
References to notes are prefixed by *n*.

Abramovitz, M. 142
Action Plan for Industrial Technology Development (APITD) 147
AFTA programme 149, 152
Agreement on Subsidies and Countervailing Measures 145
alliances: territorial 59–60
Anglo-American companies 9
Anglo-American countries: development 26–7; financial regulations 19–20; stock markets 18
Anglo-American economies 3
Anglo-American institutions: suitability for developing countries 26–8; value of 22–4
APITD (Action Plan for Industrial Technology Development) *see* Action Plan for Industrial Technology Development
Arrow, K. 142
austerity measures 126–8
Australia: economic growth 23, *24*
Austria: interventionist industrial policy 16
automobile industry: Korea 55–9, 164–7, *179*; Malaysia 148–9, 152–3, 164–7, *179*
automobile trade unions 163–4, 167–78, *179*

baby boomers: China 97
bank debts 119–21
bank loans 122–6
Bank of International Settlements (BIS) capital adequacy ratio *see* BIS (Bank of International Settlements) capital adequacy ratio
banking sector: China 6; Japan 7, 119–26
banking system: Korea 84–91
bankruptcies 42
banks: restructuring of 130–5
"Big Deal" case 4–5, 55–9
birth regions: and job displacement 193–202
BIS (Bank of International Settlements) capital adequacy ratio 1, 13, 15, 19, 20
bonds 117–18
Bordo, Michael D. 33
Brazil: FDI regulations 145
bubble economy 117–24
Bumiputera policies 8, 149, 151, 153, 165
Busan: Samsung Motors 56–9

Canada: economic growth 23, *24*
Cancun Meeting 144
capital flows 25–6, 79–81, 83
capital market liberalization 6–7, 117–24
CBRC (China Banking Regulatory Commission) 104
central banks 19–20
chaebols 40, 42, 73, 74, 75, 78, 81–2, 172
Chang, H.-J. 73, 140, 145
Chiang Mai Initiative scheme 112–13
China: baby boomers 97; capital flows 83; domestic consumption 99–102; economic growth 95; employment 96–7; energy consumption 110–11; environmental issues 110–11; exchange rate regime 104–5, 112–13; exports and imports *98*; farmers 106–7; financial–banking sector 102–5, 112–13; foreign investment 26; government

spending 99–101; income distribution 102, 105–7; incremental capital to output ratio (ICOR) 101; institutional reform 101, 106–7; interregional disparity 105–7; market controls 90, 96–7; M&As 109–10; open-door policy 2; overview 6; value chains 107–10; and WTO 95–6
China Banking Regulatory Commission (CBRC) *see* CBRC
Citigroup 85–8, 89
coalitions, international 9
collective bargaining 172, 175
competition 32, 34
complementary model 38–9, 41, 43
conglomerates, financial 132
"convoy system" 127
corporate bonds 117–18, 119
corporate governance system 20–1
corporate sector debt–equity ratios 21, *22*, 40
Cox, K.R. 52, 66
"cream-skimming" 104
credit cooperatives: failure of 125–6

Daewoo Motors (DMC) 56–9, 164, 165, 167, 168
Daihatsu 149, 166
DaimlerChrysler (DC) 164
debt: dependence on 21
decentralization 54
demographic changes: China 97
Denmark: economic growth 23, *24*
Deposit Insurance Law (DIC) 125–6, 129, 130, 132
deregulation: financial sector 34; Japan 117–24; as a strategy 54
developing countries: and Anglo-American institutions 26–8
DIC (Deposit Insurance Law) *see* Deposit Insurance Law
Dicken *et al.* 50
Dicken, P. 51
DMC *see* Daewoo Motors (DMC)
Doha Conference 144, 145
Doha Declaration 146
domestic consumption: China 99–102
Doraisami, A. 146
Dymski, Gary 86, 89

East Asian countries: and GSIs 28–9; *see also* individual countries
ECB (European Central Bank) *see* European Central Bank
Economic Development Board (EDB): Singapore 39
economic growth 23, *24*, 36, *37*
"economic patriotism" 90
economic stagnation 36, 83; Germany 23; Japan 2, 6, 13, 131–5
Eichengreen, Barry 33
elections: Korea 189
employment: China 96–7
energy consumption: China 110, 111
environmental issues: China 110–11
equipment investment: Korea 76
Euro-yen bonds 119
European Central Bank (ECB) 20
Evans, P. 73
exchange rate fluctuations 42
exchange rate regime: China 104–5, 112–13
export-oriented growth strategies 2

family ownership 20–1
farmers: China 106–7
FDI regulations 145
FDIs (foreign direct investments) 33, 51, 144; China 6; early twentieth century 45*n*1; incentives 36; Korea 5, 55, 75, 78, 81; Malaysia 147, 148, 151–2
Federal Reserve Board 19–20
FEZs (Free Economic Zones) *see* free economic zones
Financial Big Bang initiative 127
financial conglomerates 132
financial crises 33, *34*; East Asia 13, 146; Japan 6–7, 126–8; Korea 2, 41–2, 55–6, 73–4; Malaysia 2, 169
financial flows 40; *see also* capital flows
financial institutions: failure of 125–6
financial liberalization 41–2, 82–4
Financial Reconstruction Commission (FRC) 130
Financial Reconstruction Law 130
financial regulations: BIS-type 26; GSIs 19–20
financial resources: mobility of 33
Financial Revitalization Program 132, 133
financial sector 34
Financial Supervisory Agency 132
financial–banking sector: China 102–5
Finland: economic growth 23, *24*; FDI regulations 145; foreign investment 16
Fischer, Stanley 73
FLC (Forward Looking Criteria) 19, 20
Ford 164
foreign debt 40

foreign direct investments (FDIs) *see* FDIs
foreign exchange law: Japan 118
foreign investments 16, 25–6; *see also* FDIs
foreign ownership: Korean banks 84–91
Forward Looking Criteria (FLC) *see* FLC
France: FDI regulations 145; foreign ownership 90; interventionist industrial policy 16; public-enterprise sector 17
fraud 87–8
FRC (Financial Reconstruction Commission) *see* Financial Reconstruction Commission
free economic zones (FEZs) 64, *65*
free marketeers: vs statists 31

GATS (General Agreement and Trade in Services) 7, 143–6, 149–51, 153–4, 155–6
GATT (General Agreement on Tariffs and Trade) 1, 140
General Agreement and Trade in Services (GATS) *see* GATS
General Agreement on Tariffs and Trade (GATT) *see* GATT
General Motors (GM) 164, 165
General Union Federation of Metal Working Industry (GUCMI) *see* GUCMI
Germany: economic growth 23, *24*; FDI regulations 145; foreign ownership 90
Gerschenkron, A. 140
GLCs (government-linked companies) 39
global norms 1
global shareholder capitalism 83–4
global standard institutions (GSIs) *see* GSIs
globalization: definition 32; top-down approach 50
GM (General Motors) *see* General Motors (GM)
government bonds 118
government intervention 143, 151
government-linked companies (GLCs) *see* GLCs
growth coalitions 52–3, 59
growth rates *see* economic growth
GSIs (global standard institutions): adoption of 9, 22–3; China 6; imposition of 13; Korea 5; need for 9, 14–15; overview 3; pillars of 3, 13, 16–22; suitability for developing countries 26–8; value of 22–4
GUCMI (General Union Federation of Metal Working Industry) 167

Hanbo Group 42
harmonization 14–15
Henry, James 88
"higher-tier" suppliers 43–4
HMC (Hyundai Motors) *see* Hyundai Motors
Hobsbawm, E.J. 32
Hokkaido Takushoku Bank 128
Honda Motors 176
Household Registration (*hukou*) System 106
Hu Jintao 106
hukou (Household Registration) system 106
human development: Malaysia 153–4
Hyundai Motors (HMC) 8, 164–5, 167, 168, 176

IBJ (Industrial Bank of Japan) *see* Industrial Bank of Japan
ICOR (incremental capital to output ratio): China 101
ICT companies 82
ICTs (information and communication technologies) 1, 32
IMF (International Monetary Fund) 14, 73, 74–5, 140
immigration patterns 188, *189*
import substitution (IS) 40, 171
incentives 36
income distribution: China 102, 105–7
income inequality: China 6
incremental capital to output ratio (ICOR) *see* ICOR
industrial action *see* strikes
Industrial Bank of Japan (IBJ) 131
Industrial Coordination Act (1975) 147
industrial policy (IP) 16, 26–7, 142–5
Industrial Revitalization Corporation of Japan (IRCJ) *see* IRCJ
inequality: Korea 78–9
inflation control 19
information and communication technologies (ICTs) *see* ICTs
instability 33
institutional reform: China 106–7
inter-scalar interactions 53–9, 64–6
international coalitions 9
international investment agreements 141–2
international investors 25–6
International Monetary Fund (IMF) *see* IMF
interregional disparity: China 105–7; Korea 184–90

interventionist policies: industrial 16, 26–7; technological development 140–1
investment measures 143–6
IP (industrial policy) *see* industrial policy
IRCJ (Industrial Revitalization Corporation of Japan) 133–5
Ireland: FDI regulations 145; R&D activities 144
"irregular workers" 78–9
IS (import substitution) *see* import substitution

Japan: bank restructuring 130–5; banking sector 119–26; bubble economy 117–24; central bank 20; debt 21; economic growth 23, *24*; FDI regulations 145; financial crisis 126–8; financial failures 129–30; foreign exchange law 118; interventionist industrial policy 16; liberalization 116–17; M&As 18; non-performing loans (NPLs) 124–6, 132–5; overview 6–7; public-enterprise sector 16
Japan premium 128
Japan–US Yen–Dollar Committee Report 118
"Jeju Free City Project", South Korea 5, 53, 61–4
job displacement 185, 190–202
Jolla provinces 186–90
"jumping scale", policies of 59–64, 66

Kaldor, N. 140, 142
KCTU (Korean Confederation of Trade Unions) 167, 173–4, 176
Kia Group 42
Kia Motors (KMC) 165, 167
Kim, M.H. 185
Kim, Y.-M. 185
Kim, Y.H. 185
Kim Dae Jung 75, 84, 189
Kim Jung Tae 89
Kim Yong Sam administration 173
Kitching, G. 140
KLIPS (Korean Labor and Income Panel Study) 188, 190
KMC (Kia Motors) *see* Kia Motors
KMWF (Korean Metal Workers Federation) *see* Korean Metal Workers Federation
KMWU (Korean Metal Workers Union) *see* Korean Metal Workers Union
Korea: automobile industry 4–5, 55–9, 164–7, *179*; automobile trade unions 8, 163–4, 167–78; banking system 84–91; capital market opening 79–82; debt 21; economic restructuring 184; FDI regulations 145; financial crisis 2, 73–4; financial liberalization 82–4; free economic zones *65*; future policies 91–2; and GSIs 28–9; Jeju Free City Project 5, 53, 61–4; job displacement 190–202; jumping scale politics 61–4; labour market 184; liberalization 15; nationalistic development 38, 39–42, 44; overview 5–6; population distribution 186–8; post-crisis economic performance 75–9; regional discrimination 184–90, 201–2; spatially selective liberalization 61–4, 66; stock markets 18–19; structural reforms 74–81; uneven economic development 186–8
Korea Exchange Bank 85
Korea First Bank 85
Korean Confederation of Trade Unions (KCTU) *see* KCTU
Korean Labor and Income Panel Study (KLIPS) *see* KLIPS
Korean Metal Workers Federation (KMWF) 167
Korean Metal Workers Union (KMWU) 167–8, 170
Kyongsang provinces 186–90

labour market: flexible 21; Korea 75
laissez-faire industrial policy: GSIs 3, 13, 16
land prices: Japan 121–2
Latin American countries 10*n*2
Lee, S.-I. 185
lending boom: China 104
Lew, S.C. 185
liberalization: capital market 6–7, 117–24; economic policy 51–9; financial 41–2; Japan 116–17; Korea 15, 82–4; Korea's automobile industry 55–9; multi-scalar view 50; spatially selective 61–4, 66; UK 33; US 33
local content policy: Malaysia 148–9, 153
location-specific factors 35
Lone Star 85
Long Term Credit Bank of Japan (LTCB) 130–1
Lotus 149
Louvre Accord 121
"lower-tier" suppliers 43–4
LTCB (Long Term Credit Bank of Japan) *see* Long Term Credit Bank of Japan

macroeconomic policies 23
Mair, A.J. 52
Malaysia: AFTA programme 149, 152; automobile industry 148–9, 152–3, 164–7, *179*; automobile trade unions 163–4, 167–78; FDI 147, 151–2; FDIs 148; financial crisis 2; GATS 149–51, 153–4, 155–6; human development 153–4; incentives 147–8; investment policy 141; investment regulations 146–7, 151–4; local content policy 148–9, 153; ownership conditions 147–8; TRIMs agreement 146–7
Malaysian Trades Union Congress (MTUC) *see* MTUC
Malhotra *et al.* 140, 145
M&As (mergers and acquisitions) 17–18, 81, 109–10
Mass-participatory Economy: a Democratic Alternative for Korea 75
mega financial groups 132
mercantilistic development model 40
Mexico: foreign-owned banking assets 88–9
MFG (Mizuho Financial Group) 131
MFI (multilateral framework of investment) *see* multilateral framework of investment
Mitsubishi Motor Corporation (MMC) 149, 164, 165
Mizuho Financial Group (MFG) 131, 137*n*19
MMC (Mitsubishi Motor Corporation) *see* Mitsubishi Motor Corporation
MNCs (multinational corporations): footlooseness 33; higher-tier suppliers 43–4; Korea 41; mobility 32; perception of 33–4; R&D activities 43; Singapore 38, 42
mobility 32–4
"Monetary Stability Bonds" (MSB) 81
money laundering 87–8
MTUC (Malaysian Trades Union Congress) 170
multi-scalar approach 4, 50–3, 64–6
multilateral framework of investment (MFI) 141–2, 143, 144, 146
multilateral rules 143
multinational corporations (MNCs) *see* MNCs

nation states: influence of 51–3
National Alliance of Trade Unions (NATU) *see* NATU
National Federation of Auto Assembly Industry Trade Unions (NFATU) *see* NFATU
National Federation of Shipbuilding Trade Unions 167
national innovation system (NIS) 142
National Union of Transport Equipment and Allied Industries Workers (NUTEAIW) *see* NUTEAIW
nationalistic development model 40
nationalistic policies 54
nationalization: financial institutions 130
national–local tensions: economic liberalization 53–9
NATU (National Alliance of Trade Unions) 167
NCB (Nippon Credit Bank) 130
neoliberalism 82–3
the Netherlands: public-enterprise sector 16
"New Basel Accord" (BIS II) 15
new growth approach 143
New Zealand: financial regulations 19
Newbridge Capital 85
NFATU (National Federation of Auto Assembly Industry Trade Unions) 167
Nippon Credit Bank (NCB) 130, 131
NIS (national innovation system) *see* national innovation system
Nissan 165, 173
Nolan, Peter 107, 108
non-performing loans (NPLs) 6, 20, 42, 104, 124–6, 132–5
Norway: economic growth 23, *24*; interventionist industrial policy 16
NPLs (non-performing loans) *see* non-performing loans
NUTEAIW (National Union of Transport Equipment and Allied Industries Workers) 168, 169

OECD countries: economic growth 23, *24*
OECD (Organization for Economic Cooperation and Development) 1
ownership conditions: Malaysia 147–8

Pan Yue 110
Park, K.-S. 185
Peck, J. 60
Peetz, D. 169
Perodua 149, 166, 169
Pioneer Status and Investment Tax Allowance (previously Investment Tax Credit) 148

Plaza Accord 7, 116, 121, 151
"politics of jumping scale" 59–64, 66
pollution 110–11
population distribution: Korea 186–8
poverty rates: Korea 79
Prasad *et al.* 105
price stability 19
protectionist policies 54, 142–3, 145
Proton 149, 165, 169, 176
"prudence" 19–20
public-enterprise sector: GSIs 3, 13, 16–17, *18*
public good activities 142

RCC (Resolution and Collection Corporation) 130, 131, 132
R&D (research and development) 32; expenditure 16, 40, 43, 144
reforms: China's banking sector 103–4; Korea 74–81
regional discrimination 8–9; Korea 184–90, 201–2
regulatory activities: and geographical scales 52–3
regulatory changes 1, 33
Reinert, E. 140
Relationship Banking 135
Renault 17, 149, 165
research and development (R&D) *see* R&D
research institutes 44
Resolution and Collection Corporation (RCC) *see* RCC
Resona Bank 132
restrictionist practices 142
Rodrik, Dani 74

Sachs, Jeffery 104
Samsung Motors 56–9, 82, 83, 165, 168
Sanyo Securities 128
Schumpeter, J.A. 142
Seoul–Kyongki region 186–90
shareholder capitalism 83–4
shareholder interest 21
shelf registration 119
Singapore 38–44, 145
Singapore Ministerial Conference 145
slums, urban 107
South Korea *see* Korea
"space of dependence" 59–60
spatially selective liberalization 61–4, 66
Ssangyong Motors 165, 167
"stability" 19–20
Standard Chartered Bank 85
standard setting 9
state, role of 3–4, 34–6, 39–44
state intervention: automobile industry 164
statists: vs free marketeers 31
Stiglitz, Joseph 74, 109, 146
stock-market financing 20
stock markets 17–19, 26
stock ownership 20
strikes 167, 169, 172
subsidies 26, 36
Sweden: economic growth 23, *24*; family ownership 21
Switzerland: economic growth 23, *24*

Taiwan: FDI regulations 145
Tan Chong 168
tariff barriers 143
tariff protection 26–7, 36
tariff rates *27*
tax evasion 87–8
technological development 140–1
territorial alliances 59–60
territorial policies 53–4
TNCs (transnational corporations) 51
Todd, T. 169
Tokyo Kyodo Bank 125, 126
tourism 62–3
Toyota 164, 165, 173
trade-related investment measures (TRIMs) *see* TRIMs
trade unions *see* automobile trade unions; unions
transaction costs 14
transition costs 3, 14–15
transnational corporations (TNCs) *see* TNCs
TRIMs (trade-related investment measures) 143–7, 149

UK (United Kingdom): central bank 20; economic growth 23, *24*; FDI regulations 145; foreign investment 27; liberalization 33; public-enterprise sector 16; stock markets 18; tariffs and subsidies 26
unemployment 96–7
union density 170
unions: Korea 75, 78; *see also* automobile trade unions
United Kingdom (UK) *see* UK
United States of America (US) *see* US

"upscale retail" market 86
urban slums 107
US (United States of America): capital flows 83; central bank 19–20; FDI regulations 145; foreign investment 27; industrial policy 16; liberalization 33; public-enterprise sector 16; stock markets 18; tariff rate 26

value chains 107–10
voting patterns 189

Wade, Robert H. 109
Woo, Wing T. 104
workers: Korea 78–9
Working Group on Trade and Investment 145
World Bank 140
WTO (World Trade Organization) 1, 33, 140, 143; and China 6, 95–6; and Malaysia 7

Yamaichi Securities 128