The New Korea: Crisis Brings Opportunity

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Executive Summary

Financial Reform to Date

Our analysis of Korea's prospects leads us to believe that Korea will not be secure against future economic crisis without structural reform of finance, enterprise, and labor markets. This is a difficult task for any country. Success inevitably creates strong vested interests, deeply ingrained habits, and a tendency to seek salvation in the solutions of the past. Will Korea resist this temptation and undertake long-term structural reform? Under current conditions, we anticipate that:

- Reform of the Korean finance system will stop at recapitalizing banks and solving bankruptcies.
- Enterprise reform will not be sufficient to restrain family control over *chaebol*s.
- Korean labor reform will not proceed beyond the recent agreement to allow layoffs only with government approval.

Given these anticipated levels of reform, the prospects for future sustained growth are fragile.

An Alternative Approach

Structural reforms must be built upon what is politically feasible. The International Monetary Fund (IMF) can work with key stakeholders, identify necessary tradeoffs, and promote broad social consensus so that the reforms are politically durable. To overcome the deadlock in Korea, we suggest as a solution that international financial institutions, the IMF and World Bank, facilitate a labor reform agreement between President Kim Dae-Jung and the *chaebol*s that would allow a tradeoff of a more open labor market in exchange for opening the financial system. With the political capital gained through this reform, the government can go on to promote minority shareholder rights within *chaebol*s.

Structural reform in Korea has been slow because multilateral officials have not coordinated appropriate tradeoffs among politically significant stakeholders. As a result, the proposed reforms have not been not politically viable. Reform bargains need to overcome the divergent interests of key stakeholders. Without such coordination, reform is inherently unstable. For conditionality to be politically viable, it must be self-enforcing; domestic political coalitions must view the reforms to be in their own interests, and they must be able to take ownership of those reforms. International financial organizations can help broker reforms, but successful implementation occurs at home.

Introduction

Korea's annual growth rate of 6.6 percent from 1960 to 1992 made it the best-performing emerging market in the world. Such sustained performance required institutional and policy adaptability in response to changing global economic trends.

However, many of the policies that helped jumpstart the economy in the past are irrelevant in today's global economic marketplace. The financial crisis of and since 1997 is the most serious challenge to Korea's future prosperity since the Korean War. Surmounting the obstacles to future growth will depend on the country's resolve to undertake long-term structural reform. This is a difficult task for any country, as success inevitably creates strong vested interests, deeply ingrained habits, and a tendency to seek salvation in the solutions of the past. Will Korea resist this temptation and forge ahead with a new development strategy, opening the society and economy to entrepreneurial risk-taking and making the ordinary Korean an owner of capital?

By diligently implementing macroeconomic austerity, Korea has inspired hope that it will be the first of the East Asian countries to recover from the financial crisis of late 1997. One year after austerity was introduced, the currency rebounded, the stock market doubled in value, and reserves were replenished. However, the strengthening of balance sheets will be temporary if the structural reforms needed to keep the problems from recurring encounter stiff resistance. Can emerging Asia's star performer overcome the hurdles to comprehensive institutional reform? Returning to the path of rapid sustained growth will require Korea to put aside differences and coordinate its divergent interests. As in the rest of Asia, politics remain the primary obstacle to economic reform in Korea.

Crisis and Opportunity

Crisis brings opportunity for change when key groups realize that their survival is at risk. The institutional reforms that turned England, France, and Japan into economic powerhouses all came out of crisis. In each case, the state's fiscal capacity had shrunk to a point where elites had to cooperate to restore basic governmental capacity so that they could compete over the future allocation of resources.[1]

Korea's first generation of institutional reforms was similarly born. After General Park Chung Hee seized power in 1961, the threat of national disintegration induced the construction of new institutions. In order to overcome opposition from deeply entrenched vested interests, President Park built needed public support on the premise that benefits would be shared by all. Labor's cooperation was necessary to prompt business to invest in long-term plant facilities, since growth hobbled by social unrest could not be sustained. Shared growth became the strategy that allowed Park to prevail over the previously insurmountable mistrust between various divergent social interests.[2] To make his promise of shared growth credible, Park worked to eliminate endemic bureaucratic corruption and to provide broad-based access to basic health and education. By upholding standards of civil service integrity and not grabbing the profits of the private sector, Park demonstrated that his government could be a reliable partner in the development process. [3] Confidence in the regime's survival grew, which in turn prompted the private sector to invest in the long term. To outsiders it looked as if Koreans were standing shoulder-to-shoulder to work for a better future.

The economic policies and practices that helped South Korea escape threats to its survival in the 1960s created interests that stand in the way of change today. They also created chronic internal weaknesses that cannot withstand global economic integration. For example, privileged access to government-subsidized credit is a vestige of a seized government/business interface that initially helped the government coordinate national resources to pursue long-term growth priorities. A highly supervised and centralized credit system that worked by fostering export contests was never fully transformed into a system of market-based financial discipline. Long before the financial system collapsed in December 1997, this underlying structural weakness already had been the subject of a government study released in 1993 showing that financial markets suffered from significant political interference on behalf of the *chaebol*s and lacked the capacity for adequate prudential supervision.[4]

Corporate governance was deeply flawed; with little accountability to minority shareholders or workers, conglomerates could migrate dangerously from their core competencies. Labor rigidity inhibited entrants into new product markets. However, Korea's outstanding growth figures led to procrastination. Reform was postponed: "Why change if we are doing so well?"

Since the collapse of the Korean currency, the won, in November 1997, new voices promising dramatic reform have been heard from the center of government. Upon his election in December 1997, President Kim Dae-Jung outlined a new vision for Korea's future in which small and medium-sized enterprises (SMEs) would become the engines of growth and new employment, just as they had been in the United States. On a speaking tour in the United States, he advised investors that Korea had more to offer than just the country's well-known conglomerates. To restrain those conglomerates from dominating the economy, he promised to end "government-controlled economic growth that made it possible for the nation's economy to be controlled by the collusive link between politicians and businessmen and government influence over finance."[5]

Foreign direct investment and enhanced opportunities for SMEs would be the two pillars of a new, more competitive economy. "Small enterprises are the most important in our time," President Kim told foreign journalists on May 30, 1997. "Small businesses are more suitable for today's demand for production of many items in small quantities, as opposed to the past demand for production of a few items in large quantities." [6] At the 1998 Asia Pacific Economic Cooperation (APEC) meetings in Kuala Lumpur, Kim championed the cause of international economic integration through trade openness and financial liberalization.

Nevertheless, fully one year after the initial agreement with the IMF, Korea's five largest conglomerates are stronger than ever within the Korean economy. They now dominate credit allocation, leaving little for their weaker partners. Domestic competition has decreased rather than increased. Indeed, opportunity has become further concentrated rather than diffused. Where 30 *chaebol*s once reigned, just five now dominate, thus increasing each's leverage over the government. SMEs have been hit hardest in the economic shakedown; many have had to lay off staff and liquidate enterprises. How did the *chaebol*s grow stronger under the nose of their historically strongest critic?

Structural Weakness of Political Institutions Prevents Legislative Solution to Crisis

Although President Kim consistently has advocated the parallel development of democracy and a market economy, Korea lacks the institutions for complex democratic politics and the vote trading necessary to promote and implement a policy dialogue about basic reforms.

The legislature does not provide an arena for disputing parties to negotiate on important policy issues.[7] The absence of appropriate interest-group intermediation holds back recovery by preventing consensus on the necessity for restoring economic well-being, namely, the recapitalization of South Korean banks. Kim will need taxpayer support for such a measure, but he has been reluctant to borrow the capital needed from citizens; he would have to explain where the money is going and how it is spent. A request for taxes could cost his presidential authority, which Kim does not want to risk. On this issue, he is supported by the *chaebols*.[8]

Kim is reported to have said that "Asian-style democracy in which governments are built around a powerful leader who dictates economic policy is the fundamental cause of Asia's current financial crisis." [9] Consistent with his observation, Korea still does not possess an administrative apparatus to adequately defend the political rights of its citizens. Many of the existing institutions were derived from the period of martial law. For example, Korea's legislative authority is weak. The National Assembly is subordinate to the executive branch in policymaking. The courts and chief prosecutor have limited independence from the executive branch. Hence, laws can be enforced only if the president wants them to be enforced.[10]

Without a strong legislature to provide a stable mechanism of interest intermediation, greater international donor pressure may be needed to settle a deal between state, labor, and business in Korea.

The IMF Program

Korea needed the IMF in late 1997 to avoid imminent default on its payments. Efforts to maintain the currency at pre-crisis levels vis-à-vis the dollar had depleted its reserves.

Depreciation of the currency would have made it difficult to pay down dollar debt. In its analysis, the IMF articulated the importance of long-term structural reform to prevent recurrence of the crisis. Nevertheless, this message was overshadowed by the macro adjustments that led the IMF to release $21 billion. Though unusual for the IMF, its insistence on the primacy of long-term issues reflected a consensus that if Korea did not abandon "authoritarian developmentalism," the underdeployment of resources would make the economy vulnerable to crisis. [11]

Ironically, the most controversial part of the reform program, macroeconomic austerity, has been implemented, while the less-controversial microstructural reforms have lagged.

Many prominent economists have publicly criticized the IMF's commitment to austerity. In fact, the World Bank and the IMF have been feuding over the merits of austerity.

Although there is much disagreement on macro adjustments, little disagreement exists over the structural reforms that the Korean economy needs. Almost everyone agrees that the conglomerates must focus on core specialties, that they must be subject to financial market discipline, that cheap credit for government favorites must end, and that a market for corporate control must be developed in order to hold management accountable to shareholders.

Similarly, there is agreement that labor costs have escalated beyond productivity gains since 1987. Labor-market flexibility should approach the standards of Korea's competitors, especially if foreigners are to find ownership of Korean assets attractive. Yet, one year after the collapse of the currency, the banking system has not been recapitalized, numerous bankrupt businesses remain, excess capacity has yet be rationalized, and the labor market is still less flexible than that of Korea's industrial competitors.

Why, then, has the usually controversial macroeconomic austerity package been so easily carried out? Macroeconomic reform programs, often overseen by a single ministry, require little political consensus to implement. Structural change, by contrast, requires political consensus, which has been difficult to construct. While most Koreans agree on the necessity of reform to restore general well-being, the groups that have the most power to influence reform have no motivation to initiate changes that may challenge their positions in the long run. The top five *chaebol*s and organized labor have felt very little of the pain and, in fact, have seen their power enhanced. Thus, these politically significant players are averse to change because it threatens their preferred political positions.

Although President Kim claims broad support for reform, support fragments when each issue is separated. Koreans view *chaebol* labor and financial markets as part of an implicit social bargain in which *chaebol*s receive public financial support in exchange for a commitment to labor stability. No one part of Korea's social contract can be separated from the other without rupturing the overall bargain. Since the key issues are interdependent, solving any one issue requires progress on the other: labor reform is needed for *chaebol* reform, financial sector reform is needed to reform the *chaebol*, *chaebol* reform creates flexible labor markets, and so forth. This triangle constitutes a package of agreed social responsibilities. As a result, a coordinated political deal is needed to restore consensus and overcome the stalemate. This deal must address all three pillars of Korea's authoritarian past: industrial concentration, labor security, and a centralized financial system.

Economic Consequences of Anticipated Financial Market Reform: Will an Entrepreneurial Korea Be Born?

Korea, Inc. discovered mercantilism at a time when its potential competitors in the Third World were discovering autarchy and import substitution. Few countries openly endorse import substitution today. The export-to-growth path is crowded with competitors. Recognizing that this blueprint for past success is no longer relevant, President Kim's vision for a new, competitive Korea is through diversification of ownership and capital. Instead of allowing a small group of companies to make all the decisions about production, Kim says he wants to end monopoly power. He hopes to promote diversification of ownership and knowledge in order to encourage the introduction of new trades and industries. But what has happened to his resolve to implement the legal changes that will enable Koreans to unlock their entrepreneurial talents? Where are the innovations in financial arrangements that will allow citizens to take risks and discover new paths toward prosperity?

In order to anticipate the prospects for reform, Milken Institute staff and consultants surveyed experts within Korea to identify the key stakeholders, their ability to influence the reform process, their stated positions, and the importance or salience of each issue to them. The goal was to define the necessary policy steps toward achieving deep financial, enterprise, and labor reform. Our analysis identifies which political coalitions support what levels of reform, as well as which reform steps are politically feasible. This approach also identifies the set and sequence of economic reform steps that can be currently implemented as well as the most effective strategy to achieve them.[12]

Financial System Reform

Problem: The financial system is an ineffective intermediary between savers and investors. Too few actors have incentives to collect information to make financial markets function effectively; thus, existing financial institutions do not effectively match capital with profitable investment opportunities.

Causes: The financial sector has not evolved in tandem with an increasingly sophisticated private sector; it has become dysfunctional and vestigial. In the 1960s, a centralized financial sector funded a mercantilist offensive by allowing government to direct credit to companies that exported successfully. An export yardstick provided a market-based criterion for credit allocation. In the 1980s, the government withdrew its direct control. It continued to indirectly approve credit allocation, but it could no longer track how much was borrowed. Nevertheless, the government was responsible for implicitly funding the banking system, leaving considerable margin for abuse. The banks could borrow overseas and, although the debt was implicitly backed by the government, government supervision was weak. At the same time, lenders believed the government was committed to maintaining its currency and had the means to do so. Long-standing exchange-rate pegs encouraged financial institutions to borrow abroad, convert the borrowed funds into domestic currency, and then lend domestically. International investors did not think they had to worry since their investments were brokered by local banks that were presumed to have government backing. Meanwhile, Korean intermediaries had little motive to develop the necessary skills in credit analysis, as they believed their loans were backed by the government.

The banks never acquired an adequate supervisory framework for another reason: The government insured the financing requirements of the conglomerates and implicitly underwrote their risks. Since the banks did not choose projects nor make decisions about which firms should expand, they did little monitoring. They provided finance essentially at the direction of state planners. But neither the planners nor the banks had an incentive to independently assess the plans they were financing and, as a result, did not acquire the skills necessary for effective loan assessment. For example, the banks continued to funnel capital into industries that already exhibited significant overcapacity and declining profits. Then bankers, gambling on resurrection, extended credit to insolvent firms to keep from going under themselves.

Without appropriate accounting, would-be bank regulators could not regulate the banks, which in turn could not regulate the borrowers. The government was unaware of how much borrowing occurred offshore and did not have realistic estimates of debt-equity ratios. It seems they were not able even to count the number of subsidiaries belonging to each *chaebol* group. The absence of fundamental information did not seem to matter. Credit was allocated on the basis of personal relationships or collateral. The largest borrowers got the rosiest assessments, since it was understood that they could always borrow more to pay off existing debts. So long as the economy grew, the potential of the *chaebol*s was considered unlimited. This general lack of oversight and transparency served the interests of the large industrial interest groups that dominated Korean society. By providing policy loans, the government had in effect exempted firms from bearing the risk of investment.

The massive quantity of nonperforming loans was actually a by-product of government policy that allowed a small group of financially unfit companies to defy the laws of profit maximization. The reforms necessary to exit this impasse now threaten the interests of the state. The clout of these companies is derived from the failure of the government to provide a regulatory framework from which a commercially oriented banking system could emerge. In effect, both the banks and the government have been captured by the very industrial concerns that they created.

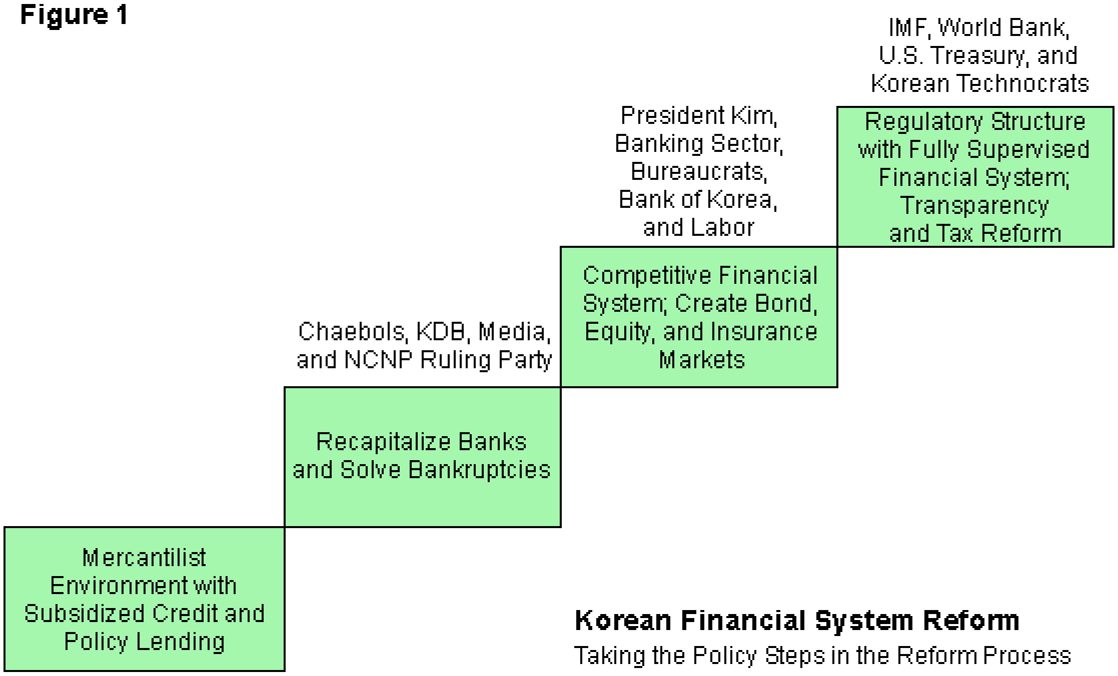
Solutions: The first matter of business is to clean up nonperforming loans. In 1998, the government set up a vehicle for acquiring nonperforming loans: the Korea Asset Management Corporation (KAMCO). Reformers believe this is only the first step, although conservatives like to view it as sufficient to restore the financial well-being of the country. Real reform requires a transfer of the skills and information necessary for running the financial system from the government to market-based institutions, forcing domestic banks to take full responsibility for the loans they authorize.

Progress in the financial sector is a prerequisite for restructuring the enterprise sector. The erosion of profit margins, low return on equity, and low return on capital all reflect a lack of financial discipline. Banks must be able to allocate credit on the basis of an objective assessment of a borrower's cash flow prospects. [13] Korea is chided for failing to establish accounting standards, which are considered a precondition for effective bank regulation. Active credit analysis, however, will thrive when loans are resold, which means that alternatives to banks must be developed. Greater independence for the central bank's inspection of the financial sector will ensure that these standards, once introduced, are maintained.

The Politics of Financial Reform

The IMF and World Bank recognize that extensive banking and credit reforms are a necessary part of the Korean economic recovery. Although there is political consensus within Korea for general financial sector reform, there is no agreement on the extent of desired reforms. Figure 1 shows the policy steps necessary for financial system reform and the divisions among the preferences of key actors.

Figure 1



Korean Financial System Reform
Taking the Policy Steps in the Reform Process

The final step in the reform process would align Korean banks with Western institutions, while the first step represents Korean banking policies at the onset of the current economic crisis. Koreans recognize the need to solve the nonperforming loan problem and recapitalize their banks. In this regard, solving the current loan problems is only the first step; decentralizing financial decisions through institutional reform is essential. Our analysis strongly indicates that discussions on financial reform are polarized. Each coalition is committed to a different step in the process. The IMF and World Bank advocate deep reforms; the *chaebol*s see the problem simply as a liquidity issue, while President Kim adopts the intermediate step of moderate institutional reforms. The parties have not been willing to compromise.

Believing that the path to prosperity includes financial reforms, President Kim currently is willing to take steps toward a competitive financial system, including the promotion of open bond, equity, and insurance markets and a Western-style investment banking structure. The majority of Koreans support moderate financial reform as well. Presidential allies include the Korean academic community, the Financial Supervisory Committee, the Ministry of Finance and Economics, the banking sector, the media, the National Congress for New Politics (NCNP) ruling party, the United Liberal Democrats (ULD) coalition party, and the Grand National Party (GNP) opposition party.

Despite such support, Kim will be unable to force the *chaebol*s or the IMF and World Bank to agree with his proposals. Indeed, he faces political pressures from two opposite sides. The *chaebol*s want to solve the liquidity problem and revert to the pre-crisis financial system while the IMF, World Bank, and Korean technocrats support deep institutional reforms. Despite a broad-based consensus for needed change, the *chaebol*s are poised to persuade their traditional allies to thwart presidential calls for reform and to oppose IMF and World Bank demands for dramatic change, thus maintaining a deadlock on banking reform. The longer reform fails, the more dissent will grow. Delaying reform entrenches positions on all sides, decreasing societal support for any reform.

Breaking Up the Credit Oligarchy is the Key to Financial Market Reform

Extensive financial market development is necessary to correct the underemployment of capital. Although most Koreans support the institutional reforms needed to create a competitive financial system, the *chaebol*s and conservative political parties in Korea advocate only recapitalizing banks, expressing hostility to foreign ownership of troubled financial institutions.

Korea is constantly chastised for not attaining universal standards of accounting. The IMF position on banking reform placed heavy emphasis on overcoming the chronic problem of poor accounting by mandating international accounting standards through legislation and governmental audits. The assumption that active monitoring is a product of legislation is a frequent misconception of the international donor approach. Experience outside of Korea suggests that active credit analysis is a by-product of an active market for loans.

When a few banks dominate the loan market, as in Korea, they have little incentive to invest in developing the skills of active credit analysis. Banks became specialized in catering to the particular needs of the companies they financed because the government mandated that they focus on particularly narrow segments of the economy. An oligarchic credit system thrives on protecting special information about the markets, structures, and performance of its clients. Making that information easily available allows rivals to use the information to expand their own businesses. In addition, greater public disclosure risks exposing information about possible nonperforming assets. Why risk kindling doubts about the solvency of established financial institutions and their clients?

Not surprisingly, the major banks in Korea have used their control over information to control the loan market. An active assessment of loan performance may threaten their ability to continue controlling the loan supply. Recapitalizing the banking sector as it existed will allow large financial institutions to continue to dominate the credit market—the very organizations that have no incentive to actively monitor their loans.

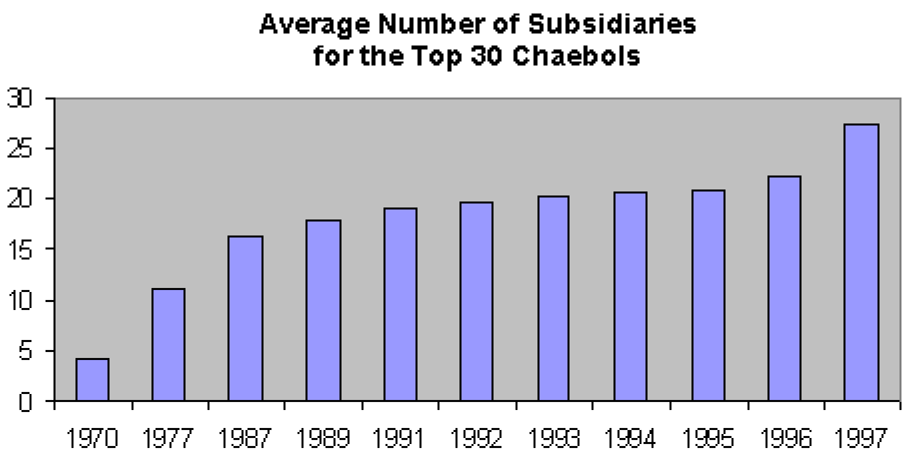
Requiring regulatory disclosure through legislation supported by technical assistance will never be as effective as liberalization. Only if direct political interference and the danger of confiscation is eliminated will companies seeking credit want to disclose convincingly. Then the skills of credit analysis will migrate to their higher-value users—the companies that buy and sell loans—and they will therefore have an interest in active assessments of loan performance.

Thus, active credit assessment will come with an active market for loans. Transparency, improved corporate accountability, and governance all facilitate proper risk pricing via the transmission of market signals and emerge along with rating agencies and credit analysis when institutional investors and issuers freely seek each other. Regulatory review, creditors' rights, and covenant structures are all products of economic competition that come into being as the government steps out of the direct management of credit allocation. Breaking up the monopoly of a few large lenders will do more to develop credit analysis than trying to regulate it into existence. Bringing foreign banks into the Korean market will be an important step in this direction.

Enterprise Reform

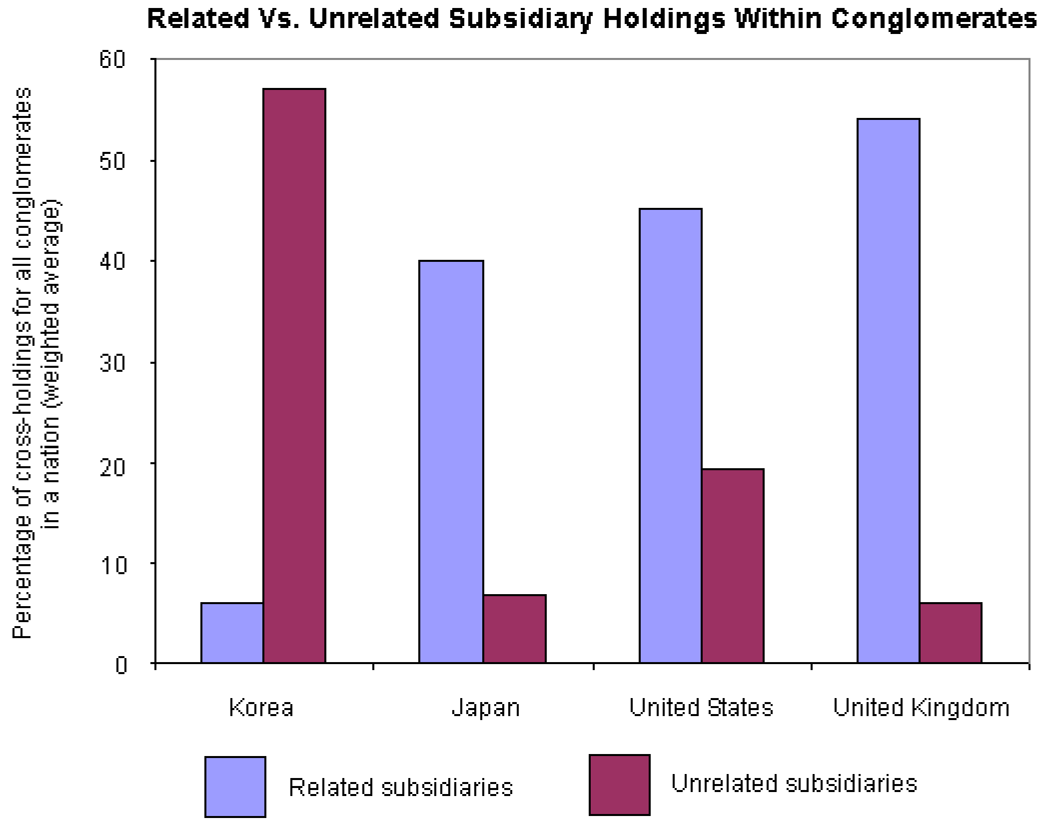
Problem: The weakness of financial-market supervision promoted unhealthy industrial development. Since the government stepped in to prevent large firms from going under, they became "too large to fail," further consolidating their grip on credit. This paved the way for their almost unlimited expansion into unrelated businesses. First, the government conferred preferential status to industries by relieving them from competitive pressures. Then it allowed the firms to expand into areas in which they had no competitive advantage through the practice of cross-guarantees within *chaebol*s. Internal cross-financing made it possible for *chaebol*s to grow in seeming defiance of market forces. Although expansion started with government support of preferred sectors, firms soon moved into unrelated sectors, using finance derived from the core specialty; electronics manufacturers, for example, eventually came to own hotels and golf courses and a host of other subsidiaries. Figures 2 and 3 show both the number and relevance to core businesses of these new subsidiaries, while Table 1 shows the fiscal results of these holdings.

Figure 2



Source: Seong-min Yoo, "Evolution of Government-Business Interface in Korea: Progress to Date and Reform Agenda Ahead," working paper (Seoul: Korean Development Institute, November 1997).

Figure 3



Source: Seong-min Yoo, "Korean Business Conglomerates: Misconceptions, Realities, and Policies," *Korea's Economy 1995* (Washington: Korea Economic Institute of America, 1995).

Table 1

Top 20 Korean Chaebols: Size and Breadth

	Company	Debt/Equity Ratio		1998 Assets (won bn)	In-Group Shareholding Ratio	Subsidiaries	
		1996 (end)	1997 (end)			1996 (end)	1997 (end)
1	Hyundai	376%	579%	73,520	56.2	57	62
2	Samsung	206%	371%	64,536	46.7	80	61
3	Daewoo	337%	472%	52,994	38.3	30	37
4	LG	313%	506%	52,773	40.1	49	52
5	Sunkyong	320%	468%	29,267	44.7	46	45
6	Hanjin	619%	908%	19,457	41.4	24	25
7	Ssangyong	297%	400%	15,645	42.0	25	22
8	Hanwha	619%	1,215%	12,469	33.0	31	31
9	Kumho	465%	944%	10,361	40.1	26	32
10	Dong-Ah	320%	360%	9,054	54.2	19	22
11	Lotte	179%	216%	8,862	22.8	30	28
12	Halla	2,930%	n/a	8,562	49.5	18	18
13	Daelim	344%	514%	7,001	34.2	21	21
14	Doosan	625%	590%	6,586	49.7	25	23
15	Hansol	290%	400%	6,268	37.3	23	19
16	Hyosung	315%	465%	5,249	44.9	18	21
17	Kohap	472%	472%	5,193	39.4	13	13
18	Kolon	350%	434%	4,894	45.1	24	25
19	Dongkuk	323%	324%	4,865	51.0	17	17
20	Dongbu	338%	338%	4,626	47.8	34	34
Top 30		387%	519%	404,180	43.0	27.3	26.8
3,179 Korean Manufacturing Companies		317%	396%				
Japan		193%					
Taiwan		86%					
U.S. (1996)		154%					

Source: Beck, Peter M., Revitalizing Korea's Chaebol, Asian Survey 38 (1998), 810-1035

Transfer pricing within a conglomerate allows one subsidiary to subsidize another, thereby allowing unprofitable subsidiaries to operate. It also prevents SMEs from operating in areas where *chaebol*s are not efficient. Many conglomerates were dragged down by their affiliates. For example, Kia Motors, despite having world-class production facilities, was dragged down by its failing sister companies: Specialty Steel, Asia Motors, and Kaisan.

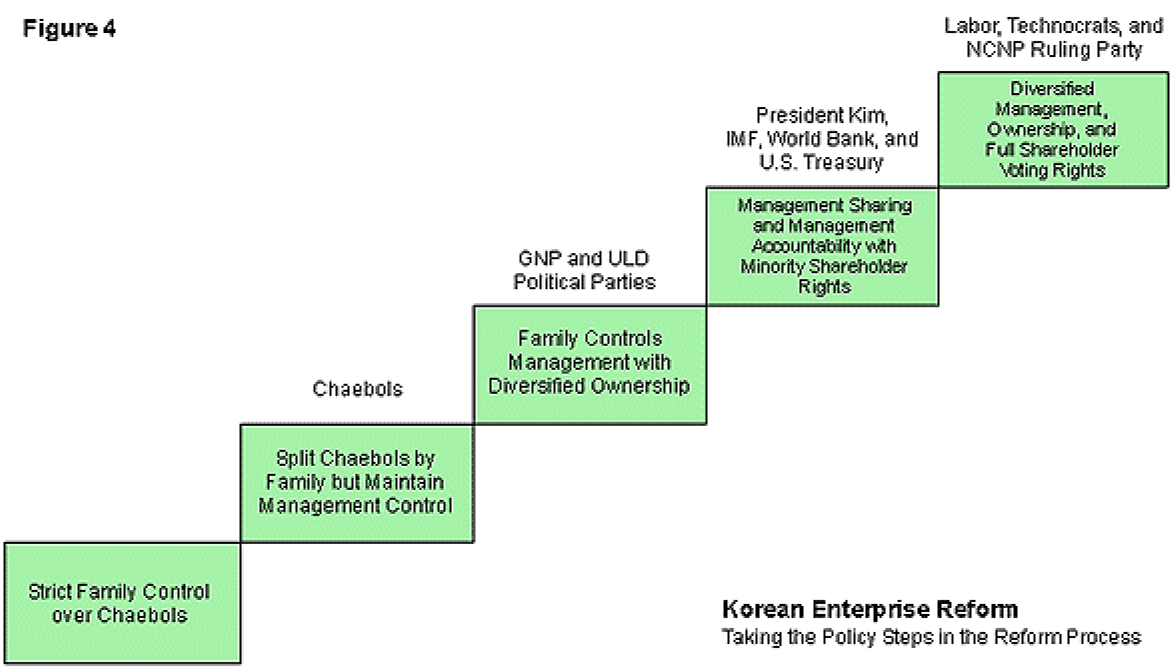
The balance between large and small businesses became disproportionately weighted toward the large firms to the point where they could dump their problems into the laps of smaller enterprises. *Chaebol*s were known to force the acceptance of promissory notes with unfavorable terms on smaller firms. They could pressure those firms to cut prices on products they sold to their big brothers. Eventually, many were driven out of their specialized niches. Thus President Kim has asserted that "if *chaebol*s restructure, it will create competitiveness for companies and more jobs for workers." [14]

Solutions: *Chaebol* reform should include restricting the practice of cross-guaranteeing loans and cross-shareholding in order to trim their lines of business to core specialties. The rights of small shareholders need protection. The boards of directors and auditors should be given meaningful, independent roles. Management should be disciplined by an active market for mergers and acquisitions. Financial institutions must play an active role as investors. In the long run, the government must shed its habit of allocating resources by decree and instead set up fair competition laws to break the collusion of business and politics. Once a culture develops where individual Koreans own shares and demand a return on the capital, business accounting practices will fall into line with international accounting standards.

The Politics of Enterprise Reform

Chaebol reform addresses the very foundation of Korea's corporatist society. President Kim clearly has stated that the future of Korea is tied to the development of SMEs and has attempted to reduce *chaebol* overcapacity through legislation. The policy steps toward enterprise reform are depicted in Figure 4.

Figure 4

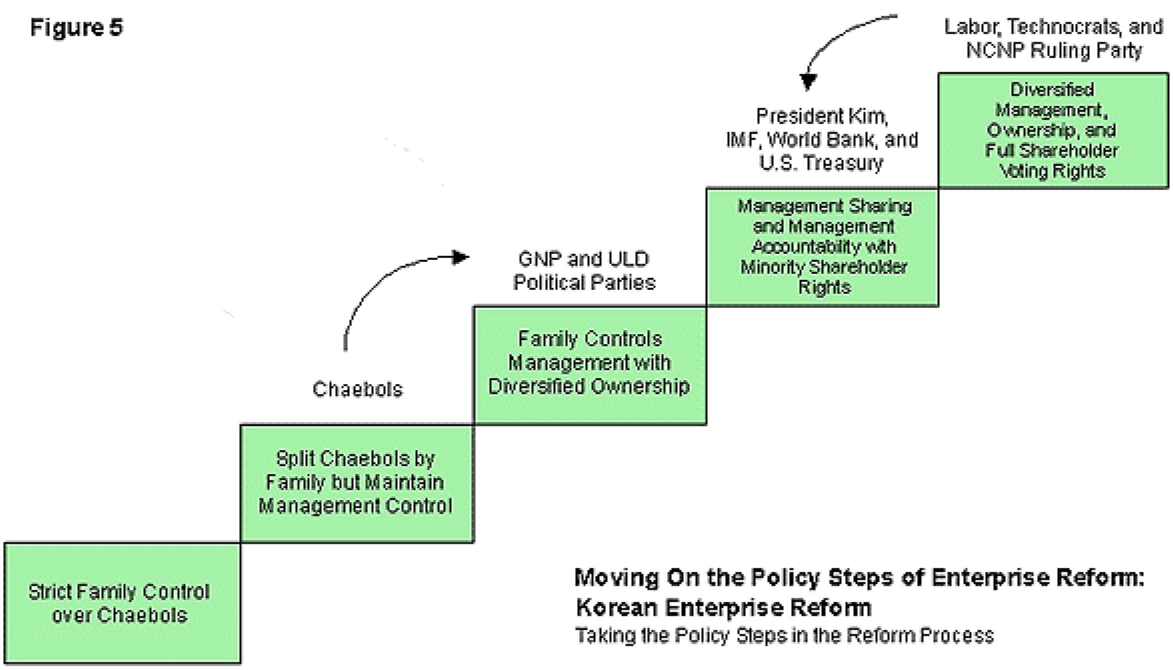


The final step toward real reform would require *chaebol* owners to accept diversified ownership structures with management-sharing concessions, voting rights, and corporate transparency. This is a far cry from the current, almost unimpeded control over business and resources that *chaebol* owners enjoy. Koreans disagree strongly on the economic and political feasibility of *chaebol* reform. Labor, technocrats, and the NCNP demand a diversified management and ownership structure with voting rights. President Kim, supported by the Fair Trade Commission (FTC), IMF, and World Bank, advocates that ownership reform be limited to ending internal cross-guarantees with some management sharing and diversified ownership. However, the ULD and GNP do not support such reforms, and instead advocate less-extensive changes that focus only on diversifying ownership and consolidating assets. Under pressure from labor, Kim has advocated far more extensive reforms than his traditional political constituency is willing to accept. However, many Koreans fear that tampering with the *chaebol*s through ownership reform risks killing the geese that lay the golden eggs.

The "Big 5" *chaebol*s—Hyundai, Samsung, Daewoo, LG, and SK—prefer to legalize holding companies but would be willing to consolidate around core competencies while maintaining all management control. The president, the Ministry of Finance and Economics, and the president's Blue House bureaucrats want to pressure the Big 5 *chaebol*s to make further concessions. In reaction to this pressure, the *chaebol*s might accept the third step of diversified ownership reforms without management sharing as token concessions to be made over time. However, such changes fall far short of the demands for significant reforms by President Kim, the IMF, and the World Bank. Currently, political support for chaebol reform is low and likely will decrease if the chaebols accept only minimal reforms. By paying more attention to *chaebol* reform, the FTC along with the GNP and ULD could prompt the *chaebol*s into accepting this deal at an earlier time.

Figure 5 illustrates the outlines of a possible policy compromise that would result if the *chaebol*s moved up one step in the reform process while labor, Korean technocrats, and the NCNP moved down one step.

Figure 5



Moving On the Policy Steps of Enterprise Reform: Korean Enterprise Reform
Taking the Policy Steps in the Reform Process

The Economic Implications of Enterprise Reform

The *chaebol*s no longer can defy the financial laws of gravity; systemic corporate restructuring is necessary. Effective equity markets will not form until *chaebol*s can be broken up into units whereby economic performance can be more directly observed. In their present formulation, *chaebol* components cannot be assessed according to the criteria set for a normal economic rate of return and shareholder value. Developing efficient equity and bond markets would require diversification of *chaebol* ownership and the establishment of minority shareholder rights.

However, given entrenched *chaebol* interests and their traditional political power, only minimal reforms, including the legitimization of holding companies and some expansion of ownership possibilities is likely through voluntary restructuring.

Initially, the Big 5 *chaebol*s, responsible for 32 percent of corporate sales in 1997, had the opportunity to restructure themselves. They first agreed to halve the number of their subsidiaries, then use the proceeds to pay off existing debts. Next, the government demanded that the *chaebol*s end their cross-subsidiary loan guarantees and prepare consolidated financial statements. The government also emphasized that it would penalize intragroup trading. When it was clear the *chaebol*s were not responding to the government's insistence that all payment guarantees across different affiliates in different industries end by 1998, the Blue House stiffened its resolve. Thirty-five years ago, General Park rounded up the *chaebol* leaders and threw them in jail until they complied with national development goals. This time, President Kim can do no more than insist that financial institutions limit their bond holdings to any one *chaebol* at a maximum of 15 percent of their portfolio. This did not move *chaebol* reform far forward on the scale of ownership transparency and management accountability, the key issues. Moreover, the *chaebol*s can evade the regulations, for example, by establishing ghost companies overseas.

Koreans view the government-*chaebol* agreement on voluntary restructuring, called the "Big Deal," as a significant step toward industrial consolidation. It is premised on the belief that consolidation around core competencies will eliminate the danger to otherwise healthy companies of being brought down by their nonperforming assets. But what is accomplished when Daewoo, already debt-ridden, acquires Sangyong Motors, or when overleveraged Hyundai acquires the debts of Kia Motors? The larger companies created are no more efficient than the ones they replaced; losing companies are not shut down, and excess capacity persists.

In the first year, the restructuring plan focused on the development of a time frame and on the specific affiliates to be spun off. However, this simply allows the conglomerates to dump on the public assets that are unsalvageable and keep the jewels for themselves. Under the new reform, the *chaebol*s are consolidating value for themselves at the public's expense. Moreover, the Big Deal does not replace the need for effective market discipline that comes when capital markets reward effective corporate strategies with investor capital. The Big Deal is trying to replace the market with government. This might have made sense when the private sector was weak and lacked experience, but it makes no sense now in an era when the private sector is more knowledgeable than the government.

Labor Reform

Problem: Labor-market rigidity weakens the competitive position of Korean industry. Companies cannot adjust to business cycles and are forced to accept high costs of maintaining labor during recessions, making economic cycles more extreme than they need to be.

Korean assets have been unattractive to foreign investors. Foreign merger and acquisition specialists report that bankrupt companies may need to lay off as many as one-third of their employees before multinational companies will consider investing. Although the government enacted new laws in early 1997 to increase labor-market flexibility, it refused to allow Hyundai to use them to lay off 8,000 workers. A contentious strike ensued, forcing President Kim to intervene. Foreign confidence in labor reform sank when only several hundred workers were let go.

Causes: Directed and financed by cheap government credit, the *chaebol*s subsidized social stability during economic downturns by keeping their employees and thousands of subsuppliers working. In return, the government furnished the conglomerates with a compliant labor force. This job security arrangement, coupled with an economy that historically has had low levels of unemployment, prevented the development of a flexible labor market.

Solution: To gain support for improved labor-market flexibility, the government needs to introduce a national safety net that includes those not presently covered and that extends benefits for those who are cut off after a short period. Clear and credible rules governing layoffs are crucial to bolstering foreign direct investment, particularly among bankrupt companies where redundancies are likely to be the highest.

Properly structured equity arrangements provide management with direct incentives to run companies more efficiently. Regulations allowing Korean companies to use equity ownership, particularly employee stock ownership plans (ESOPs) and stock options, offer management alternatives to cash to motivating employees. Moreover, investors prefer companies with high management-ownership ratios. Increased equity incentives also will help to unlock Korea's highly developed human capital.

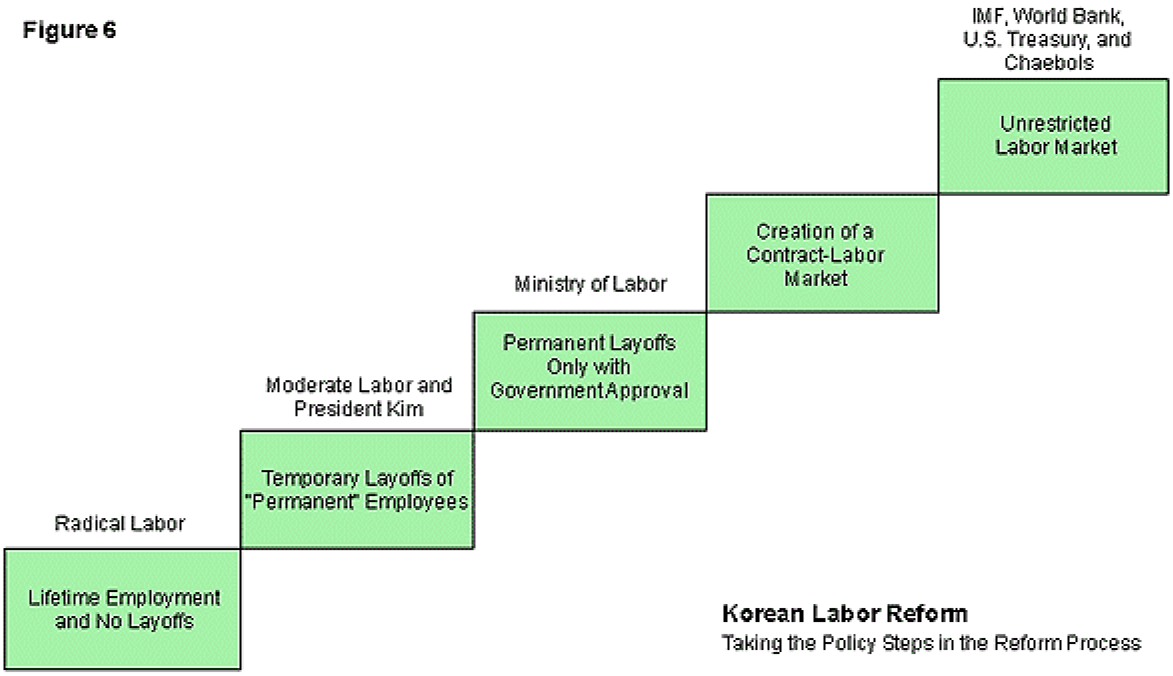
The Politics of Labor Reform

In 1998, the Korean government took taken the first policy step toward labor reform by allowing temporary layoffs of permanent employees among firms that have obtained government approval. Since Korea has no national unemployment insurance system, labor opposes unrestricted layoffs, relying on the president's commitment to overseeing them. Layoff reform faces stiff impediments. As business and labor interests clash, most Korean political and social groups recognize the difficulty in initiating substantive labor reform. Moderate labor groups (such as the Federation of Korean Trade Unions, or FKTU), government bureaucrats, the Ministry of Labor, and most political parties recognize the need for some mechanism to expand layoffs without provoking a political backlash. However, temporary or permanent layoffs are acceptable to the majority of Koreans only if the government maintains control over which employees and sectors are affected. Radical labor groups (such as the Korean Confederation of Trade Unions, or KCTU) will continue to push for the old system of implicit lifetime employment, and President Kim will continue to advocate government control over layoffs to retain domestic political support.

The IMF, World Bank, and *chaebol*s all advocate real labor market reform, making strange bedfellows indeed. They would like to see an unrestricted and flexible labor market similar to Western standards. However, the IMF and World Bank refrain from pushing for significant labor reform because they recognize the domestic political pressures. They fear that protests targeted at reforms suggested by them could exacerbate the situation. In addition, labor reform is not the IMF's or the World Bank's highest priority. Under current conditions, these institutions are expected to do little more than observe the (minimal) progress between business and labor. By contrast, the *chaebol*s' stake in labor reform is much greater and hence they will continue to pursue a flexible labor market.

Figure 6 suggests that most Koreans believe that a flexible labor market could expose the nation to social upheaval; labor unions are able to play on their fear of the social consequences of unemployment. Consequently, when strikes and protests do occur, President Kim is expected to make political concessions to soften radical labor demands and appease moderates. While there is no returning to "lifetime employment" of the past labor reform seems likely to remain limited to temporary layoffs under government supervision. Such a policy generates moderate societal support, but is likely to increase over time.

Figure 6



Korean Labor Reform
Taking the Policy Steps in the Reform Process

Although outcomes we anticipate based on current conditions indicate little real reform in Korea, several reform opportunities do exist. If the conservative parties (GNP and ULD) were to politicize the labor issue in the media by claiming that the president was prisoner to labor interests, they might be able to pressure labor to allow some permanent layoffs. Even so, substantive changes are not likely.

The Economic Implications of Labor Reform

Labor is unwilling to make any significant concessions. Only temporary layoffs can occur—and these only with government approval. Korean labor markets are less flexible at this level than those of their international competitors, making Korean assets unappealing to foreigners who do not have access to the subsidized credits of Korean owners. However, labor is willing to trade employment security for management and decision-making participation. Consequently, *chaebol* reform is closely connected to labor reform. Labor reform is potentially politically volatile. The government is thus unwilling to attempt it unless it can also help labor achieve some of its goals, namely opening the management system of the *chaebol*s and establishing minority shareholding. Hence, barring unforeseen events, the prognosis is for stagnation on this critical front. Yet, as the following section shows, labor reform has the capacity to expand the entire reform process.

An IMF/World Bank Grand Reform Bargain

Our study has revealed that the IMF and World Bank have not fully realized their potential to contribute constructively to substantive labor reform. An approach that links labor, banking, and *chaebol* reform under IMF and World Bank leadership could lead to the following outcomes:

- A more flexible contract-labor market that labor will support
- A competitive financial system that a majority of Koreans will support
- Diversified *chaebol* ownership with management sharing and minority shareholder rights

We believe international donors have underestimated their ability to broker a broad-based structural reform deal that would (a) be politically feasible and (b) enhance the openness of the economy. By supporting President Kim's proposals, the IMF and World Bank can bolster the reform process. A strengthened president could then push the major parties to collectively bargain on *chaebol*, bank, and labor reforms. Each party would gain on the issues that are important to each while conceding others in a package deal that would allow for a higher level of liberalization than has been attained so far. A key to striking such a deal is to identify what is politically acceptable in Korea. [15]

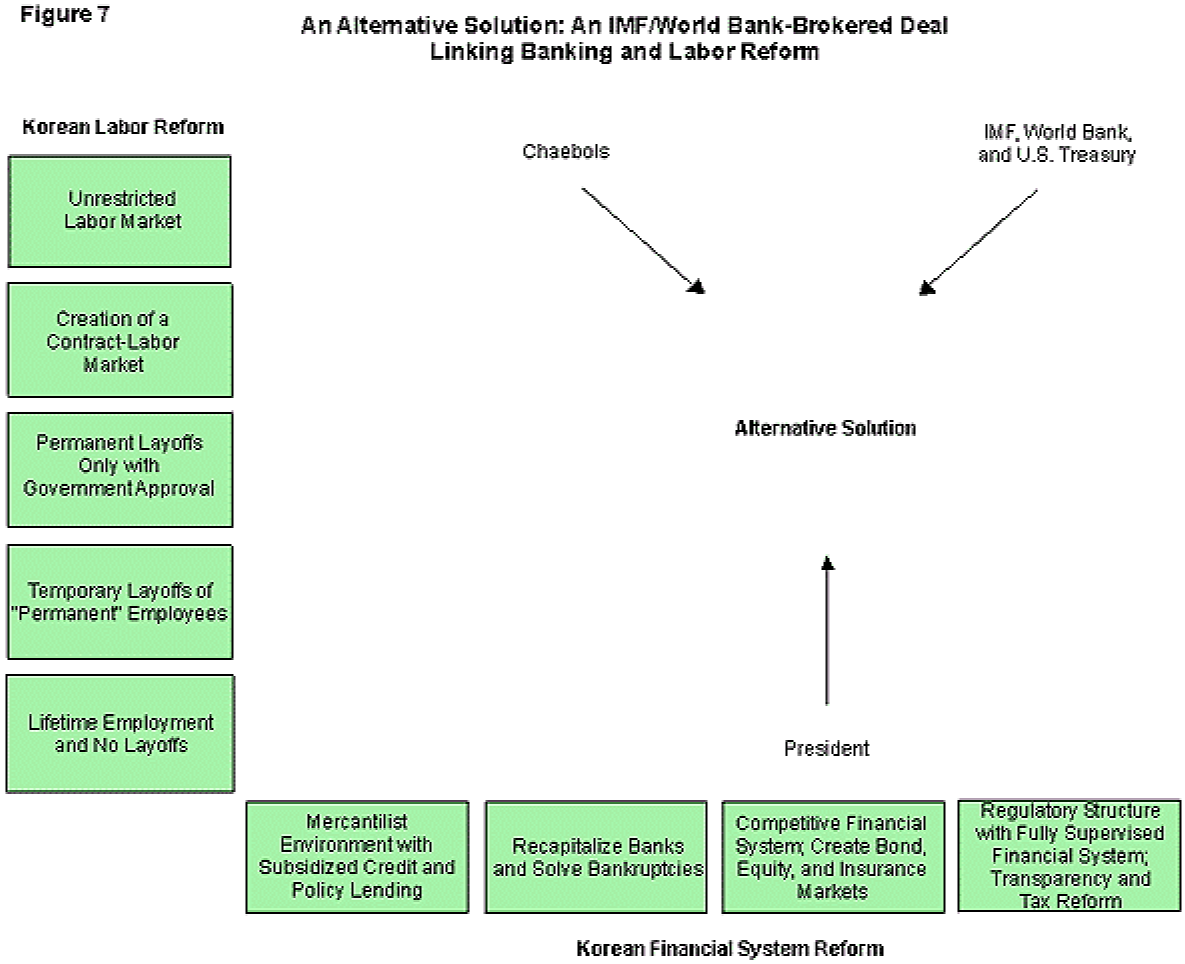
The IMF and World Bank can be effective brokers for structural changes in the Korean economy by becoming involved in all three dimensions of reform. While labor supports the IMF and World Bank on *chaebol* ownership reform, labor opposes their calls for a flexible labor market. Nevertheless, the *chaebol*s agree with the IMF/World Bank position of creating a flexible labor force in Korea and oppose their position of diversifying ownership and management sharing. Meanwhile, President Kim is seeking a political consensus for levels of reform not far from IMF/World Bank objectives. Aligning these interests on banking and labor reform creates a window of opportunity to generate an effective bargain, while effecting more substantive *chaebol* reform.

As Figure 7 shows, the IMF and World Bank side with the *chaebol*s on layoffs and with Kim on banking. On policy steps of labor-market reform, both the *chaebol*s and the IMF and World Bank advocate a flexible labor market. On the policy steps of financial system reform, Kim and the IMF and World Bank are calling for institutional reform.

An IMF/World Bank-brokered deal between the *chaebol*s and the president could break the present stalemate by linking labor and banking reforms. In order to gain the economic advantages of a more flexible labor market, the *chaebol*s may be willing to make concessions on financial reform. Likewise, Kim can offer labor flexibility in return for financial-sector reform. The outcome of this agreement can result in the promotion of open bond, equity, and insurance markets, coupled with the emergence of a contract labor market that allows some permanent layoffs.

Such a brokered deal would require the president, IMF, World Bank, and *chaebol*s to build domestic support in order to avoid opposition from labor. Once a deal between the president and *chaebol*s was struck, labor might well allow progressive reform toward the creation of a contract labor market rather than risk losing further societal support as the public realizes how entrenched labor interests impede Korea's economic future. Moreover, in contrast to the pattern of past secret agreements, this new style of social engagement would entail openness and the building of a broad social agreement.

Figure 7



Successful banking and labor reform would have a second important payoff: It would strengthen support for Kim's enterprise reform initiative, opening an opportunity to achieve substantial change. Striking a deal on financial system reform and labor reform would create the necessary political capital for the forces of reform. Kim, with the help of IMF and World Bank, would then implement enterprise reform, encompassing management sharing, meaningful minority rights, and management accountability.

In this scenario, the level of management sharing would be far above what was previously acceptable to the *chaebol*s. Moreover, by allowing some labor participation in the management process, a broad-based societal consensus can be created.

The IMF/World Bank directive we recommend above would achieve:

- a labor market moving toward flexible contract labor,
- a competitive financial system, and
- a diversified *chaebol* ownership structure with management sharing

Such a comprehensive brokered package of measures would not give Korea the openness and flexibility of a Western economy, but it would produce a durable foundation for economic competitiveness and dynamism for political cohesion.

Conclusion

Korean society has changed dramatically since General Park became president in 1962 of a country in ruin: North Korea, backed by China, then possessed much of the peninsula's industrial capacity. The United States had lost faith in the ability of South Korea to govern itself and had just withdrawn economic support. With this formidable threat at their door and no one on which to rely for future security, Koreans put their differences aside to accept institutional reforms that would allow Park to "modernize the fatherland." Park's campaign to modernize was fueled by the urgency of pulling together a country at war. Individuals were expected to put aside private advantages to prevent mutual destruction.

The financial crisis that broke out in December 1997 is the most serious threat to Korea's future survival since the 1960s. When the government, on the verge of defaulting on its international payments, turned to the IMF for relief, the crisis affected every social interest in the country. The IMF wisely saw an opportunity to draw attention to the need for fundamental institutional reform to help Korea withstand future regional downturns. However, the breathing space the IMF provided unwittingly altered the incentives of different groups to cooperate in preventing future crises.

The IMF assumed that, once out of the danger zone, the country would focus on what went wrong and the president would have time to build support for reforms. After the agreements were signed, President Kim confidently asserted that "we have become keenly aware of the consequences of not adjusting to exchanges in the world and of losing competitiveness." [16] In fact, the opposite occurred: Support for Kim's reforms weakened. The five largest *chaebol*s defiantly went to the international credit market to secure more loans for more acquisitions. They had to be coerced to comply with what was initially intended to be voluntary restructuring. The liberalization program set forth in the IMF accord is on a much grander scale than any political group in Korea would find acceptable. If he attempted to introduce such radical reforms, Kim would risk destabilizing his political base, which even for a proponent is a highly unrealistic expectation. Essential to crafting a stable reform bargain is to build upon what is feasible by discovering where support for reform rests. Here the IMF proposals were lacking.

The hopes of the IMF and World Bank to reform Korea's basic economic institutions were based on the notion that the interests of the government parallel those of the governed. Motivated to revitalize his economy, Kim, it was presumed, would do what informed opinion deemed the best overall bet for the country's future. This approach to economic policy reform assumed the task was a matter of identifying the best possible program and then coordinating national resources to achieve that result: i.e., place the right experts in the right positions and the rest would be easy. World Bank President James Wolfensohn assured investors, "Korea has a first-class team which understands what's going on and it's going in the right direction."[17] However, experts in Korea had been trying to get the government's attention about the weakness of financial institutions for some time. Even before the crisis the right people were in the right places, but to no avail. The politicians were not listening—and not because they did not understand.

Much can be learned about the role of crisis in generating support for lasting reforms from Korea's experience. IMF officials did not prepare themselves with appropriate knowledge about what was politically feasible before going into negotiations, and then relied too much on declarations of good will expressed by the president and his technocratic advisers. They did not recognize that the positions they advocated lay outside of what was acceptable to any single group other than internationally trained economists, and therefore took a position potentially harmful to the president. They also failed to see the interconnectedness of the issues with which they were dealing, ignoring the importance of labor reform for gaining support for financial-market liberalization.

It is now apparent that division of labor among the multilateral players can be an obstacle to implementing comprehensive reforms. The IMF gave up its leverage by leaving the details to be worked out by the World Bank. Once the bailout funds were dispersed, however, the World Bank had little leverage. Its one tool was intellectual persuasion. To break the deadlock, World Bank officials must be able to offer some guidance to help politicians gain political support by advocating comprehensive reform.

Crisis can bring change when the interests of key players are at stake. In Korea's case, once the country had been rescued from immediate disaster, the groups that the president depended on to stay in office had little to gain and much to lose from radical change. Although these influential groups represent a minority of Koreans, Korean civil society is still relatively undeveloped. Political parties are weak and are organized around regions and personalities rather than issues. Hence political authority is highly dependent on a few well-organized interest groups. These groups were in many cases stronger after the crisis than before.

If a single universal message stands out from Korea's experience of the currency meltdown, it is that, before the bailout, the overall condition of the economy was everybody's concern. After the bailout, each group could again concentrate on its own affairs, ignoring the plight of the nation.

Recovery without comprehensive reform is unlikely to be politically secure or socially durable. Although partial reform has opened the country to greater foreign ownership, it also makes the country ripe for future discord and social conflict. Labor has not gained management reform; the industrial empires still have a politically driven credit system to exploit. The few winners now own more of what is profitable, and are discarding loss-making activities on the public. If the costs of restructuring are not borne evenly, a populist backlash remains a distinct possibility, making today's foreign investment a target for tomorrow's unrest.

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Notes:

[1]Hilton Root, *The Fountain of Privilege: Political Foundation of Markets in Old Regime France and England* (Berkeley, Calif.: University of California, 1994).

[2]Hilton Root and J. Edgardo Campos, *The Key to the East Asian Miracle: Making Shared Growth Credible* (Washington, DC: The Brookings Institution, 1996).

[3]Hilton Root, *Small Countries, Big Lessons: Governance and the Rise of East Asia* (London: Oxford University, 1996).

[4]*Shifting Towards the New Economy: Korea's Five-Year Economic Plan, 1993-1997* (Seoul: Korea Institute for International Economic Policy, July 1993).

[5]President Kim Dae-Jung, speech, April 23, 1998.

[6]President Kim Dae-Jung, *Bloomberg*.

[7]Jongryn Mo*, The Political Origins of the Asian Economic Crisis: Democracy, Gridlock, and Failed Economic Reforms in South Korea* (Yonsei University and Hoover Institution, August 24, 1998).

[8]Compared to OECD countries, personal income taxes are relatively low in Korea, as is government expenditure as a share of GDP. *OECD Economic Surveys 1997-1998: Korea* (Paris: OECD, 1998).

[9]*Bloomberg*, January 9, 1998.

[10]For example, a law exists that allows firms to dismiss redundant labor with government authorization. However, when Hyundai attempted to apply the law, the government refused to authorize the dismissal and forced Hyundai to rehire its workers.

[11]Of the so-called "development dictatorship" that began in 1960, President Kim Dae-Jung has written: "Authoritarian governments control the economy, including its financial structures. Business owners have no incentive to compete in domestic or overseas markets; instead, they seek an easy way, searching for windfalls through collusion. Under this system, political authorities appoint and dismiss heads of financial institutions at their whim. Bank loans are made according to government directives, not sound business practices. The end results are mountains of non-performing loans and, eventually, bankrupt financial institutions. Such an economy is guaranteed to fail in a competitive business world that knows no borders." President Kim Dae-Jung, June 10, 1998.

[12]For details on this type of political analysis, see Jacek Kugler and Yi Feng (Eds.), "The Expected Utility Approach to Policy Decision Making: Assessments, Forecasts and Strategies," *International Interactions* 23/3 (Spring 1997). Decision Insights, Inc., a New York-based consulting firm, uses this approach to analyze major political decisions and optimize business negotiation strategies.

[13]The process should include an evaluation of current and projected economic conditions, a review of industry characteristics, and an analysis of the issuer's historical and projected cash flow, capitalization, financial resources, and asset values. Specific bond characteristics, including seniority, covenants, call, refunding, sinking fund provisions, and the use of proceeds all require analysis.

[14]*Bloomberg*, April 29, 1998.

[15]Our analysis of Korea shows that a frequently mentioned reform package—Japan's notion of an "Asian solution" to the crisis—would produce counterintuitive results. Advocacy by Japan alone or in conjunction with conservative Korean political parties to provide an "Asian solution" is expected to provoke a political backlash. This would empower President Kim Dae-Jung to implement his stated policy of institutional reform, including opening the bond, equity, and insurance markets.

[16]*Bloomberg*, December 3, 1997.

[17]*Bloomberg*, February 7, 1998.