

The IMF Bailout in Korea: A Socialist Poison

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## **The IMF Bailout in Korea: A Socialist Poison**

The prime cause of the Korean financial crisis is the perverse behavior of the special interest groups infected with the moral hazards that decades-long government intervention in the economy fostered. By injecting bailout money through the government bureaucracy, the IMF helped revive insolvent banks and chaebols, which are responsible for the crisis. But, the ultimate beneficiaries of the IMF bailout are another group responsible for the crisis, namely international lenders, who are rewarded by the IMF for their reckless and risky lending with protection from defaults.<sup>1</sup>

The IMF diagnosis of the Korean economy is false. It has diagnosed that Korea needs more foreign funds. But, Korea's illness was not generated by a shortage of foreign funds, but rather by too much of them so that they fell into the wrong hands. The IMF bailout may alleviate temporary symptoms, but it saves the very groups which caused the crisis - reckless chaebols and bankers, and foolishly greedy foreign lenders. The bailout encourages their moral hazards, preparing the road to a bigger disaster. The IMF treatment impedes the true reform of the Korean economy.

The IMF bailout socialized private debts and coerced Korean taxpayers to pay the international lenders' \$57 billion for the mistakes of chaebols, banks, and international lenders themselves, inflicting pains on innocent people. The IMF bailout is not medicine, not even an ineffective placebo, but socialist poison.

### The Government Guaranteed Debt Rescheduling Accord: Another Socialist Poison

As if the \$57 billion transfer of income from poor Korean taxpayers to rich international lenders was not cruel enough, the IMF prodded the Korean government to guarantee another \$24 billion of Korean commercial banks' short-term debts owed to the international banks. On January 28, 1998, the Korean government and the consortium of international bankers haggled over the terms to finally settle at 7.85% to 8.35% annual interest rates for loan periods lengthened up to 3 years. It was reported that the deal is favorable to Korea and that both the Korean bureaucrats and international bankers were satisfied.<sup>2</sup> But shouldn't they have been considerate to those who assume the ultimate burden, the Korean taxpayers? Why should the taxpayers pay when those bankers' contracts are breached?

The U.S. treasury pressured international banks to accept the rescheduling accord.<sup>3</sup> On the other hand, the IMF had insisted on Korea's conversion of the short-term debt to the

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<sup>1</sup> See for the same argument in the Mexican case W. Lee Hoskins and James W. Coons, "Mexico: Policy Failure, Moral Hazard, and Market Solutions," *Cato Institute Policy Analysis*, No. 243, October 10, 1994 and Bryan T. Johnson and John Sweeney, "Down the Drain: Why the IMF Bailout in Asia is Wasteful and Won't Work," *Heritage Foundation Backgrounder*, no. 1150, December 5, 1997

<sup>2</sup> Timothy O'Brien, "Banks in Accord to Extend \$24 billion in Korea Loans," *The New York Times*, Jan. 29, 1998; David Wessel and Stephen Frank, "Korean Loan Deal Looks Favorable for Seoul," *The Wall Street Journal*, Jan. 30, 1998.

<sup>3</sup> "Banking on Korea," (Editorial), *The Wall Street Journal*, A22, January 27, 1998, and "David Wessel and Stephen E. Frank, Ibid.

long-term one. The Korean government was reminded that the next installment of \$8 billion of IMF bailout money would not come unless the government made the conversion accord with the international lenders who wanted the government's loan guarantees or conversion into public debts.<sup>4</sup> But where were the Korean commercial banks that owed the money? Why weren't they invited to the haggling? The negotiations should have been between the Korean borrowers and the international lenders to make a private accord, which has nothing to do with the IMF, the U.S. Treasury, or the Korean government.

In this IMF-insisted, U.S. Treasury-assisted, socialist solution to private debt negotiations, international lenders won big. Just like the IMF bailout money, the Korean government's loan guarantees reward the parties responsible for the mistakes - the international lenders and Korean commercial banks - at the expense of a third party. The losers are again Korea taxpayers, who are left with the onerous bailout bill.

### The IMF Food Chain

The IMF was to give the \$57 billion worth of bailout money to the Korean government, which would hand the money to the insolvent chaebols and Korean banks, which then would give the money to the undeserving international lenders. The \$57 billion bailout money is squandered perversely not just once, for the international lenders, but a second time, because the bailed out chaebols and Korean banks also waste exactly \$57 billion, each. Hence the IMF's \$57 billion has the perversion effect of \$114 billion.

Now, who suffers? Naturally, the Korean taxpayers who pay \$57 billion even though they have nothing to do with the mistakes of the international lenders, chaebols, and the Korean banks. Thus, the waste sums to \$114 billion. We forgot, however, that the IMF took the original \$57 billion from the taxpayers of the contributor countries such as the U.S. Including the loss to this second group of taxpayers, the total waste to the world is \$228 billion.

### The IMF and Statism: The IMF bailout makes the already big government bigger.

In a developing economy which does not have a firmly rooted tradition of individual liberty, foreign aid given to the government is an invitation to the statist expansion of the government, if not corruption. This occurs because the government can wield the power to determine how to allocate the aid money. In the process, individuals' economic liberty deteriorates. IMF assistance is no exception, as witnessed by the fact that the majority of the long-term recipients of IMF credit in the past suffer from low economic freedom in the present. The countries which received 25 or more years of IMF credit during 1949-1989 are Ghana, Kenya, Mali, Sudan, India, Pakistan, the Philippines, Sri Lanka, Turkey, Egypt, Syria, Bolivia, Chile, Dominican Republic, and Haiti.<sup>5</sup> For 10 of these 15

<sup>4</sup> Chosun Ilbo, (in Korean), 1.10. 1998.

<sup>5</sup> See Doug Bandow, "A Record of Addiction and Failure," in Doug Bandow and Ian Vasquez, ed., Perpetuating Poverty: The World Bank, the IMF, and the Developing World (Washington, D.C.: Cato

countries, their index of economic freedom eight years later in 1997 are “Mostly Not Free” or “Repressed” as shown in Table 1.<sup>6</sup>

When Korea started its industrialization in the early 1960s, the main source of the capital was government borrowing of foreign funds from multilateral aid agencies such as the IMF and the World Bank as well as the governments of the developed countries. As the government used Korean banks to direct the funds to corporations, it established banking sector controls to carry out industrial policies. The legacy of the government’s control of Korean financial sector continued to 1990s but abated considerably over the few years prior to the IMF bailout.

Now, the IMF bailout enhances the power of the state. In the process of negotiating for and allocating the bailout money and of collecting the additional tax to return the IMF loans, the interventionist bureaucracy rejuvenates its prestige and authority. Emboldened by the \$57 billion IMF bailout agreement and the subsequent debt rescheduling accord, the Korean government immediately determined to raise its own bailout fund of \$30 billion in public bond offering so that the bailout-related burden on the Korean taxpayers would be an oppressive \$112 billion, which amounts to 50 percent of the \$225 billion GNP in 1997 at the 1998 exchange rate.

#### The IMF Conditionality

The IMF touts their reform package as a precondition for receiving the bailout money. The conditionality includes opening the domestic currency and capital markets to the world. However, market opening requires discipline of the market participants: to obey the market rules. Otherwise, it is an invitation for disaster, as witnessed in the mishandling of foreign capital inflow which produced the current Asian financial crisis. Since the IMF bailout corrupts the incentive system and dampens the very discipline to withstand the sometimes-brutal forces of the market, the IMF conditionality is doomed to fail in reforming the economy. For this individual discipline, the IMF found a substitute, tighter government regulation over corporations and banks which only extends the bloated, inefficient and often corrupt government bureaucracy.

#### Against Security Reasoning for the IMF bailout

A non-economic argument to justify the IMF bailout of Korea would be to help prevent the security threat from North Korea. North Korea is dangerous, but too weak to attack the South due to famine and economic collapse. More realistic threats to Korean security are internal, with radical students and union militants opposing the IMF conditionality. Because the IMF bailout extends the life of inefficient banks and corporations, and

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Institute, 1994), pp. 32-35. Yugoslavia was not rated in Holms, et al., 1997 Index of Economic Freedom and hence omitted here.

<sup>6</sup> See Kim R. Holms, Bryan T. Johnson, and Melanie Kirkpatrick, 1997 Index of Economic Freedom (Washington, D.C.: The Heritage Foundation, and New York, N.Y.: the Wall Street Journal, 1997)

because the IMF calls this the free market reform, the militants' anti-market rhetoric gains the moral upper hand.

During the long period until genuine economic recovery, the radicals and unionists may use any intermittent recurrence of economic crisis to blame the genuine market economy without differentiating it from the tainted IMF version. As the radicals gain popularity, the country may move further away from the free market and from liberal democracy, which is a more plausible threat to national security than the military attack from the North.

The economic recovery coming after the bailout poses a threat too. For ending the economic turmoil, the IMF and the statist Korean government would be the first to take the credit. The bailed-out corporations and financial institutions would be vilified for causing the crisis, but they would continue to do business. As a result, the business community as a whole would suffer public disgrace. This would retard the country's progress into a free market system, which requires people's respect for private businesses, the main actors of the market. It is feared that the statist ideology may gain popularity over the fledgling free market economy of Korea.

### The IMF stigma

Why did common Korean people resist the IMF bailout in the beginning? They were afraid, and rightly so, of the reputation plunge or stigma, which can be interpreted in economic terms as the downgraded credit rating of the country, its banks and corporations. They were told that the IMF bailout program would quickly rescue Korea from the currency crisis. What happened instead was that, as soon as the news of the impending IMF bailout leaked in late fall, 1997, the foreign debt revolving of Korean borrowers deteriorated disastrously. If the IMF really rescues the economy, shouldn't even a mere rumor of its impending bailout program stabilize the economy? The IMF hurried to the rescue, perhaps worried that Korea might try to recover on its own, without the IMF help. The IMF bailout agreement lowered the credit rating of Korea to the level of Malaysia, Indonesia, and Thailand and worse. The expected improvement in credit rating with the IMF bailout announcement never happened. The currency crisis worsened with the bailout announcement.<sup>7</sup>

One may allege that the credit rating might have been worse without the IMF bailout. But, how could a country's rating become worse than the junk status Korea received so quickly thanks to the IMF? After the bailout made the country unable to borrow on its own, the IMF straightjacketed Korea with the IMF conditionality. Some of these conditions sound reasonable as flexible labor, and transparent bookkeeping. But the essential ingredients, to raise tax burden and to strengthen government control of the economy, are deadly to a country already gasping with oppressive government actions of taxation and regulation. The market was aware of that and hence the credit rating of Korea is slow to recover.

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<sup>7</sup> Monthly Chosun, (in Korean), Jan. 1998, p. 287.

## Conclusion

To prevent future financial crisis, the Korean economy should rely on market forces. The government should liberate the banking sector from its controls. It should stop bailing out the failing financial institutions with taxpayers' money. Unfortunately, the IMF rejuvenates the bailout food chain and stalls the reform of the Korean economy. By injecting bailout money through the government bureaucracy, the IMF helped rescue insolvent Korean banks and chaebols, and their international creditors from self-inflicted plights, preparing the road to a bigger disaster. The IMF socialized private debts and coerced Korean taxpayers to pay for the international lenders' \$57 billion mistakes, suppressing the free market private sector. It helped expand the big government even bigger. But it is the big government, which is the root cause of the current crisis.

The IMF pretends to play the invisible hand of the market, requiring policy changes on payment of each installment of the bailout money. This IMF conditionality is an utter hypocrisy. For the IMF bailout violates the fundamental principle of the market: removal of failed businesses. The reform of Korean economy must come from the Koreans' understanding that free market, not the big hands of the government and the IMF, prevents future financial crisis.

Table 1. Countries which received 25 or more years of IMF credit in 1947-89 and their scores of the index of economic freedom in 1997.\*

| Country     | Index | Country            | Index |
|-------------|-------|--------------------|-------|
| Ghana       | 3.2   | Turkey             | 2.8   |
| Kenya       | 3.05  | Egypt              | 3.45  |
| Mali        | 3.1   | Syria              | 4.2   |
| Sudan       | 4.2   | Bolivia            | 2.85  |
| India       | 3.7   | Chile              | 2.25  |
| Pakistan    | 3.1   | Dominican Republic | 3.45  |
| Philippines | 2.8   | Haiti              | 4     |
| Sri Lanka   | 2.45  |                    |       |

\*Free for scores of 1.00-1.99, mostly free for 2.00-2.99, mostly unfree for 3.00-3.99, and repressed for 4.00-5.00.

Sources: Doug Bandow, "A Record of Addiction and Failure," in Doug Bandow and Ian Vasquez, ed., Perpetuating Poverty: The World Bank, the IMF, and the Developing World (Washington, D.C.: Cato Institute, 1994), pp. 32-35 and Kim R. Holms, Bryan T. Johnson, and Melanie Kirkpatrick, 1997 Index of Economic Freedom, (Washington, D.C.: The Heritage Foundation, and New York, N.Y.: the Wall Street Journal, 1997).