Economic Crisis and Structural Reforms in South Korea

Chung-In Moon
Jongryn Mo
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Executive Summary

South Korea has long been touted as an outstanding model of economic development. Despite poor resource endowment, a colonial legacy, and protracted military conflict with North Korea, it has transformed itself from one of the poorest nations to become the 13th largest economy and the 8th largest trading state in the world in a relatively short span, through aggressive pursuit of an export-led growth strategy.

In November 1997, however, a vicious economic crisis jolted South Korea’s miracle economy, shattering its economic dynamism and national pride. Several factors accounted for the genesis of the crisis: eroding international competitiveness and dismal corporate performance, excessive investment and leveraging, proliferation of nonperforming loans and paralysis of the banking and financial sector, mounting foreign debts and acute liquidity crisis, and economic mismanagement of the government. The confluence of flawed fundamentals and liquidity problems precipitated the crisis. South Korea was able to escape from the brink of default and collapse only through rescue financing from the IMF, which imposed comprehensive structural reforms as conditions for the financing.

The Kim Dae Jung government, which was inaugurated in February 1998, has undertaken the structural reforms quite successfully by complying with the IMF conditions. While labor market rigidities have been considerably relaxed through extensive labor reform, institutions of the old Korea – such as the chaebol, bank-centered financial intermediation, and collusive state-business relations – have been cracking under the weight of widespread demands for global standards, accountability, transparency, and liberalization.

The structure of corporate governance has undergone a sweeping overhaul, and the banking and financial sector has become much more liberalized and rationalized than ever before, with sources of moral hazard being substantially reduced. The liberalization of foreign trade and investment has also been unprecedented in its scope and rate.

Indeed, all indications are that the Korean economic system is moving toward a more market-oriented economy. Largely as a result of lessons learned from the crisis, the Korean government is now much better prepared, both institutionally and intellectually, to deal with remaining sources of economic instability.

The structural reforms have begun bearing fruit. By all measures of macroeconomic performance, South Korea has fully recovered, and its economy is growing rapidly, with few signs of inflation. Moreover, foreign
exchange reserves have risen close to $90 billion in 2000 due to current account surpluses and continuing inflows of foreign capital, enough to give any currency trader second thoughts about attacking the Korean won.

The unemployment rate has also been dramatically reduced from the high point of 8.6 percent in February 1999 to 3.4 percent in July 2000. Foreign imports have soared with the recovery of consumer confidence.

Korea’s accomplishments since 1997 represent positive developments for the United States. Even though Korean capitalism may not converge to the U.S. model, the days when internally collusive and externally exclusive institutions are used as a source of comparative advantage are clearly drawing to a close. Although these new institutions are likely to be more nationalistic and interventionist than the United States might desire, they will no longer be able to support the government-directed growth strategy that distorted markets in the past.

The Kim Dae Jung government has also generally complied with the United States in implementing structural reforms and liberalization. Sources of bilateral trade friction still remain, but their magnitude will be much smaller and manageable in comparison with the past.

Despite such positive developments, however, there are some causes of concern for the future of the Korean economy. The labor sector has become increasingly unruly, defying the rule of law. The corporate sector, especially the chaebol, has been persistent in trying to evade reform mandates. As the credit crunch of June 2000 shows, restructuring of the banking and financial sector has been far from effective. More critically, the specter of the developmental state – i.e., the interventionist state, and a mercantilist ethos – has been resurfacing, and threatens to undercut the government’s reform efforts.

Meanwhile, the Kim Dae Jung government is rapidly losing its political support base, not only because of the collective action dilemma embedded in the structural reform process, but also because of a prevalent “reform fatigue.” Thus, the possibility of another crisis cannot be completely ruled out unless the South Korean government addresses these constraints effectively and completes the unfinished tasks of structural reform in a timely manner.

It is undeniable that recent reforms have created building blocks for further reforms. And once institutions are set up, it is difficult to get away from their path dependency. Global standards, accountability, transparency, and liberalization will serve as dominant rules in the South Korean economy.

Nonetheless, it is imperative that South Korea continue to reform itself, with the goal of eliminating residual structural rigidities and remaining
competitive. Restructuring of corporate governance, rationalization of the banking and financial sectors, and labor market reforms should be continued without further delay. Economic liberalization and corresponding economic restructuring should also be undertaken without interruption. For this, the South Korean government needs to solidify its domestic political support by consolidating its gains in structural reform.

At the same time, the United States should continue to support Korea’s reform efforts and also apply pressure when necessary.
Chapter 1:

Introduction

South Korea has long been touted as an outstanding model of economic development. Despite poor resource endowment and a large population, a colonial legacy, the devastation following the Korean War, chronic political instability, and the protracted military confrontation with North Korea, South Korea has made an impressive ascension in the international economic system, becoming the 13th largest economy and the 8th largest trading state in the world in a relatively short span.

Beneath the economic miracle lay human capital investment, a timely transition to an export-led growth strategy, and the visible hands of the developmental state. As a developmental state, South Korea was able to expedite the pace of economic growth by identifying strategic industrial sectors, making discretionary allocation of resources to those sectors, and minimizing the collective action dilemma pervasive in most developing countries.

In November 1997, however, a vicious economic crisis jolted South Korea’s miracle economy. Eroding international competitiveness and dismal corporate performance, proliferation of nonperforming loans and paralysis in the banking and financial sector, economic mismanagement of the government, mounting foreign debts and an acute liquidity crisis, regional contagion effects, and the panic behavior of international lenders drove the South Korean economy to the brink of default and collapse.

The subsequent IMF bailout was predicated on the government’s agreement to carry out comprehensive structural reforms that would remake the South Korean economy and transform it from a semi-mercantilist economy to a more market-oriented one. Kim Dae Jung, who won the presidential election in the middle of the crisis and was inaugurated in February 1998, has undertaken the structural reforms quite successfully by complying with the IMF conditions.

As a consequence of the president’s reform efforts, the South Korean economy has recovered. The GDP growth rate rose from minus 5.8 percent in 1998 to 10 percent in 1999, while the rate of industrial productivity increased from minus 7.3 percent to 20 percent in 1999. The current account balance went from deficits of $23 billion in 1996 and $8.2 billion in 1997 to a surplus of more than $20 billion in 1999. Foreign reserves rose from a meager $7.2 billion in November 1997 to $68.4
Economic Crisis and Structural Reforms in South Korea

billion two years later. The stock market also revived, going beyond the 800 level since June 1999. Along with this, the rates of dishonored corporate bills also returned to pre-crisis levels, recording 0.10 percent since January 1999. The unemployment rate was also drastically reduced from a high of 8.6 percent in February 1998 to 4.7 percent in March 2000. (MOFE a 2000, 111-113)

Can the improvement in macroeconomic indicators be interpreted as the sign of full economic recovery? Can it be ascribed to the structural reforms? To what extent have the structural reforms been successful? And is there any chance for recurrence of the economic crisis? This monograph is designed to explore these questions from a political economy perspective.

Chapter 2 provides a detailed examination of the causes of the economic crisis in South Korea, looking into the dynamic interplay of both internal and external factors. Chapter 3 presents a comprehensive overview of the IMF’s conditions and the structural reforms undertaken by the Kim Dae Jung government, focusing on the banking and finance, corporate, and labor sectors, as well as on liberalization and deregulation. Chapter 4 explores the political dynamics of the structural reforms. Chapter 5 makes critical assessments of Kim Dae Jung government’s structural reforms by analyzing actual implementation and outcomes. Chapter 6 discusses newly emerging barriers to the continuation of structural reforms. Finally, in Chapter 7, the monograph suggests several comparative policy implications.
Chapter 2:

The Causes of Korea’s Economic Crisis

Before reviewing the domestic structural causes of the economic crisis, it is important to recognize that the Korean crisis was a symptom of a larger problem in international capital markets. So powerful was the influence of the international system on Korea’s economic crisis that it is possible, though inaccurate, to describe the onset of the crisis without mentioning domestic factors.

If one looks at the situation from the outside, the story of the Korean crisis is rather simple. Korea’s capital account transactions opened just as the need for foreign capital was growing and the incentive to borrow from abroad was high. In preparation for the 1996 accession to the OECD, the Korean government eliminated many restrictions on the movement of capital, allowing Korean banks and firms to borrow from abroad and international investors to invest in Korean assets. Moreover, there was plenty of capital in international financial markets at that time, especially from Japan, which was keeping interest rates very low to stimulate its sagging economy.

The demand for foreign capital in Korea was strong. The country needed to finance a current account deficit that swelled to $23.7 billion in 1996. Moreover, Korean firms and banks sought foreign capital to take advantage of large interest rate differentials between the Korean and foreign credit markets.

Then, just as Korea was increasing its reliance on foreign capital, its export juggernaut was weakened. World prices of Korea’s key exports, such as semiconductors, steel and ships, fell to such a low level that Korea’s terms of trade (the ratio of export to import prices) in 1996 deteriorated to levels last seen during the second oil shock of 1979.

It is no coincidence that many of the bankrupted firms had a major presence in the steel industry. Export-oriented industries that had benefited from a strong yen in 1994-1995 saw their advantage wither as the yen depreciated. Other domestic industries, such as construction and retail, had not fully recovered from the recession of 1991-1992 and could not take up the slack. Consequently, profits declined at many Korean firms, which found it difficult to service their debts. By 1996, corporate profits, as measured by the ratio of ordinary income to sales, fell to 1 percent, the lowest since 1987.
Thus, a host of external factors, such as the premature opening of the capital market and the terms-of-trade shock, increased Korea's vulnerability heading into 1997. What finally triggered the crisis in South Korea was a chain of events in the rest of Asia, beginning with the devaluation of the Thai baht in July 1997. As the Asian crisis spread, Korea became a victim of self-fulfilling speculative attacks and contagion (Moon, 2000).

The discussion of the causes of Asia's and Korea's economic crises has been dominated by a focus on economic, and especially international economic, factors discussed above. In this literature, there are two schools of thought having different views on the “rationality” of the currency crises. "Fundamentalists" believe that the crises hit countries that were fundamentally vulnerable. According to their accounts, currency crises follow a familiar pattern characterized by a commitment to fixed, or heavily managed, exchange rates, along with the related problems of overvaluation, current account deficits, loss of investor confidence and pressure on the exchange rate that can ensue (Corsetti, Pesenti, and Roubini, 1998).

On the other hand, critics of the fundamentalist account have underscored the way that premature capital account liberalization increased the vulnerability to crisis, as well as the role of self-fulfilling speculative attacks and contagion (Radelet and Sachs, Special Issue on Asian Financial Crisis, in Cambridge Journal of Economics 1998).

Although all of these factors were evident, the Korean case suggests certain anomalies in these accounts (Haggard and Mo 2000). Export growth slowed in all countries in the region in 1996, but Korea's current account deficits did not deviate substantially from levels that had been financed by private capital inflows in the past. Also, recent research on the extent of overvaluation suggests that it has been exaggerated, and that the Korean won was even slightly undervalued at the time the crisis broke (Chinn 1998). And while it is certainly true that Korea was affected by contagion from the stock market crash in Hong Kong during the week of October 20-24, there were strong signs of vulnerability in the Korean economy well before the onset of the crisis in early November.

Attention has thus shifted to the domestic factors that generated vulnerability to short-term capital movements, including macroeconomic and other policies that permitted credit and investment booms and weak regulation of financial markets (for example, World Bank 1998).

However, behind those policy problems stand important political questions that have received somewhat less attention. As Krause (1998) points out, the arguments of both the fundamentalists and those
emphasizing self-fulfilling speculative attacks have not systematically addressed the role of political factors in the onset of the financial crises.

The first question concerns the role of government in the investment boom that preceded the crisis. Critics of the East Asian model, and of Korea in particular, have suggested that some combination of industrial policy and corruption generated fundamental problems of moral hazard – i.e., firms invested at high rates because risk was socialized. The banks were willing accomplices in those strategies because they were effectively still under government control.

A second set of political questions center on the government’s response to impending signs of corporate and financial difficulty and emerging problems with the external account. Financial crises typically require a trigger, and that trigger may come from uncertainty about the future course of government action. If relevant economic parameters are deteriorating, and investors come to believe that the policy status quo will persist, because the government is prone to delay corrective action, those investors have incentives to exit quickly.

A third question focuses on the Korean political system’s failure to reform the very economic system that was the fundamental source of vulnerability. Since the 1960s, the Korean government had intervened in the labor, corporate and financial sectors to promote strategic industries. A unique set of economic institutions emerged from this industrial strategy – such as rigid labor markets, the chaebol,1 and a state-dominated banking and financial sector. Although this system had been the engine of economic growth in the 1960s and 1970s, it had come under attack as the need for a market-based system became apparent by the mid-1980s.

The crisis of the banking sector, in particular, resulted from the long period of government intervention and dominance. Credit control and allocation had become the key instruments of Seoul’s industrial policy, and for a long time, it allocated credit to favored sectors through policy loans and administrative guidance (Cho and Kim 1995; Woo 1991). The risk for the banks was minimal, because the government, acting as “an effective risk partner of private industry,” provided explicit guarantees for

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1 Chaebol (Zhambatsu in Japanese) are business conglomerates characterized by a high degree of economic concentration in areas such as ownership, business, and markets. Touted as agents of economic and industrial transformation in the 1970s, they have been singled out as the primary cause of the economic crisis in 1997 (See Jo 1997; Chung 1987).
depositors while bailing out the companies that they supported. And because the government was deciding where the money went, banks had little incentive to develop project evaluation skills.

The implicit co-insurance scheme among government, banks, and industry worked well for a long time, fueling the industrialization of the Korean economy, but it left the banking sector inefficient, backward, and dependent. Furthermore, the state-dependent banking sector provided a breeding ground for corruption. Because capital was in short supply and the government regulated interest rates, banks could, and did, allocate credit under government direction to those who could deliver favors, such as friends of powerful politicians, or those who offered the highest bribes.

One must be careful about blaming the economic system, however, because it is the responsibility of the political system to oversee and correct structural economic problems. Indeed, the Korean government made numerous attempts to reform the domestic economy before the crisis, but failed. An ineffective political system that cannot implement necessary economic reforms may be more culpable than the economic system itself.
The Role of Government in the Investment Boom of 1994-1995

Korea experienced an investment boom from 1994 to 1996 that ultimately contributed to the economic crisis. As Exhibit 2.1 illustrates, the period immediately preceding the 1997 crisis showed the second highest rate of growth in facility investment, recording an annual average growth rate of 30.1 percent. Facility investment in manufacturing rose by 38.5 percent annually, with peaks in 1994 and 1995, when investment grew at rates of 56.2 and 43.5 percent respectively. Investments were geared towards the expansion of product lines (65.7 percent) and were concentrated among large firms in certain industries. Investments in heavy and chemical industries grew 43.1 percent annually, while the rate of growth for light industries was only 15.0 percent. Large firms expanded at a rate of 45.7 percent, while small and mid-size firms increased their investments by 17.7 percent.

The greater emphasis on manufacturing and large enterprises and the greater dependence on borrowing foreign currency distinguish the 1994-1996 boom from earlier periods of rapid investment growth (1972-1979 and 1983-1991). Dominated by large chaebols' real manufacturing investment in heavy industries, such as automobiles, petrochemicals, steel and electronics, this boom lay at the root of Korean firms' heavy indebtedness and subsequent insolvency.

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2 This section draws heavily on Haggard and Mo (2000).
3 Investments in corporate restructuring and rationalization (15.5 percent), pollution control (2.5 percent) and research and development (6.2 percent) were relatively small.
### Exhibit 2.1 Cycles of Facility Investments

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<td>(Percent)</td>
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<td>All Industries</td>
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<td>20.0</td>
<td>-1.0</td>
<td>30.1</td>
<td>-18.8</td>
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<td>Manufacturing</td>
<td>41.3</td>
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<td>29.6</td>
<td>-8.9</td>
<td>38.5</td>
<td>-29.0</td>
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<td>39.9</td>
<td>-11.2</td>
<td>32.0</td>
<td>-10.8</td>
<td>43.1</td>
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<td>Non-manufacturing</td>
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<td>1.1</td>
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<td></td>
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<td>Capacity Expansion</td>
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<td>69.6</td>
<td>64.2</td>
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<td>2.5</td>
<td>2.5</td>
<td>1.7</td>
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<td>8.4</td>
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<td>8.5</td>
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<td>External Financing</td>
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<td>65.8</td>
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<td>Bank loans</td>
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<td>Foreign currency</td>
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<td>12.1</td>
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<td>Internal Financing</td>
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<td>23.6</td>
<td>34.3</td>
<td>31.3</td>
<td>28.3</td>
<td>27.4</td>
</tr>
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</table>

Sources: Reprinted from Haggard and Mo (2000)

Various economic factors contributed to this increased investment. With rising labor costs due to the country’s democratization, Korean firms had been losing competitiveness since the 1980s (Mo and Moon 1998). As a result, firms increased their investments in capital equipment, much of which was purchased from abroad (Cha 1998). Cyclical factors also played a role in the increased facility investment. Having risen continuously since 1980, investment growth in Korea experienced a short period of decline from 1992 to 1993 and was again on
the upswing. Certain sectors, such as semiconductors, were enjoying unprecedented growth. The yen’s appreciation against the dollar from 1993 to 1995 contributed to this expansion by increasing the competitiveness of Korean exporters (see Exhibit 2.2).

### Exhibit 2.2 Macroeconomic Management, 1993-1996

<table>
<thead>
<tr>
<th>Year</th>
<th>Yen-Dollar Exchange Rate$^a$</th>
<th>Money Supply (M$^b$)</th>
<th>Interest Rates</th>
<th>GDP (Percent Increase)</th>
<th>Equipment Investment (Percent Increase)</th>
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<td></td>
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<td>Overnight Call Rate$^c$</td>
<td>Yields on 3-yr. Corp. Bonds$^c$</td>
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<td>10.86$^+^$</td>
<td>11.44$^+^$</td>
<td>4.1</td>
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<tr>
<td>1993</td>
<td>1 117.07</td>
<td>16.7</td>
<td>13.02$^+^$</td>
<td>12.37$^+^$</td>
<td>4.9</td>
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<tr>
<td></td>
<td>2 107.34</td>
<td>18.9</td>
<td>12.41$^+^$</td>
<td>14.04$^+^$</td>
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<tr>
<td></td>
<td>3 105.28</td>
<td>21.5</td>
<td>11.50$^+^$</td>
<td>12.21$^+^$</td>
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<tr>
<td></td>
<td>4 109.70</td>
<td>17.3</td>
<td>11.29</td>
<td>12.16</td>
<td>8.9$^d$</td>
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<td>12.39</td>
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<td>2 108.86</td>
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<td>3 109.75</td>
<td>17.4</td>
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</tr>
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</table>

$^a$ - end of quarter  
$^b$ - annual increase in end-of-quarter average balance  
$^c$ - average over the period  
$^d$ - estimates

Sources: Reprinted from Haggard and Mo (2000)
The government’s macroeconomic and microeconomic policies played a key role in igniting the boom. On March 22, 1993, the new Kim Young Sam government announced an economic stimulus package, the so-called “New Economy 100-Day Plan,” which consisted of interest rate cuts, increased supply of funds for facility investment, and early implementation of government projects. Intended to revive the relatively sluggish growth, by Korean standards, and thus to promote the new president’s ambitious economic and political programs, the package stimulated an increase in money supply (M2) in 1993.

At the micro level, investment was boosted by a policy of deregulation. With the support of what Lew (1999) calls the deregulation school, made up of market reformers at the Economic Planning Board and Korea Development Institute, various barriers to corporate entry and the financial system were removed. In 1993, the Kim Young Sam government introduced a “business specialization policy” whereby, in return for concentrating on core industries and phasing out non-core businesses, chaebol were granted reprieves from credit and equity controls in place since 1974.

Having limited entry into a number of sectors in the past, the government’s moves toward deregulation stimulated an investment rush. Pressured to open up sectors such as petrochemicals in 1990 and steel and semiconductors in 1994, the government subsequently struggled to deal with over-capacity in those areas due to the resulting increase of investment.

The increased investment of 1994 to 1996 relied heavily on short-term borrowing facilitated by the government. Instead of forcing weak short-term finance companies to restructure or close down, the government allowed 24 of them to convert into merchant banks in 1994 and 1996. Many of these new merchant banks aggressively pursued new businesses, including risky foreign exchange transactions. By 1998, after many of these banks were technically insolvent, the government revoked 15 of those licenses.

The government’s deregulation of the commercial paper market in 1994 also led to a rise in short-term financing (Cho 1998). The government deregulated the commercial paper market by lifting administrative controls on the yields and supply of commercial papers (CP), offering companies an attractive financing instrument and CP-discounting merchant banks a profitable market.

Foreign capital was also plentiful after the Korean government began liberalizing foreign currency controls. Domestic banks and firms
were now freer to borrow from abroad, and international investors could more easily invest in Korean assets. Korea’s entrance into the Organization for Economic Cooperation and Development (OECD) in February 1996 confirmed to investors that Korea was an attractive place to invest. In 1994, when Korea’s entry passed its first test, foreign lending was at $52 billion. By the time Korea officially entered the OECD in 1996, foreign banks had more than doubled their lending to $108 billion.

Many have felt that Korea’s financial market liberalization was misguided, because of the lack of appropriate regulation (Goldstein 1998; The IMF 1998; The World Bank 1998). However, the claim of inadequate regulation leads to the deeper issue of whether lending was effectively encouraged and supported by government policy. The government’s history of designating favored sectors for allocation of credit through policy loans and administrative guidance has led some to argue that the crisis was caused by industrial policy (Cho and Kim, 1995). With the government using credit control and allocation to further its industrial policy, even after privatization, banks faced very minimal risk and had few incentives to develop sophisticated project evaluation capacities. As a result, Korean banks became inefficient, backward and dependent, emphasizing collateral rather than the merits of investment proposals. They were notoriously overstaffed and over-expanded. However, this situation was not new to the investment boom period of 1994-1996, so one must also question why the problem became so serious in the mid-1990s.

It appears that the move to deregulate corporate activity and the banking sector contributed to the problem of moral hazard during the investment boom of the mid-1990s, despite Kim Young Sam’s deregulation efforts. The first source of moral hazard arose from the relationships among the government, companies and banks. Critics of the chaebol have argued that unchallenged investment decisions by chaebol owner-managers led to unwise expansion. Such owner-managers control an entire network of firms through cross-shareholdings, with little internal or external culpability. For example, the owner-managers of Samsung and Ssangyong put their groups at risk by following their dreams of entering the automobile industry. Had other stakeholders been allowed significant influence in investment decisions, the chaebols may not have expanded as much as they did.

Although corporate governance failures explain certain “excessive” investments, they are not convincing as a general explanation...
for the investment boom. Even enterprises with diffuse ownership and control structures, such as Kia, expanded their capacity from 1994 to 1996. On the other hand, government control of the banks did lower incentives to monitor lending, particularly when macroeconomic policy was accommodating. Moreover, liberalization created additional incentive problems for Korea’s non-bank financial institutions as chaebols began to increase their hold on such institutions (i.e., merchant banks) to finance group investments. It is no surprise that these chaebol-controlled financial institutions did not carefully monitor loans made to their parent companies. This problem was exacerbated in the 1990s when financial deregulation allowed the non-banking financial sector to expand market share rapidly. The rise of non-bank financial institutions with questionable governance systems made the banking sector as a whole more vulnerable to the problem of moral hazard.

Second, the moral hazard related to corporate failure worsened in the 1990s. Up until the late 1980s, the Korean government had been the sole dispenser of corporate discipline, because financial markets were underdeveloped (no market for corporate control), and internal discipline, such as minority shareholders and workers, was weak. Thus, during times of rapid growth (i.e., 1969, 1971-72, 1981-82, and 1985-1989), the Korean government periodically intervened to force insolvent firms out of the market. However, after the late 1980s, the government was, paradoxically, reluctant to face the political costs of forced corporate restructuring and anxious to promote a policy of deregulation. Thus, the government stopped intervening and no major chaebol failed after 1989.

Influence-peddling and corruption in the banking sector provided a third source of moral hazard. Banks had fewer incentives (and weaker information) in managing their loan portfolios due to the relationships among politicians, banks and their clients. The bankruptcy of Hanbo provides a case in point. The bankruptcy investigation revealed the existence of an influence-peddling network that facilitated the expansion of credit lines to Hanbo. All the principal actors in the Hanbo lending scandal, including the President of Korea First Bank (Hanbo’s main creditor), key officials in the Ministry of Finance and Economy and the Blue House, and the superintendent of the Bank Supervisory Board (the agency responsible for banking regulations), were members of Kim Young Sam’s political faction. Though some dismiss the role of corruption as being limited to a few cases (Chang 1999), Hanbo’s significance in the banking sector should not be underestimated, as will be discussed below.
Finally, despite the nominal abandonment of targeted industrial policies, the government continued to participate directly in the financial markets through the Korea Development Bank (KDB), whose main function is to provide companies with long-term investment loans. The KDB was a major source of funds for the facility investments of 1994-1996, and its lending decisions were likely seen as signals of government support by private financial institutions. The KDB increased its supply of credit rapidly during the investment boom period. In fact the rate of increase in KDB lending surpassed that of facility investment in manufacturing in 1996, when it was supporting the government’s investment promotion policy. KDB loans accounted for 11 percent of total financial credit in 1995. Even more telling, in 1994, the KDB accounted for 44.2 percent of the total increase in equipment investment financing by the KDB and all deposit money banks. The KDB’s outstanding loans for equipment investment at the end of 1994 (18.2 trillion won) were 45.7 percent of the total outstanding loans of the KDB and all deposit banks combined (39.9 trillion won). In short, KDB lending was significant enough to constitute a signal of government policy and commitment, and it is no surprise that commercial banks followed its lead.4

With both market forces and government policies at work, it is difficult to explain the investment pattern of such a short time frame. However, the argument that domestic macroeconomic policy and deregulation contributed to the burst of facility investment in the mid-1990s is compelling. At the same time, the moral hazard problem in the banking sector was exacerbated by the nature of government intervention in the economy and, more profoundly, by the ongoing characteristics of government-bank-chaebol relations. These characteristics included direct government involvement in lending, weak incentives for banks to conduct appropriate due-diligence and monitoring, the expansion of the chaebol into the non-bank financial sector, the government’s unwillingness to force corporate bankruptcies, and outright corruption. The distorted incentives in the financial sector allowed the chaebol to raise and invest unprecedented amounts of capital in 1994-1996.

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4 Indeed, commercial banks followed the KDB’s lead by lending to Hanbo Steel in 1993, when it was clear the firm was already in trouble.
Ineffective Crisis Management

The financial crisis of 1997 can certainly be traced to the investment boom of 1994-1996. But the amount of investment by itself was not a sufficient condition for the crisis. If the government had stabilized the economy in 1995 and/or better managed the mini-crisis that emerged prior to the November crisis, it might have averted the crisis altogether or at least have been able to weaken its severity.

Signs of an overheating economy began appearing as early as January 1994, when the current account balance turned into a deficit. The next year, the yen peaked and began a three-year period of depreciation that put pressure on Korean exporters. Analysts began issuing warnings about the level of facility investment as early as 1995 (Marvin 1998), voicing fears that further investments would lead to larger current account deficits, over-capacity and lower corporate earnings.

The government took heed and introduced a variety of measures to control corporate investments. It requested that the chaebol adjust their investment plans and discouraged the use of foreign loans to finance facility investments by lowering the ceiling on foreign currency loans and strengthening banks’ foreign currency reserve requirements. The government slowed the growth of the money supply (M2), which increased at a relatively low rate (12-16 percent), and raised interest rates during the first half of 1995. Seoul also put deregulatory actions on hold in early 1995, abandoning plans to relax entry barriers and investment controls in the power generating equipment and semiconductor industries.

These efforts were gradually reversed in 1996. During the first quarter of 1996, the growth rate of the money supply began rising and capacity reduction efforts began to falter. Although the government rejected Hyundai’s application to enter the steel industry, it failed to stem expansion in the petrochemical industry. By September 1996, the government, concerned about an economic slowdown, was again promoting facility expansion.

The government’s concern over the performance of the small- and medium-sized enterprise (SME) sector tempered its stabilization measures. The Kim Young Sam government saw promotion of SMEs as an effective response to strong anti-chaebol sentiment among the public, and SMEs, along with farmers, became the biggest beneficiaries of government programs (Mo and Kim 1999). SMEs were slow to recover from the 1992-1993 slowdown, and their difficulties provided a rationale for not taking strong stabilization measures (Moon 1999).
After 1995, any hope for a soft landing was gone, and the first to suffer from the hard landing were Korean firms. Domestic economic growth showed down in 1996. Exports could not make up for lower domestic sales because export prices fell in key export industries, such as semiconductors and steel. Large Korean firms began to accumulate losses and, by early 1997, many of them were on the brink of bankruptcy. The key task for the Korean government at that time was to maintain investors’ confidence with a speedy resolution of corporate insolvencies. But the government got mired in succession politics within the ruling party and bureaucratic turf battles, and could not stop a series of ensuing corporate bankruptcies.

The disposition of the Hanbo case in January 1997 is one example of how the government, as a result of political infighting, failed to manage emerging corporate and financial distress leading to the crisis. That failure sent mixed signals about the government’s intentions with respect to failing enterprises and exacerbated uncertainty about the health of the banking system. In the case of Hanbo, the government nationalized the company and injected capital without making efforts to save Hanbo’s management.

When other top-30 chaebol folded – Sammi in March and Jinro in April 1997 – the financial system also became caught up in events. Announcing an “anti-bankruptcy” pact, 35 commercial and state banks moved to extend credit to, and defer payments of, at-risk chaebol. This added exposure damaged the banks, forcing the government to inject liquidity into the financial system and supplement the concerted lending and rescheduling effort. After Hanbo’s collapse, according to Kim Sok Tong, Chief of the Ministry of Finance and Economy’s Foreign Capital Section, a number of major Korean commercial banks were technically insolvent. However, the government prevented outright bankruptcy (Cho and Pu 1998, 126) and, on August 25, announced measures to shore up the financial system, an $8 billion infusion (Newsreview August 30, 1997, pp. 24-25).

The Kia bankruptcy and subsequent mismanagement by the government caused further turbulence and uncertainty in the Korean financial and foreign exchange markets. The crisis broke on June 23, 1997 when Kia’s Chairman Kim Sun-Hong directly appealed for government

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5 To be part of the program, a chaebol had to be considered “basically sound” and had to come up with a “self-rescue” package.
assistance in persuading creditors not to call maturing loans. What ensued was a highly politicized battle over the future of Kia, as Kia's management sought to blackmail the weakened government, which was locked in a tightening presidential race, into providing a bailout. The chairman mobilized support for the company from suppliers, employees, competitors and the public at large, eventually forming a “save Kia” movement through a coalition of more than sixty social groups.

On August 4, the banks postponed the final decision on the bailout package until September 29 and withheld further credit until that time. Kia's management quickly warned that many of Kia's suppliers would fail, and appealed for government intervention. The government, however, began to signal its impatience, both with Kia's open campaign for intervention and support and with the anti-bankruptcy pact established by the banks, because the very uncertainty and delay over the firm's future was itself becoming a major source of financial market instability.

Seeking to exploit legal loopholes to avoid bankruptcy, Kia management fought government receivership but could do little against the threat that the government would refuse to guarantee the company's foreign obligations of $687 million. Creditors delivered an ultimatum to Kia at their final meeting on September 29. Still, it took a full month, until October 22 – the day before the biggest stock market fall in Hong Kong – before the government intervened definitively to settle the Kia issue (Moon and Moon 1999a).

Thus, the Korean financial system was already on the verge of collapse when the shock from Hong Kong hit on October 23. Events spiraled downward quickly. On October 28, as foreign investors rushed to exit the Korean stock market, the government announced that it would raise foreign ownership limits on the stock exchange in order to induce an infusion of foreign capital. Then, on October 28-30, despite heavy market intervention, the won depreciated by its daily limit of 2.5 percent, and the government halted trading of the won. On November 1, Moody's and Standard & Poor's downgraded the credit rating of Korean banks. Soon, the foreign press began issuing reports that the Bank of Korea's foreign exchange reserves were evaporating and that the BOK was committed to extensive forward contracts to defend the won for the rest of the year (Cho and Pu 1998, 91). Foreign banks began refusing to roll over the short-term foreign debt of Korean financial institutions.
There are good reasons to believe that a full-blown crisis was inevitable after the Hong Kong shock. Yet, Finance Minister Kang Kyung Shik’s strategy was to turn to the IMF only if various other steps, such as passing financial reform securing alternative sources of finance, failed. A package of financial reform bills appeared ready for passage in early November, and a full committee vote was finally scheduled for the 14th. Passage of the bills was held up by contention over control of the proposed new Financial Supervisory Board (FSB), an amalgamation of several existing regulatory agencies. At issue was whether it would be under the direct control of the Prime Minister or under the Minister of Finance and Economy, where the National Assembly believed it would have more oversight powers.

The issue reflected the long-standing conflict between the Ministry of Finance and Economy and the BOK over central bank independence and the placement of regulatory authority. The BOK wanted to maintain its authority to regulate commercial banks while increasing its independence. The Ministry of Finance was willing to grant such independence only with the removal of the regulatory power. After many months of negotiation, the heads of the MOFE and BOK agreed on June 16, 1997 to a financial reform package.

However officials of the BOK revolted against their governor and rejected the compromise. The employees of the central bank and four agencies targeted for elimination held several demonstrations and threatened to strike immediately if the National Assembly passed the reform legislation. A group of former central bank governors held a press conference to voice their opposition to the bills.

The reform bills’ fate became entangled in election politics. With Lee Hoi Chang’s supporters concerned about the political costs of passage, the ruling party decided to consult with the Kim Dae Jung opposition. However, the opposition had few incentives to cooperate. It would be associated with potentially costly reforms if it signed on. If it withheld consent, subsequent blame would still rest with the president and ruling party candidate Lee Hoi Chang. Up to the last day of the session, Kang

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6 Officials of the Ministry of Finance and Economy appeared to downplay the acuteness of the liquidity crisis in October. They thought they could borrow from Hong Kong and Tokyo, but stock market crashes in both cities deprived the South Korean government of any leverage to cope with the liquidity crisis (an interview with Kang Man-soo, vice minister of MOFE).
Kyung Shik and his staff tried to persuade the National Assembly to pass the financial reform legislation, but the Finance and Economy Committee did not even bother to send the bills to the floor for debate.

This failure to pass the reform legislation clearly roiled markets, and left bilateral support from Japan or the United States as the only means of avoiding the IMF. Recognizing the difficulty of securing such bilateral support, Kang proposed a package of measures to deal with insolvent financial institutions and to widen the won's trading band to 15 percent. The president then dismissed Kang and several other economic advisors, which further eroded confidence. The BOK's reserves plummeted, losing $1.6 billion on the 19th and $1.1 billion on the 20th. The next day, a new Minister of Finance and Economy announced that Korea would turn to the IMF.

Critics of the IMF program in Korea question whether it was appropriately designed, both with respect to the demands placed on fiscal and monetary policy and the closing of failed financial institutions. Indeed, the IMF program did not stem the won's decline. Moreover, the foreign exchange and equity markets experienced substantial turbulence while the program was being negotiated, and the finalization of the program did not stabilize the markets.

Nevertheless, it is important to point out that the markets initially responded favorably to the announcement that Korea was turning to the IMF. Moreover, the final weeks of the election campaign overlapped with the interim between the announcement of the program on December 3 and its subsequent revision on December 24, causing further uncertainty. In the end, Kim Dae Jung won by only two percentage points, and only with a plurality.

After the elections, the very bills that the National Assembly failed to pass as a package in November passed in special sessions during the transitional period between Kim Dae Jung's election and inauguration. This clearly indicates that the election and political considerations hindered the government's ability to respond effectively to the crisis. The government's ineffectiveness in stabilizing the economy, managing corporate and financial distress, and addressing the deteriorating external account was thus mainly due to factionalization, the election, and other political concerns.

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7 Only provisions geared toward the expansion of presidential power failed to pass during the National Assembly special sessions.
Failed Economic Reforms under Democracy

According to the Korean model of economic development, the government allocates credit to favored sectors through policy loans and administrative guidance (Cho and Kim, 1995). Credit control and allocation are thus the key instruments of the government’s industrial policy. Because it is the government that decides where the money goes, the banks do not really have an incentive to develop their own capacity for project evaluation. Moreover, risks for the banks are minimal, because the government provides explicit guarantees for depositors and bails out the companies that banks support. The government thus acts as “an effective risk partner of private industry.”

This implicit co-insurance scheme among government, banks, and industry worked well for a long time, fueling the industrialization of the Korean economy. As its limitations began to show in the early 1980s, the Korean government began experimenting with reform. President Chun Doo Whan attempted to change the 1970s legacy of high inflation and government intervention, first with macroeconomic stabilization and later with a program of deregulation and liberalization. In 1986, the government ended formal, open, and selective promotions of industries and firms with the enactment of the Industry Promotion Act, which replaced a variety of industry-specific promotion acts. The Chun government also initiated a voluntary program of financial deregulation and liberalization (Moon 1988; Haggard and Moon 1990).

The focus of reform then shifted to social welfare and economic justice when the democratic reforms of 1986-1987 unleashed reform demands from previously disadvantaged sectors, such as agriculture and small- and medium-size enterprises. By the time Kim Young Sam came to power in 1993, he faced the twin and often-conflicting challenges of democratization and market reform. Regardless of one’s opinion of Kim Young Sam’s accomplishments, it is clear that Kim Young Sam’s reforms were left incomplete.\(^8\)

In retrospect, it seems safe to say that Roh Tae Woo and Kim Young Sam’s reforms focused more on addressing some of the inequalities spawned by industrial policy than on dismantling the

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\(^8\) For a balanced and comprehensive assessment of the Kim Young Sam government, refer to Moon and Mo (1999a).
developmental state and making the economy more market-oriented. Although the balance shifted toward the building of a market economy after Kim Young Sam’s announcement of the globalization (‘regehwa’) campaign in 1994, economic reforms in the first seven years of democracy (1987-1994) were identified more with the goals of economic justice and redistribution.

Why did the reforms fail? In view of the importance of structural reforms to the IMF program, we can infer that, had the Korean government taken similar measures, it may have been able to prevent the crisis or at least weaken its severity. Indeed, as early as 1987, the government was aware of the problems and tried to tackle them. In that year’s presidential campaign, ruling party candidate Roh Tae Woo pledged to reform the financial and corporate sectors. Thus, the Korean government attempted to carry out almost all the reform measures that Korea is now undertaking. Before 1997, however, there had been few tangible reforms. Some progress was made in the financial liberalization plans in 1993-94 and the labor reform of 1997, but they came too late and were ineffective. Unions and management were disputing the interpretation of the new layoff clauses more than a year after they became law in 1997. As the IMF bailout conditions showed, the level of financial liberalization was far short of international standards.

One reason for the failures of the economic reform efforts was the structural rigidity inherent in the old model itself. Dependence on big business and a strong state created a concentrated, triad social structure consisting of chaebol, unions, and the state, and each acted as a powerful vested interest against economic reform. As Korea became more democratic and more advanced economically, the members of the triad turned more confrontational towards one another, and the old system of discipline that held the triad together broke down. This metaphor of a “fractious triad” is perhaps the most concise description of the Korean political economy under democracy (Mo 1999a).

Each member of the triad was powerful enough to resist the pressure for reform. The chaebol, with all their resources, are a formidable interest group. Their influence on politicians is especially strong because the latter have been increasingly more dependent on the chaebol for campaign contributions over the years.9 The chaebol are also

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9 Political contributions in South Korea have taken three distinctive forms: designated contributions through the National Electoral Commission (NEC), contributions to politicians through support committees, and clandestine
powerful because of their presence in every segment of society, especially their ownership and control of the media. Most importantly, the chaebol problem is intractable because it presents a fundamental dilemma for policymakers: chaebol represent the best and worst of the Korean corporate sector simultaneously. They remain the internationally competitive segment of the Korean economy, yet their anticompetitive business practices have come under regulatory scrutiny. Given this reality, political leaders embarking on economic reform are unlikely to succeed without showing tangible benefits in a relatively short period of time.

Labor unions are another source of political resistance. Although labor suffered under the growth-oriented development strategy, it also developed a reputation as a vested interest by refusing to give up some of its rights, especially those outlined in clauses discouraging layoffs. By international standards, Korean labor laws at the time of the democratic transition contained both exceptionally strong labor standards (e.g., job stability) and exceptionally repressive organizational rights (e.g., restrictions on union activities and collective action). In the first four years of democracy, labor took control of the reform debate and applied relentless pressure to change certain laws. In particular, labor unions wanted to organize their own regional and industry associations instead of joining the government-sanctioned associations, to lift a ban on third-party intervention in labor disputes,¹⁰ and to expand labor rights for defense industry workers and low-level government officials.

However the labor movement began to lose public support as its tactics became more radical, despite the rapid increase in the wage level over the first three years of democracy. During the economic recession of 1992-1993, criticism of the labor movement grew, casting a new light on contributions. While the first two are tax-deductible, the last is unaccountable and illegal. Over 90 percent of designated contribution to the NEC came from the top-thirty chaebol, most of which contributions were allocated to the then-ruling New Korea Party. In 1993, the first year of the Kim Young-sam government, 21 top chaebol contributed 12.7 billion won to the NEC, but the figure increased to over 30 billion won in 1996, just one year before the 1997 presidential election (Weekly Hankuk, November 20, 1996).

¹⁰ Labor laws in South Korea did not allow peak or intermediate labor organizations' intervention, be it arbitration or mediation, in company-level labor disputes. The government monopolized arbitration and mediation in labor disputes.
the rigidities that benefit labor. By then, the idea of reciprocal labor reform – i.e., greater labor rights for greater labor market flexibility – had gained support in policy circles, and it became a driving force behind the labor reform debates of 1996-1997, which led to more permissive rules on layoffs (Mo 1999b). The new rules, which limited layoffs to cases of “urgent business conditions,” were inadequate to support the massive scale of economic structuring necessary for Korea. It would also be difficult for Kim Dae Jung to ease restrictions on layoffs, because labor unions were certain to put up a fight, as they had in 1997, by leading nation-wide strikes.

The economic bureaucracy is the last member of the triad. Bureaucrats have had a powerful influence on the allocation of credit and resources in Korea, and they are not about to give it up. In the aftermath of the economic crisis, most criticisms were directed at bureaucrats in the Ministry of Finance and Economy, especially those from the financial policy office. Despite a small number of staff and lack of expertise on increasingly sophisticated financial instruments, finance bureaucrats micro-managed Korean financial markets and were responsible for spectacular regulatory failures with respect to non-bank financial institutions, such as merchant banks and foreign exchange management. Skeptics argue that many deregulation and liberalization measures were, in fact, designed to consolidate the bureaucrats’ power, not to promote competition and efficiency.

Merchant banks are a case in point. In 1994 and 1996, the MOFE allowed 24 short-term finance companies to enter the merchant banking industry in the name of deregulation – i.e., dismantling business boundaries among financial institutions. However, MOFE had other reasons to promote merchant banks. MOFE favored the development of a larger merchant-banking sector at the expense of money deposit banks, because it had regulatory power only over the former, which were supervised by the MOFE’s rival, the Bank of Korea.

The mere presence of vested interests, however, is not sufficient to explain the failure of reform, because resistance by vested interests is a natural part of reform politics. The question is why vested interests were able to resist pressure for reform. We argue that the immaturity of the Korean democracy led to policy gridlock and stalemate that doomed reform efforts.

There are four contending views that link policy gridlock to an immature democracy. First, the influence of Korea’s traditional political culture and practices has been pervasive (Mo, 2000). For example, negotiation, which is an essential component of democratic governance,
has not taken root in Korean political culture, which explains why groups have had difficulties reconciling their differences and negotiating agreements. Emphasis on consensus building has also undermined the functioning of majority rule in the National Assembly. The Korean National Assembly was not able to tackle the issues that pit strong interests against each other.

Second, there was a mismatch of domain between the democratic transition and the authoritarian ethos, which is not unusual in transitional democracies (Mo and Moon 1999b). Democratic transition not only has altered the political landscape by expanding space for pluralistic maneuvering by social forces, but also has fostered democratic reforms and institutional changes. But the major political actors, including executive leadership, bureaucrats, the ruling New Korea Party, and even national business and labor organizations, did not completely shed their authoritarian behavior. Authoritarian inertia, deeply embedded in people and institutions, persisted, undermining the consolidation of democratic processes, the rule of law, and respect for negotiated outcomes.

Third, the government/business nexus has also been blamed for the policy stalemate. Even though Korean society has made much progress in procedural democracy since 1987, the government/big business coalition has not changed, and may even have become stronger under democracy. According to this view, it was the unwillingness of the government and business elite to sacrifice their private interests, or give up some of their privileges, that defeated most reform initiatives.

Lastly, some attribute the failure to implement the reforms begun in the 1980s to incompetent executive leadership under a presidential system. Despite democratic institutional constraints, the president in South Korea is expected to play an important role in formulating, monitoring, and implementing public policies. It is more so because of the historical legacy of an imperial presidency in which power is extremely concentrated in the hands of the president and his staff. Presidents Roh Tae Woo and Kim Young Sam were not known to have any political and economic convictions or commitment, and they became indecisive when faced with difficult policy choices. In particular, President Kim Young Sam was widely criticized for lack of expertise, knowledge, and competence, especially on economic issues. Though he delegated his power and authority to his staff, he failed to monitor the formulation and implementation of economic policies. As past history illustrates, lack of executive leadership commitment and monitoring has always ended in
fierce bureaucratic fighting and policy gridlock. Kim’s dismal leadership performance thus aggravated government shortcomings.

In large measure, the preceding four views represent differences of opinion on how widely the blame for policy gridlock should be shared in the Korean society. We find the first and second views most persuasive, because problems of unruly and irresponsible behavior were more pervasive throughout the society than the third and fourth seem to imply. It was not just the president or the ruling elite that failed to show tolerance, the willingness to compromise, or respect for the rule of law. Policy gridlock seems to have been a society-wide problem resulting largely from the incompatibility between Korea’s inherited political culture and the requisites for the effective functioning of democracy.

Finally, it should be noted that the Korean political system might still have performed reasonably well if its electoral system had succeeded in resolving policy conflicts. Since 1987, however, national elections have been dominated by regionalism, without producing any policy mandates. Deeply conservative Korean voters have been voting according to their regional loyalty, and this electoral regionalism is especially strong in three regions: the southwestern Cholla provinces (Kim Dae Jung’s home base), the southeastern Kyongsang provinces (where Chun Doo Hwan, Roh Tae Woo and Kim Young Sam’s home towns are located) and the central Chungchung provinces (where Kim Jong Pil’s support is concentrated). As a result, economic issues have been marginal campaign issues, so no political party has been able to obtain a reform mandate through elections.
Chapter 3:

Structural Reforms under the Kim Dae Jung Government

On November 21, 1997, the South Korean government formally asked the International Monetary Fund for standby loans, thus admitting its inability to meet international debt payments on its own. It was hoped that the request for IMF aid would end the tumultuous Korean banking-currency crisis.

As part of its agreement with the IMF, the Korean government pledged to take drastic reform measures to deregulate and liberalize its economy. Restrictions on capital movement and foreign ownership would be lifted, in order to induce foreign investment in Korean assets. To ease corporate restructuring, the government proposed to make it easier for firms to lay off workers. At the same time, the government would take measures to make the Korean economic system more transparent and accountable. In particular, the owner-managers of the chaebol would be forced to report consolidated financial statements and discontinue the practice of mutual-payment guarantees, in which chaebol member companies promise to pay third-party lenders if their sister firms default on loans. The government also committed itself to a big-bang type of financial reform intended to accelerate ongoing programs of deregulation and liberalization, restructure financial institutions, enhance transparency in financial transactions and strengthen prudential regulation and supervision.

By February 1999, the initial labor and banking reforms were completed, and the first stage of corporate reform was soon to follow. By most accounts, the reform efforts have been successful. The Korean government not only has restructured and liquidated the “debt mountains,” which were the immediate cause of the economic crisis, but also has introduced fundamental reforms in corporate finance, corporate governance, and the financial markets. These reforms will change the way the Korean economic system works, especially the relationships among the government, businesses, and banks. Foreign observers have been very positive about the financial market reforms — i.e., the extent to which the government consolidated the devastated financial sector and liberalized financial markets for foreign investors.
Economic Crisis and Structural Reforms in South Korea

The Korean government’s reform efforts are paying off. The liquidity crisis is over, and the exchange rate has stabilized. A rapid rise in the 1998 current account surplus, which totaled a record 40 billion U.S. dollars, alleviated concerns about foreign exchange shortages and another currency crisis. In mid-February, the Korean won was trading at 1,181 won for one U.S. dollar, moving closer to the pre-crisis rate of around 900. Responding to this development, Standard and Poor’s and Moody’s upgraded the credit ratings of Korean foreign currency bonds to investment grade, in early 1999. The domestic economy also shows signs of recovery due to falling interest rates, and industrial output began to rise in the fourth quarter of 1998 after four consecutive quarters of negative growth.

Labor Reform

One of the first hurdles to implementing the IMF program was the strict employment regulations that made it difficult to lay off employees and to hire temporary workers. They not only kept wages high but also impeded corporate restructuring efforts involving the reduction of workforce. The revision of labor laws in March 1997 was an improvement. For the first time, the law provided explicit conditions for layoffs and gave firms some flexibility in deciding work hours. But the reforms fell short. Because of strong labor opposition, the government put a two-year hold on the implementation of the new regulations. Moreover, the conditions for layoffs were too narrow and did not cover cases of mergers and acquisitions. Under the 1997 regulations, firms were not allowed to lay off workers when they merged with or acquired another company. Therefore, following the IMF bailout, the government returned to the task of labor reform.

Further relaxation of employment regulations would not be possible without labor’s consent. With the world watching, Kim Dae Jung could not afford another wave of strikes engulfing Korea. To stave off labor protests, he chose to work with labor, including even the more radical Korean Congress of Trade Unions (KCTU), and invited them to participate in a tripartite committee of labor, management and government, launched on January 15, 1999. After a month of negotiations, the committee reached a historic agreement in which labor agreed to more permissive rules on layoffs and employment of temporary workers. In return, the government pledged to improve labor rights, fight unemployment (e.g., with public works programs and subsidies to

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unemployed workers), and reform the system of corporate governance. The most important changes in this agreement were the immediate implementation of layoff rules and the inclusion of mergers and acquisitions as one of the “urgent business conditions” justifying layoffs.

**Financial Reform**

Regarding the financial sector, the government faced two challenges in the aftermath of the economic crisis. With the initial task of cleaning up nonperforming loans, the government injected W64 trillion to acquire nonperforming loans (W32.5 trillion) and to recapitalize viable financial institutions and deposit repayments (W31.5 trillion).

As soon as Kim Dae Jung came to power, he quickly moved to stabilize the devastated financial markets along many fronts. First, the government had to close or merge insolvent financial institutions and strengthen the capital base of “viable ones,” which required disposal of nonperforming loans and recapitalization of financial institutions through public funds and/or foreign investment. Second, the regulatory system needed to be reformed to ensure transparency, accountability and sound management in financial institutions. Third, continued deregulation and liberalization of financial markets was needed to induce foreign investment and to demonstrate a commitment to financial reform. Lastly, the government had to develop the institutional capacity to carry out these reforms.

Fortunately for Kim Dae Jung, the institutional and legal foundations for financial reform had already been laid by the time he came to power. In December 1997, the National Assembly passed the thirteen financial reform bills that the Kim Young Sam administration had wanted so desperately during the months preceding the IMF bailout. They consolidated the fragmented regulatory agencies into one with streamlined responsibilities (to become the Financial Supervisory Commission), reformed the deposit insurance system, and created the legal foundations for raising bank bailout funds and reorganizing troubled financial institutions. The new institutional arrangement became fully operational in April 1998.

The Kim Dae Jung government simultaneously moved to force out insolvent financial institutions. In January, the government effectively nationalized two commercial banks (Korea First Bank and Seoul Bank) by reducing existing shareholder equity by one-eighth and injecting W1.5
trillion ($1.5 billion at the exchange rate of 1,000 won per dollar) of new equity into each. It then announced plans to sell the banks to foreign investors. In April, the government listed twelve banks that failed to meet the BIS capital adequacy requirement and asked them to submit restructuring plans for further review of their status.

Government actions against troubled non-bank financial institutions were also swift. By April 1998, thirteen out of thirty merchant banks had their licenses revoked, one merchant bank was suspended, one trust company was closed, and two securities firms were suspended. At the same time, the government, through the Korea Asset Management Company, purchased nonperforming assets from financial institutions and sought to reduce their debt burden by purchasing the bonds that they issued.

In the following months, the government committed public funds to support purchase of nonperforming assets, recapitalization, and deposit protection. On June 29, 1998, the government finally decided the fate of those twelve banks without adequate capital provisions. Five of them (Donghwa, Dongnam, Daedong, Kyunggi, and Chungchung) were suspended and ordered to merge with stronger banks. The rest survived, but with strong restructuring conditions, such as change of management, reduction of manpower, and new equity financing. As a result of these measures, financial market stability returned and banks again began to lend.

Corporate Reform

In the wake of the financial crisis, the corporate sector was under heavy attack from all sides, and the chaebol became everyone’s favorite scapegoat. Their excessive investments with borrowed money, dominance over the domestic economy, lack of transparency and exclusionary corporate governance structure, and convoy-style corporate management have all been singled out as the primary cause of the financial crisis. Thus, the IMF and the South Korean government made structural reforms to the corporate sector a major priority.

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11 Since the announcement of the plan to sell the two banks to foreign investors, the government has had difficulty completing the sales. The talks with HSBC for the sale of Seoul Bank have been terminated. The KFB was finally turned over to U.S.-based Newbridge Capital in Malaysia, in 1999, after almost two years of tortuous negotiations.
On January 13, 1998, Kim Dae Jung, then president-elect, reached an agreement with chaebol leaders on five principles of corporate restructuring: enhancing transparency in accounting and management, resolving mutual payment guarantees among chaebol members, improving firms’ financial structure, streamlining business activities, and strengthening managers’ accountability. By February, the government had revised the ten relevant laws and was ready to implement them.

The reliability of Korean firms’ accounting data became an issue because murky accounting practices allowed firms to bypass restrictions on investment and transfer pricing and also discouraged foreign investment. In response, the Kim Dae Jung administration pushed the revision of the Outside Auditor Law, which the National Assembly passed in February 1998, to accelerate the adoption of consolidated financial statements and require listed firms to establish an “outside auditor selection committee.” Consolidated financial statements would provide more accurate information about the chaebol’s financial conditions by showing internal transactions among chaebol’s subsidiaries, including their cross-shareholdings and mutual payment guarantees. The government also strengthened the role of outside auditors by having them selected by a committee of shareholders and creditor banks rather than by controlling shareholders alone, and by increasing the penalty that the outside auditors had to pay for any wrongdoing.

The government moved to resolve the issue of mutual payment guarantees by prohibiting any new issuance of such guarantees among the chaebol’s subsidiaries, beginning on April 1, 1998, and requiring the chaebol to phase out existing ones by March 2000. Such authority was granted to the government by the revision of the Fair Trade Law on February 14, 1998.

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12 Chaebol in South Korea have relied heavily on practices of cross-ownership and cross-payment guarantees among their affiliates in the process of corporate expansion. While cross-ownership refers to a practice in which member companies of chaebol own each other through mutual equity holdings, a cross-payment guarantee is predicated on a payment guarantee of corporate debts among affiliates of the chaebol. By guaranteeing these debts, the large conglomerates were able to solidify the ownership and control of their affiliates. The practice of cross-debt guarantee often generated collective insolvency when the parent companies that had guaranteed these debts went belly-up.
To induce corporations to reduce their debts, the government directed banks to negotiate financial restructuring agreements with their debtor companies by April. A total of 64 conglomerates or debtor groups were directed to this program. The five largest chaebol were asked to reduce their debt ratios below 200 percent by the end of 1999. Those agreements between banks and chaebol were officially voluntary, but there was no doubt that the government was deeply involved. To discourage future corporate borrowings, the government revised the corporate tax law on February 14 to disallow tax deductions of interest payments on “excessive” borrowing, beginning in 2000.

The government also relied on the banks to close insolvent firms and to force the chaebol to streamline their business activities by liquidating and consolidating subsidiaries, including the requirement of subsidiary “swaps” among the chaebol (known as “big deals”), as well as other restructuring measures. On June 18, the banks announced a list of 55 insolvent firms, including 20 chaebol subsidiaries, which were to close. Other firms, judged to be troubled if not insolvent, were required to enter into “workout” plans with their main creditor bank, under which the troubled firms could receive additional financial support in return for restructuring efforts. The workout plan has been applied to the smaller chaebol, those ranked 6th or below in total sales.

The fifth and last principle of corporate restructuring aimed at holding owner-managers accountable for their decisions. Although the chaebol’s owner-managers had exercised effective control over their subsidiaries, they held positions with questionable legal status, such as group chairman, and were not legally liable for the damage their actions may have caused. To address this problem, the government changed the regulations to force chaebol to abolish the office of group chairman and appoint owner-managers to the board of at least one of the member firms. To enhance the monitoring of corporate decision making, the government required listed firms to appoint outside directors, by revising the regulations on listing in the stock market in February 1999. The government further strengthened minority shareholders’ rights in May 1999 by lowering the minimum share requirement (from 1 to 0.01 percent).

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13 The “Big deals” are designed to avoid overlapping investment, surplus capacity, and excessive competition in seven business areas (refineries, semiconductors, train cars, aircraft, power plants, ship engines, and petro-chemicals) by inducing voluntary swaps among chaebol affiliates.
for filing a derivative suit. This change enables investors to sue
management for serious breaches of due diligence.

These government efforts have been enhanced by a grassroots
movement, led by People’s Solidarity for Participatory Democracy, to
protect the rights of minority shareholders (Jang 1999). These changes in
corporate governance have allowed citizen groups, acting as
representatives of minority shareholders and even foreign investors, to
uncover questionable transactions in several prominent chaebol firms,
including SK Telecom and Samsung Electronics. Many predict that the
new corporate governance system, more than any other reform, will bring
about fundamental changes in the way companies are run in Korea,
because foreign shareholders, whose numbers are growing, have started
demanding accountability and board representation.

Clearly, Kim Dae Jung went to great lengths to force the chaebol
to reform. Some of the measures used, such as the forced limitation of
debt ratios and “big deals,” were unthinkable only two years ago. It is also
noteworthy that the National Assembly played a more active role in
crafting the corporate reform bills, compared to its role in financial and
labor reforms.

**Economic Liberalization**

Along with extensive structural reforms involving the banking
and financial, corporate, and labor sectors the IMF has also pushed hard
for economic liberalization. This is more pressing because of the lingering
inertia of the developmental state, which was framed around the
mercantile template. Despite progress in economic liberalization since the
mid-1980s, South Korea still engaged in extensive mercantile practices,
such as market protection and selective promotion of strategic industries.
Ensuring employment, generating trade surpluses, and ultimately getting
rich through market intervention, remained unfailing goals of the South
Korean government. The logic of the governed market prevailed over the
logic of free market.

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14 Unlike so many reforms implemented after the economic crisis, the initial steps
to protect minority shareholders had been taken during the presidency of Kim
Young Sam.
In the wake of the financial crisis and the imposition of IMF conditions, the Kim Dae Jung government received a mandate to undertake massive reform measures for economic liberalization in four areas: trade, capital markets, foreign exchange transactions, and foreign investment.

Bilateral pressure from the United States and multilateral pressure from the GATT/WTO have induced South Korea to undertake substantial trade liberalization since the mid-1980s, resulting in the removal of quantitative restrictions on all but a few items. It also lowered the average tariff rate on manufactured goods to around six percent. However, neo-mercantilist elements involving nontariff barriers were still pronounced at the time of the economic crisis. Trade-related subsidies still remained, and the practices of restrictive import licensing and import diversification,\(^{15}\) along with the lack of import certification procedures, also continued.

As part of its pledge to the IMF as well as to the WTO, the South Korean government undertook reform measures to liberalize its trading regime further. It committed not only to eliminate trade-related subsidies by the end of 1998, but also to phase out the import diversification program covering 113 items by the end of 1999.

While import certification procedures were harmonized with WTO standards, their implementation was strengthened. As part of its agreement to join the OECD, South Korea implemented its WTO commitments allowing foreigners to engage in securities dealing, insurance, leasing, and other property-related businesses (Chang and Wang 1998:282, 320).\(^{16}\)

Capital account liberalization was wide-ranging. The government enabled foreign investors to accumulate equities for the purpose of friendly mergers and acquisition and eliminated the aggregate ceiling on foreign investment in Korean equities. The government permitted foreign

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\(^{15}\) The import diversification program refers to conscious government efforts to restrict the import of Japanese products when the same products are available from other countries. It was designed to protect South Korea’s domestic industries and to improve its trade deficits with Japan.

\(^{16}\) South Korea’s admission to OECD in 1996 contributed to facilitating its compliance behavior with WTO, especially by fostering liberalization of the service sector and the capital account. It also directed South Korea’s attention to new global environment, labor, and quality of life standards in line with debates within the WTO.
investment in the guaranteed corporate bond market (for maturities
greater than three years) and removed limits to foreign investment in other
sectors of the bond market. Limits on foreign investment in domestic
money market instruments were also eliminated. At the same time, the
government deliberated on lifting restrictions on corporate foreign
borrowing and allowed foreign banks and brokerage houses to establish

The liberalization of foreign exchange transactions was
undertaken in two phases. The first phase involved the replacement of
the Foreign Exchange Management Act by the Foreign Exchange
Transaction Act, which became effective in April 1999. The new law
abolished limits on current account transactions between domestic firms
and foreigners. The positive list system was transformed into a negative list
system, which allows all capital account transactions except those
forbidden by law and presidential decree. Foreign exchange dealing has
also become liberalized, so that all types of domestic and foreign financial
institutions can participate. The second stage liberalization, which will be
effective by the end of 2000, aims at liberalizing remaining capital account
transactions, except those related to national security and the prevention
of criminal activities (KDI November 1999:48-50).

The Kim Dae Jung government has also undertaken drastic
measures to liberalize foreign direct investment regimes. The most
noticeable change involved the liberalization of foreign mergers and
acquisitions, including hostile take-overs, in May 1998. And by amending
the Foreigner's Land Acquisition Act, the Kim government fully liberalized
foreign purchase of domestic land. The measure converted the license
system for purchasing land into a reporting system, and eliminated limits
on a variety of real estate purchases. These two measures, which were
fiercely resisted by bureaucrats in the past, underscore the landmark
change in South Korea's foreign investment regime. As of October 1999,
99.8 percent of all industries, including real estate services, were liberalized
or opened to foreign direct investment. Along with this, the new Foreign
Investment Promotion Act, designed to streamline all laws related to
foreign direct investment, was passed in August 1998. The new law not
only simplified the administrative procedures, but also stipulated various
tax, administrative, and infrastructure incentives for foreign investors
(KDI, November 1999:50-52).

In sum, economic liberalization under the Kim Dae Jung
government has been comprehensive in scope and speedy in
implementation. In fact, compared with structural reforms involving the banking and financial, corporate, and labor sector, reforms for economic liberalization encountered a lesser degree of political opposition, not only because international pressures, both bilateral and multilateral, had socialized the importance of liberalization, but also because the number of beneficiaries of the liberalization, such as importers and consumers, became increasingly larger than the number of its victims. It turned out that major barriers to economic liberalization in the past were the economic bureaucrats and their mercantile inertia, rather than banks, firms, and other social agents.
Chapter 4:
The Political Economy of Reform under Kim Dae Jung

The performance of the Kim Dae Jung government has received positive evaluations overall, though reviews vary across sectors. Financial reform has been viewed positively, while the slow pace of corporate reform has drawn criticisms in recent months. What accounts for his initial success?

As a rule, managing economic reform successfully is difficult. The political dilemmas associated with economic reform are the asymmetric distribution and the temporal mismatch of benefits and costs, and the lack of consensus on efficient solutions. The benefits of reform are distributed diffusely, while the costs are concentrated among a smaller number of people. Therefore, the losers have a much stronger incentive to take political action than do the winners, because of the difference in the per capita stake. The problem is compounded by the slow realization of benefits compared with the costs. The costs of reform affect the losers immediately, while the benefits to the winners come only after reform is successfully completed.

Reform is complicated further by disagreements over the optimal solution, even among supporters of reform. Although economists seem to have gathered around the Washington consensus,17 others continue to challenge it on both economic and non-economic grounds. When opponents of reform begin to justify their position in terms of public interest, they become less willing to compromise or cooperate.

Choosing an efficient solution requires the following difficult trade-offs. First, what is the optimal mix of government and market in designing reform policies? Second, which of the two should receive priority: culture or institutions? Institutions and culture are mutually enforcing, but the relationship between the two is complex and nuanced. Third, the government should also decide where to devote its limited resources: reform enactment or implementation? In many cases,

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17 The Washington consensus refers to a view shared by the World Bank, the IMF, and the American government regarding economic reforms in developing countries. It is often called neo-liberal reform, which emphasizes the combination of macroeconomic stabilization and structural adjustment.
preoccupation with reform diverts attention from the important issue of implementing the reforms already undertaken. The fourth trade-off is between short-term and long-term economic gains. Reformers may have to give up those measures that are efficient in the long run if they require large short-term economic costs. The last trade-off is between past strengths and past weaknesses. Ideally, reformers should select only what is desirable from past practices and institutions. In practice, however, the parts of the old system are so integrated that the “good” cannot be separated from the “bad.”

Once reformers choose an efficient solution, they move to the critical task of pushing it through the policymaking process. Because they are likely to face opposition to reform, reformers need to exercise strong leadership during the reform process. Reformers are advised to take the following steps:

1. build a coalition of core supporters,
2. articulate a vision,
3. communicate the vision to the public,
4. make adjustments with feedback from the public,
5. provide a forum for negotiation,
6. foster an atmosphere of civil dialogue, tolerance, deliberation and pragmatism, and
7. protect procedural integrity and the rule of law throughout the process.

Political strategies for managing reform must address several process-related trade-offs. First, reformers must confront the trade-off between decisiveness and the rule of law. During the reform process, the imperatives of prompt government action may tempt democratic leaders to circumvent democratic procedures. However, the costs of authoritarian tactics are also significant. Such actions not only undermine democratic development, but also threaten the reforms themselves by weakening their legitimacy. The choice of top-down versus bottom-up and open versus closed process poses a similar challenge. The basic trade-off, again, is between efficiency and legitimacy.

The scope and speed of reform are also integral parts of political strategies, because they affect the intensity of support and opposition and, thus, the political nature of reform. Big-bang and gradual reforms represent two polar examples. Proponents of the big-bang approach emphasize the comprehensive, interdependent nature of economic
reforms, arguing that the effectiveness of reform programs will increase if they are implemented together and simultaneously. Politically, too, big-bang reforms have certain advantages. For example, under a big-bang reform, opponents of reform have little time to organize themselves.

Supporters of gradualism argue that reform cannot be based solely on efficiency. The success of reform depends on the ability of reformers to manage the social costs, and it is difficult to manage such costs under a big-bang process. To protect and expand public support for reform, reformers are told to pace and sequence reform programs in a gradual manner.

Compensation is another instrument available to reformers. Reformers can co-opt and weaken their opponents by compensating them for their losses. Compensation should be designed to maximize the support for reform. Reformers should carefully choose targets for compensation and make compensation contingent on their support.

The Kim Dae Jung government has been able to make progress because of the presence of various conditions conducive to reform — namely, a crisis environment, external pressure and help, democracy, a visionary leader, a honeymoon period, use of the media, and a comprehensive program (Williamson and Haggard, 1993).

The Crisis Environment

Crisis shocked Korea out of its traditional policy patterns and practices, disorganizing the interest groups that used to veto policy reform and generating pressure for politicians to change the failed policies. All three of the main vested interests — the chaebol, labor unions, and bureaucrats — were heavily criticized for their role in contributing to the economic troubles, and so, they could not openly resist reform mandates. The chaebol, in particular, have been singled out as the villains by the media and politicians. As a result, the influence of vested interests on the political process weakened considerably, especially in the first several months of the Kim Dae Jung government.

The economic crisis has also helped people to see economic reform as being a positive-sum rather than zero-sum situation and to realize that the cost of maintaining the status quo is much higher than previously thought. The economic crisis helped everyone understand the need for a better dispute settlement mechanism in the political system. In short, a collective learning process has taken place.
External Pressure and Help

The Kim Dae Jung government had no choice but to accept the IMF mandates, but its acquiescence was not grudging. In fact, his administration has actively sought foreign help and advice. Some of this was necessary because Korea was in desperate need of foreign capital following the IMF bailout. The extent to which the administration favored foreign investors even prompted the chaebol to complain about “reverse discrimination.”

However, Kim Dae Jung’s open embrace of American values — i.e., the U.S. model of democracy and a market economy — seems to reflect more than the need to attract foreign capital. In fact, it is difficult to ascertain how much of Kim Dae Jung’s promotion of foreign investment was politically motivated and how much was economically motivated. However it is clear that his government has been carefully building support abroad, and this foreign support has helped it domestically.

Democracy

Democracy has also provided unexpected opportunities for economic reform. Because of his commitment to democracy, Kim Dae Jung received much goodwill and support from foreign investors and allies, especially the U.S. government, that wanted him to succeed. Domestically, too, democracy gave legitimacy and credibility to the government’s reform efforts.

Furthermore, the problems commonly associated with democracy, such as indecisiveness and the rise of special interests, were largely absent during Kim Dae Jung’s first year (Mo and Moon 1999b). To deal with vested interests, the president encouraged them to participate in the policymaking process. The Tripartite Committee was created to gain labor’s support for labor market reform. The president used a similar method in dealing with business, by inviting chaebol leaders to negotiate instead of offering proposals unilaterally. This inclusive approach helped the government to forge a social consensus on contentious issues.
A Visionary Leader

Unlike previous presidents, Kim Dae Jung brought with him strong credentials as an economic expert. He was one of the few politicians with his own vision for the Korean economy. Earlier in his career, he had embraced a liberal economic agenda with emphasis on government intervention, participation, and social justice, as indicated by the title of one of his books, *Mass-Participatory Economy* (Kim 1985). Over the years, however, President Kim cultivated a more conservative image, supporting private enterprise and market competition. Although the political right, including the chaebol, was suspicious of President Kim’s sincerity, his background as a supporter of social justice gave credibility to the promotion of economic reform as socially desirable.

A Honeymoon Period

Because the incumbent government of Kim Young Sam was completely discredited, President Kim Dae Jung had to begin rebuilding the economy as soon as he won the election, even though, as president-elect, he and his transition team were not formally in power. This allowed them to have the benefit of freedom from domestic constraints while enjoying widespread political support from the public and media. The incoming government seemed to have the moral authority to discredit the past regime or policies, and the public and media did not challenge the adjustment program imposed by the IMF. The chaebol and labor unions may have opposed the reform measures, but they were not in a position to demand anything, since both of them were criticized for their role in causing the economic crisis. In short, Kim Dae Jung had few domestic constraints in the first months of his administration.

Use of the Media

The government has used the media effectively, beginning with a move to control the public media. The government appointed its supporters to lead government-owned media organizations, such as the Korea Broadcasting System and Yonhap News Service. It has been rumored that the government also sought to “tame” private media and newspapers. Many feel now that newspapers, especially the traditionally
conservative papers, like the Chosun Daily and Joong-ang Daily, are pressured to moderate their criticisms of the current administration. But apart from such tactics, the crisis situation drove the mass media to join the government’s efforts in overcoming the crisis by publicizing the importance of economic reform mandates.

A Comprehensive Program

To a large extent, the Korean government had no choice but to implement a comprehensive reform program, because the IMF demands were so comprehensive. In addition to the usual macroeconomic stabilization and structural reform measures, the IMF sought to change the nature of the Korean economic system by asking for corporate governance reform, labor market flexibility, and market liberalization.

The scope of economic reform became even larger when the IMF mandates were combined with President Kim Dae Jung’s desire to transform the Korean economy. What the Kim Dae Jung government has in mind is the simultaneous pursuit of democracy and a market economy. Although there are different interpretations of this model, it is clear that the government seeks to dismantle what they view as a monopoly structure in the Korean market and to promote those areas that received less attention from previous governments, such as social welfare, SMEs, and economic justice.18

Ironically, one of the reasons for the initial successes was extensive government intervention in the reform process. This is not surprising, since economic adjustment often demands a strong state. However the problem is that some of the intervention has been incompatible with democratic principles, especially with the rule of law. For example, Kim Dae Jung has preferred informal procedures to formal ones in deciding major policy issues. Informal arrangements such as the tripartite committee and private meetings with chaebol leaders were used as an arena

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18 On August 15, 1999, president Kim Dae Jung announced the new initiative called “productive welfare,” which aims at transforming the developmental state into a welfare state by emphasizing the importance of comprehensive social welfare programs and economic justice through tax reform (Office of the President 2000). Economic justice refers to the process of reducing the unfair concentration of wealth and economic power enjoyed by the chaebol and their chairmen’s families. It is similar to the western concept of societal corporatism or populism.
for consensus building and negotiation, instead of the formal legislative body, the National Assembly.

Although the tripartite arrangement was instrumental in preventing labor protests in the short run, it created a new set of problems that may undermine labor stability later. First, the committee had a questionable legal status. Formally, it is only an advisory body to the president without any legal authority to make binding decisions. This informal status not only disappointed labor, who wanted more formal access to the decision-making process, but also raised questions of constitutionality and legality.

It is undesirable to employ such an informal body, with non-elected officials, to decide important public policy issues in place of constitutional organizations like the National Assembly, even if its decisions are not formally binding. Although the tripartite committee was subsequently formalized in 1999, it continues to undermine the development of legislative bargaining. Second, the committee’s agenda was too broad. The February 1998 agreement, for example, called for reforms in areas that were not directly related to labor issues, such as corporate governance, teachers’ associations, and bureaucratic reorganization. Third, the Kim Dae Jung administration acted as if it had the authority to offer such reforms to labor, but this authority formally resides in the National Assembly.

Instead of promising to work toward reform, Kim Dae Jung basically declared the committee agreements fair accompli before the legislature formally approved them. At that time, it was not certain that the reforms had enough political support in the National Assembly.

When implementing economic reforms, the Kim Dae Jung government has also used informal administrative guidance, with an implicit threat of sanctions. In carrying out financial reform, for example, the government dictated the terms of restructuring to private financial institutions, and some of its decisions, such as bank closings, were viewed as arbitrary and politically motivated. Unlike the labor reform, the government did not even try to build consensus. As a result, bank shareholders and employees protested the government’s restructuring plan, sometimes violently.

The rule of law has also been compromised in corporate reform. Kim Dae Jung tried to project an appearance of consensus by announcing five principles of corporate reform with chaebol leaders. Unlike the Tripartite Reform, however, negotiations with the chaebol leaders were
informal and closed. This caused some to wonder whether the chaebol leaders had any choice.

Informal administrative guidance is another problem. The government used its control of banks, for example, to force the chaebol to improve their financial structure and streamline their business activities. Banks now have enormous power over the chaebol, because, as their main creditors, they can practically bankrupt firms by cutting off credit. Among the measures the government has tried to implement through the banks so far, the reduction of debt ratios and the requirement of “big deals” have been the most controversial. Chaebol are being required to lower their debt ratios to 200 percent of their shareholder equity by the end of 1999. Moreover, in what has been dubbed “big deals,” the five largest chaebol are being required to exchange subsidiaries and business areas among themselves in order to consolidate and reduce the number of competitors in business sectors burdened by excess capacity. For example, Daewoo was forced to turn over Daewoo Electronics to Samsung in return for the latter’s passenger car business.

Regardless of their economic logic, these measures raised serious concerns about the rule of law and, thus, about democratic principles and President Kim’s confidence in market mechanisms. Admittedly, the banks have some role to play in the management of the firms to which they lend. However, it is not appropriate for the banks to force their debtors to give up business lines and to reduce debt ratios when the debtors are not formally in default. It is especially troublesome because the chaebol, upon receiving such demands from their main creditor bank, cannot turn to another bank. No bank is in a position to do business against the wishes of the government.

In the long run, the controversial measures employed by the Kim Dae Jung government may have unexpected costs. Opponents of reform may use them to undermine the whole reform program. The opposition Grand National Party (GNP) did just that in January 1999 by taking political advantage of the backlash created by the forced exchange of business units among the chaebol. GNP further utilized it as a major campaign issue during the April 13 general election, accusing the Kim Dae Jung government of reviving the specter of the old developmental state through abuse and misuse of its interventionist power in economic management.
Chapter 5:
The New Korean Economy: Critical Assessments

The structural reforms under the Kim Dae Jung government are significant because they mark an important step toward the creation of a competitive and market-oriented economy in Korea. Nevertheless, more needs to be done, because the structural reforms implemented as of mid-2000 are not sufficient.

The continuing dominance of the Korean financial sector by the government, which, to a large extent, was a by-product of successful financial restructuring, is a particular concern. The government now owns majority shares in a number of financial institutions that it bailed out with public funds, and has used the banks, which they control, to force the chaebol to restructure (see Exhibit 5.1). Although the government promises to withdraw once the reform is completed (Financial Supervisory Commission, 1999), there is no evidence that it has begun to dilute its role, and people are wary of the government's promise of withdrawal because it is unlikely that bureaucrats will give up their power voluntarily.
Economic Crisis and Structural Reforms in South Korea

Exhibit 5.1 Bank Equity Subscription of Korea Deposit Insurance Corporation
As of November 1999 (100 Billion Won)

<table>
<thead>
<tr>
<th>Bank</th>
<th>Subscription amount</th>
<th>KDIS share of stocks</th>
<th>Types of stock owned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Korea First</td>
<td>49,586(^1)</td>
<td>96.96</td>
<td>Common</td>
</tr>
<tr>
<td>Seoul</td>
<td>40,701(^1)</td>
<td>97.78</td>
<td>Common</td>
</tr>
<tr>
<td>Hanvit</td>
<td>32,642</td>
<td>94.75</td>
<td>Common</td>
</tr>
<tr>
<td>ChoHung</td>
<td>27,179</td>
<td>91.84</td>
<td>Common</td>
</tr>
<tr>
<td>Peace</td>
<td>2,200</td>
<td></td>
<td>Preferred</td>
</tr>
<tr>
<td>Sub-total</td>
<td>152,308</td>
<td></td>
<td>(convertible)</td>
</tr>
<tr>
<td>Shinhan</td>
<td>2,925</td>
<td></td>
<td>Preferred</td>
</tr>
<tr>
<td>Kookmin</td>
<td>2,000</td>
<td></td>
<td>Preferred</td>
</tr>
<tr>
<td>Korea Housing and Commercial</td>
<td>2,965</td>
<td></td>
<td>Preferred</td>
</tr>
<tr>
<td>Koram</td>
<td>2,600</td>
<td></td>
<td>Preferred</td>
</tr>
<tr>
<td>Hana</td>
<td>4,728</td>
<td></td>
<td>Preferred</td>
</tr>
<tr>
<td>Sun-total</td>
<td>15,218</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>167,526(^3)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1) Government direct subscription of W750 billion excluded
2) Equity subscription as part of the Chungbuk-Kangwon merger included
3) Government direct subscription excluded

Source: Korea Deposit Insurance Corporation

The government has also been less than forthcoming about its true intentions on layoffs. It is now legal in Korea to lay off workers, but Seoul has been urging firms to refrain from doing so. Its reluctance to allow layoffs stems partly from a desire to minimize the social costs of economic reform, but in addition, President Kim finds it difficult to impose costs on the labor unions who have been his main supporters over the years. In one incident, the Hyundai automobile strike of August 1998, the government intervened to pressure the management to minimize layoffs. This kind of informal guidance overriding formal rules may have certain economic and political justifications, but it has undermined the rule of law and the credibility of government policy.

Then, there are the chaebol, especially the top-five chaebol, who have shown a remarkable degree of resilience in the face of the gravest political and economic threats to their survival. Refusing to reduce their capacity to a level necessary to ensure profitability, they have been able to
tap into a large pool of capital outside the banking system, such as the corporate bond and trust fund markets. As a consequence the absolute total amount of debts held by the top four chaebol, despite their pledges, have actually grown since 1997. LG showed a moderate decrease in total liabilities between 1997 and 1999, but the other three leading conglomerates—Hyundai, Samsung, and SK—have all shown increases in total liabilities (see Exhibit 5.2).

### Exhibit 5.2 Total Liabilities of Top 4 Conglomerates (Billions of Won)

<table>
<thead>
<tr>
<th>Year*</th>
<th>Hyundai</th>
<th>Samsung</th>
<th>LG</th>
<th>SK</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>33,357</td>
<td>40,565</td>
<td>20,726</td>
<td>10,358</td>
</tr>
<tr>
<td>1995</td>
<td>37,102</td>
<td>51,277</td>
<td>27,635</td>
<td>11,820</td>
</tr>
<tr>
<td>1996</td>
<td>48,709</td>
<td>67,687</td>
<td>35,872</td>
<td>19,111</td>
</tr>
<tr>
<td>1997</td>
<td>61,745</td>
<td>50,107</td>
<td>42,944</td>
<td>23,901</td>
</tr>
<tr>
<td>1998</td>
<td>72,532</td>
<td>43,181</td>
<td>36,334</td>
<td>22,627</td>
</tr>
<tr>
<td>1999</td>
<td>67,384</td>
<td>89,781</td>
<td>35,942</td>
<td>24,539</td>
</tr>
</tbody>
</table>

*As of December 31 each year

Source: Fair Transaction Committee (www.ftc.go.kr)

Meanwhile, as Exhibit 5.3 illustrates, production capacity in major industries has continued to rise throughout the crisis period. Except for declining industries, such as textiles, only machinery and equipment and fabricated metal products have experienced a slight decrease in their production capacity. Such trends can be partly explained by a rapid economic recovery, but the government’s continuing support for ailing firms, including some chaebol with emergency loans, has been equally responsible for the trends. Thus, the increase in production capacity in major industries can be seen as a result of government intervention defying the logic of market forces.
### Exhibit 5.3 Production Capacity Indexes in Key Manufacturing Industries (1995=100)

<table>
<thead>
<tr>
<th>Year</th>
<th>Manufacturing</th>
<th>Food Products &amp; beverages</th>
<th>Textiles</th>
<th>Chemicals &amp; chemical products</th>
<th>Non-metallic mineral products</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1996</td>
<td>108.3</td>
<td>102.4</td>
<td>95.5</td>
<td>107.1</td>
<td>113.6</td>
</tr>
<tr>
<td>1997</td>
<td>113.6</td>
<td>102.3</td>
<td>90.7</td>
<td>116.2</td>
<td>118.5</td>
</tr>
<tr>
<td>1998</td>
<td>119.1</td>
<td>101.0</td>
<td>86.0</td>
<td>128.6</td>
<td>118.8</td>
</tr>
<tr>
<td>1999</td>
<td>129.2</td>
<td>100.7</td>
<td>84.9</td>
<td>131.8</td>
<td>117.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Basic metals</th>
<th>Fabricated metal products</th>
<th>Machinery &amp; equipment n.e.c.</th>
<th>Radio, T.V. &amp; communication equipment</th>
<th>Motor vehicles &amp; trailers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1996</td>
<td>104.5</td>
<td>102.7</td>
<td>105.3</td>
<td>130.9</td>
<td>107.2</td>
</tr>
<tr>
<td>1997</td>
<td>108.7</td>
<td>106.2</td>
<td>107.0</td>
<td>144.4</td>
<td>118.5</td>
</tr>
<tr>
<td>1998</td>
<td>121.2</td>
<td>103.0</td>
<td>100.5</td>
<td>184.5</td>
<td>126.7</td>
</tr>
<tr>
<td>1999</td>
<td>127.8</td>
<td>97.6</td>
<td>98.6</td>
<td>255.5</td>
<td>136.0</td>
</tr>
</tbody>
</table>


The ultimate success of economic reform depends on how closely the “new” Korean economy resembles a market system. In the context of Korea, the achievement of a market economy requires, most of all, the elimination, or the significant reduction, of moral hazard that was deeply entrenched in people’s values and attitudes and the institutions of the Korean economy. Critics argue that there have not been any fundamental changes to the way the economy was run prior to the crisis – i.e., the government still controls the banks, the firms are still afraid to lay off workers, and “insolvent” chaebol firms are still allowed to stay open (Root 1999). Indeed, the South Korean economy could encounter another round of economic crisis unless it corrects these structural problems.
Effects of Financial Reform

After the initial round of financial restructuring in 1998, the financial market regained stability. At the end of 1998, nearly all of the remaining banks had capital adequacy ratios that met or exceeded BIS norms. The average BIS ratio of the commercial banks rose to 8.2 percent at the end of 1998, up from 7 percent a year earlier.

But the recovery of the banking sector has been precarious. As the workout programs for the troubled firms got underway, the banks have been forced to write down their assets through debt reductions or debt/equity swaps, putting further pressure on their balance sheets. In addition, beginning in mid-1999, many loans under workout programs became automatically classified as precautionary. As a result, the amounts of NPLs held by the commercial banks have not decreased significantly (Exhibit 5.4).

Exhibit 5.4 Ratio of Non-Performing Loans to Total Loans in Commercial Banks (End of Period)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3.9</td>
<td>6.0</td>
<td>7.4</td>
<td>8.7</td>
<td>6.2</td>
<td></td>
</tr>
</tbody>
</table>


Moreover, these government estimates of NPLs, as shown in Exhibit 5.4, understated the extent of the problem. At one point, private investment banks estimated the ratio of NPLs as a percentage of total loans to be about 30 percent for Korean commercial banks (Wall Street Journal, April 4, 2000). Due to this uncertainty, and due to rumors about the troubles at Hyundai, the financial market became jittery again in June 2000. The government was then forced to release data on the extent of nonperforming loans calculated under forward-looking criteria (FLC) on June 30, 2000 (see Exhibit 5.5). The average ratio of nonperforming loans under FLC turned out to be 14.0 percent for commercial banks.
### Exhibit 5.5 Nonperforming Loans and Estimated Potential Losses at Local Banks as of End-March 2000
(100 million Won and Percent)

<table>
<thead>
<tr>
<th>Bank</th>
<th>NPLs under Forward Looking Criteria</th>
<th>Net NPLs under Forward Looking Criteria</th>
<th>Estimated losses from NPLs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>NPL Ratio</td>
<td>Amount</td>
</tr>
<tr>
<td><strong>National Commercial Banks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cho Hung</td>
<td>59,756</td>
<td>16.7</td>
<td>29,428</td>
</tr>
<tr>
<td>Hanvit</td>
<td>103,135</td>
<td>19.1</td>
<td>62,658</td>
</tr>
<tr>
<td>KFB</td>
<td>37,802</td>
<td>25.3</td>
<td>7,735</td>
</tr>
<tr>
<td>Seoul</td>
<td>28,952</td>
<td>22.3</td>
<td>18,452</td>
</tr>
<tr>
<td>KEB</td>
<td>60,765</td>
<td>18.6</td>
<td>36,033</td>
</tr>
<tr>
<td>Kookmin</td>
<td>50,338</td>
<td>10.7</td>
<td>29,578</td>
</tr>
<tr>
<td>H&amp;CB</td>
<td>32,489</td>
<td>8.3</td>
<td>15,545</td>
</tr>
<tr>
<td>Shinhan</td>
<td>16,461</td>
<td>5.6</td>
<td>6,854</td>
</tr>
<tr>
<td>Kor.Am</td>
<td>21,252</td>
<td>13.2</td>
<td>12,537</td>
</tr>
<tr>
<td>Hana</td>
<td>25,835</td>
<td>9.1</td>
<td>16,359</td>
</tr>
<tr>
<td>Peace</td>
<td>9,064</td>
<td>16.5</td>
<td>5,069</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>445,847</td>
<td>14.1</td>
<td>240,248</td>
</tr>
<tr>
<td><strong>Regional Commercial Banks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taegu</td>
<td>8,342</td>
<td>12.5</td>
<td>5,615</td>
</tr>
<tr>
<td>Pusan</td>
<td>5,353</td>
<td>9.4</td>
<td>3,684</td>
</tr>
<tr>
<td>Kwangju</td>
<td>4,478</td>
<td>12.4</td>
<td>3,730</td>
</tr>
<tr>
<td>Cheju</td>
<td>1,540</td>
<td>18.4</td>
<td>1,032</td>
</tr>
<tr>
<td>Jeonbuk</td>
<td>1,701</td>
<td>10.7</td>
<td>1,168</td>
</tr>
<tr>
<td>Kyungnam</td>
<td>7,218</td>
<td>15.6</td>
<td>5,604</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>28,632</td>
<td>12.4</td>
<td>20,833</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>474,479</td>
<td>14.0</td>
<td>261,081</td>
</tr>
<tr>
<td><strong>Special Purpose Banks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KDB</td>
<td>95,398</td>
<td>17.3</td>
<td>8,151</td>
</tr>
<tr>
<td>IBK</td>
<td>19,186</td>
<td>7.3</td>
<td>8,151</td>
</tr>
<tr>
<td>Ex-Im</td>
<td>13,126</td>
<td>10.1</td>
<td>8,089</td>
</tr>
<tr>
<td>NACF 1)</td>
<td>24,150</td>
<td>5.9</td>
<td>12,977</td>
</tr>
<tr>
<td>NFFC 2)</td>
<td>12,852</td>
<td>29.5</td>
<td>9,548</td>
</tr>
<tr>
<td>NLFC 3)</td>
<td>2,534</td>
<td>4.2</td>
<td>1,148</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>167,446</td>
<td>11.5</td>
<td>95,781</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td>641,925</td>
<td>13.2</td>
<td>356,862</td>
</tr>
</tbody>
</table>

**Note:**
1) National Agriculture Cooperative Federation
2) National Federation of Fisheries Cooperation
3) National Livestock Cooperative Federation

Source: Financial Supervisory Service
Among the non-bank financial institutions, the plight of investment trust companies (ITCs) has been a particular concern. Investment trust firms have suffered heavy losses in 1999. Two of the largest, Korea Investment Trust and Daehan Investment Trust, lost W3.5 and W1.5 trillion, respectively, in the 1999 fiscal year ended March 21, 2000. Heavy exposure to unsecured bonds issued by units of the dismantled Daewoo Group was the most proximate cause of their financial woes.

But the problem at ITCs goes deeper. The portfolios of ITCs are exposed to further losses as mark-to-market valuation is applied. ITCs also face competition from mutual funds, which were authorized in 1998. Recognizing the difficulties of ITCs, customers have withdrawn as much as W90 trillion from securities investment funds offered by ITCs since the outbreak of the Daewoo Group crisis in July 1999. In April 2000, the government finally announced a plan to inject W5 trillion to bailout Korea Investment Trust and Daehan Investment Trust (Chosun Ilbo, April 28, 2000).

Restoring financial stability continues to receive top priority. In the long run, however, real reform in the financial sector requires a transfer of authority from the government to market-based institutions that force banks to take full responsibility for the loans they authorize. In the past, banks had little incentive to develop the necessary skills in credit analysis and loan monitoring because the government implicitly insured depositors and backed bank loans made to large conglomerates. In other words, the financial sector was a classic case of moral hazard where the insured agents did not manage their risks prudently.

In theory, the extent of moral hazard can be measured by the amount of insurance, usually in the form of loan and bond guarantees, extended to financial institutions. In practice, however, the problem is complicated by the presence of informal or implicit guarantees. Furthermore, what matters may not be the total amount of insurance but the adequacy or quality of monitoring and discipline that are intended to reduce moral hazard.

In terms of formal insurance measures, the economic crisis has increased, not decreased, the amount of government insurance (see Exhibit 5.6). To preserve confidence in the banking system and prevent a run on deposits, the government had to provide a blanket guarantee covering all bank deposits as well as certain other liabilities of financial institutions. In January 1998, the government also guaranteed payment of
Economic Crisis and Structural Reforms in South Korea

24 billion dollars for foreign liabilities of domestic banks, as part of a debt rescheduling agreement with foreign creditors. Furthermore, in the summer of 1999, the government was forced to guarantee the principal of corporate securities funds issued by investment trust companies.

Exhibit 5.6 Payment Guarantees by the Government (Billions of Won, End of Year)

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
<th>1999*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total debt guarantees</td>
<td>13,039</td>
<td>71,953</td>
<td>83,020</td>
</tr>
<tr>
<td>(share of GDP)</td>
<td>(2.9%)</td>
<td>(16.0%)</td>
<td>(17.1%)</td>
</tr>
<tr>
<td>Loan guarantees</td>
<td>1,975</td>
<td>31,298</td>
<td>16,050</td>
</tr>
<tr>
<td>Bond guarantees</td>
<td>10,864</td>
<td>40,541</td>
<td>65,050</td>
</tr>
<tr>
<td>Guarantees of official foreign loans</td>
<td>200</td>
<td>114</td>
<td>1,920</td>
</tr>
</tbody>
</table>

*projected

Source: Joong-Ang Economist, October 26, 1999

The amount of informal insurance is more difficult to track. Based on the level of government intervention in the financial market, evidence also points to an increase in government insurance (i.e., whenever the government intervenes, it provides financial institutions with partial insurance because it has to share some responsibility). During the past two years of financial restructuring, the government has become the largest shareholder in the financial sector, acquiring major shares in ten commercial banks, eight insurance companies and two investment trust companies. Exhibit 5.1 shows more detailed data on the shares that the government acquired through the Korea Deposit Insurance Corporation.

More importantly, the government has not been reluctant to exercise its ownership rights to force financial and corporate restructuring.

Once financial stability has been restored, a fundamental challenge for the Kim Dae Jun government will be to phase out its overarching presence in the financial market. The government does have plans to reduce formal guarantees, for example, by introducing a partial deposit insurance system after 2001 and a mark-to-market valuation standard for securities. However, no timetable has been offered to privatize government-held shares of financial institutions.
At the same time, the second phase of financial and banking reform is sorely needed. The Kim Dae Jung government injected 101 trillion won into the banking and financial sector, in order to cope with the issue of nonperforming loans in 1998 and 1999. Despite that injection, however, 67 additional nonperforming loans have emerged as a result of the bankruptcies of the Daewoo group, Samsung Motors, and Daehan Life Insurance (Hankyung, May 16, 2000). In view of this, financial reform in South Korea is not yet complete, and the government needs to strengthen its reform efforts over the banking and financial sector.

**Labor Reform and the Labor Market**

The economic crisis has imposed high costs on workers. Unemployment soared to 8.1 percent in March 1999, up from 2.2 percent only three years earlier (see Exhibit 5.7). No group was spared; every group saw its unemployment rate tripled, at least, from the 1996 mark. Particularly hard-hit have been high school graduates. Their unemployment rate reached 10.4 percent in March 1999, while the rate for college graduates remained at 6.4 percent. Back in 1996, both groups had an unemployment rate around 4.0 percent. This so-called “collapse of the middle class” is particularly discouraging because the Kim Dae Jung government has worked hard to minimize unemployment from the very beginning.
Economic Crisis and Structural Reforms in South Korea

Exhibit 5.7 Unemployment Rates (Percent, Seasonally Adjusted Data in Parentheses)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Overall</strong></td>
<td>2.2</td>
<td>3.4</td>
<td>6.5</td>
<td>8.1</td>
<td>3.7</td>
</tr>
<tr>
<td></td>
<td>(1.8)</td>
<td>(2.8)</td>
<td>(5.4)</td>
<td>(6.7)</td>
<td>(4.3)</td>
</tr>
<tr>
<td><strong>Sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>0.7</td>
<td>0.9</td>
<td>1.9</td>
<td>2.2</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.5)</td>
<td>(0.6)</td>
<td>(1.3)</td>
<td>(1.5)</td>
<td></td>
</tr>
<tr>
<td>Non-agriculture</td>
<td>2.4</td>
<td>3.7</td>
<td>7.1</td>
<td>8.8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(2.0)</td>
<td>(3.1)</td>
<td>(6.0)</td>
<td>(7.5)</td>
<td></td>
</tr>
<tr>
<td><strong>Sex</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>2.5</td>
<td>3.7</td>
<td>7.3</td>
<td>9.0</td>
<td></td>
</tr>
<tr>
<td>Female</td>
<td>1.9</td>
<td>2.9</td>
<td>5.2</td>
<td>6.6</td>
<td></td>
</tr>
<tr>
<td><strong>Level of education</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Junior high or below</td>
<td>2.3</td>
<td>5.5</td>
<td>8.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>High school</td>
<td>4.0</td>
<td>7.5</td>
<td>10.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>College or above</td>
<td>3.9</td>
<td>5.9</td>
<td>6.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Age</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15-19</td>
<td></td>
<td>10.6</td>
<td>21.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20-29</td>
<td></td>
<td>6.3</td>
<td>11.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30-39</td>
<td></td>
<td>2.7</td>
<td>5.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>40-49</td>
<td></td>
<td>2.3</td>
<td>5.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>50-59</td>
<td></td>
<td>1.7</td>
<td>4.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>60 and above</td>
<td></td>
<td>1.1</td>
<td>2.3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


To protect the unemployed, the government has expanded Korea's social safety net. Unemployment insurance benefits have increased and various public works projects have been initiated. The government plans to spend 7.7 trillion won on “protecting the unemployed and the social safety net” in 1999, a 35.7 percent increase from the previous year. Despite general budget cutbacks, government spending on social welfare has grown substantially since the crisis began (Moon and Yang 2000).

Despite large social costs, there have not yet been visible signs of social unrest and protest. Many attribute this to the strength of the family as the provider of social safety, as well as the culture of shame that discourages unemployed workers from revealing their unemployed status.

However, this reservoir of social capital may dry out soon. Since the second half of 1998, labor unions have become more confrontational.
Both the Federation of Korean Trade Unions and the more radical Korea Congress of Trade Unions have bolted from the Tripartite Committee, criticizing it as an arena for demanding unilateral labor concessions (Yu 1999). Union opposition has also been the main stumbling block to the government efforts to merge chaebol firms in semiconductor, automobile and electronics. In April and May 1999, the labor movement threatened nation-wide strikes and launched an all-out effort to pressure the government to slow layoffs, revise labor laws, and increase spending on worker welfare. The call for national strikes has not gained widespread support, however, because the government has vowed to stop them.

The current standoff may be a prelude to a new system of economic management in Korea. Although workers have suffered a great deal under the current economic crisis, their political gains have been significant. The Tripartite Committee has now been institutionalized with the passage of the relevant laws on May 3, 1999, giving labor formal access to the policymaking process. The labor movement thus seems to be intent on achieving as many legislative victories as it can under the Kim Dae Jung government.

With fewer regulations on union activities, labor unions are also undergoing a deep internal change. Different unions now compete with each other to represent the same set of workers. How this will affect the labor movement remains to be seen. On the one hand, labor unions may become more radical as internal divisions drive labor leaders into extreme positions. On the other hand, competition may force labor leaders to become more attentive to the economic welfare of their members and, thus, less focused on national political issues. Regardless, the role of labor is bound to increase in the future.

Has the labor market become more flexible as a result of labor reform? In the past, the government ensured employment for Korean workers through legal restrictions on layoffs and the hiring of temporary workers. The Kim Dae Jung government introduced more permissive rules on layoffs in February 1998, but the labor market still lacks flexibility. The true test of labor market flexibility is how wages and employment respond to changes in aggregate demand. At this time, there is not enough evidence to draw any definitive conclusions. However, at the company level, signs of rigidity persist. Although unemployment has risen, there have been few formal layoffs, despite the new laws. Due to informal pressure against layoffs, employers have adjusted their work force by freezing new hires or employing informal tactics to fire workers.
Progress of Corporate Reform

Effects of corporate reform are quite visible. As Exhibit 5.8 demonstrates, the IMF has imposed a long list of conditions dealing with corporate governance and restructuring, including transparency, shareholder rights, company directors, intra-group relations, insolvency procedures, foreign investment, and other issues. The South Korean government has been quite successful meeting these obligations. Chaebol were required to prepare combined financial statements of all affiliated firms, starting from 1999. External auditors and corporate accounting officers are subject to stiffer penalties. Minority shareholder rights have been significantly improved, and listed companies are now required to fill one-fourth of their boards of directors with outsiders, beginning in 1999.
Exhibit 5.8. Measures for Corporate Governance and Restructuring

<table>
<thead>
<tr>
<th>Topic</th>
<th>Actions taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transparency</td>
<td>● Chaebol are required to prepare combined financial statements beginning in 1999.</td>
</tr>
<tr>
<td></td>
<td>● External auditors and corporate accounting officers are subject to stiffer penalties.</td>
</tr>
<tr>
<td>Shareholder rights</td>
<td>● Minority shareholder rights strengthened by lowering the shareholder threshold for various initiatives.</td>
</tr>
<tr>
<td>Company Directors</td>
<td>● The shadow voting requirement was abolished.</td>
</tr>
<tr>
<td></td>
<td>● Listed companies were required to fill one-fourth of their board of directors with outsiders beginning in 1999. The requirement will gradually be expanded to half of the total directors.</td>
</tr>
<tr>
<td></td>
<td>● De facto directors, including controlling shareholders, face the same liability as elected directors.</td>
</tr>
<tr>
<td></td>
<td>● The fiduciary duty of corporate directors was introduced.</td>
</tr>
<tr>
<td></td>
<td>● Cumulative voting for directors was made possible.</td>
</tr>
<tr>
<td>Intra-group Relations</td>
<td>● New debt guarantees between chaebol subsidiaries were prohibited in 1998; existing guarantees are to be eliminated by March 2000.</td>
</tr>
<tr>
<td></td>
<td>● The 25 percent ceiling on equity investments by chaebol subsidiaries was temporarily lifted and then revised in 1999.</td>
</tr>
<tr>
<td></td>
<td>● Investigation of intra-group transactions led to the imposition of fines.</td>
</tr>
<tr>
<td></td>
<td>● Holding companies subjected to restrictive conditions.</td>
</tr>
<tr>
<td>Insolvency Procedures</td>
<td>● Introduced economic criteria in evaluating applications for corporate re-organization, and introduced time limits.</td>
</tr>
<tr>
<td>Foreign Investment</td>
<td>● Ceiling on foreign shareholdings in individual companies was abolished May 1999.</td>
</tr>
<tr>
<td></td>
<td>● All forms of M&amp;A, including hostile takeovers by foreigners, permitted.</td>
</tr>
<tr>
<td></td>
<td>● Number of business lines where foreign direct investment is restricted was reduced from 53 to 24.</td>
</tr>
<tr>
<td>Others</td>
<td>● The ceiling on banks’ equity investments in individual companies was boosted from 10 to 15 percent.</td>
</tr>
<tr>
<td></td>
<td>● The corporate tax system will not allow interest payment on any debt exceeding five times the equity capital to be deducted from taxable income.</td>
</tr>
<tr>
<td></td>
<td>● The corporate Restructuring Fund was established in Oct.1998 with W 1.6 trillion to assist SMEs.</td>
</tr>
</tbody>
</table>

At the same time, shareholder rights have improved considerably (see Exhibit 5.9). There were also major changes in intra-group relations. Cross-payment guarantees, cross-investment, and cross-ownership among affiliates, which served as principal vehicles for the octopus-like expansion of South Korean chaebols, were prohibited. In fact, investigation of intra-group transactions led to the imposition of huge fines (by Korean standards) to such chaebol as Samsung, Hyundai, and LG. In addition, the new corporate tax system will prohibit the deduction from taxable incomes of interest payments on any debt exceeding five times the level of equity capital.

**Exhibit 5.9 Minimum Ownership to Exercise Shareholder Rights**
*(Share of Common Stock in Percent)*

<table>
<thead>
<tr>
<th></th>
<th>Share Former</th>
<th>New</th>
<th>Listed Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judicial removal of a director</td>
<td>5</td>
<td>3</td>
<td>0.5</td>
</tr>
<tr>
<td>Right to injunction</td>
<td>5</td>
<td>1</td>
<td>0.5</td>
</tr>
<tr>
<td>Right to file derivative suit</td>
<td>5</td>
<td>1</td>
<td>0.01</td>
</tr>
<tr>
<td>Shareholder’s Proposal in statements</td>
<td>-</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Demand for convocation of SGM</td>
<td>5</td>
<td>3</td>
<td>1.5</td>
</tr>
<tr>
<td>Right to inspect account books</td>
<td>5</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Right to inspect affairs and company property</td>
<td>5</td>
<td>3</td>
<td>1.5</td>
</tr>
<tr>
<td>Removal of liquidator</td>
<td>5</td>
<td>3</td>
<td>0.5</td>
</tr>
</tbody>
</table>

1) Small companies are those with paid-in capital of less than W 100 billion.

Source: KDI (1999)

Radical corporate restructuring has also taken place. First, the five top chaebol met the deadline for reducing their debt-equity ratios to 200 percent or less by the end of 1999. Samsung reduced its debt equity ratio from 366 percent in 1997 to 96 percent in 1999, while Hyundai, LG, and SK reduced their ratio to 199 percent. Second, in order to reduce their debt-equity ratios, these chaebol were encouraged, even by the president himself, to sell off some of their subsidiaries. This administrative guidance led to a sharp reduction in the number of affiliated firms. As Exhibit 5.10 illustrates, the Hyundai Group, the largest business conglomerate in South Korea, downsized the number of its subsidiaries from 63 in 1998 to 26 in 1999, exceeding its original objective.
of 30, whereas the Samsung Group reduced from 65 subsidiaries in 1998 to 40 in 1999. LG and SK undertook sweeping measures to reduce the number of their affiliates, in order to meet the government guideline on debt-equity ratios.

Exhibit 5.10 Restructuring Plans of the Top Five Business Groups¹

<table>
<thead>
<tr>
<th>Groups</th>
<th>Core industries</th>
<th>Number of subsidiaries End-1998</th>
<th>Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hyundai</td>
<td>• car, construction, electronics, chemicals and financial services</td>
<td>63</td>
<td>30</td>
</tr>
<tr>
<td>Samsung</td>
<td>• electronics, financial services and trade/service</td>
<td>65</td>
<td>40</td>
</tr>
<tr>
<td>Daewoo</td>
<td>• cars, heavy industry, trade, construction and financial services</td>
<td>41</td>
<td>10</td>
</tr>
<tr>
<td>LG</td>
<td>• chemical/energy, electronics/telecommunications, construction, distribution and financial services</td>
<td>53</td>
<td>30</td>
</tr>
<tr>
<td>SK</td>
<td>• energy, chemicals, telecommunications, construction, distribution and financial services</td>
<td>42</td>
<td>20</td>
</tr>
</tbody>
</table>

¹ Based on the agreement between the government, the top five chaebol, and their creditor banks, signed on 7 December 1998.

Source: Financial Supervisory Commission.

The most drastic measure involved the bankruptcy and dismantling of the Daewoo Group, the third largest business conglomerate in South Korea. Frequently in trouble over the years, the Daewoo Group was viewed as being too big to fail. Thus, the government’s handling of Daewoo’s financial difficulties was a litmus test of its commitment to corporate restructuring. Grave political and economic risks notwithstanding, the government did not bailout Daewoo, leading to its demise.¹⁹

¹⁹ The Daewoo Group as a chaebol ceased to exist. But some of its subsidiaries still exist as beneficiaries of workout programs. The most troublesome subsidiary,
Finally, there was an overall corporate restructuring to avoid duplication and excess capacity by realigning the core industries of the five top chaebol. Of seven industrial sectors targeted through the “big deal” scheme, six swaps were completed by the end of December 1999.\(^\text{20}\)

Despite the impressive reform measures, the chaebol did not reduce their borrowing, and they achieved their improved ratios in part by reevaluating existing assets. The ultimate test of corporate reform is whether or not firms compete according to market principles and are subject to market discipline (Yoo 1999), and one indicator is whether or not the government allows insolvent firms to fail. The evidence so far is mixed. While the government allowed failed chaebol such as Kia, Hanbo, Samsung Motors and Daewoo to go bankrupt, some of their subsidiaries are still operating. For example, twelve subsidiaries of the Daewoo Group are still operating under workout programs (\textit{Chosun Ilbo}, July 19, 2000). Moreover, the government has kept many non-viable, smaller chaebol alive with workout programs instead of letting them go bankrupt, which, in turn, has led to another round of nonperforming loan crises for major banks.\(^\text{21}\)

Exhibit 5.11 shows that the number of bankruptcies of large enterprises significantly declined in 1999. This is due partly to government efforts to find suitable foreign buyers for these firms, but the potential for political backlash due to bankruptcies and massive lay-off has also prevented the government from taking more decisive actions.

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\(^{20}\) The only problematic sector is the petro-chemical industry (\textit{Chosun Ilbo}, May 7, 2000).

\(^{21}\) While Hyundai has acquired Kia Motors, Samsung Motors was sold to Renault. Hanbo Steel was also sold to a foreign buyer. At the time of this writing, Ford was negotiating a purchase price to assume control over Daewoo Motors. Likewise, the subsidiaries of chaebol are in the process of mergers and acquisitions by foreign and domestic firms. But a great number of those firms under workout programs have performed dismally. For example, eighteen firms under workout programs have failed to pay interest for the past three years. Yet, they are kept alive (\textit{Chosun Ilbo}, July 24, 2000).
Exhibit 5.11 Number of Dishonored Checks and Bills

<table>
<thead>
<tr>
<th>Year</th>
<th>1/4</th>
<th>2/4</th>
<th>3/4</th>
<th>4/4</th>
<th>1/4</th>
<th>2/4</th>
<th>3/4</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>17,168</td>
<td>9,449</td>
<td>6,357</td>
<td>4,221</td>
<td>2,801</td>
<td>1,036</td>
<td>1,932</td>
</tr>
<tr>
<td>1998</td>
<td>58</td>
<td>16</td>
<td>8</td>
<td>8</td>
<td>7</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>1999</td>
<td>8,168</td>
<td>4,275</td>
<td>2,847</td>
<td>2,031</td>
<td>1,344</td>
<td>526</td>
<td>925</td>
</tr>
<tr>
<td>SREs</td>
<td>8,942</td>
<td>5,158</td>
<td>3,502</td>
<td>2,182</td>
<td>1,450</td>
<td>509</td>
<td>1,005</td>
</tr>
</tbody>
</table>

Source: “Dishonored Checks and Bills in October 1999,” Bank of Korea

Another problematic area is chaebol corporate governance. Despite extensive measures to ensure transparency and accountability in corporate governance, chaebol owners still exercise control disproportionate to their level of share ownership. Stumbling blocks to reform in this area include the owners’ control of affiliates through various holdings of large equity stakes in non-listed firms that, in turn, hold a majority share in the affiliates. Inheritance schemes and gift-giving among chaebol family members, which have profound impacts on corporate governance, have posed an additional challenge to the Kim government’s corporate reform efforts.

In this regard, restructuring of the Hyundai Group will be pose a significant litmus test for South Korean government efforts to reform the chaebol. Since the failure of the Hyundai Investment and Trust Company in April 2000, the Hyundai Group has experienced severe liquidity problems. The government urged Hyundai to resolve them by undertaking major corporate restructuring, including the change of its corporate governance based on family ownership. Hyundai so far has resisted undertaking a major restructuring. The future of chaebol reform will depend on whether the government will succeed in restructuring Hyundai’s corporate governance (Financial Times August 4, 2000).

Effects of Economic Liberalization

In contrast with domestic banking, corporate, and labor reforms, the liberalization of international trade, capital account, foreign exchange transactions, and foreign direct investment has produced more visible effects. In accordance with the Uruguay Round agreements, both manufacturing and service sectors have become liberalized. Except for rice (tariffication has been delayed until 2004), most agricultural products have also been liberalized. Trade-related subsidies have been phased out,
and Japanese exporters are benefiting from the end of the import diversification program.

Trade liberalization, coupled with economic recovery, has led imports to soar, though they remain below 1997 levels in many industries. In 1998, foreign imports decreased by 35.5 percent, but they rose by 28.4 percent in 1999, driven largely by demand for capital goods. Imports of electric and electronic goods, including telecommunication equipment, rose from $22.5 billion in 1998 to $33.1 billion in 1999. South Korea's import of steel was $3.9 billion in 1998, a 44.9 percent reduction from 1997. But in 1999, steel imports increased to $5.3 billion, reflecting a 36.1 percent rise. Imports of consumer goods also grew by 27.5 percent. For example, imports of foreign automobiles, which continue to be well below international norms, increased by 35.3 percent in 1999 (MOFE 2000b). Expansion of foreign imports has significantly narrowed the margin of current account surpluses in the first quarter of 2000.

Capital account liberalization has also increased the gross inflow of portfolio investments from $4.7 billion in December 1997 to $13.6 billion in 1999. Net portfolio investment increased as well, from $1 billion in 1997 to $4.7 billion in 1998 and $5.2 billion in 1999. Liberalization has increased volatility, because foreign investors have been quick to exit on negative news, such as the Daewoo bankruptcy, only to return en masse once the problem appears resolved. In addition, the liberalization of foreign exchange transactions has helped stabilize the foreign exchange rate at $1.00 to W1,100 since November 1999.

Most remarkable is the expansion of foreign direct investment. After lifting restrictions on foreign direct investment and providing various incentives, Korea experienced an inflow of foreign direct investment amounting to $1.3 billion in 1994, $6.9 billion in 1997, $8.9 billion in 1998, and $15.5 billion in 1999. The manufacturing sector enjoyed the largest share of foreign direct investment (54.4 percent), followed by the service sector. The electronic sector accounted for 42 percent of entire foreign direct investment in the manufacturing sector in 1999, followed by petrochemicals (10.18 percent) and transportation (9.28 percent). In the service sector, the rate of increase in FDI has also been impressive, rising 50.8 percent in the first three quarters of 1999, compared to a 38.7 percent in 1998 (MOFE 1999:113-115). The banking and financial sector attracted the largest amount of foreign direct investment (27.06 percent). Foreign investment in the internet industry has also become pronounced since early 2000 (MOFE 2000b).
In tandem with economic liberalization, massive deregulation has also taken place. The Regulation Reform Commission decided to abolish 5,326 regulations, which amounts to 47.3 percent of the current total of 11,125. In addition, 2,441 other regulations out of the remaining 5,799 were revised by the end of 1998. In this regulatory reform, the economic sector has been subject to the most sweeping changes, with 3,293 out of 6,443 economic regulations (51.1 percent) either abolished or in the process of revision and abolition. Economic deregulation has been much greater than social deregulation (45.1 percent, 1,788 out of 3,967) and general administrative deregulation (34.3 percent, 245 out of 715) (KDI 1999). This deregulation drive has fundamentally altered relationships between the public and private sectors.

According to a government survey conducted in November 1999, foreign businessmen in South Korea have given positive assessments of the Kim Dae Jung government's liberalization efforts, with 70.2 percent of respondents expressing the view that the overall business climate for foreigners has substantively improved compared with the pre-crisis period. In fact, 87.8 percent responded that South Korean markets have become liberalized after the crisis, and 77.2 percent believed that South Korea has become an attractive country for foreign direct investment. In the past, foreign investors' primary complaint was centered around government regulations, but the survey results show that government regulations are no longer a barrier, while labor market inflexibility remains a major obstacle (72.7 percent) (MOFE 2000b:204). Likewise, responses from foreign investors reveal that Kim's liberalization efforts have been quite effective.

Despite these changing perceptions, South Korea still remains a challenge for foreign business. South Koreans have not given away their mercantilist ethos completely, and a myriad of legal, institutional, bureaucratic, and even political barriers still remain, hampering the operation of foreign businesses in South Korea.
Chapter 6:  
Newly Emerging Debates and Barriers to Reforms

Under difficult economic and political conditions, the Kim Dae Jung government has been able to introduce significant economic reforms that have begun to bear fruit. Nevertheless, there are several obstacles that could delay or derail Kim Dae Jung’s structural reforms. First, the specter of the developmental state is resurfacing, undercutting the government’s reform efforts. In the process of campaigning for the general election on April 13, 2000, the opposing GNP accused the Kim Dae Jung government of transferring national wealth to foreigners through forced mergers and acquisitions. The GNP has called for suspension or modification of reforms affecting the capital account and foreign direct investment.

These anti-liberalization attacks have drawn widespread public support. For example, a recent government survey supported such public sentiments. Fifty percent of responses from the general public and 59.1 percent of responses from economic experts replied that the inflow of foreign capital has made a marginal contribution to the Korean economy, and 26.8 percent of the public respondents and 7.9 percent of the economic experts expressed the view that inflows of foreign capital have not made any contribution. Those critical of capital inflows cited the dependency of the Korean economy on foreign capital and excessive outflows of capital as two principal reasons for their opposition. Of foreign businessmen interviewed, 42.1 percent responded that South Koreans have not changed their attitude on foreign business (MOFE 2000:202-204).

Apart from this, public campaigns to boycott foreign products, such as automobiles, have not disappeared, causing serious grievances on the part of foreign countries. For example, the national tax authority has resumed its audit of luxury foreign car buyers and leasers at a time when Korean auto exports are booming. In fact, as margins of current account surpluses begin to dwindle since the first part of 2000, both the government and mass media have pushed for the anti-import campaign. Although foreign firms are acquiring two domestic automobile manufacturers, nasty nationalist campaigns to block these acquisitions have raised serious reservations about South Korea’s economic liberalization.
The software and film industries, also, have encountered similar protectionist tendencies.

All this implies that the mercantilist, if not xenophobic, ethos has not profoundly changed, despite the government’s hard liberalization drive. The prevalence of such attitudes, and their political misuse and abuse, could seriously undermine South Korea’s pathway to opening and liberalization.

A second obstacle to reform is that the proper role of the government in the Korean economy remains an open question. It is generally conceded that the economic crisis was a product of excessive government intervention in the economy in the name of industrial policy. Yet, despite the current trend toward reform, the government has not been shy about intervening. Opposition parties have accused the Kim Dae Jung government of excessive intervention in the economy, reviving the specter of the developmental state. As basis for their accusations, they cite the revival of executive guidance to circumvent the rule of law, excessive control of banking and financial institutions through the Financial Supervisory Service, reform of corporate governance through coercive means, and the forced corporate restructuring and artificial dismantling of chaebol.

In response, the Kim Dae Jung government argues that its catalytic role has been indispensable to correct market failures and to install market principles, and that such intervention is, by and large, transitional. After all, deregulation often requires state intervention if the deregulated entities are powerful.\(^{22}\)

However, the behavior of economic technocrats reveals that the malign inertia of the developmental state is still rampant. Commissioner Chun Yun-cheol, of the Fair Trade Commission,\(^{23}\) intervened in the selection process for chairman of the Federation of Korean Industries (FKI), the Korean analog to the Business Roundtable in the United States. Lee Hyon-jae, the Minister of Finance and Economy, called for the dismantling of the FKI, arguing that it is nothing but a private club.

While steps to reform the chaebol are appropriate, anti-chaebol sentiments by public officials are difficult to justify. After all, the FKI is a

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\(^{22}\) The breakup of AT&T is the best-known example of this.

\(^{23}\) Another remarkable institutional change under the Kim Dae Jung government is the enhanced role of the Fair Trade Commission (FTC). In the past, the FTC served as a nominal agency, but it has now become more powerful in enforcing fair trade and regulating antimonopoly and oligopoly-related activities.
full-fledged interest group whose rights are constitutionally guaranteed. Bureaucrats are again taking a commanding position in the process of structural reforms, which not only can obstruct the transition to opening, liberalization, and market economy, but also violate democratic principles.

Third, newly emerging tensions between the current global standard and Asian capitalism could become another source of political contention clouding the future of Kim's reforms. Kenichi Ohmae, a prominent commentator on the Japanese economy, and former champion of globalization and global standards, contributed a column in the Japanese weekly Sapio depicting President Kim Dae Jung as an American puppet (Ohmae 1999:74-76). Ohmae argued that Kim's reforms – dismantling of the chaebol, economic liberalization, and the adoption of the global standard – are the surest way to economic chaos and crisis. The opposing Grand National Party circulated his column nationwide as evidence of the failure of Kim Dae Jung's economic reforms, precipitating hot debates between proponents of global standards and proponents of Asian capitalism. Surprisingly, a majority of Koreans, including the mass media, took side with Ohmae's view, underscoring the depth of covert resistance to Kim's reform drive.

Fourth, the fragility of his political coalition heightens concerns about the sustainability of Kim Dae Jung's reforms. A great majority of reform bills have already passed through the National Assembly, and Kim can take advantage of the presidential system to steer the remaining structural reforms. Nonetheless, the weakness of the current coalition may undermine his ability to govern in the economic arena. He needs strong political support in order to complete the unfinished tasks of corporate reform and banking and financial reform. His failure to win the majority in last April's general election, along with a rather precarious alliance with the Liberal Democratic Union, could further dampen his reform drive. The opposition GNP, which holds the majority in the National Assembly, has already expressed its dissenting views on financial reforms and corporate reforms (Hankyung, April 15, 2000). It will not be easy for the Kim Dae Jung government to steer his reform efforts through the GNP-dominated National Assembly.

Furthermore, his reform coalition is rapidly losing its support base as the process of structural reform touches chaebol, small and
medium-sized firms, workers, and even government bureaucrats. The rapid economic recovery has defused the sense of economic crisis, which was vital to the success of early reform efforts, and “reform fatigue” has now become prevalent. Despite his productive welfare initiative, for example, even the middle and lower classes are refusing to support his government. The only reliable coalition partners are his regional constituents, foreign capital, and international lending institutions. It is likely to be difficult, therefore, for Kim to continue his structural reforms with such a fragile foundation, especially as a one-term president. And it will be a daunting challenge for him to build and consolidate a credible reform coalition.

Fifth, fiscal constraints will restrict the ability of the Kim Dae Jung government to use public funds for financial restructuring and welfare programs. The amount of new money needed to clean up nonperforming loans in the financial sector is staggering, with estimates ranging up to W30 trillion. The original W64 trillion allocated for bank recapitalization and deposit protection has already been depleted. With a budget deficit reaching 22.3 percent of GDP (108 trillion won), the government can no longer count on fiscal means to raise necessary capital. Moreover, a new fiscal burden might arise from inter-Korean economic exchanges and cooperation, as a result of the successful June 13-15 summit meeting between North and South Korea.

Finally, South Korea has not overcome its built-in structural rigidity. It still relies heavily on manufactured exports, and its exports are highly concentrated in terms of destination and composition. Roughly half of Korea’s exports are destined for the United States, Japan, and European Union markets, and a high percentage of its exports are concentrated in semiconductor, steel, automobile, and petrochemical products. In 1999, for example, heavy chemical products accounted for 77.4 percent of total exports. This lack of diversity leaves South Korea’s current account situation extremely vulnerable to cyclical swings in the global economy. At the same time, structural dependency on parts and components from abroad, mostly from Japan, also poses a challenge to South Korea’s external accounts. For example, South Korea’s exports of mobile phones reached a record-high $2.4 billion in the first three months of 2000, but imports of foreign parts and components for mobile phones were $1.5 billion during the same period. Such dependency considerably reduces the profit margins of Korean exports (Chosun Ilbo, May 16, 2000).
Chapter 7:  
Conclusions and Policy Recommendations

South Korea has undergone a dramatic economic reversal over the past three years. Rising industrial production, continuing current account surpluses, a sharp decline in the unemployment rate, and increased consumption signify a full economic recovery. This reversal can be attributed largely to extensive structural reforms. In fact, with very few exceptions, such as Mexico, it is hard to think of a country where institutional change has been more drastic and extensive than in Korea. Although it might be premature to make a definitive assessment of the reform efforts, on balance, the Kim Dae Jung government’s structural reforms have proven to be quite successful. There have been sufficient institutional changes to form building blocks for further reforms.

Indeed, all indications are that the Korean economic system is moving toward a more market-oriented economy, and global standards, accountability, transparency, and liberalization increasingly will serve as the dominant rules of the game in the South Korean economy. But a rocky road is still ahead. Structural rigidities, which were responsible for the genesis of the 1997 economic crisis, have not been completely stamped out, and concerns about future economic instability still linger. Incomplete reforms of corporate governance, the banking and financial sector, labor, and the state sector could cloud the future.

It is imperative, therefore, that Korea continue to reform itself. As the credit crunch of June 2000 shows, Korea is still vulnerable to another crisis unless further restructuring of the corporate and banking sectors is undertaken.

Korea must also reform in order to remain competitive. At the same time, the government should strengthen the rule of law with respect to corporate restructuring. It has already suffered a backlash against measures taken without strong legal foundations.

In the short-to-medium term, however, the government should focus on implementing its recent reform measures. Consolidation of those hard-won gains is urgent, because the recently enacted reforms in the financial, corporate and labor sectors still need to be fully implemented. This is a particularly important problem in Korea, where there is a large gap between formal rules and actual practices. Given the scope of the
recent reforms, the government’s hands will be full in the next couple of years simply trying to implement and improve them. For example, the government needs to deal with the chaebol’s attempts to “evade” their responsibilities under a new system of corporate governance. The chaebol recently scheduled several shareholders meetings simultaneously, and at large distances from each other, in order to disperse shareholder-rights activists.

The government also needs to realize that it is not enough to require firms to appoint outside directors to their board; it needs extensive monitoring and additional regulations to enable outside directors to perform their proper duties.

In addition, failure to phase out troublesome banking and financial institutions, as well as increasingly erratic state intervention in the banking and financial sector, are reviving the old fear of moral hazard and loss of market confidence. The government should be reinforcing the logic of market mechanisms in restructuring the banking and financial sector.

Economic liberalization is another example of issues the government will need to address. Many Koreans are counting on foreign investors as agents of change. Foreign firms are expected to increase competition and lead the Korean firms with their advanced management techniques and systems of corporate governance. Indeed, the ownership and participation of foreign investors will, in due time, increase the pressure on Korean managers to maximize shareholder value and improve the accountability of their actions.

However, it takes time for foreign investors to play such a constructive role, and it does not happen automatically. If the government does not actively nurture foreign investment, foreign investors may just leave or may play by the local rules instead of trying to change them. The fact that foreign investors do not always improve the economic system of their host countries can be seen in some Latin American economies that have inefficient economic institutions despite large foreign direct investments.

In addition to foreign investment, South Korea also should pay attention to trade liberalization. Despite its impressive liberalization measures, major trading countries have been voicing strong concerns over the revival of protectionist tendencies. Economic liberalization will be less effective if it is not tied to an overall economic restructuring. The previous pattern of export-driven economic growth cannot be sustained perpetually nor will it be tolerated by major trading partners. A balance between
exports and domestic demand needs to be maintained, and import liberalization should be regarded as a constructive stimulus to domestic economy rather than as a threat to national economic welfare.

Along with that, efforts should be undertaken to diversify the economic structure, with a greater emphasis on parts and components. The current pattern of export concentration in a limited number of big-ticket items, such as automobiles and semiconductor chips, can expose the South Korean economy to chronic vulnerability, with its fortune dictated by the whims of volatile international export markets.

One way to cope with export market uncertainties is to expedite the process of intra-regional economic integration. Recent deliberations on the formation of a free-trade area involving China, Japan, and South Korea, as well as a new currency arrangement within the framework of the Asia Monetary Fund, can be seen as a positive step in that regard.

But these reform efforts cannot be successful without corresponding domestic, social and political support. After all, some of the negative effects of “reform-mongering” have already begun to emerge. Social capital (i.e., the ability of members of society to cooperate based on trust) is rapidly eroding, because every group in Korea is now a target of reform. Politicians and interest groups, in particular, are politicizing the reform process by discrediting their political competitors as opponents of reform. Some groups even use reform rhetoric to avoid demands for their own reform. “We refuse to reform until others reform” has become a common refrain.

Clearly, the consolidation of gains is necessary if political support for continuing reform is to be solidified. Ultimately, the sustainability of economic reforms will depend on the emergence of new groups having stakes in continuing the process. To the extent that it is possible, therefore, the government needs to distribute the gains to the winners as much, and as soon, as possible. To some extent, the Kim Dae-jung government used this tactic to secure support from foreign investors, but the government is not gaining new domestic allies, because the benefits of reform have not yet materialized.

None of this necessarily means that the structural reforms will lead the Korean economic system to evolve into a U.S.-type market economy. Some features of the old model may remain the same. For example, the government is likely to continue to play a significant role, even though its tasks may change. The Korean system will also take on some form of social corporatism, in which the state, capital, and labor
form a system of mutual collaboration as labor likely becomes more influential in economic management.

At the same time, a lingering mercantilist ethos, and the underlying forces of opposition, will continue to resist the process of structural reform and liberalization. Whatever the eventual outcome, it is important at this juncture to pay more attention to consolidating the gains and charting the direction of future reforms. Refoms of the labor, banking and financial, and corporate sectors have not yet been completed, so there must be ongoing efforts. Otherwise, the specter of another round of economic crisis cannot be ruled out. Failure to phase out delinquent firms through market forces could cripple the banking and financial sector, triggering another round of financial crisis. Heightening such concern is recent legislative gridlock involving the passage of bills to provide public funds to the banking and financial sector, to reform bankruptcy law, and to permit bank holding companies. In addition, delayed corporate, especially chaebol, reforms could severely undercut markets’ trust in the government by reviving the old dilemma of economic concentration and moral hazard.

Unruly labor could also critically jeopardize state and corporate governability, eventually paralyzing the economic system. Likewise, current reform efforts are going through the twilight zone of precarious transition, and failure to implement them in a systematic manner could bear considerable negative consequences for the future of the Korean economy.

The Kim Dae Jung government has generally complied with the United States in implementing structural reforms and liberalization. His government deserves moral and policy support from the United States. Nevertheless, there will continue to be areas of bilateral trade friction between the two countries. The USTR has already pointed out South Korea’s unfair trade practices regarding intellectual property rights, automobiles, citrus fruits, and other agricultural products. Nonetheless, the American government needs to be prudent in dealing with such bilateral trade frictions at this juncture. Any high-pitched bilateral pressures could backfire, given the growing domestic critique of the Kim Dae Jung government for its pro-American stance.

It would be more desirable, therefore, if the United States were to support the Kim government while, at the same time, pressing it for further reforms and liberalization through such multilateral institutions as the OECD, WTO, and APEC. After all, the WTO was an effective vehicle for enforcing liberalization of the agricultural market, including rice, and admission to the OECD led to comprehensive institutional changes for
liberalization in trade and foreign direct investment. Likewise, multilateral institutions proved to be very useful in fostering South Korea's economic liberalization in the past. Especially in the current environment, bilateral approaches, though important, should be reserved for special situations, and more emphasis should be placed on multilateral approaches.

Despite continuing liberalization efforts, foreign firms, including American firms, will continue to experience difficulties in gaining access to South Korean domestic markets. Over time, however, the South Korean people will become better acquainted with the benefits of market opening, deregulation, and global standards. There must be continuing pressure and persuasion, guided by patience and prudence, to nudge Korea in the direction of appreciating, and embracing, the virtues of economic liberalization and global standards. In this regard, it also seems desirable for the U.S. government, multilateral economic institutions, multinational corporations, and international lenders to mount concerted efforts to support the Kim Dae Jung government's reforms while applying appropriate multilateral pressure when necessary.

Finally, it should also be noted that, even though Korean capitalism may not converge to the U.S. model, the days when internally collusive and externally exclusive institutions are used as a source of comparative advantage are clearly drawing to a close. New institutions are emerging to replace institutions of the old Korea, such as the chaebol, bank-centered financial intermediation, and lifetime employment. Although these new institutions are likely to be more nationalistic and interventionist than the United States may desire, they will no longer be able to support the government-directed growth strategy that distorted markets in the past.
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