

The Economic Crisis in East Asia and the Nonprofit Sector

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IN THE ANALYSIS that follows, I would like to stress the following main points: first, the current economic crisis in East Asia raises important questions related to globalization, domestic governance, and the nonprofit sector; second, East Asian societies can be described generally as one-sector or two-sector societies—the nonprofit sector, or civil society, is either nearly nonexistent or very weak in these societies; third, the economic crisis in East Asia is placing significant strains on the nonprofit sector in the region both in terms of demand for its services as well as availability of the resources needed to sustain it; and fourth, it is precisely in those societies characterized by corruption and an inefficient state sector that independent advocacy groups are most needed.

THE CURRENT ECONOMIC CRISIS AND GLOBAL/NATIONAL GOVERNANCE

In his January 27, 1998, article in the *International Herald Tribune* titled "To Liberalize, Indonesia Has to Reform the State," Hilton L. Root wrote, "It is the shortage of governance, not of capital, that has led Indonesia to ruin."

The economic and currency crises in several East Asian countries, including Indonesia, Thailand, and South Korea, force us to reexamine old assumptions about our societies and economies. Although I draw on my

own experience in South Korea, some of my observations may be relevant to other countries in East Asia, as well. This economic crisis is still so recent and came so abruptly that we can not fully understand its cause and predict its impact at this moment. Up until early November 1997, we did not expect that the crisis would come this quickly and severely. South Korea requested rescue funds from the International Monetary Fund (IMF) on November 21, and an agreement was reached between the two parties on December 3. The country moved very close to default on December 23. In the meantime, presidential elections took place on December 18. President-elect Kim Dae Jung acted promptly and swiftly upon being elected, narrowly avoiding the disaster of default. In late January 1998, an agreement was reached between South Korean government representatives and international private banks to replace short-term loans with longer-term loans. On February 6, a new social contract was drawn up by a tripartite committee composed of government, labor, and business representatives. This very significant agreement in South Korean history could well be a starting point for a major domestic restructuring, including layoffs, a general corporate reorganization, and downsizing of the government.

How and why have the currency and financial crises so suddenly attacked East Asian countries, many of which have experienced more than two decades of sustained economic growth? Why have they affected particular countries more severely than others? To find answers, many issues should be studied and explored from different perspectives. I would like to suggest that the current crisis raises at least two main points, one related to global governance and the other to national governance. One characteristic of this financial crisis is that foreign currency debts are assumed mostly by private actors, both banks and corporations. In the three countries most severely affected by the crisis, government budgets have been more or less in balance; transactions were made between private parties, that is, between international private banks and local private banks. Part of the problem is too much private short-term capital—for which there is no effective regulation—flowing around the world in search of quick profits. The IMF is a firefighter who is called upon only once the blaze has already started, that is, only once a country has a serious balance-of-payments problem and is nearing default. No existing organization or mechanism can regulate the global financial market under normal conditions. This is certainly a problem of global governance. When a currency depreciates by half in one month, is this a market failure or a systemic failure?

Put differently, the globalization of financial markets has spread too

quickly and widely in the past decade or so. Profit-seeking private investors and banks tend to move as a group and thus can engender a panic situation. When this happens, no nation or individual actor could escape from the sudden collapse unless it is effectively insulated from the global market by the closure of the domestic economy. Those countries in East Asia with relatively stable currency and financial markets have either followed very conservative policies in economic management and have large foreign currency reserves, such as Japan and Taiwan, or have not opened up their financial markets to the extent of the three countries currently under IMF supervision, such as Vietnam and China.

To point to such relevant factors as the instability of the global financial market and the lack of effective supervision of the system is not to say that the three "IMF countries" in East Asia have managed their economies well. On the contrary, these three countries have been most reckless in their economic management. Indeed, the immediate cause of the financial crisis is mismanagement of financial institutions. That East Asian banks have ended up with such a high proportion of nonperforming assets can be traced to two reasons. First is their excessive reliance on real estate both as an investment asset and as collateral. As the real estate boom collapsed, many banks have ended up with insolvent borrowers and assets. A second reason is interference by the government, which in many cases has forced commercial banks to lend to certain borrowers who are connected with politicians or government bureaucrats. Thus, a main cause of the East Asian economic crisis is market intervention by the government and corruption of politicians/bureaucrats.

In the case of South Korea, bank failures have been caused by the mismanagement of large business firms, notably two companies. The first is the Hanbo Group, which went bankrupt in January 1997. This company's behavior is an extreme example of bribing politicians and bureaucrats and getting various favors in return. The most important corporate failure that adversely affected bank performance in South Korea was that of Kia Motor Company. This company, which was managed by professional managers who did not own a significant share of the company's stock, made excessive investments in the automotive and related industries. In addition, it is speculated that internal corruption was widespread. Other large business groups, or *chaebol*, that went bankrupt in 1997 were all managed by owner families. Here there is a serious problem of agency cost, meaning that there was little effective governance system to monitor and control owner-managers who had a small but controlling share of

companies. Because of these factors, corporate governance emerged as a key area of reform in the IMF conditionality.

Clearly, the internal causes of the recent financial crisis boil down to a malfunctioning governance system and a dysfunctional government sector. A governance system can be defined as a mechanism in an organization to make critical decisions such as resource allocation and the appointment of key personnel, as well as to coordinate various interests of stakeholders. Before the crisis, financial institutions did not have functional governance systems to monitor and correct management practices. Family-owned business firms, which are nonetheless listed and traded on stock markets, did not have effective governance systems. The government sector, which has long been in the habit of regulating markets and, in many cases, is very corrupt, has unduly influenced business decisions but at the same time has not effectively supervised financial institutions. More elaboration is needed to clarify this final point. It can be argued that unless deficiencies in governance systems are corrected, the rescue packages designed to restore the macroeconomic balance will result only in a short-term reprieve from the crisis. What is needed is the development of a self-governing mechanism by which organizations in these societies can make correct decisions and discipline those actors who do not contribute to the organizations.

ONE-SECTOR AND TWO-SECTOR SOCIETIES

How can a society force its private-sector organizations to develop a functioning governance system? Basically, it must develop institutions, or a social infrastructure, that ensure the correct functioning of market mechanisms. As far as corporate governance is concerned, it is the responsibility of the state to design a functioning governance system. A slow, gradual process is necessary to develop and implement such a system, and only in a society with a rule of law and a clean government can this be achieved. In this sense, the role and responsibility of the state sector are critical. How can we make the state sector act in the interests of society? Only a democratic system can achieve such an objective.

In East Asia, some societies have only one sector, i.e., the state sector. An extreme example is North Korea, one of the few countries still clinging to socialist ideology. Absolute power is destined to corruption. A few other countries in this region were formerly socialist but are now moving

toward a market economy. In both China and Vietnam, the ruling socialist party has introduced market mechanisms without substantially changing the political system. These societies raise a critical question in the context of the current crisis in East Asia: Can they successfully move to market economies without developing a private sector monitored by a proper governance system? In China, for example, the distinction between the state sector and the private sector is still blurred, not to mention the distinction between for-profit and not-for-profit organizations. I would venture that China will be faced with the internal governance issue sooner or later, although in the context of a society with no functioning private business sector as of yet, it is premature to discuss civil society.

I tend to view South Korea as a two-sector society, which has been dominated in the past few decades by an interventionist government. It can be argued that the *chaebol* are the outcome of an economic environment in which the domestic market is protected from foreign competition and the government is involved in credit allocation and pursues an interventionist industrial policy. Here a clear distinction should be made between regulation by law and regulation by arbitrary intervention. In a society where corrupt politicians and bureaucrats distribute favors to business friends and then receive kickbacks in return, it is less harmful overall to have corporations run by individuals even without proper governance. In other words, the underdeveloped state of corporate governance in South Korea is partly a result of an interventionist government policy in the developmental decades from the early 1960s to the early 1990s. Although the South Korean business sector has grown quickly and become very powerful, it still depends on government for some critical resources and thus is very vulnerable. The South Korean business sector has yet to develop an effective governance system.

Given that a functioning nonprofit sector must meet three conditions, namely, reasonable size, independence/self-governance, and a stable source of funds, clearly South Korea does not have a vibrant nonprofit sector. Of these conditions, size may be the least important because there is no absolute definition for size. However, a critical factor clearly is a nonprofit sector's ability to self-govern. In this respect, it is difficult to say that South Korea has an independent nonprofit sector except for a few advocacy groups active since 1987, when the democratization process notably started. A major source of funds for nonprofit activities in South Korea is corporate foundations, but such organizations do not consider themselves to be part of the nonprofit sector—people working at corporate

foundations consider themselves to be working in corporations rather than in the nonprofit sector. In fact, people in general have no concept of what a nonprofit organization is. Even the concept of a legal person is alien to many people. A publicly listed company is still considered by many people to be family fortune. The rule of law has a long way to go in many East Asian societies, including South Korea, and thus it is my contention that South Korea can not yet have a functioning nonprofit sector. This is true of some other East Asian countries, including perhaps Japan and ethnic Chinese societies.

IMPACT OF THE ECONOMIC CRISIS ON THE NONPROFIT SECTOR

How might the current economic crisis affect the weak nonprofit sector in East Asia, particularly South Korea? The nonprofit sector has relied on the government and on private firms for the lion's share of its operating budget. However, the government budget is contracting in line with the economy and as a result of IMF requirements for a balanced budget. Social services, including unemployment benefits, will be increased owing to the rapid rise in unemployment. Other budgets also will be reduced. Business firms have already been severely damaged by high interest rates, the devalued currency, a serious shortage of liquidity, and falling demand for their products, hence severely limiting local corporations' involvement in philanthropy and community affairs. In South Korea, funds coming directly from corporations have been a much larger source of corporate philanthropy than gifts from corporate foundations. Direct giving programs will be drastically cut back; indeed, the impact of this is already being felt by many organizations relying heavily on such funds.

Nonprofit organizations (NPOs), including private universities and others, have not yet felt the full impact of the IMF conditions, but they will be gradually exposed to a fall in demand for their services and a significant reduction of financial support from the other two sectors. Individual giving, which is channelled through religious organizations and some media campaigns, may also be affected, although to a lesser degree. While the sources of funds will be reduced because of the crisis, the demand for social services will increase because of the rapid rise in unemployment and resulting social problems such as family conflicts, psychological disturbances, crime, and poverty. From my perspective, South Korea does not have

a viable third-sector that can handle these social and economic problems set to arise from the severe economic depression of the next few years. As a result, the government will be asked to provide even more social welfare services in the coming years, perhaps resulting in a bigger societal role for government, ironically.

What can nongovernmental organizations (NGOs) in East Asia do that is of use in the coming years? Certainly, a big demand exists for service-providing NGOs at this time of economic crisis. Also, I would like to suggest that advocacy-type NGOs need to be activated at this time. The economic difficulties being experienced by some East Asian countries result partly from overinvestment and unproductive investment by the government and private firms. Furthermore, an underlying reason for unproductive investment is corruption in government and business. For example, it is estimated that as much as 40 percent of construction contract money in South Korea is diverted away from its intended use owing to bribes and corruption. Under such circumstances, the creation of a partnership among three, as opposed to just two, sectors will not in and of itself help the society greatly. Unless the two dominant sectors typical of most East Asian economies change fundamentally, the relatively weak nonprofit sector can have only a very limited impact toward the betterment of society. Accordingly, pressure should be put on the government and business sectors by citizens in an organized way. It should be noted that citizens' groups which are funded by government or business are by definition unable to put pressure on their donors to fundamentally change. What is really needed are independent NGOs supported by citizens at the grass-roots level. In South Korea, although we have only a few such advocacy groups, they exert a disproportionate influence on society simply because of their independence from the two dominant sectors.

CONCLUSION

The current economic crisis in East Asia forces us to reexamine our manner of operating during the past four decades. The management of business firms and government has to be different from now on: the *modus operandi* of the past forty years, the developmental decades, can not be continued. The *chaebol* will be forced to restructure, and governments and bureaucrats also have to change drastically, although I am not so optimistic about this latter prospect. Big business will be forced to change

both by the market and by the government, which will also feel pressure from the IMF. However, the government will not be forced by the market to change, and IMF pressure for change on the government will be less than that on big business.

Again, we can not simply assume that the NPO sector can improve society merely by working closely with the two dominant sectors. This assumption will be valid only once those two sectors become efficient and reasonably clean. As long as they are not, working closely with them will only compromise the nonprofit sector's true reason for existence. The current economic crisis shows very clearly that some indigenous business firms in East Asia suffer from serious governance problems, as well as inefficiency. It also highlights the fact that the governments in the region have been ineffective in dealing with the real problems in their societies. The nonprofit sector must exert influence on both sectors to clean up their own houses first before it is able to work positively in tandem with them. This is the challenge that the current economic crisis imposes on the region's small and feeble nonprofit sector.