

The Aftermath of the Asian Financial Crisis for South Korea

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1. INTRODUCTION: REFORM THE KOREAN WAY

The Asian Financial Crisis (AFC) of 1997-1998 was a watershed in the economic evolution of South Korea. It has, as a result, initiated more reforms than any other countries most seriously impacted by the AFC. The resolution of the crisis is being done in a very Korean way. Personal relationships, rather than legal processes, remain the primary mechanism for policy and decision-making, information transmission, and policy execution. South Korea has a homogeneous population, a relatively small geographic space, and Seoul dominates the political, cultural, and economic life of the country. Practically all members of the ruling elite, both in and out of government, have known each other for many years. While a legal framework exists and has been improved, it is still not surprising that the Korean way is very personalized and politicized. The government was centrally involved in all industrial restructuring in the past (Nam, 1999) and the government is universally believed to be involved in every important economic event today.

It is not an exaggeration to suggest that the Korean government is more involved in the operation of the economy than at any time since the administration of President Park Chung Hee. Frequently, declarative statements are made by government officials to the effect that the intention is for the government to remove itself from running the economy and leave it to market forces, but what that really means is unclear. Very likely the government does not want to own the means of production and is actively privatizing government assets. It is also unlikely that the government wants to maintain a heavy hand in directing the use of financial resources by

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controlling the banking system as is now the case. However, there is no evidence that the government is willing to let important economic outcomes be determined solely by impersonal market forces. Koreans do not believe that markets are impersonal, and there is a widespread feeling that the government should look after the country's economic interests as it interprets them.

The AFC has forced Korea to face some fundamental issues. In his recent book "The Lexus and the Olive Tree," Thomas L. Friedman discusses the tension that the global economic system places on a traditional society. Korea is the exemplar of that tension. Korean history is full of episodes of powerful neighbors dominating and sometimes abusing it. Hence, Koreans by nature are nationalistic and suspicious of foreigners. Recent demonstrations against the purchasing of bankrupted Korean automobile factories by foreign companies is but the latest sign that nationalism is alive and well in Korea, however much that attitude may be incompatible with globalization.

During the first two decades of the postwar Korean miracle, a skilled and powerful government bureaucracy developed which directed the modernization of the economy. Subsequently, that role was shared with, and superceded by, the large business groups or chaebols. The AFC undermined the economic position of the chaebols, hence, the bureaucracy and the Blue House have regained their dominance. The challenge for the Korean leadership is to push forward a reform agenda that is acceptable to Korea and will, at the same time, make Korea compatible with the evolving market-dominated and impersonal global economic system.

2. CAUSES OF THE CRISIS

Both international and domestic variables were involved in the AFC. Five domestic factors have been identified as all being essential if a crisis were to occur, and they were all present in Thailand in 1997 (Krause, 1998). They include a technical overvaluation of the exchange rate; excessive foreign borrowing (especially of short term); weak financial infrastructure, including poor prudential oversight and improper corporate governance (by international

standards); and uncertainty in political decision-making. Since many of these deficiencies had been present for some time —even when the economies were growing rapidly —one can conclude that the salience of certain deficiencies changes with the degree of economic development itself. Hence, having a viable and efficient domestic financial system was not a barrier to growth at the early stages of industrial catch-up, but became critical when economies became too complex for the resource allocation function to be performed by the government. After the crisis began, international transmission mechanisms took over and the contagion spread to other countries. It reached Korea in November/December 1997.

It is now generally recognized that the AFC has ended. Financial stability has returned, exchange rates have stabilized, inflation has subsided, sovereign-debt interest rate differentials have been reduced, and domestic interest rates have declined in both nominal and real terms. Real growth recovered in all seven economies that contracted in 1998 and Korea had an exceptional "V" shaped recovery. Progress has been made in correcting some of the deficiencies noted above, but not in all of them in Korea. Thus, the question arises, how serious are the remaining deficiencies, and how much of a threat are they to financial stability. These are the question that must be addressed.

3. THE IMF REGIME FOR KOREA

When it became clear to the government that its own resources were inadequate to stem the foreign exchange squeeze that international banks were imposing on Korea, it sought help from the IMF. An agreement was signed on December 3, 1997 providing it with a \$21 billion line of credit; however, a unique set of conditions were included that were so far-reaching that the then candidate for president, Kim Dae Jung, indicated that they might have to be renegotiated. The market reacted badly to this and the run on the won continued. After the election was held, President-elect Kim reversed his previous position and endorsed the agreement. Another rescue package was put together, under the leadership of the United States, that totaled \$58 billion,

and the foreign exchange market was stabilized by the turn of the year. Shortly thereafter, Korea's short-term debts to international banks were renegotiated and the foreign exchange crisis ended.

Macroeconomic policy for Korea was set down in the agreement with the IMF and it called for contraction. The budget deficit was reduced and interest rates were raised dramatically. This had the intended effect. The exchange rate of the won stabilized and a reversal begun. Inflation was halted before it really began. The societal costs, however, were enormous. The real economy went into a sharp recession as GNP declined 5.8% in 1998, with a gigantic rise in unemployment to 8.7%, and there were numerous bankruptcies and disappearances of small and medium sized enterprises (SMEs). In the twelve months following the start of the crisis, there were 26,200 bankruptcies of domestic firms, more than twice the usual number. In addition many small firms just disappeared without going through bankruptcy procedures.

When it became clear that the financial situation had stabilized, the macro policy was eased in order to permit a recovery. A point of contention with the IMF was the fiscal squeeze. When the World Bank weighed in on the Korean side advocating more expansion, the IMF agreed and the budget deficit was increased to the point of being expansionary. Furthermore, interest rates were reduced faster than the decline in expected inflation. In fact, corporate bond interest rates fell below 10%, which was lower than before the crisis. Under the encouragement of macro policy and with a more supportive external environment, the real economy began its sharp recovery.

4. FOUR AREAS NEEDING REFORM

In the original agreement with the IMF, several structural changes were suggested for the Korean economy, which the government accepted. The reforms were wide ranging and included selling two large commercial banks to foreigners. Of course Koreans were well aware that many reforms were needed. Observers both in and out of the country had been suggesting them for several years. President Kim identified four areas needing reform: the financial system; corporate governance —especially of large chaebols; the

labor market; and the government itself. Even before his inauguration (but after the election) some progress was made on the legislative front. The previous government was having a difficult time getting the National Assembly to approve a set of reform measures dealing primarily with the financial system and labor market. Under the pressure of the AFC and the urging of the President-elect, thirteen measures were passed (Haggard, 1999). Most importantly, these included the creation of a unified supervisory agency for the financial system, the Financial Supervisory Commission (FSC).

5. FINANCIAL REFORM

It was obvious that the financial system needed immediate attention and financial reform has gone further than the other reform areas. Ever since the Heavy and Chemical Industry program was undertaken in the 1970s, the major banks have been saddled with a significant amount of non-performing loans. The bad loan problem was magnified exponentially by the AFC. With the burst of activity at the turn of 1997, the National Assembly passed legislation to improve the financial system. In addition to creating the FSC, the Bank of Korea was made independent of the Ministry of Finance, the bankruptcy law was modified, the Korea Asset Management Company (KAMCO), was created to buy non-performing loans in order to recapitalize financial institutions, special legislation dealing with non-bank financial institutions was enacted and external auditing was addressed, in addition to several other matters.

Operationally, the first task was to perform "triage". A determination needed to be made as to whether financial institutions were so weak as either to be closed or merged with stronger institutions, whether they can be saved by capital injections, or whether they were self-sustainable and could be left to their own devices. As a result of this review, the FSC closed five banks, merged four banks, closed four life insurance companies, six securities firms, and completely recapitalized the Seoul and First Korea banks in order to prepare them for sale to foreigners. With the injection of public money, a significant portion of the banking system had been nationalized. The Korean

Development Bank (already a government institution), combined with the newly nationalized banks, became the principal agents of corporate workouts (along with the newly merged and recapitalized Hanvit Bank and Chohung Bank). The scheme was for the government to recapitalize banks so that they, in turn, could negotiate with borrowers to achieve workouts. However, the banks were the government in a different guise.

Rather than being in the background just setting the rules of the game, the FSC, in reality, is the operating instrument of financial reform. Each major workout decision is a very public event. Hence, the process has been politicized. Managers and board members of banks are loath to make decisions without the appropriate nod from the government. They would not want to force the closure of a major enterprise even if they believe it is hopeless. Rather, they are likely to keep it on life support in the hope and expectation that someone else would undertake the gruesome task, and the someone-else would be called before the National Assembly to explain their actions. It has not been forgotten that the MOFE Minister, and his principal deputy, in the previous government were jailed for incompetence. While eventually cleared of criminal wrongdoing, their incarceration is very much in the minds of bank loan officers.

The politicization of financial reform is seen in the proposed sale of the Seoul and Korea First banks to foreign interests. While the announcement to sell these banks to foreigners, who were identified (HSBC and Newbridge Capital) within the time frame specified by the IMF, the deals were not consummated. Selling to foreigners is particularly suspect in Korea. No bureaucrat wants to be accused of selling the national treasures too cheaply and, therefore, impossibly tough conditions were put on the foreign buyers who refused them. Indeed, a public refusal was politically necessary to protect the Korean negotiators. One of the sales is likely to go through, but only after a public demonstration that tough terms could not be extracted from the foreigners, and the Korean government is being forced into taking full responsibility for any loans that subsequently turn out to be bad.

Of course, the continued delay has been costly to the government, which has had to inject increasing amounts of public money into them. Indeed, delay in banking reform —as demonstrated most vividly by Japan—is very costly

to a country. While resolving its savings & loan crisis, the United States did use considerable amounts of public monies and probably enriched some undeserving persons in the process, but it was done quickly which permitted the economy to move forward to achieve greater efficiency, and probably saved money in the long run. The reverse was the case in Japan. Korea does not appear to want to follow the bad Japanese example as they are not trying to hide the problem from public view (as did the Japanese), but on the other hand, they also do not seem to recognize that time is money when it comes to bank restructuring.

While much has been accomplished, there is still much to do to complete the restructuring of the financial system. The disclosure in July 1999 that the Daewoo group was in serious financial difficulty brought home the fact that loans to Daewoo, and possibly other firms in difficulty, were being classified as fully performing by the banks. Thus, the estimate of bad loans must be revised upwards (and capital adequacy ratios downward) to reflect the reality. Therefore, much more government funding will be needed beyond the 64 trillion won already allocated to KAMCO (The totality of the debt of Korean corporations was estimated at 1,000 trillion won, or approximately twice the annual GNP). Furthermore, the Daewoo crisis put a spotlight on the fragile condition of the Investment Trust Companies (ITCs), which have invested heavily in Daewoo bonds. Since the ITCs do not mark-to-market, the decline in their asset portfolios is not passed on directly to investors. Hence, investors in ITCs have an incentive to withdraw their money, since these investments do not carry an explicit government guarantee. The government countered an incipient run on the ITCs by limiting the withdrawal of investments backed by Daewoo bonds, and by creating a \$16.5 billion fund (mainly provided by banks) to buy Daewoo bonds from them. Also, the securities companies that sold the bonds to the ITCs are being forced to share some of the losses. However, these stopgap measures still do not correct the structural flaws of the ITCs, and possibly those of the Leasing Trusts as well. Nor is it clear how the insurance industry is to be made viable again. Some public money had to be pumped into three life insurance companies as recently as November 1999, however, rescuing is not reform.

How much public money would it take to absorb all of the bad loans from

the past and set Korea on a sounder growth path? The liabilities side of the balance sheets of the financial institutions suggests that the public could be made whole by allocation of approximately two-thirds of one year's GDP. Such a huge expenditure is unthinkable. However, if there were to be a domestic credit crisis, then the political atmosphere might be conducive to such a mammoth bailout. A crisis would be helpful, but may not be necessary if the economic recovery continues and financial institutions exercise proper risk management. In any event, after the government clears away the financial underbrush, the question must be answered as to whether a moral hazard situation has been created which could encourage more irresponsible lending behavior in the future.

6. CORPORATE GOVERNANCE AND CHAEBOL REFORM

The Korean economy was shaken starting early in 1997 by the news that the Hanbo, Sammi, Jinro, Haitai, Halla, and Kia groups had all gone bankrupt (Jung, 1999). A total of thirteen chaebol with assets nearing 47 trillion won and debts of 28 trillion won had failed (Lieberman, 1999). While these were not among the biggest chaebol and, therefore, could be dismantled as independent enterprises, they were still large enough so that the government wanted to ensure that their facilities would remain in operation and workers not be made unemployed. When it came to the big five —Samsung, Hyundai, Daewoo, LG, and SK—the story was much different. From all accounts they were considered too big to fail. There is no other OECD country where five firms dominate the economic life of the nation to the extent found in Korea. However, not all was well with the big chaebol and they were coming under increasing public criticism. The AFC brought the problem to a head.

The most damning criticism of the big chaebol was that they had expanded recklessly with borrowed money. By world standards, they have remarkably high debt-to-equity ratios, which also applies to most of the smaller chaebol as well. This makes them very vulnerable to a cyclical downturn, which the AFC was in spades. Through their huge investments in facilities, they created over-capacity in several industries, such as semiconductors, petrochemicals,

and automobiles. These excess supplies put downward pressure on world prices of these commodities, which made them unprofitable with normal economic growth and disastrous with the AFC. Furthermore, the chaebol became widely diversified by investing in many different industries and services. The chaebol came to dominate not only the high profile industries in Korea, but also many of the molehills as well. These latter are usually left to SMEs in other countries. Also, in other OECD countries, large multinational firms were moving in the direction of limiting their industrial spread to concentrate on core competencies, but not so in Korea. Finally, some chaebol had become so large that adequate competition in the domestic market was called into question. If they believed that they were too big to fail then highly speculative behavior was only to be expected.

The chaebol had developed two practices with serious consequences. One was for one member of the group to provide credit guarantees for another member of the group. Such guarantees were particularly helpful in getting into new industrial ventures and help explain the wide diversification of the chaebol. A complex web of cross credit guarantees developed such that if any major firm of the group got into financial difficulties, its default could bring down the entire group.

Another practice was for one member of the group to "buy" equity shares of other members of the group or lend money to them. Cross equity purchases, or loans, brought no new cash to the group as a whole, but did relieve the liquidity pressures on particular firms within the group. The top five chaebol are major owners of nonblank financial institutions which provides the opportunity for self-dealing. This behavior may have violated prudential guidelines. Dealings between Daewoo Securities and the Daewoo Group have been investigated in this light. Cross ownership also permitted the chairman and his family to control the group even while owning a small share of the equity. Hence, the chairman could make investment decisions by himself, but not personally suffer greatly if the investments went sour. Of course there were many business transactions among members of the group that were not at arms length and may have disadvantaged minority stockholders.

Most of these activities were not illegal under Korean law as generally understood. How then could the government force the chaebol to change their

ways? Over the years and under different presidents, three techniques have been used to twist the arms of the chaebol. One was to threaten a comprehensive tax audit. The Korean tax code has been so complex with over-lapping provisions as to make it nearly impossible to comply with the letter of the law. Hence, most firms would feel threatened by the prospect of such an audit. Second, legal prosecution of the chairman, his family, and/or senior managers has been hinted at and, on occasion, utilized. Again, individual tax compliance and certain financial transactions between firms in the group and individual family members would not bear close scrutiny. Hence, fear of personal prosecution was a prospect for the family of the founder if the group really fell out of favor with the government. Of course, the banks could also be utilized to deny credits to, or raise the interest rates on, chaebol that did not cooperate. In sum, the Korean government does not lack instruments to work its will on the chaebol, be they large or small.

What did the government want to achieve with respect to the chaebol? First, in traditional Korean fashion, they wanted the chaebol to take over and operate the (large) facilities of failing firms. Of course, this was the way that some chaebol, such as Daewoo, had become diversified in the past. It was also a reason for their being over-leveraged as the carrot held out by the government was increased credit. As an example of this government pressure, it is not unfair to suggest that the Posco purchase of the steel-making facilities of Sammi was meant to placate the government, and to deflect efforts to force it to take over the even more troubled Hanbo Steel. While the case is less clear, it is widely believed that the takeover of Ssangyong Motors by Daewoo Motors could not have taken place without a nod from the government. In a more public demonstration, Hyundai Motors won the right to take over Kia Motors rather than sell it to foreign interests. The exaggerated value of Kia insured that only a domestic firm with implied help from the government would be willing to absorb it.

It was expected that President Kim Dae Jung, who came to power as an outsider and who was not beholden to the large chaebol, would have a different agenda and approach toward them. He called a meeting of the chairmen of the four largest chaebol in which five principles were agreed upon (failure to dissent was taken as agreement). One of the five principles

was to provide more transparent accounting and management practices by the chaebol including the publishing of consolidated financial statements beginning with fiscal year 1999. Another was the elimination of cross loan guarantees among subsidiaries of the top 30 chaebol by March 2000. The Fair Trade Commission was authorized to use new authority to track chaebol bank accounts to monitor such transactions (Jung C.Y., 1999). It was through this mechanism that charges have been brought against the family of the Hanjin Group. To reduce over-leveraging, the top five chaebol were directed to reduce their debt/equity ratios to 200% by the end of 1999. These ratios were conservatively estimated to have averaged 458% in 1997. The chaebol were directed to set out plans to accomplish this for review by the government in, the so-called, Capital Structure Improvement Plans. Fourth, the chaebol were directed to reduce their diversification and concentrate on core competencies. They were to accomplish this by selling off assets and by swapping divisions with other chaebol in, the so-called, "big deals" to be brokered by the government. Finally, in order to improve governance, the chaebol were advised to appoint outside directors to their management boards and strengthen the rights of minority shareholders.

It took approximately a year for the big chaebol to file Capital Structure Improvement Plans outlining how they were to achieve their target debt/equity ratios. To push them along, President Kim brought the chairmen together again (all five) and out of that meeting three more principles were added to the previous five. Most importantly they included a prohibition on cross equity holdings by firms within the same group.

Both the substance of the eight principles, and the process by which they became guides for action, have been subjected to significant criticism. Many of the tasks asked of the chaebol had no basis in law, but nevertheless, the chaebol felt compelled to comply. Thus, with respect to the biggest chaebol, it appears as if the government has a policy that is tailor made for each one of them. Given their size and ability to disrupt the entire economy, the government may feel that it has no choice but to act decisively when any of the five is in difficulty. Nevertheless, this leaves the government responsible for their survival in the mind of chaebol managers, and of even greater importance, in the mind of the public.

Two policy directives have been particularly criticized. The first involves the big deals (Jung Ku-Hyun, 1999; Yoo, 1998). The idea was to get the big chaebol to swap facilities so that each would narrow its focus to one less industry and reduce over-lapping production facilities. This by itself does not cure any of the over-capacity problems or improve efficiency, and would likely worsen the problem of excess concentration and control of an industry by one or two firms. Furthermore, the sheer complexity of doing two such deals simultaneously would challenge the skills of even the best merchant bankers. In reality, no real swaps ever took place. The most significant transaction that did occur was the transfer of the LG semiconductor business to Hyundai; however, LG did not get any facilities in return. In retrospect, getting out of the semiconductor business was probably a bad decision for LG, however, it may have been a cheap way to get the government off its back. Other plans were made by, and for, the big chaebol, but how much has actually occurred and to what effect is unclear.

The other questionable directive was setting a target for debt/equity ratios at 200% by a specific date. While no one would deny that these ratios had to be reduced, most economists would leave this to the market through negotiations between the chaebol and their lending institutions. This would permit the plans to fit the specific needs of the group. As it is, the chaebol may have had to sell assets—including to foreigners—at a disadvantage since everyone knows the chaebol were under pressure to sell by the end of 1999. Alternatively, the firms may have resorted to accounting gimmicks such as arbitrarily writing up the value of assets or expanding equity through cross purchases. Surely the government should want to monitor progress, but need not set arbitrary deadlines.

The Daewoo case is a major test for the government because, if handled badly, could disrupt the economic recovery. Daewoo is the fourth largest chaebol in Korea. Its demise would send shock waves throughout the economy because literally thousands of small firms depend on Daewoo and would be compromised if the group were to close down. A total of 2.5 million persons are involved in some connection (Graham, 1999). Chairman Kim Woo Chung, at the outset of the AFC, proclaimed that the crisis presented an opportunity for Daewoo to continue to expand. Thus, rather than conserving

its financial resources, it continued to pile on even more debt.

On July 19, 1999, it became clear that the group was running out of money (Ministry of Finance and Economy, 1999) and under direction from the government, an emergency meeting was called among its domestic creditor banks. Approximately 12.4 trillion won of Daewoo's 60 trillion won of debt outstanding was coming due, yet, even more would have to be lent to them to keep them operating. A deal was put together whereby the domestic banks would roll over existing debts and provide 4 trillion won in new loans and, in return, Chairman Kim Woo Chung would post, as collateral, in excess of 10 trillion won of equity claims on affiliates, including claims on a closely held insurance company. Daewoo promised to raise \$13.6 billion through asset sales and security offerings. Daewoo owes \$6 billion to foreign creditors who were not included in the deal and immediately objected, but were promised continuation of interest payments if they would avoid lawsuits to recover their loans.

By mid August 1999 it became clear that merely refinancing its debt was going to be inadequate to rescue Daewoo, and plans for dismantling the group were begun. Disclosure that the previously announced sale of the Seoul Hilton Hotel by the group was a sham helped poison the atmosphere. Chairman Kim of Daewoo seemed to concur that the group should be reduced to just those firms involved in the automobile business, and the remainder should be sold or taken over by its creditors. Again, foreign creditors were not permitted to participate in this planning and this may present an obstacle to a mediated resolution. The issue seems to be coming to a head since \$4.7 billion of foreign currency borrowings were due at the end of 1999, of which \$2.7 billion is from foreign financial institutions.

The Daewoo case illustrates the difficulty of the Korean way to reform when issues or firms are linked to global markets. Working out an agreement among a few people in Seoul may be possible, and such an agreement can be forced upon domestic parties —even unenthusiastic ones. However, foreign interests may want to go by the rule of law and establish their rights in court proceedings. The Korean government will have less leverage on them, and the foreigners may be in position to forestall an agreement, or extract more favorable terms for themselves.

There are certain similarities between Daewoo and the Hyundai Group as both increased their debts during 1998, although all observers believe that Hyundai has much more productive assets than did Daewoo. Hyundai did take over the debts of Kia. It did use credit to buy L.G.'s semiconductor business. It also made commitments to spend almost \$1 billion to open up a tourist business in North Korea that could not possibly prove profitable. If one excludes asset revaluations, the debt/equity ratio of Hyundai reached 769% by the end of 1998. All of these moves seem to have had the blessing of the Blue House. It is as if Hyundai were a favored company, as it was during the Park years. Thus, the government seems to be getting itself into the position of being a guarantor of Hyundai, which has the potential of becoming a serious moral hazard situation.

On the surface it appears as if the government's approach to the smaller chaebol —numbers 6 through 64 —seems less ham-handed. These firms are required to renegotiate their debts with the lending institutions. A Corporate Restructuring Coordination Committee (CRCC) has been formed to mediate disputes between borrowers and lending institutions, and can institute solutions in case of deadlock. Eighty-one firms, from thirty-eight chaebol groups, are in the midst of workouts. The concern over these efforts centers on whether the banks are capable of overseeing financial turnarounds. According to Sang-Woo Nam, debt-restructuring plans have been agreed to for 72 firms, which included only 3.7 trillion won of debt-equity swaps and 27 trillion won of interest subsidy (total debt of 33 trillion won). The controlling shareholders have lost their managerial control in only three firms, and three firms have gone bankrupt. Since the principal banks are mainly government-owned institutions, they may still be getting their signals from the FSC of MOFE. Also, the role of the CRCC could be harmful in the long run. Unless the banks learn by experience how to manage this situation, they will miss the opportunity to master risk management.

The remaining enterprises in Korea are considered SMEs. The rhetoric of the government suggests that these are the firms that will become the most entrepreneurial and provide for expanding employment as in other OECD countries. Whether this will happen or not may not be up to the government, however, the government is trying. It has instituted several policies to help the

SMEs. The government directed that SME debts to banks should be rolled over for six months (and extended for another six months), created a credit insurance fund, provided a central bank credit line, provided funding for trade finance and created four SME restructuring funds (Haggard, *op cit.*). However, if government help amounts to putting the SMEs on life support, then the Darwinian process of survival of the fittest will be undermined, and the economy will suffer in the long run.

The Korean way of handing the chaebol problem is by direct government action, rather than letting the market work its will. This may have been inevitable under the circumstances. Nevertheless, a question must be raised as to what sort of legacy this leaves for the future. In a globalized economy, it will take significant entrepreneurship to survive and grow. Hence, the heavy hand of government may keep the existing chaebol from being the instruments for creating the next Korean miracle, and the leadership will be taken by firms not now attracting the attention of government.

7. LABOR MARKET REFORM AND THE SOCIAL SAFETY NET

One cannot understand the labor market in Korea without some reference to history. Under the authoritarian regimes of Presidents Park and Chun, independent labor union activity was suppressed. This put workers at a disadvantage relative to employers. The governments did not forget workers, however, as from time to time the Blue House would mandate wage increases. The government believed that workers would benefit through the rapid economic growth with full employment that was the focus of policy. Nevertheless, workers felt they did not get their fair share of the economic miracle. All of this changed in 1987 with the beginning of the democratic transition. An unprecedented number of strikes and other industrial actions ensued, and wages spiraled upward.

To deal with this chaotic situation, a number of legislative actions were taken to assuage labor. Not only was the right to organize and bargain collectively enshrined in law, but many proscriptions were also laid on

management, which limited their ability to discipline workers, and firing workers became almost impossible. The consequence of all this was that the labor market became remarkably inflexible. What adjustment capability there was came from new entrants into the labor market and transfers out of the SME sector to the chaebol sector.

For several years, wage gains exceeded productivity advances by a wide margin. This created inflationary pressures within the economy and undermined the international competitive position of Korean exporters. The market solution to these circumstances would have been for the outsized wage increases to lead to unemployment, which would have tempered labor demands, but this was not permitted to happen. The new Roh administration felt that it had to sustain growth —lest democracy get a bad name—and undertook an unprecedented policy to stimulate home construction. Indeed, every time the economy faltered, the government applied stimulation to overcome it. Hence, the market did not discipline labor unions, and the need for unemployment benefits and other social programs were buried since there was no unemployment.

It was universally recognized that adjusting to the AFC required more labor market flexibility. Korean firms could not downsize to regain competitiveness unless they were permitted to fire workers. Also, foreign investors could not be induced to take over ailing firms if they could not adjust levels of employment. Under the pressure of the AFC, the National Assembly did pass labor market reform, but even that was subsequently watered down in response to public displeasure. The companion social safety net was slower in coming. Most of the unemployment generated in the 1998 downturn came from the demise of SMEs, even though the social safety net was designed for the labor situation of the chaebol. Some chaebol employees were terminated with lump-sum compensation payments. There is a nagging worry in the government that if some financial institutions go bust without deposit guarantees (such as the ITCs), they will hit this group of discharged workers. The government also directed a 10% wage cut for workers and a larger one for management —again the Korean way.

It is clear that, emotionally, Koreans do not like flexible labor markets. Discharging workers is seen as a way for a company to make more profits,

not a way to safeguard the jobs of the remaining workers. Such attitudes change slowly. If Korea is to choose a more market-oriented approach to its economy, then change is required.

8. GOVERNMENT AND POLITICAL REFORM

While President Kim Dae Jung did identify governmental reform as being necessary, it is unclear that the extent of the flaws in Korea's political system has been recognized (Mo, 1998), and analysts believe that nothing can be done, or even seriously discussed, before the April 2000 elections for the National Assembly. In addition to the need for administrative reform, Korea's political parties, its electoral laws, and even the basic outlines of the mixed presidential-parliamentary system may not be sustainable.

Much of the criticism of the government has been aimed at its large size and lack of efficiency. The number of civil servants has been reduced as has the number of regulations outstanding, but the impact of these changes is unclear. Korea's administrative setup has been subject to several changes in recent years. With respect to the economic ministries, it was decided during the YS years to concentrate power into the hands of the Ministry of Finance, which became the Ministry of Finance and Economy (MOFE) by absorbing the Economic Planning Bureau of the Deputy Prime Minister's Office. Since MOFE already had the budgeting and taxing functions, controlled the prudential oversight of financial institutions and dominated the Bank of Korea, macro policy was completely absorbed by it. With the advent of the new DJ Administration, several functions were removed from MOFE. The Bank of Korea gained independence, the FSC was created, and a new budget entity—first a commission and then a ministry—was formed. Worthy of note is that the EPB remained within MOFE where it could not perform the critical coordination and mediation task among ministries. The only place where this can be done is in the Blue House itself. Importantly, none of the ministers were themselves economists, as they tend to have come up through the bureaucracy. It may well be that President Kim Dae Jung is his own economic czar. It is unlikely that this will be the last administrative change.

Meanwhile the problems of the political parties have not been addressed. In a representative democracy, parties have some critical functions. They are responsible for selecting candidates for political office, they put together policy platforms to educate voters as to what politicians stand for, they organize voters and run electoral campaigns, and they can serve as a two-way information channel between ordinary citizens and political leaders. Of course, all of this activity requires resources, and how politicians obtain money is a critical test for all democracies.

In Korea, political parties have primarily been the personification of particular politicians. They tend to be transitory, confined to a particular region of the country, and lack professionalism. They tend to have very ineffective organizations with few specific rules or regularized processes, and they lack strong linkages with the citizenry (Hoon, 1999). The raising of money by political parties is also a matter of concern. Some individual politicians have been accused of buying their nomination for election from party leaders, which suggests that money can be made by being elected. Unrealistic limitations have been put on election spending, and these limitations have been ignored which further undermines the rule of law.

It is also clear that the election laws are deficient. First, the election dates for the presidency and the national assembly are not synchronized. Hence, it is almost certain that opposition parties will dominate the national assembly in the first instance. This forces the president to try to merge parties or gather individual members from other parties. The inducements required to put together a working majority in the national assembly are usually not in the national interest. Furthermore, existing electoral districts are of vastly different size in terms of population. The correct way to approach 'one person one vote' would be to redraw election boundaries. In the process, the total number of legislators could be reduced (Young, 1999). However, an alternate suggestion of creating multiple member districts for urban areas has been put forward. This is the old Japanese system that has been discredited because it leads to the exaggeration of money politics —the only way members from the same party running in the same district can differentiate themselves is by spending more money. Hence, the election law needs attention.

More fundamentally, it is unclear whether the existing mixed presidential/

parliamentary system in Korea is sustainable. Korea has a strong presidential system, but lacks the checks and balances that such a system requires. The national assembly lacks a credible committee system with the requisite qualified staff to create an independent view of policy. Since political parties do not represent legislative programs, there is little incentive to create such professionalism. The independence of the judiciary is also questioned. Meanwhile, the system has a Prime Minister whose functions are unclear. In time Korea may have to choose between going one way and the other.

9. CONCLUSIONS

Despite making greater progress than other Asian countries, the reform process in Korea still has much ground to cover. The huge rise in foreign direct investment coming into Korea is a sure sign that international investors believe that some fundamental changes have taken place. Nevertheless, there has been much more talk and planning for reform than has actually been accomplished. Fortunately, the continuation of the economic recovery from the cyclical downturn does not depend on the completion of reforms. The Mexican experience clearly illustrates this point. However, growth may depend on some progress being made in the proper direction. Backsliding could undermine the confidence of investors at home and abroad that could derail the continuation of growth. Hence, there is concern that the rapid economic recovery will undermine the political will to continue the reform process.

Clearly, the most critical reform area is in finance where most progress has been made. If the banking system is revitalized by privatization and possibly by new entrants, then the behavior of non-financial firms will also change in a desired direction. In second place are labor market reforms. Attitudes must change toward downsizing or else Korea will not be able to remain competitive in global markets. Rapid growth will not bury all mistakes as in the past. This means that the safety net, as well as retraining programs, must be crafted. Corporate governance reforms are also desirable, however, the payoff is in greater equity in the society (especially the perception of equity)

rather than in efficiency or greater growth. Finally, political reforms may never be completely achieved, however, if the system works, then they are not critical to the running of the economy. If the system breaks down (as in Thailand and Indonesia), then the political will for change can be mustered.

The Korean way of reforming is not the American way, but it may well be effective. The Korean people may be willing to accept a larger role for government in the economy, and to accept personalized decision-making, which would not be acceptable in the United States. The danger inherent in the Korean way is the ease through which close personal relationships can become corrupted and lead to crony capitalism. Personal relationships also tend to support the status quo rather than encouraging change. Moreover, the Korean way heavily depends on political and business leaders maintaining the trust of the people. In this sense, Korea has become more dependent on perfecting its democracy than has the U.S.

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