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THE 1997 FINANCIAL CRISIS AND GOVERNANCE:
THE CASE OF SOUTH KOREA

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Working Paper #272 – March 2000

ABSTRACT

The paper examines from a recent historical perspective the changing roles of the state in governing and regulating South Korea's market economy. After surveying the scope and nature of statism in the earlier periods of industrialization, the analysis turns to the causes and consequences of the current economic crisis. The paper then explores the broad socioeconomic implications of economic governance for reform along with the prospects of the economy, focusing on the future challenges facing the Korean polity in the new global economy.

RESUMEN

Este artículo examina, desde la perspectiva de la historia reciente, los roles cambiantes del estado en el gobierno y la regulación de la economía de mercado de Corea del Sur. Luego de relavar el alcanze y la naturaleza del estatismo en los primeros tiempos de la industrialización, el análisis se orienta hacia las causas y las consecuencias de la actual crisis económica. El artículo luego explora las amplias implicancias socioeconómicas del gobierno económico para la reforma, junto con las perspectivas de la economía, concéntrandose en los desafíos futuros que enfrenta Corea en la nueva economía global.

1. Introduction

The financial crisis that erupted in Thailand in mid-1997 led in no time to sharp declines in the values of currencies, stocks, and other assets in a number of Asian countries, including South Korea (hereafter referred to as Korea), disrupting these countries' financial systems and real economies. For Korea, large contractions in economic activity have been accompanied by soaring numbers of unemployed and homeless. The current crisis unfolded against the backdrop of the miraculous performance that had registered an outstanding average annual GDP growth of 8.0% over the preceding three decades. While Korea's success has in the past been acclaimed as a model of the 'developmental state', neoliberal economists today see the current crisis as reflecting the legacy of state governance. It is now argued that in the context of the contemporary global economy, the state should do less where markets work and focus only on improving the climate for enterprise and competition, opening the economy to global markets.

Defining governance in a broad sense of the structure and exercise of political authority to manage the affairs of a nation, this paper surveys Korean experience in governance and its link to economic development and takes a close look at its governance during the latest economic crisis. In the next section the evolution of the changing role of the state is reviewed from a recent historical perspective. The causes of the current crisis are analyzed in Section 3. Economic governance under IMF stewardship (Section 4) is then compared with that of the subsequent Korean state (Section 5). The analysis looks into the role of Korea's new democracy in promoting and supporting market reforms, taking into account state-business relations as the key element in effecting systematic changes. Section 6 examines elements of policy change as future challenges in governance for Korea and other emerging nations. This section argues that many of the neoliberal reforms may be necessary but are far from sufficient for economic success and some are even harmful. The concluding Section 7 highlights a few important lessons to be drawn from the Korean experience.

2. State Governance and Development: The Path Leading to the Crisis

Korea up to well into the 1960s represented a truly backward economy based on subsistence agriculture. Its per capita income in 1961 was $82 (in 1960 prices), which was then below those of Haiti, Ethiopia, Peru, Honduras, and Yemen and about 40% below India's. In the immediate post-Korean War period the country was an economic basket case. It relied on foreign aid for sheer survival. Undisciplined capitalism during this period did very little for development.

Beginning with the military coup in 1961, the country's economy began to make a dramatic turnaround. In two decades the country's real per capita income more than tripled, placing Korea in the top third of all middle-income countries. By 1996 Korea with its 42 million population and per capita income of over US $10,000 emerged as the world's eleventh largest trading nation. In 1992 a civilian president was elected for the first time after three decades of authoritarian regimes. Externally, Korea began to play active roles in global affairs by joining the World Trade Organization (WTO) and the Organization of Economic Cooperation and Development (OECD).

Behind this transition to a modern economy has been an evolution in the complex and subtle ways that the economy was managed by the state. Guided by the belief that a well-managed, state-led economy would function better than one based on unfettered market forces, the state begun to take an active role in development in the early stage of industrialization. Korea had what Myrdal referred to as a 'hard state' whose interventions focused on the development of the areas of the economy perceived to have longer-term potentials. Korea's authoritarian state pursued pragmatic approaches to industrialization, accommodating to market forces only when it was perceived that they would work. The market system did not serve as an organizing principle of the economy but as an instrument in attaining the national goal of industrial transformation. That Korea's rapid industrialization owed much to the developmental-state role played by the government has been extensively documented (Amsden 1989; Chang 1993; Wade 1995; Kim, K.S., 1995 and 1997). Over the longer term, nonetheless, the developmental-state strategy paved the way to structural imbalances and distortions and, eventually, to the financial turmoil in 1997.

The centerpiece of the strategy was industrialization via export promotion. An extensive system of industrial targeting was introduced in which a set of promising industries for export was chosen for government support. The most important means of supporting the targeted firms was the allocation of financial resources by the state. While high-leveraged financing for targeted firms relied heavily on state-guaranteed external borrowing, the domestic banks were restricted in credit decisions by government regulations and were required to hold large amounts of monetary stabilization bonds which paid below-market rates. This practically inhibited the development and growth of interbank money markets and established a centralized banking system.

As all the support and incentives were to be given to those firms in the targeted sectors, the large conglomerates in Korea, known as the *chaebols*, received the lion's share in subsidized loans. Large-scale enterprises can capitalize on scale economies in production and were in a better position to outbid smaller firms in government-financed projects. This practice of 'policy loans' not only led to a rapid rise in industrial concentration but also rendered Korea's corporate sector and the economy vulnerable to external shocks, financially unstable, and fragile.

As bankers complied with government guidance in credit allocation, they placed a trust in the state's unspoken guarantee of bank loans. They became lax in examining loan applications, particularly from large conglomerates, and extended loans indiscriminately for profitable but risky ventures. While bankers did not take very seriously the risk factor in lending, the centralized economic systems in Korea created clientelistic relations between the state and the corporate sector—a kind of crony capitalism. The *chaebols* cultivated a symbiotic relationship with the government, which could help them out if something went wrong with investment. The Korean state's intervention in the financial sector ended up in the problem of moral hazard (Radet and Sachs 1998). The results were over-borrowing by the *chaebols*, putting them in an unstable debt-equity position, and a rise in external debt for the economy. By the late 1970s it was not uncommon to find the *chaebols* having liabilities five to ten times as high as their own net worth. Burdened with excessive interest payments in relation to their equity, they became increasingly vulnerable to changes in economic conditions and external shocks. Their operations were rendered precarious, particularly in bad times when the economy was in downturn as was the case in the early 1980s. By the end of 1996 the average debt-equity ratio of the top 30 *chaebols* reached 400%, which was twice the international banking norm of 200%. When Korea joined the OECD in 1996, it further encouraged capital inflows by opening its financial market. The domestic banks, mostly merchant banks, heavily imported foreign capital, mostly of short-term maturity. The cumulative external debt rose from $42 billion in 1992 to $157 billion in November 1997, the eve of the crisis. Significantly, almost 90% of the debt originated from the private sources of merchant and commercial banks.

The debt issues aside, it is worth noting further that the industrial targeting policy of the past three decades has led to serious structural imbalances and distortions in the Korean economy. The past targeting approach specified only what sectors of the economy should be promoted for expansion. Loans tended to be approved on the basis of superficial compliance with the administrative guidelines and not on merits of individual projects. Many worthwhile projects failed to win acceptance. These weaknesses were manifest as early as the late 1970s when a number of government-supported projects had to be discarded. Too many production units were crowded into a few sectors, resulting in overcapacity of these industries. On the other hand, the borrowed money was all too often lavishly invested in speculative real estate markets and other unproductive nontradable activities. Korea's developmental state also rewarded successful exporters by basing support on the quantitative results of their exports. This policy not only resulted in an economy-wide inefficiency in resource allocation but also created structural imbalance biased against the development of domestic goods industries. Moreover, such a support system favored production of assembly-type exports that relies heavily on foreign raw materials. This led to the need for more imports through exports with the consequent chronic pressures on trade balance.

In summary, Korea's past strategy for growth maximization led to serious structural distortions and imbalances, as reflected by the syndromes of business concentration, stagnant productivity, fragile corporate financial structure, corporate bankruptcies, and tenuous interindustry linkage. The Korean state's failure to reform flawed industrial and financial systems in preparation for global economic integration turned out to be the major structural cause of the current crisis.

3. The Origin and Nature of the Crisis

Korea entered the current crisis under a reasonably healthy macroeconomy with a balanced budget, high savings, and a low inflation rate. Few scholars expected that the financial turmoil erupted in Thailand would so quickly spread to a country like Korea, whose economy until the eve of the financial meltdown in November of 1997 had been perceived by international creditors to be "fundamentally sound," in the words of then IMF Managing Director, Michel Camdessus.[1] Beneath the seemingly placid surface, however, the Korean crisis had been brewing for some time: The country's external balance began to deteriorate beginning in late 1996. By mid-1997 Korea had a serious problem with its

[1] Indeed, up to well into 1996 Korea's trade deficits as shown in official statistics had also been below the manageable level of 5% of GDP, which did not seem to have posed much concern to policymakers.

external debt which, as already noted, rose rapidly as a result of cumulative trade deficits. The total external debt right before the Korean government's request for the IMF bailout was more than five times the country's usable foreign exchange reserves, which had shrunk to $30 billion. Moreover, the financial structures of the Korean corporate sector were over-leveraged by relatively short-term debts.

With the breakout of the ASEAN turmoil that erupted in the summer of 1997, it was simply a matter of time before investors would lose confidence in the Korean financial market and began withdrawing investment funds from Korea. The country found itself unable to defend the value of the Korean *won* at the time of capital flight. It could not secure new funds from international markets. Nor could it have maturing loans rolled over. Foreign capital continued to pull out. Domestic stock prices plunged and the exchange rate soared. Concerned about the continued depreciation of the *won,* foreign as well as domestic investors panicked and fled the stock market, creating a vicious circle of plummeting stock prices pushing the value of the *won* down further. The nation plunged into a full-blown financial crisis involving real-sector adjustments. What started as a liquidity problem has soon turned into a triple crisis—balance of-payments, financial, and corporate governance crises.

In retrospect, the main causes of the crisis can be attributed to deep structural factors both internal and external in origin. Chief among them is the legacy of structural distortions and weakness inherited from past industrial policy. More direct external causes can be found in the unfavorable international developments after the mid-1990s when the country's trade health was severely eroded. More significantly, the poor governance of the economy under Yong-Sam Kim's civilian regime is another contributing factor.

As for the structural causes, unlike the debt crises elsewhere in the developing world the snowballing rise in Korea's external debt after the mid-1990s resulted from the microeconomic problems of low performance and profitability of domestic firms—especially of the *chaebols*. As already noted, at the root of the problem was the clientelistic state-business relationship inherited from the past industrial policy. Korean governments excessively relied on the *chaebols* for export success and the latter in turn had privileged access to government-subsidized credit. The *chaebols*, accustomed to rapid growth and under the belief that they were too big to fall, became overly ambitious in their investment decisions. External borrowing during the boom years of the early 1990s caused the short-term debt to reach almost $100 billion or about a third of GDP. Business clientelism was reinforced by Korea's deeply flawed financial systems that operated under the presumption of implicit bailout policy by the state. This expectation led to imprudent lending by bankers to meet *chaebols'* excess demand for credit. Imprudent lending continued despite the rise in banks' nonperforming assets as the asset market bubble introduced in the late 1980s began to bust in the 1990s with Korea's declining exports. As a result of Korea's highly centralized banking system there were frequent political interventions on behalf of the *chaebols.* Imprudent and undisciplined borrowing led to overinvestment in the sense that too many investments that turned out to be not very profitable were undertaken. As profit margins at the enterprise level became increasingly narrower, the business sector was rendered potentially more vulnerable to any unanticipated shock (Graham 1999).

This explosive situation was exacerbated by unfavorable external developments after the mid-1990s. Korea's export expansion slowed down from the annual growth rate of 33% in 1995 to 3% in 1996. This resulted in the drastic rise in Korea's current-account deficits and external debt, as indicated in Table 1. Among the factors contributing to Korea's growing trade deficits were the collapse of Korean export prices and the loss of competitiveness resulting from the Chinese *yuan* depreciation in 1994 and the subsequent *yen* depreciation against the US dollar to which the Korean *won* had been essentially pegged. While the nominal exchange rate of the *won* had remained stable until October of 1997, there is evidence to indicate that it actually appreciated substantially in real terms during the summer of 1997 when its regional trade competitors in southeast Asia (Thailand, Malaysia, the Philippines, and Indonesia) had large devaluations of their currencies vis-à-vis the US dollar (Corsine, Pesenti, and Roubini, 1998).

Table 1

Macroeconomic Indicators in Korea: 1994–8

	1994	1995	1996	1997	1998
Real GDP Growth Rate (%)	8.6	8.9	7.1	5.5	–5.8
Unemployment Rate (%)	2.4	2.0	2.0	2.0	7.0
Inflation Rate (%)	6.2	4.5	4.9	4.5	7.5
Current Account (US $ in billions)	–4.5	–8.9	–23.7	–8.2	–40.0
Capital Account (US $ in billions)	–	–	23.3	1.3	–4.0
Foreign Debt (US $ in billions)	89.0	120.0	164.0	158.0	154.0
Won/Dollar Exchange Rate	789.0	775.0	844.0	1,415.0	1,215.0

(Appreciation rate, %)	2.4	1.8	–8.2	–40.3	16.5
Yield Rate on Corporate Bond (%)	12.9	13.8	11.9	13.4	9.0

Source: Korean Development Institute.
Notes: Figures for foreign debt, exchange rate, and bond rates are for the end of the year.

The collapse of export prices, particularly in Korea's major export items of semiconductors, chemicals, shipbuilding and steel products, beginning in 1996 was particularly drastic in eroding Korea's trade balance. The decline in Korea's terms of trade started in 1994 and continued until the eve of the crisis in late 1997. Relative export prices fell as much as 30% over the period (Aiyer 1999). Declining external demand for Korean exports coincided with a depressed Japanese economy and a cyclical downturn in the Asian region, and was associated with an oversupply of manufactured goods exports in the regional and global market. The results for Korean industry were the syndromes of overinvestment, stockpiled inventory, and stagnant productivity associated with wage increases, which quickly dissipated the strong profit positions of Korean firms in the preceding years.

Weakened profitability exerted pressure on the stock and currency markets, simultaneously slowing investment growth. As political uncertainty ahead of the presidential election for 1997 prevailed, Korean industry's productive capacity was by then greatly underutilized, thereby raising costs when sales were already weakening. Consequently, many enterprises began to incur losses and encounter cash flow problems and difficulties in servicing the debts that had been accumulated during the boom years to finance large investments.

While the above external and internal factors in combination provided a fertile ground for the crisis to erupt, the directly contributing factor was poor governance of Yong-sam Kim's (hereafter Y.S. Kim) civilian state (1992–7), to which much hope and trust were given as a regime legitimate to undertake political and economic reforms for a market-oriented democracy. In hindsight, there were two aspects of policy failure: first, the premature decision to move toward financial liberalization by joining the OECD in 1996, and second, the lack of political will or the governance to undertake long overdue, necessary structural change.

First of all, the Y.S. Kim regime was complacent and unprepared to undertake the necessary structural changes and to properly address the problems of its pronounced boom-bust cycle occurring during the mid-1990s. Around this period there had already been a series of threats of bankruptcies by major corporations, which at the same time created huge bad loan problems for the financial sector. The lack of credit from the banking sector hammered stock and property markets. Big corporations such as Hanbo Steel and Kia Motors, once virtually guaranteed by the government, sought protection from creditors after banks were forced to cut them off. The government was indecisive and in some instances continued with bailout efforts, which caused nonperforming loans to surge even higher.[1]

Perhaps the most significant policy blunder was the decision for an abrupt financial liberalization in 1996 when Korea did not have a fully developed, market-disciplined financial system. Under the blessing of superb international credit rating, Korea quickly was inundated with unmonitored fresh credit. Many newly created financial institutions, called 'the merchant banks', procured foreign currency funds on a short-term basis which were used for long-term investments in Southeast Asian countries such as Thailand and Indonesia.[2] Claessens, Ghosh, and Scott state (1999, 83): "Following a long period of government control over the financial system, [Korea's] liberalization measures in the late 1980s and the 1990s were mostly half-baked and often not backed up by improvements in the supervisory and disclosure framework."

By borrowing directly from abroad or indirectly from domestic merchant banks that in return borrowed from abroad, the *chaebols* acquired more than $30 billion of foreign assets since 1996. The merchant banks, with little prior experience in the global capital market, quickly piled up foreign currency liabilities. By the end of November 1997 Korea's total external debt rose to US $157 billion, of which short-term liabilities accounted for about 40% of the total. The external liabilities of financial institutions, which consisted mostly of domestic merchant banks, reached US $112, accounting for the lion's share of more than 70% of the external debt. Unlike the case of Latin America's external debt, public sector liabilities were less important; they remained below 14% of the total debt throughout

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1 When such *chaebols* as Hanbo Steel, Jinro, Dianong, New Core Group, and KIA motors—which had been considered 'too big to fall'—went bankrupt as a result of low performance and consequent cash flow problems, this should have given plenty of signals to the government that something was going terribly wrong.

2 By the time of the region's currency crisis in mid-1997, stiff lending competition was reflected by extremely low margins in Southeast Asia, which were often 0.2 percentage point above funding costs—the difference of only one tenth of what they were in 1993 (Kim, Y.S., 1998, 521).

1997.[1] Many merchant banks had outstanding loans to *chaebols* that had either gone bankrupt or sought protection from creditors. In addition, they had sizable amounts of Russian Treasury bills, as well as Thai, Indonesian, and other ASEAN bonds, which became unredeemable or had to be resold at a huge discount.

At this juncture foreign banks started to curtail their lending to Korean banks. Their major creditors, Japanese banks that had their own problems, began to call in their loans from Korea. The merchant banks were forced to buy up dollars with the *won* reserves to pay their foreign-currency debts. This resulted in a drastic depreciation of the *won*. On 18 November 1997 when the Korean Congress failed to legislate the Bank Reform bill—a Korean version of the Big Bang—investor confidence in the market fell to rock bottom, precipitating a liquidity crunch for Korean banks.

These were the circumstantial factors that could have been mitigated by proper governance. Unlike their counterparts in Taiwan, Singapore, or China, Korean policymakers were complacent about the economy and ignorant of or oblivious to the potential consequences of inaction. The central government's monetary and bank supervisory authorities did not even seem to realize the magnitude of indebtedness incurred by the private sector.[2] For example, the competitive strength of Korea's export sector in the mid-1990s continued to erode with a large gap emerging between the real exchange rate and the total factor productivity for Korean exports. And yet the government did nothing to make adjustments. An overvalued exchange rate system continued.

In this context, there is also some evidence to suggest that the state's relations with business were so bad that the economy became practically ungovernable. The 'embedded bureaucracy', as Peter Evan (1998) described Korea's developmental state, no longer functioned in the regime in transition to democracy. Despite the economic downturn and declining profits at the enterprise level, the *chaebols* continued with their expansionist plans. The civilian government also began to lose control over labor movements although increases in labor costs began to exceed productivity gains, contributing to the decline in international competitiveness for Korean exports.

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[1] That Korean banks had high proportions of short-term debt in relation to gross external liabilities was attributable to the banking reporting system. The Korean government required borrowers to report any long-term loans being sought from overseas but exempted the reporting of short-term loans. Short-term loans were considered to be used mainly to fund trade activities and thus did not need to be monitored. Borrowers had an incentive to acquire short-term over long-term loans.

[2] There was also the problem of lack of transparency in corporate data. Big businesses in Korea are embedded in the web of cross-shareholdings and debt guarantees with their affiliates. Sorting out their transactions separately would be an accounting challenge.

In sum, the latest economic crisis did not so much result from macroeconomic imbalances[1] as from the weaknesses in Korea's corporate and financial systems and, to a greater extent, poor governance of the economy. The outbreak of the crisis in Southeast Asia served as the ignition that triggered a spark in the field of land mines waiting to be exploded. In retrospect, Korean policy makers' complacency and misguided management have much to do with the crisis in 1997. With properly cautious and preventive measures, the crisis could have been avoided or at least the impact could have been lessened.

4. IMF Governance

The Korean government, realizing that the nation was in serious financial crisis, agreed in December 1997 to a $58 billion bailout led by the International Monetary Fund (IMF). The IMF's bailout decision was based on the fear of possible default by Korea, which was the world's eleventh largest economy. The default of Korea would pose a grave threat to the international monetary system. The immediate purpose of the bailout was to provide a bridging finance to reduce current-account deficits, keeping inflation in check by restricting domestic demands. Specific adjustment measures called for austere fiscal and financial policies, introduction of a floating exchange rate system, complete liberalization of the capital market, and abolition of the import source diversification system. The agreement further stipulated macroeconomic targets for monetary, fiscal, and exchange rate policies.

The IMF adjustment package for Korea went well beyond its standard stabilization program. It added far-reaching institutional reforms across the board in an effort to make the entire system operate more like a Western model. These structural reform measures encompass the banking, corporate, trade, and labor sectors and are aimed at removing the features of the economy that have been seen as impediments to growth (such as monopolies, trade barriers, and nontransparent corporate practices) and at improving the efficiency of financial mediation and financial institutions.

Specific provisions for the financial sector reform include: establishment of an independent central bank with the primary function of controlling inflation; creation of a consolidated supervisory body with jurisdiction over all financial and corporate operations; requirements that firms report audited and consolidated financial statements; closing down or recapitalizing troubled financial institutions; elimination of government-initiated loans;

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1 A country's macroeconomic stability is conventionally measured by such indicators as government budget deficits, inflation rates, debt-GNP ratio, and current account deficits.

enhancement of transparency in banking transactions; and removal of all restrictions on foreign borrowings by domestic firms. As for corporate restructuring, the *chaebols* are required to focus on their own specialties and must be subject to stricter disclosure rules and financial market discipline. Ownership must be shared widely by the public and the *chaebols* must be accountable to shareholders. Although the structural adjustment program centers on corporate governance and restructuring of the banking sector, it also calls for labor market reforms. They are seen as an integral part to the problem of corporate governance. The adjustment program urges a sweeping reform to facilitate redeployment of labor to make Korea's labor market more flexible.

The key element in the IMF's stabilization package was the elevation of the interest rate. Interest was raised from the precrisis rate of 12% to 27% by the end of 1997 and up to 30% in early 1998. The objective of interest policy was to induce the investors to keep their savings in domestic currency and additionally to attract foreign investment in the hope of stabilizing the value of the Korean *won*. High interest rates would not only attract capital inflow but also crimp aggregate demand, which should improve the country's trade balance.

The interest rate policy, to a certain extent, succeeded in stabilizing the currency market by preventing capital hemorrhage. Although high deposit rates offered by domestic banks seem to have suppressed outflow of domestic capital, the social cost of doing this has been a widening income gap between a few rich and the remaining impoverished population. The high interest policy enriched the domestic capitalist class in the midst of the economic turmoil that has adversely affected the rest of the working population. Moreover, the increase in the country's foreign exchange reserves has largely been attributable to drastic reductions in domestic demand. In this respect, the IMF prescription for high interest rates was an excessive austerity measure in a country where the macroeconomic conditions were basically healthy to begin with. Above all, the high interest policy failed to achieve its primary objective of inducing net capital inflows. On the contrary, it diminished investors' confidence in the economy as they were concerned that excessively high rates could push Korea's corporate sector into insolvency.[1] Figure 1 gives some sense of how interest rates changed with the IMF stewardship.

The IMF prescriptions for austerity, which centered on high interest rates and the currency depreciation, had been in force during the first six months since the eruption of the

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[1] It is worth noting one positive side effect of high interest rates on the restructuring of the *chaebol*. Given the already high debt-equity ratios, the higher rates forced the *chaebols* to stint on capital spending,

crisis. On the positive side, Korea's trade balance showed some improvements. Nonetheless, this was due to recession-induced reductions in imports.[1] Korean industry heavily depends on imports of raw materials and energy. The depreciated domestic currency raised the cost of production while high interest policy contracted both investment and consumption. As export growth depends on the country's ability to import, recession-induced improvements in trade balance are not sustainable in the long run.

On balance, the IMF program had an adverse impact on Korea's macroeconomy; it triggered a stagflation in which consumer price inflation continued in an environment of rising unemployment.[2] Figure 2 shows movements of the consumer price index (CPI), industrial output, and retail sales. They are plotted on the basis of year-on-year percentage change since the outbreak of the crisis. In the first half of 1998 under the IMF stewardship both industrial output and retail sales plunged rapidly while consumer prices continued to rise. In effect, during the first half of 1998 alone consumer spending fell by 12% with investment dropping by 40%. Korea's real GDP contracted by 5.3% while the unemployment rate soared to a 7% high by mid-1998 in an economy where the average

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which accelerated the process of restructuring of the *chaebols* as they began to shed nonprofitable businesses and break the old ties between member firms.

[1] Exports, which are the locomotive of Korea's economic growth, fell over the first seven months under the IMF regime, a decline by 13.9% to $10.1 billion in July 1998 for the third straight month. Shipments dipped 3.5% in May and 6.0% in June of the same year.

[2] The pace of the *won* depreciation actually tapered off soon after the president elect, Dae Jung Kim, recommitted himself to comply with the IMF reform program and G7 countries announced their relief intention to Korea.

unemployment rate hovered around the low 2% before the crisis. Given the industry's heavy dependence on imports, the devaluation of domestic currency raised production costs while high interest rates policy crimped both investment and consumption.

At the enterprise level, the high rate policy exacerbated firms' financial instability. Especially for a number of large, indebted *chaebols* that already had a high debt-equity ratio, high rates lent themselves to soaring debt-servicing costs, precipitating possibilities of bankruptcies (Kim and Koo 1998). Foreign investors, in fact, remained concerned that soaring interest rates could push the *chaebols* into insolvency, which deterred inflow of foreign capital.

Smaller firms have been even more severely impacted. Credit squeeze and excess capacity in industry hit small-scale establishments especially hard as most of them heavily depend on the *chaebols* for business. With the economy contracting, as their big business customers cut back on production and investment, small, subsidiary firms were left with plummeting sales and bankruptcies. The figures for small business bankruptcy have been alarming: during the first five months of 1998 all but 18 of the 5,239 corporations that went bankrupt were small firms that had fewer than 300 employees each. In Korea three times as many workers are employed in small firms as in large companies.

'Whirlwind' layoffs and pay reductions of workers have been another effect of economic meltdown and corporate bankruptcies. The jobless rate in Korea, after showing a stabilized rate around 2% until November of 1997, started to increase, peaking at 7.6% in July 1998 (Figure 3). The July figure is more than three times the unemployment rate before the economic crisis. The rapid rise in the first half of 1998 was attributable largely to the bankruptcies of small and medium firms, which were hit disproportionately severely by the IMF's high interest rate policy (Park 1999). Moreover, the IMF crisis shattered the tradition of lifetime employment to which Korean workers had been accustomed and aroused a constant fear of being laid off. Workers have succumbed to the pressure of huge pay cuts or freezes, which have resulted in a drop in their real income. Figure 3 shows the year-on-year percentage changes in real wages for all industries and manufacturing. Monthly real wages are calculated as a ratio to those in each corresponding month of the preceding year. The comparison shows declines in all months during 1998 except January. In February 1998, for instance, the real income of Korean worker was lower by more than 20%.

Government statistics do not distinguish part-time workers from full-timers. Nor do they count as 'jobless' those workers discouraged from searching for a job. If those potentially employable persons are included, the actual jobless rate could be much higher. According to a National Statistical Office estimate, the number of jobless may have surpassed the two million mark.[1] Given that a jobless worker in Korea has on average three additional family members to support, nearly 8 million people—or about one-fifth of the total population—are having extreme difficulty in making ends meet. It is well to note that the jobless as defined in government figures include the homeless and daily workers without fixed residence.

While corporate failures and restructuring gave rise to wage cuts and mass layoffs, high interest policy benefited a few rich who could continue to live off their bank deposits with higher income. In Figure 4 the trends during the 1990s in incomes of the lower and middle groups, represented by the bottom three and the next four deciles respectively, are plotted as a percentage of the high income group represented by the top three deciles. The trend shows how the wealth of the rich has increased under the strict terms of the IMF bailout package while the income gap between the rich and the rest has widened. The relative income of poorer Koreans fell to 28.5% in 1998 from the preceding seven-year

[1] *The Korea Times*, 22 February 1999, p. 8.

period's 31.4% average, and that of middle-income Koreans dropped to 68% in 1998 from a 75% over the corresponding period.[1]

One of the more worrisome features of the crisis is social disturbance and violence. Joblessness and recession have driven many Korean workers into a desperate situation, triggering an explosion in the number of homeless and the desperate. As the unemployment rate and poverty incidence increase and income distribution deteriorates, property-related crime rates as well as the frequency of suicide have risen sharply. Robberies and thefts in the first half of 1998 rose 60% over the same period of the preceding year. The incarcerated population also increased by 20% compared to a year ago.[2]

5. State Governance in Economic Restructuring

The IMF initially assumed that, after a swift financial and corporate restructuring, Korea could survive its recession through a flexible interest rate policy under a stabilized foreign exchange rate regime. As its policy prescriptions led to a deeper recession than earlier anticipated, after several months of its stewardship the IMF finally allowed the Korean government to exercise its own discretion in governing on the economy. The newly elected President Daejung Kim (hereafter D.J. Kim), upon taking office in February 1998, began the task of leading the country out of the IMF 'trusteeship'. D.J. Kim's government took a Keynsian stance and formulated a new macroeconomic policy to stimulate domestic demand and ward off a worse economic collapse. The IMF's high interest rates and retrenchment policies employed to tide over the currency crisis had led to a severe deflation. An agreement was soon reached with the IMF that the budget deficit for the remaining 1998 was to increase to 4% of GDP from the 1.7% initially stipulated by the Fund. To finance the deficit the government issued eight trillion *won* ($6.12 billion) in bonds.

The macroeconomic policy took a reverse turn: the central bank was allowed to increase the money supply to lower interest rates, and the IMF-mandated fiscal targets were progressively relaxed to accommodate the cyclical downturn in revenues. At the same time, the D.J. Kim government took a swift and active role in financial-sector restructuring.[3] It

[1] Income distribution improved in 1996 due to a downturn in the real estate market, which adversely affected the income growth rate of the affluent group. *Newsreview*, 6 June 1998, p. 27.

[2] *Newsreview*, 6 June 1998, p. 34.

[3] Critics were concerned that ongoing efforts for structural adjustment might fail if the government took pump-priming steps at a time when financial and corporate restructuring was incomplete. There was also a question whether lowering interest rates would successfully expand the total money supply.

took a risk by assuming responsibility for a portion of the bank debts and used public funds to rescue financial institutions. The goal of the financial reform was to strengthen the regulatory framework in the financial sector to conform more closely to international norms and to promote private efforts for bank recapitalization in this context. Thus, the rehabilitation of banks, which were to take the responsibility for negotiating workouts with troubled corporations, was a key element in the strategy for corporate financial restructuring. To expedite the financial reform, the D.J. Kim government has first opted for consolidating and enhancing the authority of the Financial Supervisory Committee (FSC), which was formally established in April 1998 as an integrated financial supervision body. Commercial and merchant banks and all other financial institutions have been continuously monitored for the attainment of rehabilitation or recapitalization plans and capital adequacy targets, as recommended at the 8% Bank of International Settlements (BIS). The government has to a certain extent succeeded in reducing insolvent institutions or recapitalizing them.[1] Nevertheless, recapitalization has to date led to significant resource commitment and unintended ownership of financial assets by government. By the end of the third quarter of 1998 the government had spent more than a half of the total budget of 64 trillion *won* (14% of GDP) that had been allocated to financial sector restructuring. Privatization of banks has so far been held at bay, because of the lack of qualified domestic capital and the reluctance of foreign investors to commit resources.

Given the vital role of the *chaebols* in causing the crisis, the D.J. Kim government similarly prioritized the reform of industrial structure. More than any time before, the state has to work closely with business community. The first phase of corporate reform, due to be completed in the fall of 1998, called for special measures from the government. The Ministry of Finance and Economy devised a complete corporate restructuring scheme, known as ‘the big deals’, which was to be agreed for implementation among major business groups. The ‘big deals’ are an attempt to alleviate one of the main problems with the Korean economy, excess manufacturing capacity. The *chaebols* had invested heavily in such industries as semiconductors that suffered from oversupply and weak international prices in global markets. This excessive investment, and the debts amassed to complete the projects, are blamed as key causes of the debt crisis.

[1] During 1998 five of the 26 commercial banks that existed at the outbreak of the crisis, along with a number of other insolvent financial institutions including 16 merchant banks, were liquidated. In addition, five banks were acquired by stronger banks under government support (Claessens, Ghosh, and Scott 1999, 90–2).

The D.J. Kim administration has been pushing the *chaebols* into mergers and asset swaps to try to increase specialization and reap the benefits of consolidation and scale economies.[1] The goal, while reducing debt/equity ratios, excess capacity, and corporate governance at the enterprise level, is ultimately to improve the country's industrial efficiency and international competitiveness. In corporate restructuring the government has opted to deal separately with the top five *chaebols* (Hyundai, Samsung, LG, Daewoo, and SK) and more urgently than with the more than sixty others. The top five are in many aspects the leaders in Korean industry more globalized in operations and much bigger in size with more access to external financing and a easier cash flow position. For the other firms, in particular for small and medium-sized suppliers to the top firms, it was felt necessary for the government to adopt more lenient measures since, unlike the top five, they would be more severely affected by the credit crunch.

The top five were required to agree on the approaches to financial and operational restructuring to meet the government-imposed targets for debt/equity ratios and other international norms. By the end of 2000 their total production units are to be reduced from 271 to 136. Their average debt-to-equity ratio is to fall below the international norm of 200% from the prevailing 400%. They are further required to raise their capital base by selling off assets and subsidiaries and issuing stocks overseas. By a recent accord among the five,[2] they have committed to raise a total of some $30 billion in foreign funds as restructuring costs by 2000.

Sweeping structural reforms are expected to continue. In December 1998 the government announced its decision to sell a 51% share of the first major Korean bank ever (Korea First Bank) to a foreign consortium led by US-based Newbridge Capital. The government's move was strikingly bold as the *chaebols* and many civic groups have been concerned with preserving the nation's economic sovereignty and were downright hostile to this deal.

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1 The series of mergers include, among others, one between two of the world's largest memory-chip makers (Hyundai Electronics Industries Co. and LG Semi-con Co.), which will be the world's second-largest DRAM-chip maker; among the Samsung, Daewoo, and Hyundai groups to combine their aerospace operations; and among the Hyundai, Daewoo, and Hanjin groups to consolidate their train-manufacturing businesses.

2 Completion of the *chaebols'* restructuring programs by 2000 is supposed to significantly boost their international competitiveness and contribute to enhancing Korea's external credit status. Hyundai alone is scheduled to reduce its debt-to-equity ratio from the current 333% to 200% by 2000 through offering of new shares or repayment of debts.

The D.J. Kim government has made a good progress in macroeconomic stabilization, although much of the problem still remains in the real sectors of the economy. Interest rates have been stabilized at 10–12% and consumer spending has been slowly rising throughout 1999. The usable foreign exchange reserves, which are the reserves available to the central bank after subtracting the country's emergency foreign loans and deposits at domestic banks' overseas branches, rose from a low $7 billion at the time of the IMF bailout to $48.5 billion a year later (Figure 5). This has clearly been attributed to Korea's all-out efforts to acquire foreign exchange.

Given the contraction of global import demand and the deterioration of the domestic demand, however, both exports and imports initially suffered declines in the wake of the outbreak of the crisis. Import—mainly for domestic consumption—fell more rapidly than exports which declined slightly throughout the first three-quarters of 1998. Nevertheless, thanks to the relentless export drive by a few *chaebols* and the government's drive for structural reform, the export of semiconductors, automobiles, ships, and machinery continued upward trends, particularly to countries in Southeast Asia. Coupled with some success in inducing foreign direct investment, the country's trade surpluses since late 1998 have been accompanied by increased imports for the first time since the crisis. Purchases of foreign plants and equipment by local companies accounted largely for increased imports. This should promote Korea's growth potential and export industry and is thus viewed as a welcome sign for an economic turnaround.

Amid the continuing current account surpluses, the domestic banks have been able to repay foreign-currency-denominated debt to the central bank. This has increased usable foreign exchange reserves and stabilized the value of the domestic currency. Indeed, with the replenished foreign reserves, the value of the *won* has firmed up against the US dollar. It moved below 1,200 *won* to the dollar at the end of 1998—an appreciation of more than 40% a year later. At the height of the currency crisis the domestic currency plunged to 1,960 *won* against the dollar. By the end of October 1998 Korea's external debt stood at $153.5 billion, of which short-term debt accounted for a little more than 20%. With this level of short-term debt, domestic financial institutions should have little difficulty in repaying external loans in the next six months. The government is moving to further reduce external liabilities by more than $20 billion before the next millennium. If this repayment plan succeeds, it will enable Korea to fully escape from the IMF retrenchment program.

Toward the end of 1998 the recovery of the rest of the economy also picked up steam. Led by the expansion of exports and domestic consumption in automobiles, semiconductors, and telecommunications, Korean industry has begun to regain much of its lost vigor. Buoyed by falling inventories and increased investment demand, foreign direct investment also picked up again, reaching $8.9 billion in 1998, up 27% from the previous year.[1] The latest estimate places Korea's economic growth rate for 1999 at a positive 10%, a turnaround from a negative 5.8% in the previous year.

Korea's success in stabilization is attributable to a combination of pragmatic domestic policy and fortuitous external developments. Reasonable global interest rates, a strong Japanese *yen*, a stable Chinese *yuan*, and low commodity prices throughout most of 1998 certainly helped in generating Korea's trade surpluses.[1] Also the fact that D.J. Kim's government inherited a balanced budget with a low inflation economy eased its efforts for

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1 *Newsreview*, 6 February p. 26

financial restructuring. Concurrently with the efforts for stabilizing the currency market, the D.J. Kim regime was able to launch rehabilitation of the financial sector as the urgent reform task with marked success. To clear up the nonperforming loans and recapitalize the financial sector[2] the government could spend 64 trillion *won*—an amount equal to 15% of the annual GNP (Cho 1999).[3] Although the exact contribution of external factors to the stabilization is difficult to sort out, the determined political will and consistency of D.J. Kim's policy had a vital role to play in restoring investor confidence and in mobilizing collaboration from diverse domestic interest groups.

It must be understood that the Korean economy is still at the crossroads as it has only begun to deal with longer-term structural problems and faces uncertain prospects in the global market. First of all, the prospect for Korean exports in the next few years is still clouded with uncertainty.[4] The Asian market, which has so far provided one of the main markets for Korean exports, still suffers from its financial crisis. The Japanese *yen* as well as the Chinese *yuan* continue to portend signs of depreciation. Second, while the macroeconomic stabilization policy is relatively easier to implement by a few centralized governing institutions, structural reform measures are much more complex and arduous as they involve conflicting interests of divergent socioeconomic groups. A year after the collapse of the currency, the real-sector structural reform in Korea was still lagging. For instance, while the number of *chaebols* has been reduced, the surviving *chaebols* have become bigger and more powerful. Excess capacity of the surviving businesses has yet to be rationalized. Their performance during the initial economic recovery period of 1998 has been lackluster. On the other hand, the bankruptcy of small firms is still frequent, as the banking system has not yet been fully recapitalized.

Third, as corporate restructuring and downsizing is expected to continue, there will be a further rise in unemployment. The modern-sector segment of the labor market is still

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1 In reality, exports fell 2.0% to $120.6 billion compared to the first 11 months of the 1997 level. Imports plunged 37% to $84.7 billion, which generated a trade surplus of $36 billion. Export started to pick up some steam after May 1998.

2 During the first nine months of 1998 the Financial Supervisory Committee ordered 5 commercial banks to close down and 11 to restructure. Out of 377 nonbank institutions, 34 were liquidated, 21 were suspended from operation, and 20 ordered to restructure.

3 Korea had a mild fiscal surplus at the time of the breakout of the financial turmoil in December 1997. The budget deficit gradually widened to 0.8% in February 1998 and 5% of GDP by November 1998.

4 Korea's imports for all of 1998 fell short of $100 billion for the first time in five years. For Korea's economy, which depends on imports of critical raw materials and energy, a serious fall in imports would not only adversely affect the nation's growth potential. Coming to 1999, the import situation seems to have improved, as export expansion has been accompanied by balanced import growth.

rigid, with possibilities of labor agitation emerging larger as the economy recovers. Workers in the modern sector, which includes mainly the regular employees in large-scale firms and some public enterprises, generally enjoy relatively higher wages and various protections of job security, often under militant unions.[1] Although this segment of the labor market is small, with the unionized workers representing less than 15% of the total labor force, disruptions in the normal operation of their employers could critically affect progress in economic recovery because of the strategic importance of the modern-sector firms in the Korean economy. There is thus a need to improve flexibility in the modern-sector labor market to enhance international competitiveness for Korean exports.

Finally, the most urgent challenge in economic governance is rising poverty and inequality in the country. In contrast to the macroeconomic indicators that show the economy on a recovery path, there has been no clear indication as yet that the indicators of human misery are kept at bay. On the contrary, unemployment reached a record level of 8.5% in January 1999 (Figure 3)[2] and is projected to peak at 10% in 1999—leaving 2 million people out of work.[3] Unskilled young people have been hit hard by the employment contraction. The teenage group consisting mostly of middle and high school graduates seeking unskilled jobs marked the highest jobless rate of 25% of the total unemployed, followed by 12.3% for the 20s age group. Farm employment increased by 4.1% to 2.65 million in July 1998 from a year earlier, reflecting a reverse migration from urban to rural areas.

In tandem with rising unemployment, the real income of an urban household during the third quarter of 1998 plunged to its lowest levels in 35 years.[4] The monthly household income of 1.76 million *won* ($1,300) reflects a drop of 20% from the previous year.[5] Corresponding to this, the monthly real income of an urban worker fell to US $420.

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[1] The rest of Korea's labor market includes mainly small-scale establishments and the informal sector labor that consists of daily workers, part-timers, and employees in family business. Employment in this sector is unstable as workers can be laid off at the discretion of employers (Park 1999).

[2] To date, the government's unemployment compensation scheme has been awfully inadequate; unemployment benefits cover only a small fraction of the unemployed and the duration and amount of benefits are very limited. Moreover, the current system tends to benefit relatively well-off workers laid off from the modern-sector firms. While temporary and day laborers represent the majority of layoffs, they are not covered by unemployment benefits (Park 1999).

[3] Estimates by the National Statistical Office, Seoul, Korea. For a summary report, refer to footnote 15.

[4] National Statistical Office in Seoul. See *Newsreview*, 28 November 1998, p. 27.

[5] The consumption slump was prevalent in all sectors except heating and lighting. Expenditures on clothes and shoes marked the highest contraction.

According to a recent survey,[1] 61% of salaried persons saw their wages cut sharply while only 10% had a slight increase in their earnings. These figures for unemployment and wages are the highest and lowest level, respectively, ever recorded in the country where layoffs and homelessness have not been known during the past four decades of industrialization.

In this regard, the impact of the crisis on the distribution of income has by no means been inconsequential. While the recession induced by the austerity measures triggered an explosion in the number of jobless and homeless, the earlier high interest rate policy benefited the rich who could continue to live off their bank deposits. Most strikingly, incomes of a small group of domestic capitalists and CEOs in fact rose during the past year of economic contraction.[2] Thus amid historic low trends in average income, the gap in income between rich and poor further widened in a country that has been proud of its heritage of growth with equity. Clearly, the problems of growing unemployment, depressed incomes for the working population, and a widening income gap remain unresolved.

6. Other Challenges and Issues in Governance

Korea made remarkable progress in overcoming the crisis in just a year. The recovery of the economy continued throughout 1999. The rapidity of Korea's economic rehabilitation reflects the fact that the crisis was a liquidity problem but, more significantly, is in large measure attributable to the good governance of the D.J. Kim administration. The range of reforms and the speed with which they have been implemented are unparalleled in recent experiences of other emerging markets.

Korea's reform process will and should by no means end with the current changes. In the long run, there remains the arduous task of transforming the entire society into one equipped to cope with the global economic reality. Without comprehensive structural and institutional reforms Korea cannot be assured of making the recovery sustainable and avoiding future recurrences of similar crises. Until the country develops a competitive financial system, a flexible labor market, a diversified ownership structure in the *chaebols*, technology-oriented small businesses, and a democratic system founded on a viable civil society, it cannot be said to be on the path to sustained prosperity in the global economy.

1 Survey data of the Federation of Korean Trade Unions.
2 See page 14.

Long-term institutional reforms are bound to involve conflicting interests of diverse social groups in a democracy. Most urgently, Korea has yet to develop a social consensus among business, labor, and government. The reform-oriented D.J. Kim government has been encountering a daunting challenge from both the *chaebols* and labor. Each is too big a contending force for the government to be able to tame.

The main agendum in corporate restructuring is to reduce the *chaebols'* overlapping businesses to a bare minimum. The 'big deals' that led to the consolidation of the top five chaebols have reshaped the nation's industry, making the business structure more concentrated. The problem is that such consolidation will not solve the basic oversupply problem in industry unless the selected businesses are willing to make hard choices on layoffs and investment. The newly installed government's supervisory committee can halt bank lending to a firm if it falls to comply with the committee's request for its merger with other firms. Over time, however, as the macroeconomic situation improved, many *chaebols* acquired access to different sources of funding in increasingly liberalized capital markets. They began to rebuff the government. These newly empowered *chaebols* throw into question the viability of the government plan for swaps and mergers among the firms.

In the context of *chaebol* restructuring, the state also has to come up with an alternative framework for a flexible labor market by breaking away from the past heritage of job security and rigid wage structure. While a flexible labor market would be necessary to make Korean exports more competitive and to induce foreign investment, the recent rise in the unemployment rate poses a serious social problem since the country does not have an adequate safety net for the unemployed. The difficulty in labor reform emanates from the divergently interrelated stakes involved in policy change among the three groups of government, business, and labor.[1] Business and labor have long maintained a symbiotic link, which traces its historical origin back to Korea's authoritarian past. In the past the *chaebols* were frequently assured of being financed by government-subsidized credits in the case of financial crisis. In return, they were able to maintain social stability by holding onto their employees and subcontract suppliers even during an economic downturn.

The D.J. Kim government prefers to have some control over layoffs to protect labor's interest since it needs to retain labor's political support. In restructuring the economy, the government must start by introducing a clear set of rules governing layoffs and establishing a national safety net for the laid-off. In the long run, labor's cooperative

[1] For a comprehensive reform proposal on business, government, finance, and labor in Korea, see Root (1999).

participation in the production process will be essential for business success. To achieve this a scheme for employee stock ownership could be introduced, for instance, which would replace part of direct cash payments. Worker shareholding in corporate governance can be a first step in the search for a consensus. Korean labor has in the past shown willingness to trade job security for management-sharing.

As regards external relations, since globalization is inescapable, Korea is destined to pursue its national strategy for global economic integration. As restructuring efforts are moving in the direction of neoliberal market reform, new roles of the state need to be articulated. There is a clear need for Korea as a later-comer in the global market to expedite development of market forces internally to prepare for global challenges. Trade strategy must aim at reducing liabilities while maximizing benefits from an integrated world. In a global environment the conventional comparative advantage theory should be understood in a dynamic context where systemic development of high-value, technology-intensive products, speed and types of investments, economic management, and strategic alliance with foreign partners are essential for success in export competition.

Over the long term, sustainable international competitiveness for a resource-poor country like Korea can be assured only by developing knowledge-based industry. Paul Krugman (1994) argues that East Asian growth is driven by simple overinvestment and not by gains in productivity. This argument suffers from the methodological problem in estimating the sources of growth,[1] as it overlooks important points about East Asia. In East Asia—including Korea—productivity and investment are virtually inseparable. Productivity gains in the region, aided by its high saving and investment, have been made possible by extensive technology transfer, adaptation, and development. The World Bank estimates that gains in total factor productivity accounted for as much as a third of East Asian growth (for Japan, Taiwan, and South Korea) during the period 1950 to 1980.[2] Thus, rather than passively embracing the dictates of free trade, the state needs to take concrete actions in creating an environment in which knowledge capital can accumulate. Specific measures should include support of R and D efforts, development of world-class clusters to create knowledge networks, joint ventures for technology transfer, and human capital development through educational reform.

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[1] Krugman's argument is based on Alwyn Young's estimates of total factor productivity, which is derived as the residuals from his production function regressions. No account is taken of the embodied nature of technology with new investments.

[2] World Bank (1993, 58). Also "The Asian Miracle: Is It over?" *Economist,* 1–7 March 1997 (23–2S).

Moreover, the task of enhancing international competitiveness must be tackled in ways that reduce domestic poverty and economic inequality. As poverty and inequality in society are likely to rise with the deepening of globalization,[1] the state will be forced to play an increasingly active role in social welfare, and to govern the market to deal with the rising human toll. The state must be prepared with comprehensive programs to develop human capital, to manage the dislocations caused by external shocks, and to provide safeguards for the victims.

In summary, the challenge facing Korea is to articulate and implement an alternative restructuring strategy—one that will conform to the GATT rules of a multilateral, open trading system, and at the same time one that can enhance the international competitiveness of the country's exports. The task of restructuring the economy in a democracy is further complicated by the fact that the democratic process of policy formulation must be learned in an environment whose culture and tradition have not been conducive to modernization.[2]

7. Concluding Remarks: Lessons to Be Learned

What lessons can be learned from the Korean case? There are three important lessons for other emerging markets: the importance of distinguishing financial liberalization from trade liberalization, good governance in the reform process, and the need for a comprehensive scope in market reform.

First of all, the Korean experience tells us that unfettered financial liberalization implemented in a weak institutional setting makes the economy liable to devastating consequences from global capital forces. In a country such as Korea with high savings and a balanced budget, the IMF's harsh austerity program transformed a currency crisis into a severe economic recession. Such painful contractions could have been avoided with a less restrictive condition on the macroeconomy (Feldstein 1998). This further reinforces the post-Washingtonian consensus that financial liberalization without adequate regulatory institutions can be counterproductive unless the country already has an autonomous and sound financial system. Although emerging markets may be intrinsically vulnerable to the volatile forces of external capital, the root cause of the Korean crisis must nevertheless be

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1 For empirical evidence, see Kim (1997).

2 According to the traditional Asian value system, family and personal relations are given primacy over and above any formal and legal rules. Clientelism and 'cronyism' have long persisted in such a corporate culture. Korea's economic institutions, which are deeply rooted in the culture of familism with a relatively

seen as originating from the factors internal to the domestic economy. Many emerging economies will ultimately have to liberalize their capital markets. Until a fair international regulatory system is established for disciplining global capital movement,[1] the developing economies owe it to themselves to take proper measures for self-defense.[1] The process of liberalization should thus be gradual and prudential, proceeding only as the domestic financial system is strengthened.

Secondly, the Korean case demonstrates the economic imperative of proper state governance in market reforms. Market forces by themselves cannot serve as a mechanism to correct various forms of market failure. They cannot be relied on to restructure the country's monopolistic corporate system. Only state intervention could expedite effective restructuring by rooting out resistance from the antireform groups. Thus, Korea's embrace of market liberalization is presumed to lessen statism, yet gives it a new space to expand. The Korean reform model has shown that less of the state is needed in certain areas but more of it in others. Proper areas for state governance, for instance, are implementing measures to enhance democratic corporate governance for the transparency and accountability of management; monitoring and regulating domestic financial institutions and corporations for potential insolvency; providing social safety for those left behind in a liberalized market economy; taking preventive measures or minimizing the potential damages of global capital forces on the economy; developing national strategies to explore new opportunities in global and regional markets; and striving as a long-term goal to build a knowledge-based economy rich in human resources and intellectual capital.

The last but not the least significant element of the Korean reform is the D.J. Kim regime's governing philosophy of a comprehensive structural reform (Kim, D.J., 1999). It involves not only changes in policy matrix but fundamental structural changes in a wide range of social, economic, and political institutions. Success in policy reform should be seen as ephemeral unless there is assurance that similar crises will not be repeated. Financial reform in an emerging economy can serve only as the stepping stone to the next phase of comprehensive structural reform. Reforms in labor, business, the rural economy, and foreign trade, as well as government, must be implemented in the framework of a coherent

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low level of social capital outside kinship circles, will thus evolve into a system far short of Anglo-American style pluralism and liberalism.

[1] For an insightful analysis of global hedge funds, see Soros (1999).

whole. For many emerging nations, there is the need to build institutions for complex democratic politics that can ensure fair competition to all participants, since market reform cannot be achieved without the rule of law and support based on democratic institutions.

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[1] China has avoided the fate of its neighbors as its capital market was closed to free international capital movements. The governing philosophy of the Chinese government is to slow down the liberalization process until adequate control mechanisms are in place.

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Appendix

TABLE 1				
Korea's Financial Market Indicators				
	3–Year Corporate Bond Yields % (Average)	Overnight Call Rate %(Average)	Ratio of Dishonored Bills (Total)	Korea Stock Price Index 1980.1.4=100
October 1997	12.5	13.6	0.56	584.1
November	14.1	14.0	0.48	494.1
December	24.3	21.3	2.09	390.3
January 1998	23.4	25.3	0.72	475.2
February	19.8	23.4	0.83	525.2
March	18.9	22.5	0.62	523.0
April	18.1	21.3	0.57	444.2
May	17.9	18.6	0.62	356.3
June	16.6	16.3	0.58	313.3
July	13.7	12.7	0.69	327.8
August	12.4	9.5	0.55	312.8
September	12.5	8.5	0.42	312.2
October	10.0	7.3	0.28	358.8
November	9.6	7.3	0.26	429.2
December	8.3	7.0	0.17	524.7
January 1999	7.9	6.4	0.12	597.6

Source: Ministry of Finance and Economy, 1999, Republic of Korea.

TABLE 2			
Trends in Price, Industrial Outputs, and Industrial Sales			
	CPI	Industrial Output	Sales
Average 1997	4.5	6.9	3.2
January 1998	8.3	–9.4	–9.4
February	9.5	–10.4	–12.8
March	9.0	–9.1	–11.6
April	8.8	–22.5	–15.5
May	8.2	–11.1	–16.5
June	7.5	–14.0	–15.9
July	7.3	–14.0	–17.5
August	6.9	–12.8	–16.3
September	6.9	–1.7	–11.6
October	7.2	–9.3	–13.2
November	6.8	0.3	–8.1
December	4.0	4.8	–3.6

January 1999	1.5	14.7	2.8

Sources: Ministry of Finance and Economy and Korean Development Institute.

TABLE 3

Trends in Unemployment and Real Wage Change

	Real Wage in All Industries	Real Wage in Manufacturing	Unemployment (%)
October 1997	2.3	1.3	2.1
November	0.4	–1.9	2.6
December	–12.3	–19.2	3.1
January 1998	2.7	–0.5	4.5
February	–20.1	–23.2	5.9
March	–8.3	–9.7	6.5
April	–6.7	–13.5	6.7
May	–6.9	–9.5	6.9
June	–13.4	–12.7	7.0
July	–13.2	–16.4	7.6
August	–12.9	–17.5	7.4
September	–18.9	–17.5	7.3
October	–8.6	–8.0	7.1
November	–8.3	–7.8	7.3
December			7.9
January 1999			8.5

Source: Calculated from Ministry of Finance and Economy data.

TABLE 4

Foreign Exchange Rates and Usable Reserves

	Gross Foreign Debts US$ Billion	Usable Foreign Reserves US$ Billion	Exchange Rate (Average) Won/$
October 1997		22.3	921.9
November	161.8	7.3	1,025.6
December	158.0	8.9	1,484.3
Yearly	**158.0**	8.9	**949.9**
January 1998	155.1	12.4	1,706.8
February	154.0	18.5	1,623.1
March	153.8	24.2	1,505.3
April	157.6	30.8	1,392.0
May	157.3	34.4	1,394.6
June	154.9	37.0	1,397.2
July	153.7	39.3	1,300.8
August	153.6	41.4	1,303.2
September	153.6	43.4	1,370.8
October	153.5	45.3	1,338.7

November	152.4	46.5	1,294.1
December	151.5	48.5	1,213.7
Yearly	**151.5**	48.5	**1,403.2**

Source: Ministry of Finance and Economy.