The Political Economy of Institutional Reform in Korea*

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Abstract

In the aftermath of the economic crisis of 1997-98 South Korea has undertaken a number of major institutional reforms. What are these reforms? Why were they undertaken? What is the outcome of the reforms? In answering these questions the paper examines the influence that the ideas of political leaders on political economy had in setting forth the reform agenda and the role that various interest groups have played in implementing the reform. It argues that there was a shift in the developmental paradigm in the early 1980s, that the new paradigm guided reforms in Korea during the 1980s and 1990s but with initial conditions and interest politics influencing the implementation and actual outcome of reform, and that the post-crisis reform was a culmination of the reform process that began in the early 1980s.

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1. Introduction

In the aftermath of the economic crisis of 1997-98 South Korea (henceforth Korea) has undertaken a number of major institutional reforms. What are these reforms? Why were they undertaken? What is the outcome of the reforms? In answering these questions for Korea we examine the influence that the ideas of political leaders or policy elites[i] on political economy had in setting forth the blueprints for reform and the role that various interest groups have played in implementing the reform agenda. Ideas (or ideologies) on political economy are important for understanding institutional reform because it is they, as mental constructs of the economy (North 1990, 1999), that inform, correctly or incorrectly, the state and interest groups what the effect of reform will be on the economy and how the interests of various groups will be affected by it (e.g., Bates and Krueger1993, Chai 1998).

Reforms take place, as pointed out Ruis and van de Walle (2003), in the context of political and cultural institutions and their outcome depends on whether the state is strong or weak. In Korea, the strength of the state and its capability to reform institutions have changed over time as the state has gone through the transformation from an authoritarian to a democratic government. From the early 1960s through the early 1980s, when there was an authoritarian government led by a president who had his own ideas of political economy, it was the state that more or less dictated institutional changes. In the early 1980s, however, with a change in political leadership there was a paradigmatic shift in political economy and there began prolonged and various attempts at reform with interest politics playing an increasingly influential role in the reform process and its outcome. The economic crisis of 1997-98, which is an outcome of that reform process, galvanized political support for reform, strengthening the state capability to make changes. In 1998, however, there was no paradigmatic shift in political economy and thus the reform that has been achieved in the aftermath of the crisis was a culmination of the reform process that had begun in the early 1980s.

In this paper we divide the reform experience of Korea into the following three periods: (1) 1961-79 when General (then President) Park Chung Hee effectively ruled the nation, starting the process of rapid industrialization and economic growth, (2) 1980-97 when the government undertook a number of reforms in an attempt to transform the economy into a freer market system, and (3) the years since the 1997-98 economic crisis when reforms were undertaken under the IMF auspices.[ii]

During the first period Korea pursued a state-led development strategy with the government in a commanding position in resource allocation. It controlled credit allocation, thus directing resource allocation and disciplining large family-owned corporations in pursuit of developmental objectives. It also maintained a repressive policy toward labor, thus keeping the wage rate close to the shadow price of labor. The second period began in 1980 when General Chun Doo Hwan began his presidency (1980-87) upon the assassination of President Park in the preceding year. The new government launched a major paradigmatic shift in political economy from state-led developmentalism to a liberal market economy at the behest of liberal reform-minded economists. This shift in paradigm was significant for Korea's political economy in that it meant a radical change in the ideas or visions held by political leaders about the way the economy was to be managed. It did not, however, mean that reforms necessarily followed the prescriptions of the new paradigm: the course that the actual reforms took was full of detours as it was constrained by initial conditions, including institutional legacies, and buffeted by pressures from various interest groups. The economic crisis of 1997-98 was a consequence of reforms ill conceived and ill carried out in the preceding years and, consequently, understanding the reforms undertaken since the crisis requires understanding the development strategy used by President Park Chung Hee and its legacies, the shift in the paradigm for political economy in the early 1980s, and the reforms undertaken since then.

Section 2 discusses the shift in the developmental paradigm that took place in the early 1980s and the new paradigm that was to guide the reforms in Korea since then. Section 3 analyzes how initial conditions and interest politics influenced the implementation and actual outcome of reforms through the 1980s and 1990s, and section 4 analyzes the post-crisis reform, which was the culmination of the reform process that began in the early 1980s with a paradigmatic shift in political economy. Section 5 offers some concluding remarks.

2. An Antecedent to Reform: A Shift in Paradigm

The political economic system that existed during the Park regime was often characterized as a state-led economy or developmentalism.[iii] Although it was basically a private market economy it differed from the Anglo-American version of a free market economy in that the state held a commanding position in resource allocation through its control over credit allocation and thus over the decisions of large family-owned enterprises called the *chaebol*. This was the system of political economy that the Park regime used effectively to promote rapid export expansion and economic growth.

This state-led system of political economy resembled, as remarked by a number of observers of the Korean economy (e.g., Amsden 1994, Cho 1994, Pyung Joo Kim 1994),[iv] the system that was used in Japan during the post-World War II period to achieve rapid economic growth and catch up with the advanced economies of the West. This resemblance was, however, no pure coincidence as President Park, trained at a Japanese military academy during Japan's colonial occupation of Korea, allegedly had little regard for academic economists and as many of the economic experts he relied on had been educated in Japanese schools, worked in Japanese banks, and looked at Japan as a model for rapid economic development (Woo 1991).

The system did not, however, go unchallenged during the Park regime. In fact, at the behest of U.S. economic advisers attempts were made to "liberalize" Korea's financial system and make it approximate a free-market financial system of the West. But the reforms did not have much of a lasting effect on the basic *modus operandi* of the system—the one employed by the Park regime, as attested in the following observation on the outcome of the reform (Kim 1994, p.278):

> During this period a host of U.S. advisors (E.S. Shaw, John Gurley, Hugh Patrick, and others) visited Korea frequently under the auspices of USAID and international organizations. Their recommendations were put into practice with much fanfare and had an apparently dramatic effect for a while. These experiments, imbued with American ideas and implemented by officials more susceptible to U.S. influence, made ripples on the surface of Korea's financial structure. *In most cases, these experiments were short-lived, distorted, ignored, and eventually overwhelmed by the main currents flowing steadily under the surface.* [Italics added]

What this failed attempt at financial liberalization demonstrates is that President Park was able to fend off challenges from external sources to his own strategy of economic development. As a matter of fact, in spite of objections from the World Bank on the ground that Korea did not have a comparative advantage he started a program to develop heavy and chemical industries in the mid-1970s (Kim 1994). As long as his strategy was successful in bringing about rapid economic growth there were few challenges to the regime to change its policies and institutions.

In the late 1970s, however, Korea ran into a number of economic problems—a terms-of-trade deterioration resulting from the second oil crisis and a high rate of inflation and excess capacity and low profitability in some of the heavy and chemical industries, a consequence of the heavy and chemical industrialization policy launched in the mid-1970s (OECD 2000). In the midst of the crisis President Park was assassinated, followed by a military coup led by General Chun Doo Hwan. The new government that followed the coup lacked political legitimacy and took the course of restoring the country's economic health as a way of securing the legitimacy and survival of the regime. Continuing with the state-led development strategy of the previous regime was not, however, a viable option for the new regime since the public held it responsible for the crisis. In need of new ideas and new policies to bring back the economic health the government brought in a number of economists who had been trained in neoclassical economics at major American universities (Moon 1994).

One such individual, brought in as the chief economic advisor to President Chun Doo Hwan, was a Stanford University trained economist named Kim Jae Ik. He and his like-minded colleagues prepared a major reform agenda—mostly macroeconomic—for the new government, basing it on the lessons they had learned in their graduate schools. That is, the agenda consisted of a reduction in government deficit, a tight monetary policy, a restraint on the growth of wages, trade-account liberalization, relaxing control over foreign investment, privatization of major commercial banks, and phasing out the subsidies to heavy and chemical industries (Kim 1991). These are exactly the set of policies that subsequently became to be known as the Washington consensus—fiscal discipline, appropriate public expenditure priorities, tax reform, financial liberalization, appropriate exchange rate policy, trade liberalization, abolishment of barriers to foreign direct investment, privatization, deregulation, and property rights (Williamson 1994).[v]

This congruence between the reform agenda of the new government and the Washington consensus is no surprise, given that Kim and most, if not all, of his colleagues were trained in economics at major American universities where neoclassical economics has dominated and given that they were cognizant of the change in the intellectual climate toward neoliberalism in the West and the policy reforms influenced by it in other parts of the world (Williamson and Haggard 1994). With the support of the president of an authoritarian government who admittedly was a *tabula rasa* in economics and, consequently, had no vision or ideas of his own for guiding the development of the economy, the newly empowered liberal economists met few challenges to translating the policy prescriptions of neoclassical economics into a concrete reform agenda to be adopted by the new government (Woo 1991).

The fact that the reform-minded economists appear to have come out as winners in changing the politico-economic paradigm does not mean that the implementation of the reform agenda closely followed the new paradigm. The actual outcome was far from it. How interest politics and institutional legacies—both formal and informal—of the country influenced the outcome of reform, thus laying a foundation for the 1997-98 crisis, is the subject matter of the following section.

3. Initial Conditions, Interest Politics and Partial Reform

> Institutions are not necessarily or even usually created to be socially efficient: rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to devise new rules.
>
> Douglass C. North (1990, p.16)

> [T]he ongoing development of social institutions is not best explained as a Pareto-superior response to collective goals or benefits but, rather, as a by-product of conflicts over distributional gains.
>
> Jack Knight (1992, p.19)

3.1. Initial Conditions

The change in paradigm that took place in the early 1980s was largely in the area of macroeconomic policies, and the policy reforms that were brought in with that change helped Korea resume rapid economic growth throughout the 1980s. Macroeconomic stability was achieved with manageable budget deficits and external debt, low or moderate inflation, and a stable exchange rate (World Bank 1993). Thus, in terms of macroeconomic policy and performance Korea was a success case of the countries following the Washington consensus. But, this success came at a cost as it dulled the urgency for solving structural or microeconomic problems, such as the power of *chaebol* and their opaque corporate governance, that were becoming increasingly evident to knowledgeable observers of the Korean economy.

It is a well-known fact that the *chaebol*, which expanded rapidly with the launching of heavy and chemical industries, played a critical role in Korea's economic development and their activities accounted for a significant portion of GDP and employment (Lee 1992, Kang 1996). During the Park regime the government exercised discipline over *chaebol* through its control over credit allocation, but with the change in the developmental paradigm and financial deregulation that began in the early 1980s they became increasingly independent of government for their financial needs. This, combined with their size and importance in the economy, gave them a political leverage to influence the course of reform in the subsequent decades.

The reform that began in the early 1980s left largely intact many of the economic institutions such as the basic economic structure that relies heavily on *chaebol*, their relationship with the state, corporate governance, and industrial relations (up to the mid-1980s). There are at least three reasons for that. The first is that the Washington consensus, the guiding principle of the reform in Korea, focused largely, if not entirely, on establishing "correct" macroeconomic policies and removing government intervention from the market. The second reason is that by the time the reform began in the early 1980s the *chaebol* had become a powerful political force that was able to influence the formulation and implementation of specific reform agenda to protect their own parochial interests. The third reason is that although changing macroeconomic policies is a politically challenging task as it inevitably impacts adversely some powerful interest groups in society it is not as difficult as disbanding or downsizing the *chaebol* and changing corporate governance and labor-management relations. The latter requires changing formal institutions such as constitutions, laws, and property rights as well as informal institutions such as sanctions, taboos, customs, traditions, and codes of conduct, which govern the way that individuals in society interact with each other. These are local-specific conditions that any attempt to reform the country's formal institutions must take into account, as they are slow to change and may not be compatible with newly introduced formal institutions.

One of the difficulties in changing institutions is that the durability of informal institutions constrains the type and speed of change that may be made in formal institutions because the newly introduced formal institutions will have to be compatible with informal institutions if they are to be effective. This is a conclusion that Lin and Nugent (1995, p.2362) reach, as in the following quote, after an extensive survey of the literature:

> [M]ere transplantations of successful institutions from DCs to LDCs [are], at best, unlikely to have the expected positive effects on performance, and, at worst, may have rather disastrous effects. Where to start and how to bring about the reforms in a country are questions that can be answered only with serious consideration of the country's existing institutional structure and human and physical endowments.

The point is that institutional reform is a path-dependent process with initial conditions—the existing formal as well as informal institutions—constraining the type of new formal institutions that can be introduced for immediate effect.[vi] Difficulties involved in reforming corporate governance in Korea are a case in point. In their study of corporate governance in Korea, Jo and Ryoo (2002) attribute the failure of corporate governance in Korea to "disparity between control and ownership, inadequate financial information, lack of credible exit threat, lack of financial institution monitoring, the exercise of few legal rights or types of protection for minority shareholders, and a limited role for directors." To establish good corporate governance Korean firms will obviously have to do away with these characteristics, but doing so may be difficult because it will require changing some of Korea's long-held informal institutions.

According to Cho (1994), in Korea the owner-head of a firm holds an authoritarian position comparable to that of the head of a typical Korean household. In such a firm the owner-head is expected to behave (and thinks he is behaving) like the head of a household; that is, with tolerance and generosity which are valued as supreme virtues of the head of a large family (You 1998, quoted in Emery 2001, p.59). As long as such persons remain the heads of enterprises and regard their employees as members of a large family it is hardly likely that any formal institutional reform designed to introduce the Anglo-American model of corporate governance in Korea would succeed in achieving its purported objectives. It would take changes in culture and social norms for that to bring about an effective change in corporate governance in the fashion of the Anglo-American model of corporate governance.[vii]

How informal institutions limit the effectiveness of newly introduced formal institutions is also demonstrated in the case of financial sector reform in Korea—the privatization of banks in the early 1980s. What actually took place is different from changes in law and official policy: the privatization of banks did not remove government intervention from their management. In spite of privatization the government continued appointing bank directors and officials, maintaining an "overly cozy" relationship with the banks (Emery 2001). This relationship between government and banks, which is obviously abnormal seen from the Anglo-American perspective, makes, however, perfect sense if it is understood that people in Korea believe in the idea of virtuous government as prescribed by Confucianism and expect the government staffed by educated mandarins to take an active role in promoting economic development (Cho 1994).[viii] It was such an attitude toward government that gave legitimacy to the extra-legal influence that the government exercised over the banks that had been legally privatized.

In sum, the political and economic crisis of 1979-80 brought about a significant change in political regime, the ruling paradigm in political economy, and the personnel for managing the economy. This did not mean, however, that there was a wholesale transition from a state-led political economy, where economic policy decisions were made by “state elites (leaders of the military, senior civilian bureaucrats, top policy specialists) in close collaboration with the top business leaders,” to a liberal market order. It was only the beginning of a new political economy where policy-making became subject to the pressures from big business firms that were becoming increasingly independent of the state as well as the pressures from the entrenched power of the bureaucracy and the previously excluded forces and short-term electoral considerations (Kong 2000, p 130-1; Moon 1994).

The new paradigm, by prescribing in principle state intervention in the market at most to "functional" intervention,[ix] led to the reduction of the power of the state relative to society and thus promoted the emergence of obstacles to implementing its own policy agenda. That is, with the new paradigm in place that constrained the power of the state it became easier for vested interests to become organized and actively pursue their parochial interests at the expense of the developmental objectives of the state. Such interest groups, becoming more active after the mid-1980s, were labor unions, consumer organizations, taxpayers, intellectuals, and the media. They began to make their voices heard in policy making, thus weakening the autonomy that the policy elites had enjoyed until then.

The voices of those interest groups had a significant effect on the actual course of the reforms undertaken in Korea. The policy elites, who were used to the practices of command and discretion but now began to be increasingly co-opted by interest groups, and the vested interests of domestic producers, who benefited from those practices, fought their rear-guard action against the forces of change, blocking or distorting the reform efforts in many sectors in the economy. The reforms actually implemented in Korea in the 1980s and 1990s were, consequently, an outcome of "conflict and contradiction between these traditional and new forces" (Seong Min Yoo 2001, p.370).

Of course, interest politics itself does not necessarily lead to the failure in economic reform if the country has a political system that can effectively mediate the claims of competing interest groups for reasonable comprise solutions. When Korea was "democratized" in the mid-1980s it was far from having such a system in place. It lacked strong democratic institutions such as a firmly established system of legislative bargaining necessary for disputing parties to negotiate (Mo 2001). Even in the areas where formal democratic institutions existed they were not very effective as they were not compatible with the country's traditional political culture. For example, in the National Assembly informal rules such as constraints on majority rule often took precedence over formal rules; people were lukewarm in supporting democracy in action although they expressed their support for it in principle; and they lacked the fundamental democratic values and attitudes such as pragmatism, trust and tolerance, and the belief in equality and rights (Mo 2001).

3.2. Partial Reform

There are two sectors in the Korean economy where substantial but still partial reforms were undertaken through the 1980s and 1990s, which we argue laid the foundation for the crisis of 1997-98. These are the reforms in the financial sector and industrial relations. In both cases reforms were undertaken as a matter of removing state intervention from markets: financial markets were deregulated without first establishing appropriate institutions for efficient and stable operation and state intervention was removed from labor markets without establishing institutions that are necessary for harmonious industrial relations between labor and management. This section discusses in some detail the reforms in these two sectors and how they laid the foundation for the economic crisis of 1997-98.

3.2.1. Financial Reform[x]

The fact that the policymakers in Korea accepted the principle of financial liberalization, even if they understood it correctly,[xi] does not mean that they were successful in carrying out the reform in strict accordance with the principle. Powerful interest groups influenced the way that financial reform was carried out.

In the early 1990s, the government deregulated the entry and business scope of financial institutions in order to promote competition in financial markets and increase market efficiency. As a result, a number of merchant banks were created but many of them were formerly investment finance companies owned and controlled by *chaebol*, which remained as the owners of those merchant banks.

Another important deregulation in domestic financial markets was a significant loosening of restrictions on *chaebol* ownership of other nonblank financial institutions (NBFIs) such as life insurance companies and investment trust companies. Before deregulation, the top 15 *chaebol* were not allowed to own and control life insurance companies while the next top 15 *chaebol* were allowed to have only up to a 50 percent ownership of life insurance companies. But, in May 1996, many of these restrictions were relaxed allowing most of *chaebol* to own and control life insurance companies as well as investment trust companies.

In the 1980s the government was not successful in deregulating interest rates because the *chaebol* were opposed to it in fear of a heavier interest burden that higher market-determined interest rates would impose on them (Choi 1993). In the 1990s, however, much progress was made in interest-rate deregulation because the *chaebol* saw an advantage in having free NBFIs and thus freer access to credit. Thus, in 1993 restrictions were lifted on all lending interest rates (except for policy loans) as well as many deposit interest rates, including long-term savings, corporate bonds, certificate of deposits, and checking account. The actual implementation of this deregulation policy took, however, a bizarre course.

As originally planned, long-term interest rates were to be deregulated before short-term interest rates. In the event, however, short-term interest rates such as the rates on the certificates of deposits and commercial papers of NBFIs were deregulated first in a speedy manner while the time deposit rates of commercial banks remained under *de facto* government control. Likewise, all restrictions were removed from interest rates on NBFIs' commercial papers and the amount that they could issue while restrictions remained on the interest rates on commercial bank loans and corporate bonds.

A consequence of this "short term commodities first, long term commodities later" deregulation was a rapid increase of the share of commercial papers in firms' external financing from 7.6 percent in 1992 to 16.1 percent in 1995 (Cho 1999). High-yield commercial papers and other short-term instruments became an important segment of the financial market with NBFIs becoming a major player. The market also became a dualistic structure consisting of tightly controlled commercial banks lending at low controlled interest rates and rapidly growing and relatively free NBFIs headed by merchant banks, many of which were owned by *chaebol*, lending at higher market-determined interest rates.

There was a confluence of three forces that made the post-1993 financial opening of Korea one of the most rapid and comprehensive ones in the developing world. First, since there was a ceiling on the aggregate amount of bank credit that the 30 largest *chaebol* could get they looked for alternative sources of finance. They turned to NBFIs for additional financing but they also sought financing from offshore banking and began pressuring the government to liberalize international financial transactions.

Second, the external pressure to open the financial markets increased starting in the mid-1980s. Korea decided to open the markets to foreign competition in the early 1980s, but its implementation was very slow until the mid-1980s when Korea experienced its first current account surplus ever and capital-market opening became a serious trade issue between Korea and the United States. The pressure to open the markets increased greatly in 1989 when the U.S. Treasury made it a policy goal to open the Korean financial markets and improve the treatment of U.S. financial institutions in Korea (Frankel 1992).

Third, the Korean government had its own reason for pushing for financial market opening, as it was keenly interested in joining the OECD and capital-account opening was a condition required for Korea’s membership in the OECD.

The measures taken to open the capital account included removing regulations on the issuance of foreign currency-denominated bonds by domestic firms and financial institutions, export-related foreign borrowing and general commercial borrowing, and abolishing the annual ceiling on foreign currency loans by financial institutions. These measures did not, however, apply equally to both long-term and short-term transactions: short-term transactions were fully deregulated while long-term transactions were either partially deregulated or not at all.

What accounts for the unbalanced financial opening in Korea? Although the Korean government was fully committed to the principle of financial liberalization it nonetheless regarded it necessary to use the commercial banks as a vehicle for achieving policy objectives such as promoting small and medium-sized enterprises and establishing strategic industries.[xii] The pressure for financial liberalization was increasing, however, from both the *chaebol* that saw the advantage of having easy access to the global capital market through their NBFIs and foreign financial interests that saw profitable opportunities in investing in the then booming Korean economy. Under such unyielding pressures the government undertook financial reform, giving in where the pressure was strong and holding back where it was not (Cho 2003). Given that NBFIs' activities were mainly in short-term transactions whereas those of the commercial banks were in longer-term maturities, the unbalanced financial opening was an inevitable outcome of the interest politics playing on financial reform.

While financial liberalization—both external and internal—gave more freedom to *chaebol* in their search for financing, the government's ability to control them and curb their highly concentrated economic power was significantly reduced since 1993. For instance, in 1993 the credit-ceiling scheme—the last stick that the government had over *chaebol*—was modified, exempting from the ceiling the *chaebol*-affiliated companies that were in *chaebol's* chosen areas of specialization. Furthermore, the number of *chaebol* to which the ceiling applied was reduced from the top 50 to the top 30 in 1993 and was further reduced to the top 10 in 1996. Restrictions on the holdings of non-business related land and the debt structure were also abolished. The ceiling on the ownership of bank shares was also raised in 1994, allowing more shares to be purchased by *chaebol*, and in 1996 they were given more freedom with respect to the ownership of NBFIs. Although the government also made effort to introduce stricter rules regarding cross debt guarantees, cross shareholdings, insider trading, the role of the board of directors, and the rights of minority shareholders it failed to translate its effort into laws.

3.2.2. Labor Reform

A significant change in industrial relations took place in the mid-1980s with political liberalization in Korea that radically changed government policy toward labor movements. Until then the primary role of the government in industrial relations was that of maintaining industrial peace by taking rather repressive measures against labor movement. Even when and where unions were allowed they were not effective in representing the interests of workers as their continued existence depended on the favor of the government that could be readily withdrawn.

The mid-1980s marked a watershed in the short history of Korea's industrial relations when with political liberalization the government shifted its policy from labor-market repression to liberalization—a lifting of state repression on labor movement. Since then workers have gained greater freedom in organizing, collective bargaining, and industrial action (Yee 2003).

The immediate effect of labor market liberalization on the economy was nothing but disruptive. Between July 1987 and June 1989 the number of unionized establishments increased dramatically from 2,725 to 7,380 while the union membership rose from 1.05 million to 1.83 million. During the second half of 1987 there were 3,600 strikes with about 70 percent of manufacturing establishments with more than 1,000 workers involved in strike in 1987. The losses resulting from the strikes were estimated at 8.2 million man-days with a significant negative effect on labor productivity, international competitiveness of Korean manufacturing firms, and the nation's output (Park, Fun-koo 1991).

When the government changed its labor policy the country was ill prepared institutionally for creating workable industrial relations. None of the three parties involved in industrial relations—unions, management, and the government—had had any experience in bargaining and negotiation, and whatever laws there existed were inadequate to bring about reasonable compromises in labor-management disputes. For instance, the existing laws did not specify what was to be bargained over between labor and management and how labor agreements were to be ratified. As a result, there were strikes over issues that are typically not negotiable in most industrialized countries and there was also a higher rate of ratification failures. The lack of bargaining experience and the knowledge of bargaining principles compounded the labor dispute problem (Kim, Dae Il and Lee, Ju-Ho, 2001).

In addition to the increasing number of strikes there were also qualitative changes in industrial relations—the strengthening of the core-workers unions in *chaebol* companies in heavy and chemical industries, the growth of white-collar worker unions, increasing solidarity among regional and industrial unions, and the unionization of public sector workers (Yee 2003). These changes had the effect of increasing labor market rigidity when Korean firms, especially the *chaebol*, were becoming increasingly subject to competitive pressures from the globalization of the Korean economy. This, combined with rising labor costs and the labor market rigidity, led to the declining profitability for the *chaebol* from the late 1980s on, laying a foundation for the economic crisis of 1997-98 (Kim and Lee 2002).

The first major labor market reform in Korea began in 1996 with the official aim of upgrading labor laws to the international standards, a condition that was required for Korea's entry into the OECD. Business leaders, however, saw the top priority of reform as that of increasing labor market flexibility while trade unions saw it as an opportunity to expand labor rights such as a right to free association and organization, collective bargaining, and political representation of their interests (Yee 2003). The state was thus confronted with two conflicting forces—democratization of industrial relations by expanding labor rights on the one hand and demands by business for increasing labor market flexibility on the other. In the end the Korean National Assembly passed a law favoring the interests of business, which was soon followed by a general strike, the first ever in Korean history. The government was forced to repeal the law and revise it to make it more pro-labor, but the revised version satisfied neither business nor labor. A more profound change in labor laws had to wait until the outbreak of the economic crisis in late 1997.

4. Post-Crisis Reforms: Description and Analysis

There is no question at all that the economic crisis of 1997-98 provided the impetus necessary for the Korean government to carry out reforms. It has undertaken a number of measures to achieve macroeconomic stability, introduce transparency and accountability in corporate governance, liberalize further the trade and capital accounts, and reform the financial sector. To improve corporate governance, for instance, measures were introduced to place outside directors on the board, strengthen the position of minority shareholders, require *chaebol* affiliates to combine their financial statements and stop cross-credit guarantees between affiliates (Jung 2002). Although the restructuring was done under pressure from the IMF and caused a severe economic hardship and popular resentment, the reforms thus carried out were not radically different from the policy stance that the country had pursued in the preceding two decades (Jwa 2001, ch.9; Kong 2000, ch.6). What the crisis did was to bring to culmination the reform process that began in the early 1980s with the aim of establishing a liberal market economy.

4.1. Financial Reform

The crisis put most of the financial institutions in a desperate situation and led to a reduction in the number of banks from 33 to 23 by the end of 1999. It forced the government to revise the Bank of Korea Act to provide for central bank independence with price stability as its main mandate (Lee, Jang-Yung 2003). It also forced the government to establish the Financial Supervisory Commission (FSC) as an independent consolidated supervisory authority for banks, security houses and insurance companies and two state-owned corporations, the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC), to clean up the non-performing loans and strengthen the capital base of banks. The funds spent by those corporations reached about $128 billion (at the exchange rate of 1200 Korean Won to one U.S. dollar), 29 percent of Korea's GDP in 2000, as of September 2001 (Crotty and Lee 2001). Although this injection of public funds into the banking system resulted in *de facto* nationalization of the banking system, that did not mean that the Korean financial system had reverted to the system established by the military government in 1961. It was only an exigent measure with no far-reaching consequence on the fundamental course that Korea had charted out for its political economy in the early 1980s—the establishment of a market-based financial system and a freer market economy.

The bills necessary for these reforms passed through the National Assembly in December 1997 with the help of the president-elect, Kim Dae-jung. These were the bills prepared by the Kim Young-sam government before the crisis but were sitting idle in the National Assembly since mid-November. What the crisis did was to "clear away any rationale there was to stop reform at a half way" and provide the president-elect a political leverage to help legislate the ready-made financial sector reform bills (Byung-Koo Kim 2003).

4.2. Corporate Restructuring

The crisis also prompted the government to carry out corporate restructuring with the objectives of restoring the health and competitiveness of the corporate sector. Its strategy consisted of promoting competition and improving corporate governance, capital structure, and profitability (Chopra *et al*. 2002, Keun Lee 2002 and 2003). To promote greater competition the government liberalized capital markets and the foreign investment regime to allow Korean companies direct access to foreign capital and promote competition at home. To improve corporate governance the government introduced measures to make the corporate balance sheet more transparent, improve the accounting standards in line with international best practices, and require independent external audits, full disclosure, and the provision of consolidated statements for business conglomerates. And to improve capital structure and profitability, the government pushed corporations to reduce their debt levels, increase their equity investment, and eliminate cross-subsidization of weaker affiliates.

Recognizing the linkage between the health of the financial sector and the profitability of the corporate sector, the Korean government pursued reforms in both sectors simultaneously. But, as it turned out, it has been more successful in carrying out reforms in the financial sector than in the corporate sector. The relatively slow pace of corporate restructuring is partly due to the rapid recovery from the crisis, which has led to a sense of complacency and a weakened political support for tough reform measures within Korea. More important, however, is the presence of certain institutional features in Korea such as weak accounting and disclosure standards, poor risk management by both corporate borrowers and banks, and an inadequate legal and judiciary framework governing insolvency procedures, which have contributed to the slow pace of corporate restructuring.

Weak accounting practices have led to a loss of credibility in company reports, which consequently has lost its usefulness as a reliable indicator of the health of the corporate sector. The practice of collateral-based lending and poor disclosure of cross-payment and cross-guarantees among affiliates of *chaebol* also made it difficult for the creditor banks to accurately assess the size of non-performing loans.

Lacking risk management skills the banks found it difficult and time-consuming to restructure troubled companies. Although they had had some experience in restructuring such companies they had never had to handle so many of them all at the same time as in the aftermath of the crisis. They just did not have the necessary expertise and experience. Another factor that made the pace of corporate restructuring relatively slow was that Korea did not have bankruptcy laws geared for expeditiously resolving deeply distressed firms. There were certainly a few large cases in the early part of the crisis in which bankruptcy procedures resulted in court-supervised reorganization or liquidation, but in a majority of cases the weak companies were left to operate under the court's protection.

In spite of all these Korea has managed to carry out some major corporate restructuring. Sixteen of the 30 top conglomerates have been dissolved and the average debt-to-equity ratios of listed companies have been significantly reduced from 337 percent in 1997 to 126 percent in December 2001. Transparency and corporate governance have also been improved with accounting and auditing standards being brought close to international best practices. In some less-distressed conglomerates, corporate divestitures and operational restructuring have taken place voluntarily.

Underlying the government's effort to reform the economic system is the idea that the strong market discipline and not the government's intervention should lead the restructuring process. Thus efforts are made to establish the institutions that empower creditors and shareholders to monitor corporate governance, identifying and weeding out nonviable players. A more rigorous bank accounting standard has been introduced, an M&A market is promoted, and the Corporate Restructuring Promotion Act has been enacted to facilitate coordination among creditor institutions in corporate debt restructuring processes.

Questions have been raised, however, regarding the government's approach to reform that basically has tried to impose the so-called global standards in corporate governance. Jwa (2003) doubts whether the global standards, which are in fact the Anglo-

American standards, will work effectively in Korea, a country that differs from the West in history, culture, and institutions.[xiii] The speed and extent of market-based corporate reform depend on whether the country has in place the supporting market infrastructure (Chopra *et al*. 2002), and such infrastructure, we should note, includes many of the country's informal institutions such as culture.

In his assessment of the outcome of the efforts to reform the corporate sector Keun Lee (2003) concludes that Korea has succeeded in bringing about changes in the areas where targets for reform can readily be quantified as in outside directors in the board and the debt ratio but has yet to see improvements in the actual workings of the board of directors and corporate governance in general. These relate to person-to-person relations where informal institutions such as culture and the "habits and mindsets" of the actors play an important role.

4.3. Labor Market Reform

The main objective of the post-crisis labor market reform was to enhance labor market flexibility, which was *sine qua non* for carrying out the IMF-mandated restructuring. To achieve this objective the government tried to legalize redundancy layoffs and the use of temporary workers. Thus one of the first things undertaken by the president-elect Kim Dae-jung in January 1998 was to form a Tripartite Commission composed of representatives from government, business and labor. On February 6, 1998 the Commission produced a Tripartite Accord that agreed on layoffs and the conditions thereof. Although there were strong protests and opposition by labor, the National Assembly approved, on February 13, a bill for new labor laws based on the Accord, which allowed redundancy layoffs in the cases of mergers, acquisitions, corporate restructuring, and a bankruptcy. The laws, however, also required the firms to “exhaust all means to avoid it” and to consult “sincerely” with union leaders on matters of how many and whom to layoff. Obviously such conditions are always subject to dispute and thus impose a heavy cost on firms undertaking restructuring. The new labor laws also made substantially easier the use of irregular or temporary workers and the hiring of substitute workers during strikes. (Kim, Dae Il and Lee, Ju-Ho, 2001, Kim, Dae Il 2002).

Whether these legal reforms in industrial relations will bring about flexible labor markets in Korea remains to be seen. What they seem to have done so far is to create a dual-structure labor market—regular workers in large firms who, represented by the Korean Confederation of Trade Unions (KCTU), are relatively well paid and have job security and temporary irregular workers who are less well paid and have no job security. As a matter of fact, one of the consequences of the labor market reform is an increase in the second group of workers. This increase is most noticeable among female workers: their share of irregular employment increased from 58 percent in 1995 to 64 percent in 1998 and to 70 percent in 2000 (Koo 2002). It is thus no exaggeration to say that the labor market reform has somewhat improved labor market flexibility at the expense of temporary irregular workers, especially female workers, and youth employment.

Improving labor market flexibility where social protection for workers and the unemployed is lacking is a difficult task for any society. It is a daunting task especially for Korea, which has yet to develop a viable social compact between labor and management. According to Koo (2002), there are a number of obstacles to developing such a compact in Korea.

The first obstacle is labor's distrust of both the government and management largely because of its past experience of being repressed by the authoritarian government. On one side are many labor leaders who take a militant and aggressive position in industrial disputes in the belief, perhaps rightly so given the legacy of past repression, that only such a stance can prevent the management from having workers bear all the burdens of corporate restructuring. On the other side is the management that regards unions as being excessively powerful and irresponsible and believe that the government has become too soft toward the organized labor. The second obstacle, which is related to the first, is the lack of transparency in corporate finance and the exclusion of labor from management, which are obstacles to building trust in labor-management relations and to encouraging a more measured approach by unions.

Third, the current union structure, which is based on enterprise unions and not industry-wide unions, is too decentralized to provide an adequate institutional base for corporatist policy concentration. The fourth obstacle, which is related to the third, is that workers lack political representation since Korea has yet to develop political parties that can represent their interests in the political arena. Finally, the media in Korea is biased against and unfriendly to labor or, at least, perceived to be so by labor. Such a perception has led to labor's mistrust toward capital.

The current state of industrial relations in Korea is clearly a classic case of the Prisoners' Dilemma in which each party pursuing its own self-interest and not trusting the other party results in a sub-optimal outcome for both parties and for the nation. To get out of this state, workers and management will have to build trust and learn to cooperate with each other. Legal reforms in the labor market, however important they may be, are only one small step toward developing new industrial relations in Korea.

5. Concluding Remarks

Reforming institutions in Korea has been a long drawn-out process involving, first, a change in the politico-economic paradigm and then an ever-present struggle among competing interest groups. The post-crisis reforms are the culmination of this reform process that started in the early1980s when a shift in paradigm took place. In the course of the process, powerful interest groups tried to and did in fact influence the outcome of reforms for the benefit of their own parochial interests although there appears to have been no dispute over the end state of that process—the establishment of a "liberal economic order" (Choi 1987). The economic crisis of 1997-98 was a consequence of the failure to make a full transition from a state-led developmentalist economy to a functioning free-market economy.[xiv] The crisis, however, redoubled the nation's commitment to that goal when President Kim Dae-jung pronounced the post-crisis reforms as an instrument to "put an end to the previous system of governmental control and to guarantee the greatest possible degree of autonomy for the management of financial institutions" (Kim 1999, p.50). As he saw it, Korea's future lay in the establishment of a genuine and open market economy and there was no going back to the state-led growth model of the earlier years whatever its merits might have been then. Even those who criticize the post-crisis reforms as a failure say that the reason for the failure is a premature dismantling of the state-led growth model and not the final goal of the reforms, which is to establish a freer market economy (Crotty and Lee 2001).

Korea has now fully recovered from the crisis of 1997-98 and its economy has grown rapidly since 1999. The short-term prospects for the Korean economy look promising but there still remains the question of whether the specific reforms undertaken to establish a liberal economic order will turn out to have been the right choice for Korea in the long run. The fact that new institutions have been established and old institutions have been modified does not necessarily mean that they will be effective and efficient. As noted earlier, formal institutions imported from abroad may not function effectively or, worse, may even be a source of social conflict, if they are not compatible with the country's indigenous institutions. If the reforms are to succeed in bringing about sustained economic growth in Korea, imported institutions will have to be modified to suit the local-specific conditions and/or changes may have to be made in those conditions including many of the country's informal institutions. Establishing effective new institutions, whether by modifying imported institutions or by altering indigenous institutions to adapt to the imported institutions, is a slow evolutionary process with no ready made blueprint to follow (North 1990).

As Jwa (2003) pointed out, what is effective and efficient in Korea may emerge through market competition when the government does not impose uniform rules. There is, however, a limit to this process as creating new institutions is a public good and thus cannot be relied solely on market forces. Clearly, market forces are needed to sort out effective and efficient institutions from those that are not, but it is the state that determines the outcome of market competition by setting up the framework within which market forces can operate (Toye 1995). A challenging issue for institutional reform is that of finding the framework that will help a country achieve sustainable economic growth and the ways to set it up, as there is no one-size-fits all framework for all societies. For whatever the reasons, some societies create new institutions when faced with new economic opportunities and constraints imposed by economic and political forces and prosper (Platteau 2000). Whether Korea will turn out to be one of such societies remains to be seen.

Endnotes

[i] Policy elites are political and bureaucratic officials who hold decision-making responsibilities in government (Grindle and Thomas 1991, p. 195).

[ii] As the rest of the paper will make it clear, institutional reforms during the first and the third periods are best explained in terms of "state-centered models" of institutional change while those during the second period in terms of society-centered models" (Grindle and Thomas 1991).

[iii] For a detailed discussion of policy reform during this period, see Haggard, Cooper and Moon (1993).

[iv] According to Cho (1994, p.29), the Japan that President Park Chung Hee took as a model for economic development was the Meiji Japan of the late 19th century. For example, Park followed the Meiji slogan for promoting a strong economy and a strong military, encouraging the rapid development of big corporations as a means for achieving a strong economy.

[v] Williamson and Haggard (1994) point out that during the 1980s there occurred a profound change in the intellectual climate in the West toward what is now commonly called neoliberalism and it had a powerful influence in policy reform in many developing countries.

[vi] G. Roland (2004) also points out that "slow-moving" institutions such as culture constrain the transplantation of "fast-moving institutions" such as laws and regulations.

[vii] Although some of these features are consequences of inappropriate formal institutions and need to be changed to improve corporate governance, it is not at all clear that Korea needs to change its corporate governance system in a wholesale manner. If Singh (2002) is correct in saying that "best practice" is not necessarily the "Anglo-Saxon" model of corporate governance and the effectiveness of a corporate governance system is dependent on the national context in which it operates, one must wonder whether there is corporate governance uniquely suited to Korea.

[viii] This point is echoed in Lin and Ho (1995, 350) who find Confucianism placing emphasis on goodwill over the legal environment.

[ix] Government intervention was focused on three "functional" areas—restructuring of distressed industries, support for the development of technology, and promotion of competition (World Bank, *Korea: Managing the Industrial Transition*, Vol.1, 1987)

[x] This section draws on Lee, Lee, and Lee (2002).

[xi] On the possibility that policymakers saw financial liberalization simply as a matter of deregulation and how such liberalization implemented in some of the countries in Asia was a causal factor for the Asian crisis of 1997-98, see Lee (2003).

[xii] The Ministry of Finance and Economy supervised long-term foreign capital transactions while the Bank of Korea had jurisdiction over short-term foreign capital inflows, and the latter was reportedly a greater predilection toward financial liberalization than the former.

[xiii] Even within the Anglo-American system there is no uniformity in corporate governance. Recently some of the big Canadian banks decided to split the jobs of chairman and chief executives, parting company with their U.S. counterparts that keep the two positions in a single person ("Big Canadian banks split top jobs, unlike U.S. cousins," *International Herald Tribune*, Saturday-Sunday, September 6-7, 2003, p.10).

[xiv] We are not saying that the 1997-98 financial crisis was caused by this failure alone. It also had to do with the so-called contagion effect but more fundamentally with deregulation of the financial system that had yet to develop appropriate supervisory and other legal institutions. For a detailed study on the absence of appropriate institutions as a cause of the Asian financial crisis, see Lee (2003).

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