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**Visible Success and Invisible Failure in Post-Crisis Reform in the Republic of Korea:****Interplay of Global Standards, Agents, and Local Specificity****Keun Lee\*****Consultant, World Bank****Professor of Economics, Seoul National University;****Byung-Kook Kim****Political Science department, Korea University****Chung H. Lee****Economics Department, University of Hawaii at Manoa****Jaeyeol Yee****Sociology Department, Seoul National University**

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## Abstract

The reform in post-crisis Korea was one of the most comprehensively designed and decisively implemented reforms. Though impressed by the quick recovery, many are now raising doubts about real changes in the economy, as the result of a cost-benefits analysis: While the business climate is more stable and supportive, the economy is now suffering from weak investment and rising unemployment. This study views the Korean story as one of “visible success and invisible failure,” based on the following findings.

First, while some new laws were enacted and several quantifiable targets met, little progress was made in changing institutional conventions, habit and beliefs, such as enhancing transparency in the management or trust in labor relations. Second, reform process involved tension between global standard and local specificity, which accounts for the mixed results. Third, special interests politics in the implementation stage, plus the complexities caused by increasing democratization and globalization, has undermined the authorities’ implementation capacity, which accounts for uneven outcomes of the reform. While globalization necessitates increasing flexibility, Korean managers are now facing much stronger labor unions. The outcome is not a fully flexible but segmented labor markets, divided between the core, unionized workers and unorganized periphery workers, and between the one over-protected and the other under-protected. Fourth, it is important to have an effective system of legislative bargaining to help resolve disputes. Only with this institutional vehicle will special interest groups reach some consensus. Korea tried to overhaul its financial system and achieve substantial financial liberalization in the early 1990s but those attempts were partly aborted and partly distorted, which paved the way for financial crisis in 1997. This was due to the lack of clear reform consensus, without which reform is more likely to be aborted or unsuccessful. Fifth, implementation problems stem from institutional complementarities and inappropriate sequencing. One logical sequence might be banking reform, corporate governance, labor relations, and then finally business restructuring.

Now, an emerging question is whether the reform blueprint was right. Post-crisis Korea just tried to be more market or Anglo-Saxon model oriented without paying attention to growth potentials. While firms have now lowered their debt ratios, they are not borrowing to fund investment. The issue of wrong or right blueprint underscores the need to define the reform goal correctly. The goals of reform should not just be a move toward market-oriented economy but toward a growth-oriented one/ or pro-growth market-oriented one.

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## 1. Introduction

Once famous for its rapid economic growth and called an East Asian miracle, the Republic of Korea became one of the crisis-struck economies. However, the Korean economy also showed one of the quickest and strongest turn-around since 1999. While some attribute this recovery to the achievement of reform, others still challenge this view and observe that not much has been changed actually.

We consider Korea a very unique country which has experienced, within a very short period of time, “everything” from miracle to crisis and stunning turn-around. The Korean case raises two important issues. The first issue is how to link the old success regime to the recent crisis. In other words, the financial crisis of 1997 has again brought to surface the old debate on the role of market vs. state in economic development. On one side is the market-based view that finds that state intervention in financial markets (i.e., over-regulation by government and/or crony capitalism) is the culprit for the crisis (Summers 1998). On the other side is the statist view that blames the reckless deregulation of financial markets inspired by neo-liberalism (Chang 1998, Crotty and Lee 2001, Singh 2002). Given this background, there has also come out an effort, the initiative of the World Bank, to reevaluate the East Asian Miracle (Stiglitz and Yusuf 2001).

While this first question has been digested in the literature, the second emerging issue is how to interpret the post-crisis reform and quick recovery. And we are already seeing some studies (Coe and Kim 2002, Hooley and Yoo 2002). But these studies do not investigate the important question of whether the Korean growth regime has really changed, whether institutional reform can be done so quickly and thoroughly, and whether recovery is really due to the reform.

Examining how Korea’s economic system has been reformed offers an exemplary case study of the process and outcome of a reform intended to introduce global standards but conditioned by a country’s political economy and initial conditions. This study will examine the role that various interest groups (agents) played in the reform and how initial conditions constrained its process and the performance of the system that has emerged from that process. Specifically, the study will examine the role played by chaebols, bureaucrats, external pressure, and the prevailing ideas on reform and liberalization espoused in academia. Thereby, the analysis will reveal the motivating reasons for reform initiatives and will identify the factors responsible for the successful and unsuccessful aspects of the reforms in Korea.

The reform history of Korea can be divided into the following three periods: (1) 1961-79 when General (then President) Park Chung Hee effectively ruled the country, starting the process of industrialization and rapid economic growth, (2) 1980-97 when the government undertook a number of reforms in an attempt to establish a liberal market economy, and (3) the years since the 1997-98 economic crisis when reforms were undertaken under the IMF auspices.

During the first period Korea pursued a state-led development strategy that put the government in the commanding position in resource allocation. It controlled credit allocation, thus directing resource allocation and disciplining large corporations to pursue developmental objectives. It also maintained a repressive policy toward labor, thus keeping the wage rate close to the shadow price of labor. The second period began in 1980 when General Chun Doo Hwan began his presidency (1980-87) upon the assassination of President Park in the preceding year. The new governments attempted a paradigmatic shift in political economy from state-led development to a more market oriented economy at the behest of liberal reform-minded economists. It did not, however, mean that reforms necessarily followed the prescriptions of the new paradigm: the course that the actual reforms took was full of detours as it was constrained by initial conditions, including institutional legacies, and buffeted by pressures from various interest groups. The economic crisis of 1997-98 is a consequence of reforms ill conceived and ill carried out in the preceding years and, consequently, understanding the reforms undertaken since the crisis requires our understanding the reforms undertaken during the 1980-97

period.

In the financial liberalization, we find that the influence of chaebols and the strategic behavior of bureaucrats affected and/or manipulated the blueprint of the reform as well as its implementations, as predicted by the thesis of economic entrenchment proposed in Morck, Wolfenzon, and Yeung (2004). In corporate restructuring, we find that initial conditions such as segmented labor markets, high premiums for owner-controller of the firm, and so on, affected the course of corporate restructuring, and thus the standard Anglo-Saxon blue-print has not realized at its purist form, and/or has not worked as originally expected. This is consistent with the argument by Rodrik, Subramanian, and Trebbi (2004) that desirable institutional arrangements have a large element of context specificity arising from differences in historical trajectories.

As analyzed in Fanelli (2003), questions regarding the reform can be addressed in terms of the following. First, why were some countries able to undertake reform while others were not? Second, what factors enabled some countries to successfully implement their reform program while the program failed in others? Third, why were some reforms more successful at delivering the expected outcomes than others?

In our attempt to answer these questions, we employ an “analytical narratives” approach that combines historical research with theoretical analysis (e.g., Bates et al. 1998, 2000). It is historical in that we describe and examine in temporal sequence the institutions and changes in Korea since the early 1960s, and it is analytical in that we analyze the reform process with the explicit framework of reform dynamics and the associated causal hypotheses presented in section 2.

As the rest of the paper will show, Korea has been relatively successful in carrying out policy and institutional reform. Whether this success has served the country well by putting the economy on a path of sustainable growth is, however, yet to be seen, since new institutions, especially when they are alien institutions such as so-called global standards, do not necessarily work harmoniously with local-specific institutions. That is, successful institutional reform—successful not simply in changing institutions but in achieving its ultimate objectives—is not simply a matter of transplanting institutions from another society: it must contribute to making the country achieve sustainable economic growth.

The next section discusses a theoretical framework for the analysis and derives the four main hypotheses. Section three is about the reform in the pre-crisis era. The pre-crisis era also played a role in the initial conditions for the post-crisis reform, because the post-crisis reform starts when the pre-crisis reform stopped. Section four describes the post-crisis reform measures and their outcomes. The reform will be discussed in terms of the overall, political, and macroeconomic aspects, as well as financial, corporate, and labor reforms. Section five provides analytical narratives of the post-crisis reform as well as verification of the hypotheses with case studies. The last section provides a summary of the main findings of the study and a reflection on the current state of the Korean economy after seven years of reform.

## **2. Theoretical Framework and the Hypotheses**

### **1) Analytical Narratives on Institutional Details**

Now, a new consensus in economic development has emerged, beyond the Washington consensus. It is the recognition that institutions are quite dominant over other determinants of economic development (Acemoglu, Johnson, and Robinson 2001; Rodrik, et al. 2004). Institutions of a given society affect the path of its economic development by structuring political, economic, and social interactions among its members (Greif 1994; North 1981; Williamson 1985). As such, institutions can either promote economic development or retard it. As noted by North (1998), societies that are stuck in an “institutional matrix” that does not evolve into the impersonal exchange will fail to achieve economic growth, as they are unable to capture productivity gains that come from the specialization and division of labor. Thus one of the critical things that the developing countries must undertake to bring about economic development is to introduce “correct” institutions in the three areas of market regulating, market stabilizing, and market legitimizing (Rodrik, et al. 2004).

But for a number of reasons, as demonstrated in the case of reforms in the transition economies in Central and Eastern Europe, such institutional reform is difficult to implement and that has to do with the incompatibility that may exist between initial conditions or local specificity on the one hand and the institutions being introduced into the country on the other (Lin and Nugent 1995, p.2362). Thus, mere transplantation of successful institutions from DCs to LDCs is unlikely to have the expected positive effects on performance.

This observation serves as a warning on the complexity involved in institutional reform and the importance of considering the country’s initial conditions in undertaking institutional reform—no “one-size-fits-all” solution. The purpose of this proposed project is to examine Korea’s reform experience to shed light on this issue of compatibility between what is known sometimes as global standards and local specificity.

In our attempt to examine the reform dynamics in Korea, we employ an “analytical narratives” approach that combines historical research with theoretical analysis (e.g., Bates et al. 1998, 2000). In its original form, the analytical narratives try to combine historical and comparative research with rational choice models, or, more flexibly, it can be understood as a combination of deep knowledge of the case and an (any) explicit theoretical model. An analytical narrative is constructed as follows. First, the analyst immerses him- or herself in the details of the particular subject or episode to construct a story out of these elements. The second stage is to formulate a rationalistic theory or model that fits this story. Then the model is crafted to fit the data. When the data does not support the model predictions, the model is not to be abandoned but to be reformulated. Then, this test and revision process iterates until a model that provides an acceptable fit with the detailed narrative has been constructed.

To build a theoretical model to analyze the post-crisis reform in Korea, we looked at the details of the reforms, and found that the key elements in explaining the reform episode include the interest politics among diverse players and how the reform blueprint is formed and changed throughout the reform process. We have named the model as a model of reform dynamics.

### **2) The Model of Reform Dynamics and 4 Hypotheses**

In our model, the reform is perceived like a two-stage game, firstly about the formation of the reform blueprint, and, secondly about implementation of the blueprint (see figure 2-1 below). Various players participate in the formation of the blueprint and its implementation. Thus, diverse ideas, theories, and interests compete with each other in this reform game. We posit that there exists an ideal blueprint, and that the actual blueprint tends to deviate from this ideal affected by the contests among theories and interest groups. The same is posited for the implementation process, such that actual

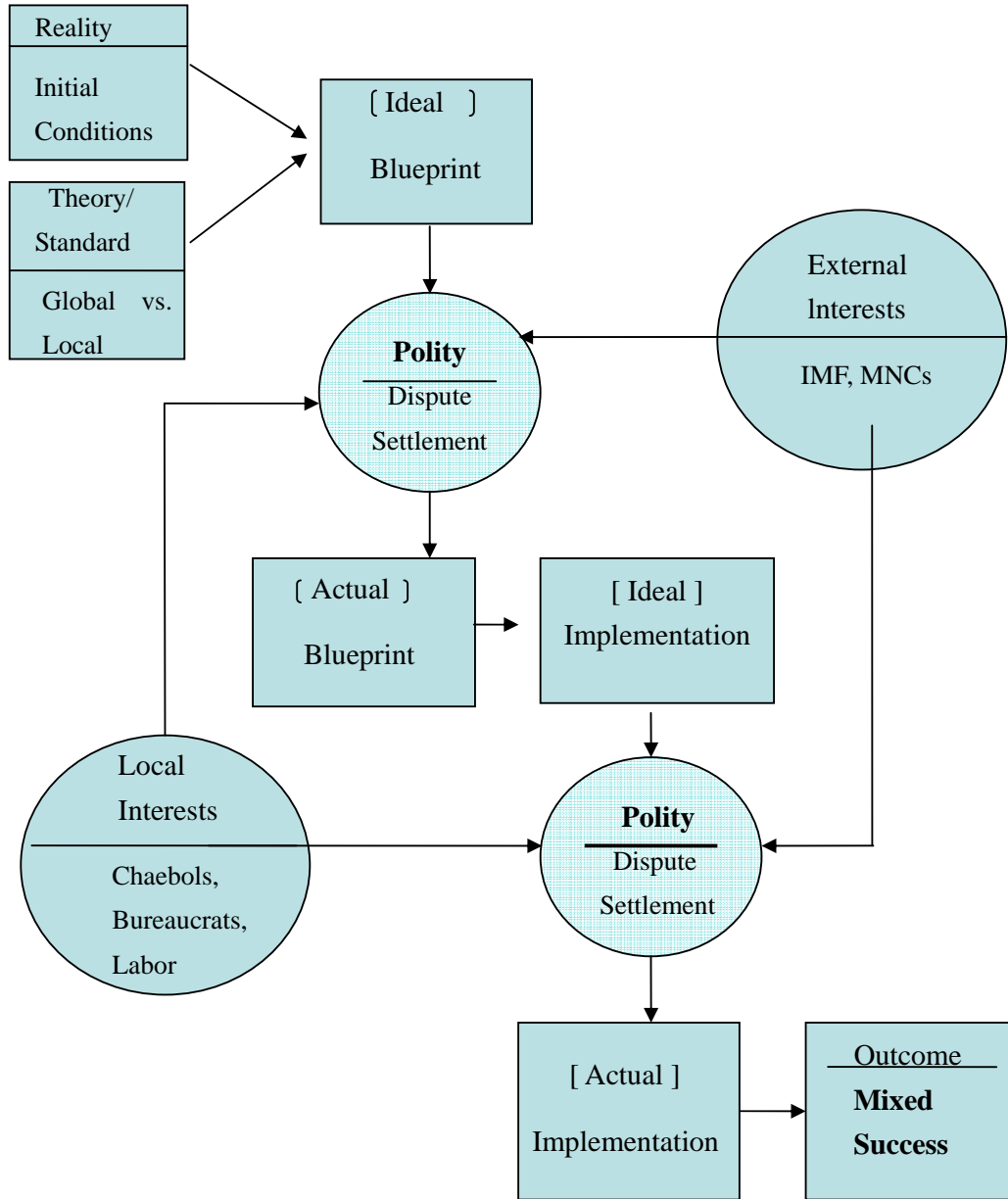
implementation tends to fall short of ideal implementation.

An ideal reform blueprint is one that reflects objectively the existing reality of the economy (the initial conditions) and the existing economic theories or ideas. Some key components of the initial conditions (or local specificity) include: historical role and the perception of the state in the economy, long prevailing structure of ownership and governance in the firms, and the level and structure of trust between management and labor, and so on. Depending upon which economic theories are adopted, interpretation of the reality (data) is different and the prescription henceforth is different. For example, at the time of the crisis, the dominant economic view was that Korea now needed to follow the Anglo-Saxon model of the economy as the old “Korean” or “East Asian” model failed, leading the economy to crisis. In other words, despite the miraculous achievement in the past decades, the old model was suddenly abandoned. The atmosphere at the time was such that no alternative voices dared to be raised. The (Korean) economists have not had a strong theoretical model to justify the past growth mechanism or systems in Korea as an alternative to the mainstream economic view which tends to be more friendly to the Anglo-Saxon economic system.

However, as Jwa (2003) argues, an ideal blueprint should take into account local specificity in Korea. For example, the global standards in corporate governance pre-supposed the American style firm where ownership and management were separated and the main agency problem was between the shareholder and the management. But, in the typical Korean firms, the owners are also the management, and thus the source of the agency problem was different from that in the Anglo-Saxon firms.

However, it is also true that the reform cannot mean preserving everything from the past. Reforms have been called upon because something went wrong, and wrong behavior or policies were linked with wrong ideas or theories.

**Figure 2-1**  
**Model of Reform Dynamics: Interplay of Diverse Models and Interests**



## Figure 2-2: Players and Strategies in Reform-Dynamics in Korea

Players and their goals

External: IMF: stability of financial order and international legitimacy  
MNCs: investment return and access to the local market

Local: Big Business: continuing control over the firm  
Government: economic growth and political popularity  
Bureaucrats: private benefits and promotion  
Labor: economic security and political power  
NGOs.: values (justice, equity; transparency etc)

Strategies: Each players proposes its own input/ideas for reform process  
To maximize their objectives

Stage 1: Formation of the Blueprint for reform

Stage 2: Implementation of the Blueprint

Thus, we can state the first hypothesis as follows

### ***Hypothesis One:***

***Tension between the global standard vs. local specificity tend to become the cause for the mixed results and/or the sources for conflicts.***

This first hypothesis is our answer to one of the three questions raised in Fanelli (2003), namely why some reforms were more successful at delivering the expected outcomes than others. In this regard, we would like to emphasize the correct handling of conflicting goals and ideas to reconcile the tension between the global and local standards. The leadership should identify the correct reform goal first, and then study the initial conditions (local specificities) of the country to write a good blueprint suitable for the goal, keeping in mind that global standards are often suitable only for developed countries (eg. bias for profitability against growth).

In our model, whatever the “ideal blueprint” may be, the actual blueprint is affected by various objectives of interest groups and their habits (behavioral patterns, eg. inertia, rigidity and so on). Here the IMF and MNCs are external interests, in addition to local interest groups, such as big business, bureaucrats, labor and so on. Each of these players has its own objectives and habits and tries to represent its interest toward the blueprint (see figure 2-2). For example, the chaebols wanted to keep their control over their corporate empire, whereas the bureaucrats wanted to preserve their influence over the economy and tend to rely on “uniform regulations” as reform measures (Jwa 2003). Workers wanted to be economically secure and protected by social safety nets, whereas civil activists or NGO’s pursued such values as justice, transparency and equity with less concern for economic competitiveness.

Since the mid 1980s, there was emerging a new kind of political economy, driven by the wave of democratization. First of all, it became easier for vested interests to become organized and actively pursue their parochial interests at the expense of the developmental objectives of the state. Such interest groups, becoming more active after the mid-1980s, were labor unions, consumer organizations, taxpayers, intellectuals, and the media. They began to make their voices heard in policy



making, thus weakening the autonomy that the technocratic bureaucracy had enjoyed until then.

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

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

With complicated interest politics, the actual blueprint would be farther from the ideal blueprint. The gap between the ideal and actual blueprint can be a source for low performance of the reforms. But, also important, is to have at least consensus about the reform itself. Reforms take place, as pointed out by Ruis and van de Walle (2003), in the context of political and cultural institutions and their outcome depends on whether the state is strong or weak and also is backed by strong or weak consensus. Without consensus or reform coalition, reform cannot start at all. Thus in the figure 1 we have a box indicating the “polity” as institutional vehicle or space for resolution of idea/interest conflicts toward building of a consensus. It is often the case that with diverse interest groups arguing for their stakes, consensus is not reached. This was the case of the early to mid 1990s reform efforts in pre-crisis Korea, especially financial reform and labor reform. Such aborted reforms eventually resulted in crisis in 1997. Thus, we have the following the hypothesis.

***Hypothesis Two:***

***2-1. It is very critical to have reform consensus, without which reform is more likely to be aborted or unsuccessful.***

***2-2 The aborted reform is likely to bring on a crisis and then the crisis can serve as the momentum to build reform consensus as well as bring back old agencies such as state bureaucracies.***

This second hypothesis is our answer to one of the three questions raised in Fanelli (2003), namely why some countries were able to undertake reform while others were not? We observe that for the reform to be undertaken, conflicting interests should be negotiated and coordinated to form a reform coalition by strong leadership, external pressure, or dispute-settling institutions.

After the agreement on the blueprint, implementation begins. However, the process of implementation itself is again subject to interest politics. We note that in the implementation stage, local interest groups tend to raise their voices more effectively and to succeed in representing their interests whereas these local interests or ideas were dominated by “global standards’ and external pressure or interests during the stage to form the blueprint. Furthermore, one of the difficulties in bringing in radical changes has to do with the durability of informal institutions which constrains the type and speed of changes in the areas of formal institutions because the newly introduced formal institutions

will have to be compatible with informal institutions if they are to be effective (Lin and Nugent 1995). For these reasons, we can expect that actual implementation of the actual blueprint is likely to deviate from the ideal implementation and their impacts will be limited or distorted. Thus we have the following hypothesis.

***Hypothesis 3:***

***3-1. While reforms tend to be more successful in the area of quantifiable or tangible targets, less satisfactory reforms are often in the areas related to habit and intangible institutions.***

***3-2. Even the quantifiable or more visible successes are often made in a disguised manner without real changes. This tendency could in turn result in unintended “undesirable” consequences, such as eroding future growth potential.***

The case of post-crisis reform in Korea is consistent with the above hypothesis. The initial state of the economy at the beginning of the reform was characterized by: an economy under heavy regulation by state bureaucrats; family-controlled business with opaque corporate governance; confrontational labor management; and state-owned or controlled banks. After the waves of the reform, the present state of the economy seems to be not much different from the initial conditions although some progress, of course, has been made. One pattern we notice is that reform tends to have achieved some nominal success in terms of making new laws and several quantifiable targets (eg. debt-equity ratio; introduction of outside directors in the board), and to be more successful in the area where interests conflicts are less acute. In contrast, the reform tend to make little success or takes more time in really changing institutional conventions, habit and beliefs, such as enhancing transparency in the management or trust in labor relations.

While the hypothesis three addresses the consequences of strategic responses from the agents who are affected by the reforms, there is some difficulty facing the reformers owing to the inter-connected nature of institutions comprising a national economy. Because the character of one reform critically depends on the character of the others, we need to find out ‘general equilibrium’ blueprint and/or take a proper sequence in reforms. It is important for the state to recognize this. That is because it is ultimately the state that executes the change although various actors or groups of actors compete to secure or increase their parochial interests.

Since Aoki and Okuno (1996) coined the concept of institutional complementarity to explain the Japanese economic system, this concept has been utilized in various contexts, especially in the debate on shock therapy vs. gradualism in transition economies. In the case of reform in Korea, we have also found various examples of complementarity or clustering of institutions. For example, to successfully carry out a banking reform, which involves writing off bad loans, restructuring debt, and prudential regulation, is directly linked to business restructuring and labor market reform. But, to go ahead with business restructuring, it encounters the difficulty associated with the owner-controlled nature of the Korean firms and corporate governance. In labor market reform, low level of transparency in the management and governance tend to interfere with the reform effort to bring in more flexibility in labor market. The discuss above suggest the following logical (maybe not practical) sequence of reforms, namely moving from banking reform, corporate governance, labor relations, and then to finally business restructuring. Thus we have the following hypothesis.

***Hypothesis 4:***

***4-1. One source of the implementation difficulty in reform has to do with the institutional complementarity (Aoki and Okuno 1996) among the sectors.***

***4-2. In consideration of inter-connectedness of institutions, the implementation should take a proper sequence in reforms, possibly moving from banking reform, corporate governance, labor relations, and then to finally business restructuring .***

This last hypothesis is our answer to one of the three questions raised by Fanelli (2003), namely what factors enabled some countries to successfully implement their reform program while the program failed in others. Our recognition is that it has first to do with the implementation strategy in taking into account institutional complementarities and in taking a proper sequencing being aware of the impact lags, so that the reform may be pursued enough long time.

### 3. Political Economy of Partial Reform in the Pre-Crisis Era

#### 1) Demise of the Initial Take-off Regime

The political economic system that existed during the Park regime in the 1960s and 1970s was often characterized as a state-led economy or developmentalism. Although it was basically a market economy, it differed from the standard textbook version of a free market economy in that the state held a commanding post in resource allocation through its control over credit allocation. As remarked by a number of observers (e.g. Cho 1994), that system of political economy resembled the one that Japan used in the post-World War II period to catch up with the West. This resemblance was, however, no pure coincidence as President Park was trained at a Japanese military academy during Japan's colonial occupation of Korea and allegedly had little regard for academic economists and as he relied on economic experts who had been educated in Japanese schools or had worked in Japanese banks. He looked at Japan as a model for rapid economic development (Woo 1991).

Envisioning Korea's transformation within his lifetime into a "second Japan," Park Chung Hee took on a few chaebols as his lifetime partners in grand business deals. To induce their entry into what he perceived as strategic industries, Park assembled a lucrative incentive system. In fact, he built a system where winning a state license for the entry into a strategic sector *de facto* functioned as a certified check for growth — if not business success. Park had state banks supply massive subsidized loans, while security agencies assured industrial peace through labor repression. The finance ministry, too, made an input, siding with chaebol owners against minority shareholders over corporate governance structures. These institutions of bureaucratically governed finance, imperial corporate governance structure centered on a single owner family, and company unionism, in effect, enabled chaebols to follow Park Chung Hee into risky business ventures without fearing a threat of financial insolvency, a revolt of minority shareholders, or prolonged labor unrest during his rule.

Moreover, once big business invested on a production scale Park Chung Hee wanted, it too inevitably acquired an interest in getting high growth going. Entrapped in large debts, small sales volume, and huge surplus capacity, any prolonged recession threatened a business collapse. Thus, whenever a global recession set in, its owner managers lined up behind Park Chung Hee, whose political instinct was to opt for an unorthodox strategy of "adjustment" through reflation. The state injected more money into Korea's overheated economy, hoping to buy time until a turnaround in global markets rescued chaebols from a financial crunch. The state-owned banks, too, endorsed its strategy of "growing out" of financial squeeze because they were sacked with massive nonperforming loans, which it thought could be controlled only if high growth continued. The original decision to grow through subsidizing chaebol conglomeration with bank loans, then, had built into Korea's economy an incentive structure strongly biased toward expansion. The state, big business and banks all became a captive of each other, backing each other's effort to keep Korea economically afloat by inflationary financing.

President Park was even able to fend off challenges from external sources to his own strategy of economic development. Despite objections from the World Bank on the ground that Korea did not have a comparative advantage, he launched the industrialization of heavy and chemical industries in the mid-1970s. As long as his strategy was successful in bringing about rapid economic growth there were few challenges to the regime to change its policies and institutions.

In the late 1970s, however, Korea ran into a number of economic problems—a terms-of-trade deterioration resulting from the second oil crisis and a high rate of inflation and excess capacity and low profitability in some of the heavy and chemical industries, a consequence of the heavy and chemical industrialization policy launched in the second half of the 1970s. In the midst of the crisis President Park was assassinated in October 1979. The sudden demise of Park Chung Hee's take-off regime in 1979 suddenly awakened society to the dangers of his way of modernization.

## 2) Early Reforms following the Washington Consensus

Taking advantage of the state of social instability, the former military general, General Chun Doo Hwan, took the power by a coup led by in 1980. The new government that followed the coup lacked political legitimacy and took the course of restoring the country's economic health as a way of securing the legitimacy and survival of the regime. Continuing with the state-led development strategy of the previous regime was not, however, a viable option for the new regime since the public held it responsible for the crisis. In need of new ideas and new policies to bring back the economic health the government brought in a number of economists who had been trained in neoclassical economics at major American universities (Moon 1994).

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

The support of the president of an authoritarian government empowered the liberal economists who met few challenges to translating policy prescriptions of neoclassical economics into a concrete reform agenda to be adopted by the new government (Woo 1991).

The economic reform since the early 1980s after the death of the President Park was largely in the area of macroeconomic policies, and the policy reforms helped Korea resume rapid economic growth throughout the 1980s. Macroeconomic stability was achieved with manageable budget deficits and external debt, low or moderate inflation, and a stable exchange rate (World Bank 1993). Thus, in terms of macroeconomic policy and performance Korea was a success case of the countries following the Washington consensus. But, the reform had not changed the other blocks of the economy, such as the power of chaebols and their opaque corporate governance and the continuing state involvement in the banking sector.

## 3) Stories of the Partial Reforms

There are two sectors in the Korean economy where substantial but still partial reforms were undertaken through the 1980s and 1990s, which laid the foundation for the crisis of 1997. These are the reforms in the financial sector and industrial relations.

### Financial and Corporate Reform

The fact that the policymakers in Korea accepted the principle of financial liberalization does not mean that they were successful in carrying out the reform. Powerful interest groups influenced the way that financial reform was carried out, which is the phenomenon called 'economic entrenchment' (Morck, etc 2004).

In the early 1990s, the government deregulated the entry and business scope of financial institutions in order to promote competition in financial markets. As a result, a number of merchant banks were created but many of them were formerly investment finance companies owned by chaebols families. Another important deregulation in domestic financial markets was a significant loosening of restrictions on chaebol ownership of other nonbank financial institutions (NBFIs) such as life insurance companies and investment trust companies.

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

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

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

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

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

While financial liberalization—both external and internal—gave more freedom to the chaebols in their search for financing, the government's ability to control them and curb their highly concentrated economic power was significantly reduced since 1993. The ceiling on the ownership of bank shares was also raised in 1994, allowing more shares to be purchased by the chaebols, and in 1996 they were given more freedom with respect to the ownership of NBFIs. Although the government also made effort to introduce stricter rules regarding cross debt guarantees, cross shareholdings, insider trading, the role of the board of directors, and the rights of minority shareholders it failed to translate its effort into laws.

## Labor Reform

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

The mid-1980s marked the watershed in the short history of Korea's industrial relations when with political liberalization the government shifted its policy from labor-market repression to liberalization—a lifting of state repression on labor movements. Since then workers have gained greater freedom in organizing, collective bargaining, and industrial action. The immediate effect of labor market liberalization was nothing but disruptive. Between July 1987 and June 1989 the number of unionized establishments increased from 2,725 to 7,380 while the union membership rose from 1.05 million to 1.83 million. During the second half of 1987 there were 3,600 strikes with about 70 percent of manufacturing establishments with more than 1,000 workers involved in strike in 1987 (F. Park 1991).

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

There were also qualitative changes in industrial relations—the strengthening of the core-workers unions in chaebol companies in heavy and chemical industries, the growth of white-collar worker unions, increasing solidarity among regional and industrial unions, and the unionization of public sector workers. These changes had the effect of increasing labor market rigidity when Korean firms, especially the chaebols, were becoming increasingly subject to competitive pressures from the globalization of the Korean economy.

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

### 1996 OECD Entry and the Crisis in 1997

Partly because of his desire to leave a lasting imprint in modern Korean history, Kim Young-sam endorsed in 1993 the plan to enter the Organization of Economic Cooperation and Development (OECD) and set December 1996 as the entry date. Without serious labor, financial and chaebol reform pursued, Korea entered the borderless global capital markets with a real sector surviving on bank subsidies, plagued by labor market rigidities, and entrapped in an opaque corporate governance

structure. Finally, exactly one year after the entry, Korea fell into a financial crisis in late 1997.

#### 4) Summary of the Pre-Crisis Reform

The economic reform since the early 1980s after the death of the President Park was largely in the area of macroeconomic policies. They were largely successful, putting Korea as a success case of following the Washington consensus. However, the reforms had left intact basic economic structure that relies heavily on the chaebols. There are at least three reasons for that. The first is that following the Washington consensus, the guiding principle of the reform in Korea, focused largely, if not entirely, on establishing “correct” macroeconomic policies and removing government intervention from the market. The second reason is that by the time the reform began in the early 1980s the chaebols had become a powerful political force that was able to influence the formulation and implementation of specific reform agenda (Lee, Lee and Lee 2002). The third reason is that although changing macroeconomic policies is a politically challenging task, it is not as difficult as disbanding or downsizing the chaebols and changing corporate governance and labor-management relations. The latter requires changing formal institutions as well as informal institutions such as sanctions, customs, and traditions.

One of the difficulties in changing institutions is that the durability of informal institutions constrains the type and speed of change that may be made in formal institutions (Lin and Nugent 1995). How informal institutions limit the effectiveness of the reforms is demonstrated in the cases of chaebol reform and privatization. chaebol reforms were difficult because they became increasingly independent of government for their financial needs. This, combined with their size and importance in the economy, gave them political power to influence the course of reform in the subsequent decades. Regarding the privatization of banks in the 1980s, what actually took place is different from changes in law and official policy as it did not remove government intervention from their management. In spite of privatization the government continued to appoint bank directors and officials, maintaining an “overly cozy” relationship with the banks (Emery 2001).

In conclusion, the pre-crisis reformers did not aim at systemic transformation. Korea continued its overexpansion up to the last days of its high growth era, which ironically made its political elite even more obsessed with the rhetoric of reform. However, political actors could not agree on what was the root cause of the recurring problems and how it could be remedied. They all called for reform, but without a common definition of the problem at hand. Even among state ministries, who possessed power and expertise to deal with the problem, opinions constantly evolved through time. The policy elite continuously developed new policy instruments, only to find them inadequate in taming their economy’s propensity for overexpansion. The result was a state continuously adding policy instruments onto their partial reform package and expanding its organization to bringing society under its tighter regulatory control.



#### 4. The Post-Crisis Reforms and the Outcomes: A Description

##### 1) Initiation of the Comprehensive Reforms

When the crisis brought down Korea to its knees in December 1997, its ability to deal with the challenges of reform looked rather limited. The candidate of the opposition party, Kim Dae-jung, triumphed over the incumbent party's Lee Hoi-chang by mere 1.5 percent of the total votes. Equally critical, Kim Dae-jung headed a minority political party.

The surprising outcome, however, was comprehensive reform. The fragile bases of power hardly obstructed him from consolidating presidential authority. The victorious Kim Dae-jung became a *de facto* president on December 19 and had his own "Hundred Days of Reform" plan even before being sworn into office on February 25, 1998. With his blessing a newly established Economic Emergency Council rescheduled private foreign loans on January 29, a Transition Committee drew "a hundred reform agenda" by February 12, and a Government Reorganization Commission reestablished a system of check and balance within economic bureaucracy by dissolving Korea's hitherto superministry FEB on February 16. Two days earlier, a Tripartite Commission consisting of labor, capital and state representatives had agreed to amend labor laws to recognize the employers' right to layoff workers. The potentially uncertain days of power transition had become a period of fundamental structural reform, as he dexterously used the International Monetary Fund (IMF) conditionalities as a political tool to change the behavior of both societal and state actors.

The political mechanism to transform Korea's financial crisis into a catalyst for comprehensive reform on all three fronts of financial, corporate and labor reform was the Tripartite Commission. Established on January 1998 as a presidential advisory commission, it produced a "social contract" by February 6. The interdependence of key issues required a "package deal," extracting concessions on job security from the labor federations in return for a reform on corporate governance structure by the chaebol, a strengthening of labor unions' political rights, and a provision of welfare programs for discharged workers. The whole episode looked surreal, with Kim Dae-jung — a politician known for nationalist and populist political inclinations — single-mindedly pursuing a "neoliberal" program of massive downsizing through a political mechanism consciously modeled after social democracy of Western Europe in Korea's fragmented society of Confucian familism.

The strategy worked, however. The Tripartite Commission's grand compromise of February 6 settled over 90 issues in 10 major policy areas. Thereafter, the employers could layoff workers and bring in outside workers on a temporary basis, while labor unions could engage in political activities including election campaigning and political fund raising. The hitherto illegal Teachers' Union would also be recognized after an interim period of a year and a half, while the chaebol agreed to gradually cut back on cross shareholding, to reduce cross loan guarantees, and to institute a new corporate governance structure with the major shareholders held accountable for their business decisions.

##### 2) The Kim Dae-jung's Leadership and the Reform Coalition

The comprehensive reform was made possible partly by Kim Dae-jung's uniquely situated political position. Unlike his predecessors, Kim Dae-jung faced a more simple political task of "letting" the crisis persuade society of the need to reform. No major societal force publicly blamed Kim Dae-jung for financial troubles. The public anger focused solely on the preceding president, Kim Young-sam, and the political establishment. Kim Dae-jung escaped criticism even when he made a U-turn to disassociate himself from his own populist election pledges to "renegotiate" the IMF conditionalities after the election. Moreover, having an advocate for a dialogue with North Korea as well as the deepening of political liberty and civil rights, Kim Dae-jung's public life had been intimately tied with more liberal wings within Washington.

The same Kim Dae-jung, moreover, had carefully projected himself as a champion of the masses,

allying with more radical segments within Korea's dissident group before 1992 to restructure society. Deeply sympathetic of American ideals of liberty, but also personifying the progressive version of Korean nationalism and populism, Kim Dae-jung of 1998 was the right man for the right job at the right time — a transformation of Korean nationalism into a constructive pragmatic force for crisis management and economic recovery. He saw American pressures for reform as legitimate advice of a concerned ally and asked labor to sacrifice in the interest of all Koreans. Kim Dae-jung was better posed than other political leaders to push through IMF conditionalities without precipitating nationalist and progressive political backlashes. No one questioned Kim Dae Jung's legitimacy. The IMF shock treatment was instead perceived by most Koreans as a package of reform measures needed for their over-regulated and over-expanded economy.

The conservative sectors of society who bore a deep mistrust of Kim Dae-jung for his previous progressive political rhetoric could not but rally behind those words of reform because they were a political pledge to put Korea firmly on a socially conservative track of economic adjustment. The labor side was in a different situation. With Kim Dae-jung endorsing neoliberal reform, the Korean labor unions in effect became a social force without a powerful spokesman within political arenas. The desertion of labor by Kim Dae-jung accordingly did not make him an enemy of the workers. He still remained ideologically closer to labor than any other political leader, which preempted labor unions from frontally challenging Kim Dae-jung's reform efforts.

Furthermore, as a political outcast excluded from power before the 1997 victory, Kim Dae-jung was free to break with Korea's prevailing model of economic growth. He did not owe much political debts. Nor was his reputation invested in the exiting policies. This fact decisively separated him from Indonesia's leaders in 1997, for whom the financial crisis was a moment of personal political crisis. The newly elect president was neither a 'Suharto' in Indonesia personally responsible for dragging society into an abyss of despair by pursuing an unsustainable path of economic growth based on a selective distribution of privileges and favors among family members and confidants, nor a 'Habibie' chosen for succession by a fallen dictator himself to ensure personal political safety.

Kim Dae-jung was free from all this. The profound sense of national crisis brought by the crisis also forced society to rally behind him under the banner of economic renewal. The harsh neoliberal reform program of shock treatment and economic downsizing became even a laudable act of statesmanship. The Korea Gallop reported a public approval rating of 70.7% for Kim Dae-jung's performance in office in April 1998 — an increase of 17.3 points from January — despite the layoff of half a million workers since January. The amazing popularity of Kim Dae-Jung as reform leader might have been partly helped by some degree of information asymmetry on the part of the ordinary people about the true and eventual costs of the reforms, given that it is the first time that Korean society faced such situation of economic crisis and IMF-conditionality reform. Randall Calvert (1985) proposed a theoretical model supporting this reasoning about the linkage between information asymmetry and political behavior. In particular, the labor side might have had an illusion that their sacrifice will be compensated later since Kim Dae-Jung has been a long-time spokes person of their interests.

### 3) Reform Measures and the Outcome in the Post-Crisis Korea

#### Macroeconomic Adjustments

#### Reform Measures

One of the important conditionalities by the IMF was tight monetary and fiscal policy and raising interest rates, a standard prescription. The high interest policy was justified to stabilize the exchange rate by inducing foreign capital and to kill heavily-indebted or inefficient firms. Some policy makers argued that it was too harsh for the economy. As the exchange rate became stabilized by the end of the second quarter of 1998, the IMF and the Korean government agreed to lower interest rates and to increase government spending.

After this turnover in the policy directions, the main momentum for recovery was the expansionary fiscal policy with massive injection of public funds. From 1998 to 2002, the government expenditure had grown at an average annual rate of 24.8 percent, while it had grown at an average annual rate of 19.6 percent during 1993-1997. The ratio of government expenditure to GDP has increased from 18.3 percent in 1993 to 22.9 percent on 2002 (see table 4-1). Such pump-priming by the government led to the revival of the domestic consumption, with growth at 9.4% in 1999.

To cure the trade deficits from the pre-crisis period and boost exports, the Korean currency Won were allowed to depreciate, as much as 47 percent from 1997 to 1998. The nominal effective exchange rate of won per dollar has depreciated by 34 percent during the same period. Such adjustment in 1998 has helped Korean firms to recover its competitiveness.

### Outcomes

After one and half year after the crisis, the Korean economy made a remarkable recovery in 1999, growing at the rate of almost 10% after a minus 6 % in the crisis year of 1998 (see table 4-1). It went through, however, a gradual slow-down since then. However, the V-shaped recovery in Korean economy had been faster and broader than those observed in most of crisis-inflicted economies. Hong, Lee and Rhee (2002) has also shown that Korea's contraction and recovery were sharper than most of other post-crisis recoveries. Changes in the stock prices also reflected the course of economic change. The stock index was as low as 200 or so at the peak of the crisis, and it soared up to 1,000 in 1999 until it decreased again to the pre-crisis level of 600 in 2000. Since 2002, the stock prices gradually recovered, sometimes hitting 800 or 700 or so in 2003.

The high interest policy at the initial stage of the reform contributed to stabilizing the exchange rate, but, at the same time, have aggravated the sharp cutback in domestic demand as emphasized in Pyo (2004). For the same reason, the sudden imposition of the BIS standard (minimum 8 percent rule of maintaining banks' own capital) was not a realistic goal for the economy which had maintained 33 – 37.5 percent domestic savings rate, 34- 40 percent ratio of gross domestic investment and high debt-to-equity ratio (524 percent for the big-30 conglomerates, 467 percent for the big-5 and 350 percent for Non-chaebol companies as of end of 1997) (Pyo 2004).

Also important is the fact that the post-crisis recovery is led by consumption expenditure helped by injection of public funds and lower interest rate policy rather than strong come back of private investment. As table 4-1 shows, consumption expenditure has grown steadily (9.4%, 6.7%, 3.7%, and 6.2% during 1999-2002), while gross fixed investment has not (3.7%, 11.4%, -1.8%, and 4.8% ).

The sharp reduction in real investment during the crisis period of 1997 and 1998 by -2.2 percent and - 21.2 percent respectively has not been fully recovered during the post-crisis recovery period (1999-2002) with the annual average growth rate of 4.4 percent. This is a fairly sizable reduction in real investment when we compare it with the average annual growth rate of 9.1 percent during the pre-crisis period of 1993-1996 (Pyo 2004). Barro (2002) also points out that the permanence of this recovery is uncertain and that the failure of investment ratios to rebound significantly in the crisis countries suggests that the crisis had a long-term adverse effect.

## Financial Reforms

### Reform Measures

In financial reforms, the strategy of the Korean government was to reform the financial system first so that the banks and other financial organizations may be in a good position to deal with their corporate clients, namely giving them pressure for change. The government revised the Bank of Korea Act to promote the central bank independence with price stability as its main mandate. It also established the Financial Supervisory Commission (FSC) as an independent consolidated supervisory authority for banks, security houses and insurance companies and two state-owned corporations, the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC), to clean up the non-performing loans and strengthen the capital base of the banks.

Restructuring of financial system took off in June 1998 as the financial supervisory authorities ordered the five commercial banks, out of a total of 20 or so in Korea, to be closed. The other 7 banks are to continue their operation conditionally and were given some time for improvement of capital structure. Thus, out of these 7, the big two, Citizens Commercial Bank and Hanil Bank, were merged each other to become Hanvit Bank, and the other three were merged too. Relatively good performing banks were also subject to merger drives. The Foreign Exchange banks succeeded in improving its capital structure by introducing foreign capital from Germany, and the Kukmin bank also sold the largest bloc of stocks to the Goldman and Sacks Co. The Cheil Bank, one of the top banks, has very recently become to be controlled by New Bridge Capital.

Most importantly, most banks have now become subject to better internal monitoring of management as they adopted a board system with a majority of non-executive director; now most commercial banks in Korea appoint 7 to 9 non-executive directors and 2 to 3 executive directors.

### Outcomes

As of end of October 2002, the financial restructuring status reported by the Korean Public Fund Oversight Committee (KPFOC) indicates there has been significant restructuring in both banking and non-banking sector. The net consequences of restructuring in the banking sector can be discussed as follows. According to the Korean Financial Supervisory Service, the total number of the employees has been reduced by 40 percent as of 2002 and that of branches by 20 percent as of 2000. The ratio of non-performing loans (NPL) in total loans has been reduced from the peak of 8.3 percent in 1999 to 1.9 percent in 2002. Both return on asset (ROA) including trust accounts and returns on equity (ROE) have improved from -0.9 percent and -14.2 percent respectively in 1997 to 0.6 percent and 11.7 percent respectively in 2002. The BIS ratio has also improved from 7.0 in 1997 to 10.5 in 2002.

## Corporate Governance Reforms

### Reform Measures

Corporate governance system can be discussed in terms of fairness, transparency, and accountability (OECD 1998).

**Transparency:** First, the business groups or chaebols are required to produce the so-called combined financial statements (CFS), beginning in fiscal year of 1999, which would help disclosure the details of complicated intra-group transactions. In addition, Korea's "Generally Accepted Accounting Practices" (GAAP) was revised to be more in line with international accounting standards. Also, the top thirty chaebols and all listed companies were required in February 1998 to introduce the independent audit committees with representations by minority shareholders and creditors.

**Fairness:** First of all, formerly forfeited voting rights of institutional investors were now fully

recognized in September 1998. Also, the threshold for filing stockholder derivative suits was also lowered from 1 percent to 0.01 percent of total shares. In addition, to make the controlling shareholders accountable for their management results, the related laws were revised in December 1998 to regard a controlling shareholder as a de facto director. This should be an important improvement since in the old system, although the controlling shareholders are actively involved in the management and makes all the important decisions, they don't take any responsibility for their actions since they do not hold either the official title of the CEO or the directors in the board. Maybe most importantly, all listed companies are required by law to appoint at least one outside director.

Increasing recognition of rights of non-controlling shareholders has also to do with the rise of foreign shareholders. Foreign investment related laws were revised in May and October 1998, which now allowed all forms of mergers and acquisitions. Now, in many listed companies of Korea, the foreign shares are reported to be higher than 51 %, such as in Samsung Electronics, Samsung Fire Insurance, Bank of Housing, and Medisson. Also, a survey by the Korea Stock Exchange (reported in 3/16/99 Maeil Business News) indicates that the listed companies with higher foreign shares tend to perform better in terms of profits and debt reductions. The former group also showed a profit increase of 132.5 percent in 1998, whereas the latter group experienced the three time increase of their loss in 1998.

Stability (Capital and Business Structure): To give pressure on the heavily indebted companies to improve their capital structure, the top 64 largest companies were forced to sign financial pacts, with their respective creditor banks, stating the commitment to reducing their debt to equity ratios to below 200 percent. New cross guarantees were already prohibited from April 1998 on, and all the existing cross guarantees are now practically eliminated.

Flexibility (Exit and M&A): Given the group-based structure of many Korean chaebols, the overall capital structure of the chaebols can be improved substantially when they are able to sell out or close non-viable member firms or business divisions. Actually, there were relatively high "exit barriers" in the Korean economy associated with rigid, lengthy, and inconsistent regulations and laws regarding the exit of the firms. Thus, several bankruptcy- related laws were amended in February 1998. The amendment simplified legal processes for corporate rehabilitation and bankruptcy filing, and gave more roles or voice for the creditor banks in the resolution process. Following the December 7th agreement of business swap, the top five chaebols signed financial pacts with their respective creditor banks of dramatically reducing the number of their subsidiaries from 272 at the end of 1998 to 136 by the end of 2000. Also, in May 1998, the creditor banks established a formal review committee to assess the viability of 313 client firms showing signs of financial weakness. Upon completion of their evaluation, creditor banks declared 55 firms as non-viable, of which 20 are affiliated with the top five chaebols, and 31 with the top 64.

#### Outcomes

One of the most notable achievements of the reform has been in the area of capital and business structure. Above all, the debt equity ratio of big businesses were reduced from more than 400% to less than 200% percent as dictated by the government. As you can see table 4-2 (part A), by the end of 2002, the simple average debt equity ratio of the top 5 chaebols are now only 177 %, and for the 6th to 30th chaebols, it was 262%. The top five chaebols have already eliminated substantially cross-debt guarantees within each group. Profitability has improved significantly in terms of both the absolute amount of profits and the profit rates. In terms of the average of top 30 chaebols, net profit to sales ratio has improved from -0.8 % in 1997 to 3.48 % in 2002, and the amount of profits, from -3.2 trillion Won to 1.01 trillion Won during the same period. This pattern implies that the big business in Korea has been reorienting their focus from sales or market share expansion to profitability or the rate of returns.

## Labor Reforms

### Reform Measures

Tripartite Committee: For the first time in Korean history, the government, business, and two labor organizations established the Tripartite Commission (TC). The Federation of Korean Trade Unions (FKTU) and the more radical Korean Confederation of Trade Unions (KCTU) joined the TC. Among the agenda agreed by the TC, one of the most important is promotion of labor market flexibility. The union accepted employers' right of redundancy lay-off and dispatch of workers. In return, unions were entitled to more political representation, unemployment insurance, and extended social safety net.

Labor market flexibility: New law specified the procedures for the redundancy layoffs, so a firm is required to "exhaust all means to avoid it" before making a layoff. Means include wage reduction, work sharing, not filling vacancy arising from quits or retirements, no new hires, and contract buyout with a bonus, and firms were bound to consult "sincerely" with union leaders on lay-off. If an employer makes layoffs without taking this procedure, he can be subject to fine or sentenced to imprisonment. It is very controversial whether all means were exhausted, or how sincere were the consultation.

Social Safety Net: The government extended subsidies for job-sharing, rehiring laid-off workers, and new business, so-called venture business. Subsidies for retraining and arrangement for job search was another component of the policy. Unemployment benefits were further expanded to cover more workers in firms. Also the minimum benefit level is increased to 70 percent of the minimum wage (from 50 percent). And the minimum duration of benefits are extended to 2 months, while the eligible minimum period of contribution was reduced from one year to six months. Unemployment policy targeting female and youth was also invented. The government extended subsidies to wages for unemployed female house heads recently hired in a new firm.

### Outcomes

Failure of the Tripartite Committee: The effect of the accord is mixed. TC has contributed to maintain social peace at the early stage of the reform, but it failed to stabilize industrial relations. TC did not have a legal binding power even to the Ministry of Labor. The only function it did was issuing recommendations. Without the support from the government officials, the committee became a symbolic entity. As time has gone, the discontent of the labor began to grow. KCTU made repeated withdrawal from the committee demanding bilateral negotiation with the government. After all, FKTU also withdrew from the committee in December 1999 denouncing government's stance regarding the ban of paying full-time service personnel of the union.

Changes in the labor markets: Main burden of the enhanced flexibility was borne by "labor" via the "labor-market flexibility" mechanism prevalent in the Anglo-American countries. It is not strange that joblessness rose, particularly among unskilled workers (see table 4-3). Unemployment and underemployment rose in terms of both quantity and duration. There appeared a significant proportion of "atypical," part-time and daily workers in the "employed" pool.

Massive reallocation was made: many new jobs were created while even more jobs were destroyed. As a result, many of those who formerly had stable, high-wage jobs became either employed in unstable, low-wage jobs, or unemployed. The increase in non-regular jobs does not appear to reflect firms' attempt to reorganize work to achieve long-term efficiency gains, but instead, it seems to reflect their temporary attempts to cut labor costs in the short run (Kim, 2002: 262). Most disadvantaged in labor market were unskilled workers. In large firms, here the flexibility was most needed; the increase of non-regular workers was least noticeable, while the proportion of non-regular workers increased very fast in small and medium size firms. It shows that the burden of introducing flexibility at the macro-level was unequally imposed in the labor market. As a result, the dual structure of the labor

market was strengthened and it was segmented into the core and the periphery.

After the crisis, unions of the large firms, led by KCTU used the opportunity to demand massive wage increase, and the wage gap between large and small firms continued to grow. Unions of large firms increased their job security at the cost of new job employment of youth and the wage of periphery workers. It is noteworthy that the scapegoat is the youth group. Unemployment rate of the youth skyrocketed at the beginning of the crisis, and still remains very high. Increasing inequality is reflected in Gini coefficient which rose from .283 to .320 between 1997 and 1999.

## 5. Analysis of Reform Dynamics: Analytical Narratives and Hypotheses

In this section, we provide an analytical narrative of the post-crisis reform in Korea and by doing so we will verify the four hypotheses derived in section 2. Verifications are done by elaborating the examples consistent with the hypotheses.

### 1) Tension between the Global vs. Local Standards

*Hypothesis One: Tension between the global standard vs. local specificity tend to become the cause for the mixed results and/or the sources for conflicts.*

#### Example 1-1: The Tension in the corporate governance reform

##### Anglo-Saxon model vs. Chaebols

What would have been the ideal blueprint for corporate governance and restructuring in post-crisis Korea? The Korean corporate model, despite its great achievement in the past, has no solid theoretical model, and thus it failed to defend itself successfully against the sudden invasion of the global or Anglo-Saxon model. The only defense of the Korean model was its success itself but the financial crisis and the collapse of the many firms nullified this position in a day. Therefore, in the post-crisis reform era, the dominant blueprint was the Anglo-Saxon model.

The core of the Anglo-Saxon model is known to be the central position of the shareholder value in corporate governance. Along this line, we can find the definition of efficient corporate governance. Shleifer and Vishny (2000) state that the efficiency of corporate governance system should be considered in view of the possibility that investors can get back the returns from their investment. They also pointed out two concrete conditions to construct efficient corporate governance system in firms. The first is the existence of large shareholders since holders of negligible shares would not have much interest in monitoring firm behavior and management, as they are subject to the free-rider problem. Here, there may be two types of large shareholders. The one is the permanent large shareholder, like the main banks in Japan or German or owner-family in the Korean firms. The other is the contingent large shareholder, which appear as a take-over bidder or LBO associations in M&A only when the firms perform bad. This is the case of Anglo-Saxon firms. The large debt-holder is also eligible since they too have a big stake in the firms they lend their money.

The second condition for efficient corporate governance is the protection of minority shareholders' rights against possible expropriation by the controlling shareholders. So, there have appeared diverse devices for this purpose, such as derivative suits, rights of access to accounting books, and so on.

We can see that the underlying idea for the conditions for efficiency of corporate governance system is that there should be an owner-controller who has a vital stake in the firms and takes responsibility for the outcomes, and at the same, while such person is given authority and initiative to run the firms, he should not be allowed to sacrifice the interests of non-controlling minority shareholders.

While these are general conditions for efficient corporate governance, we can address another issue which is especially important in the Korean context. That is the reduction of the private benefits from being the controlling-owner. This is important since the reason for the controlling-owner to want to set up the controlling minority structure is to enjoy the private benefits from such control. The bigger the private benefit from controlling the firm, the more likely the controlling-owner is to take the otherwise-unjustifiable projects. In a similar context, Bebchuk (1999) observes that the founder of the firm would like to maintain the control over the firm, rather than take the firm to the public, when there is available bigger private benefit. The same logic applies to the case of the CMS (controlling minority structure) firm; the controller would like to maintain the CMS structure as long as it continues to give him/her private benefits. So, if the CMS or separation of control rights and cash



flow rights is the source of the problem for the chaebols, then we have to first reduce the private benefits from controlling the firm. Then, the owner-controller would have less incentive to maintain the CMS setup of the firm by circular stock ownership and/or stock pyramids. In the Korean context, higher protection of non-controlling shareholders' rights, and more disclosure of accounting and financial information of the firm would be effective.

Now, given the dominance of the Anglo-Saxon model and the definition of efficient corporate governance, let us examine to what extent the reform followed this model and blueprint. First, we can see that we should not try to get rid of the owner-controller from the Korean firms. It is so good to have such family that has a stake in the firms. Rather it is necessary to induce them to increase their share in the firms. Second, there is a definite urgency to increase and protect the rights of non-controlling shareholders and investors. Third, it is important to reduce the private benefits of the controlling shareholders. Fourth, if we are also concerned with competitiveness of the firms, the firms are to be given full freedom in their investment decision-making. Then, the revival of the regulation on the inter-firm equity investment by firms belonging to big business groups should be avoided. Any shortcomings or illegal matter had better be handled now by shareholder activism than by the clumsy visible hands of the government.

Now let us compare this ideal blueprint with the actual blueprint. Then, we first notice that despite that the active role of the board is not one of the critical components in the ideal blueprint, post-crisis corporate reform put heavy emphasis on the reform of the board system and introduction of outsider directors. But, as noted before, the boards is the key institutions in the Anglo-Saxon models of the firms and it is important because the board is expected to provide the check and balance against the management so as to alleviate the agency problem is between the shareholders and the top management. However, it is also well-known that the board's role in this check and balance is limited because they are usually friends of the top management.

In light of the ideal blue print, a more critical area should be the strengthening of the rights of non-controlling shareholders. Shareholders' rights have of course increased in terms of the threshold for exercising rights to file suit, making proposals at a general meeting, inspection of firms' accounts, and the dismissal of directors. But, class action suit against directors, which is one of the most effective tools to enhance the rights of shareholders, are not introduced and delayed for later period, like 2002. And as of 2003, the Korean society was still debating whether and how to introduce this scheme. It seems somewhat strange why the scheme was put off for later periods. Maybe the Anglo-Saxon package did not realize the important of this measure or maybe strategy of big business was to allow the not-so-critical components such as the outside directors and to try to delay this critical measure of class actions. Anyway, few agree that now in Korea the non-controlling shareholders have effective means to protect their rights in the firm, and for this reasons, we can say that the second important conditions for the efficient corporate governance has not yet been fulfilled in Korea. In this sense, it was a kind of "partial implementation" (Ruis and de Walle 2003). As noted, in partial implementation, the least onerous components or the one that has the least impact on the status quo tend to be implemented (*ibid.*).

#### Reversal of the Global Standards: the Revival of the Regulation on Inter-firm Equity Investment

If non-controlling shareholders are given effective means (class actions) to protect their rights (invested capital and returns), then the government would not have to worry much about the firm management and not have to impose so many regulations over the firm behavior. In this regard, one interesting example is the regulation against chaebol firms' equity investment over other firms. The Korean government and the Fair Trade Commission have set a maximum limit on the inter-firm equity investment as the 25 to 40 % of net asset of each affiliated company. It is well known that with this circulating equity holdings among affiliates, the chaebol families were able to keep their control over the empire, and it seems natural for the regulation body to try to limit such investment. However, it is against the global standards since it regulate investment behavior of the private firms; in the US

there was no such restrictions. Furthermore, with the opening of the stock market and heavy inflow of the foreign portfolio investment in the stock market, the foreign share increased rapidly. The Korean firms then complained about the possibility of hostile takeover by the foreigner whereas they cannot defend themselves given the regulation against the inter-firm investment. Such restriction against investment was also perceived as hindrance to restructuring, entry into new business and exit from old business. Thus, this regulation was abolished in February 1998.

However, from April 2001, just 3 year after the abolishment, the restriction was re-instated. That argument was that without this restriction, chaebols had been trying to just issue more stocks to meet the debt-equity ratio reductions rather than paying off the debts. As table 4-2 shows, the debt-equity ratios actually declined substantially without paying off debts. This was possible as the top chaebols issued simply more stocks taking advantage of the re-bounding stock markets. However, this revival of the investment restriction signifies the reversal of the global standards or the reform, by the bureaucrats. While many foreign firms have now entered the Korean markets competing against the Korean firms and while any former barriers to M&A are now all abolished, it is unfair and against the market principle that the Korean firms are discriminated in terms of investment. Owing to this restriction, firms are using up substantial resources to defend against possible M&A threat as exemplified by a famous case of the SK group against the Sovereign investment group which bought and held a largest block of shares in 2003 and 2004.

One of the reasons for the revival of this regulation of inter-firm investment, despite that it is not a component of the global standards, might has to with the interests of the political leadership to satisfy the activist NGO groups and the general attitudes in the Korean public against the big power of the big business, as well as possible wishes of the bureaucrats who want to maintain their influence. In a sense, it might be called another example, or Korean version, of the clientalism although in this case the clients were not big business but NGO's and popolarism (Ruis and De Walle 2003).

#### Rigid Imposition of the Global Standards: The 200% Debt-Equity Ratio

Another important reform measure was the reduction of debt-equity ratio. In Anglo-Saxon model and in most developed countries, debt-equity ratios are lower than 200% while it used to be around 400% in Korea. With development of capital market, progress in related reforms, and the experience of financial crisis itself, it is natural to expect a gradual and eventual decline of this ratio in the Korean firms. But the Korean government declared the uniform and abrupt goal of the 200 % as the ultimate targets. While the Korean firms actually fulfilled this target, it is out of question that such uniform regulation is neither efficient nor beneficial to competitiveness (Jwa 2003). An acceptable or optimal debt ratio varies among the firms, industries and countries.

The issue of uniform reduction of debt ratio is the problem of both blueprint and implementation according our model. Preference for such extraordinary practice of uniform regulation sits at the bottom of the habit set of the Korean government and bureaucrats. As a legacy of the state-led industrialization, the paternalistic government, refusing to discriminate among different firms, has often found it "politically safe" to apply the same disciplinary measures across the board to all firms (Jwa 2003).

#### Example 1-2: Tension in the Labor Market Reform

Whereas post-crisis reform aimed to restore market forces in the bureaucratically structured labor market, the interactions among major actors and groups has produced such a segmented labor market that core sector workers are over-protected while periphery workers are under-protected. The gap between aspiration and achievement cannot be explained without considering the local specificity such as institutional and cultural context for reform. Whereas the central intent of the reform agenda was to alter Korea's institutions, the reform effort was itself embedded in that same institutional matrix. It was inevitably compromised as a result.

One of the key reasons for the confusion and conflict during the post-crisis labor reform is closely related with the conflict between two different types of economic system. In return for the bailout program, IMF has imposed the liberal market economies model that was a ready-made prescription for the economic illness in Latin America or in Eastern Europe. Without enough time to reflect on the validity of the model, Kim Dae Jung hastily accepted the prescription of the IMF.

Reviewing the history of capitalism, we find varieties of capitalism based on different institutions and reflecting diverse natural environment, culture and historical backgrounds (Hall, 1986). Notwithstanding the differences in the details, Korean version of capitalism has been rather closer to the Japanese than the Anglo-American or European version of capitalism, as is marked by the close relationship between the government and the business, enterprise-based welfare system, and firm based internal labor markets.

After the economic crisis, however, the reform is equated with imposing the global standard that is another name of Anglo-American model, on local context. However, we find at least three different types of institutions are mixed as a result of reform. First of all, industrial restructuring and change in corporate governance was based on the Anglo-American model, while the tripartite commission was based on the European model of “private interest governments,” where the state delegates her power to the peak organizations in labor and business sector, and these peak organizations, with the representation and holding power over the affiliated members, coordinate and bear the responsibility of the macro-economic policy. Two different blueprints were in conflict with each other, and with the local employment system.

#### Anglo-American Model of Labor Market Flexibility and its Problem

Coupled with the long tradition of paternalism and cherish for long-term relationship between employer and employees, Korean employment regime (K-type hereafter) is quite different from the Anglo-American employment regime. This Korean model resembles the Japanese employment system in several points, especially its emphasis on harmony among workers and the role of leadership and teamwork. Wages are determined by seniority of workers, and had very rigid structure with wage sum well protected from the fluctuation of economic cycles. Therefore the speed of promotion becomes the main incentive, as it ultimately determines the amount of life-long remunerations. In the Korean model, as in Japanese case, the most important skill is firm-specific skills and knowledge.

It is obvious that Korean type employment has quite opposite characteristics from the Anglo-American system, or “the global standard” in employment system. Labor market reform, therefore, is a shock in several aspects. First, layoffs give more impact to K-type workers than to the A-type workers. Layoffs deprive of the contextual knowledge from workers, as it is embedded as sunk cost in tightly coupled employment relationship in K-type system. As K-type is a ‘task-oriented system,’ laid-off workers have more difficulty to find a comparable job in different firms. Secondly, the dynamism of the K-type employment has been maintained by the rapid growth of the economy, and implicit agreement that workplace is a ground for life-long commitment comparable to family. But economic crisis and stagnation has destroyed the myth of family-like life-long engagement. Economic stagnation undermined the stability of promotion system, thus making higher positions increasingly redundant. Thirdly, many companies have identified layoffs as panacea to their problems. For the first time in Korea’s recent economic history, these core workers, usually highly educated managers and skilled technicians, became the target of mass layoffs. However, mass layoffs of core members undermined the moral foundation of the K-type system, such as harmony and commitment. Gradually, the implementation of layoffs confronted the resistance of the labor, especially from the well-organized sector.

## Implanting European Corporatist Model to the Korean soil

Tripartite Pact among the government, the labor, and the business was a valuable gift for the Korean delegates in New York who were negotiating for rollover from the international financial community. The pact was regarded as the elimination of major barrier to the economic reform, i.e., removing labor market rigidities. But the tripartite committee was a hurriedly constructed without institutional legacy. There are several reasons for the failure of the TC in Korea.

First of all, there is no tradition of party-politics based on class-cleavages in Korea. TC was rather an arbitrary arrangement without the support of political party that represents the interest of the working class. Both KCTU and FKTU did not hold the real power to or properly represent affiliated unions. Enterprise-based unionism, which has been the tradition in Korean trade unionism, was not functionally compatible to the TC that was developed in corporatist institutional framework. As peak labor organizations have neither the capacity for policy-making nor the power to impose the decision to affiliated unions, social pact became a mere scrap of paper. Secondly, Korean companies have developed enterprise-based employment system, represented by the firm internal labor market. Also labor unions tried to develop isomorphic structure to respond effectively to the enterprise-based employment system. Companies tried to develop “employee consciousness” and trade unions responded with “union member consciousness,” but both of them were based on the same enterprise.

While there is neither tradition of macro-level institutionalization nor compromise between labor and capital at the enterprise level, the hastily signed Tripartite Pact includes all macro-level policy issues such as legislation of layoffs and labor dispatch, corporate reform, social insurance reform, social integration, and government restructuring. Without power and dedication to monitor the agreement and to sanction the violator, the maintenance of the Pact was very vulnerable to abrogation by any part.

### 2) Reform Consensus and Aborted Reforms

#### *Hypothesis Two:*

*2-1. It is very critical to have strong reform coalition and/or consensus, without which reform is more likely to be aborted or unsuccessful.*

*2-2. The aborted reform is likely to bring in the crisis and then the crisis can serve as the momentum to build reform consensus as well as bringing back old agencies such as state bureaucracies*

Example 2-1: The aborted financial reform in the 1990s that could have avoided the crisis.

With democratization since the late 1980s, the diverse vested interests groups became organized to pursue parochial interests at the expense of overall goal of growth. These groups included labor unions, NGOs, intellectuals, and new media. In contrast, the autonomy of technocratic bureaucrats has gradually been weakened. While there was also reform effort immediately before the 1997 crisis, it got astray in midst of conflicts and contradiction between traditional and new forces. A specific example is the abortion of the 1993-94 financial reform. The lessons is that we need to have first a system of effective legislative bargaining necessary for disputing parties to negotiate. Only with this, interest politics does not necessarily lead to reform failure. In what follows, let us provide the details of the effort for financial reform in the early 1990s.

President Kim Young-sam established a Presidential Commission on Financial Reform (PCFR) in January 1997, precisely when the fiasco over labor reform profoundly discredited his government. The initial talks of orchestrating a “big bang” in financial sectors quickly disappeared. The president had lost all moral authority with his labor fiasco as well as the scandal over corruption involving a now-insolvent Hanbo Group. Moreover, the PCFR itself was a moderating force on reform, with

thirteen of its thirty members drawn from big business who — as the primary beneficiary of bureaucratically distributed bank loans — had an interest in avoiding any “radical” solution. This was most unfortunate since any realistic solution on nonperforming loans could not be but radical, given their astronomical size hitting the level of 14.3 percent of all outstanding loans. Only through a radical program of corporate workout, massive layoffs, bank privatization, and foreign takeover could Korea put the banks and NBFIs on a financially viable footing. The PCFR predictably — and for understandable political reasons — focused on administrative reorganization instead, producing a proposal which would give the central bank an effective control over monetary policy, while concentrating all regulatory powers over banks and NBFIs in a newly proposed Finance Supervisory Commission (FSC).

However, even this proposal for organizational reshuffle did not survive bureaucratic struggles. The hitherto excluded Finance and Economic Board (FEB, established in 1994 by the merger of EPB and MOF) rebelled, successfully revising the reorganization bill to win back most of its power over monetary policy. The FEB retained its power to prepare financial laws, including the authority to distribute licenses and permits to set up NCB and NBF branches. The Financial Monetary Committee — formally the highest authority in monetary policy — was also placed above rather than inside the central bank (in direct opposition to the PCFR’s proposal), with its chairperson subject to “removal by the President upon the recommendation of FEB Deputy Prime Minister.” These revised reorganization bills then sat idle in the floors of the National Assembly because the legislators would not put them to the vote. Even the leaders of the ruling NKP publicly advocated an indefinite postponement of financial reform as early as May 1997, even before the bills were prepared by the PCFR and revised by the FEB. With only six months left for the presidential election, it was difficult even to convene a national assembly session to deliberate on the reorganization bills. Entrapped in a devastating war of negative campaign after July 1997 and hit by massive business failures since January, both ruling and opposition political parties chose to evade making a choice on financial reform (B. Kim 2000). The president meanwhile had become a lame duck, discredited by the charges of corruption as well as incompetence since the political fiasco over labor reform in January. Even his own political party turned against him, arguing for a national assembly hearing on economic mismanagement and irregularities. The party even forced Kim Young-sam to “withdraw” the party membership in November. The reform accordingly drifted without a political supporter until Korea pleaded for an IMF bailout.

To sum up, the forces of democratization and globalization undermined the two mechanisms to force adjustment when the Korean economy over-expanded. Democratization made it difficult for the state to transfer much of adjustment costs to the workers through political repression, whereas globalization opened a way for the chaebols to escape from the state’s regulatory control and to finance their business ventures by directly borrowing from abroad.

Example 2-2: Case for the state brought back, or the reason for the continuing supremacy of the state in the Korean economy

The financial crisis was a joint work of the reckless chaebol expanding into uncompetitive business fields, the ideologically contentious but organizationally fragmented labor movements defending job security and company welfarism, the illiquid financial sector opposing workout, and the increasingly clumsy bureaucratic leviathan that not only opposed reform for its fear of losing discretionary power, but also fostered financial troubles by mismanaging macroeconomic policy and pursuing partial reform since 1988. However, one of those culprits — elite career bureaucrats — saw their power increase with Korea’s liquidity crisis and became entrusted with the task of restructuring the very economic system they had created since 1961.

The survival of elite bureaucrats has to do with the unique background of the new Korean president, Kim Dai-jung, who used to be a long time political outsider. Right upon taking the new post, he recognized early on his lack of a broad brain pool and decided to make the old guard — elite career

bureaucrats — his people by entrusting them with key posts. The former EPB and MOF bureaucrats monopolized all key economic policymaking posts, including the presidential staffs and cabinet portfolios as members of the New Mainstream. The party politicians ruled, while career bureaucrats governed, as they had been doing all along since Park Chung Hee instituted the developmental state in 1961. Neither the transfer of power nor the explosion of financial crisis fundamentally altered Korea's way of making economic policymaking. The opposite was true, as political outsider Kim Dae-jung could only turn to the “neutral” state bureaucrats for a guide on economic policy if he were to respond effectively to the challenge of financial crisis. Kim Dae-jung knew of what the state bureaucracy could do for his reform, and unambiguously sided with the proposal to strengthen its role.

The state bureaucracy, on the other hand, realized that Kim Dae-jung's “neoliberal” reform is not contradictory to its interests as the reform itself needed the help of bureaucrats for implementation. On the contrary, the economic authorities — reorganized in early 1998 into a “policymaking” FSC, a “regulatory” Financial Supervisory Service, a “strategic” PBC, and a “coordinating” Ministry of Finance and Economy (MOFE) — in fact saw its power drastically enlarged with comprehensive reform, because more stringent prudential regulations and supervisions over financial institutions prevented planning bureaucrats and party politicians from intervening on behalf of industrial policy to demand subsidized policy loans for their constituents. Even the recapitalization of banks with public money strengthened the FSC and MOFE by driving out the chaebol from financial institutions. The state filled in as a shareholder, acquiring by May 1999 over 90 percent of shares in Korea's top four commercial banks, and between 20.1 and 46.2 percent in seven others banks.

Whereas the crisis threatened the chaebol with financial collapse and demoralized labor unions with the specter of massive layoffs, it empowered the FSC with the power to restructure banks and corporations, as well as transformed the FTC into a credible fair trade regulator. The Korean state bureaucracy certainly lost autonomy vis-à-vis international capital when it accepted the IMF bailout in 1997, but this loss became a source of power in its dealing with domestic economic actors.

Herein lay an ironic twist in post-1997 Korean politics. Enjoying powers delegated by the President and filling in the institutional vacuum left by the bickering political parties, former state planners and finance bureaucrats found themselves leading comprehensive reform. The power of elite economic bureaucrats hardly suffered a blow. Thus, we can say that Kim Dae-jung was doing new things in very old ways. The reform initiative remained within the hands of elite career bureaucrats, as it had been in the past decades.

### 3) Visible Success and Invisible Failure

#### *Hypothesis 3:*

*3-1. While reforms tend to make more success in the area of quantifiable or tangible targets, less satisfactory are often the areas related to the habit and intangible institutions.*

*3-2. Even the quantifiable or more visible successes are often made in a disguised manner without real changes. This tendency could in turn result in unintended “undesirable” consequences, such as eroding growth potentials.*

#### Example 3-1: The 1980s reform

The economic reform that took place in the early 1980s was largely in the area of macroeconomic policies, and the policy reforms helped Korea resume rapid economic growth throughout the 1980s. Macroeconomic stability was achieved with manageable budget deficits and external debt, low or moderate inflation, and a stable exchange rate (World Bank 1993). Thus, in terms of macroeconomic policy and performance, Korea was a success case following the Washington consensus. But, this

success came at a cost as it dulled the urgency for solving structural or microeconomic problems, such as the continuing arbitrary involvement of the government in the banking sectors, power of chaebols and their opaque corporate governance.

Privatization of banks was one of the main reform measures, and many banks were actually privatized, selling the formerly government owned stocks. However, the privatization of banks did not remove government intervention from their management. In spite of privatization the government continued to appoint bank directors and officials, maintaining an “overly cozy” relationship with the banks (Emery 2001). This relationship between government and banks could continue to prevail partly because the Korean people used to believe in the idea of virtuous government as prescribed by Confucianism and expect the government staffed by educated mandarins to take an active role in promoting economic development (Cho 1994). It was such an attitude toward government that provided legitimacy to the extra-legal influence that the government exercised over the banks that had been legally privatized. This indicates how informal institutions limit the effectiveness of newly introduced formal institutions or reform measures.

Also it was not easy to disband or downsize the chaebols and to improve their corporate governance and labor-management relations. According to Cho (1994), in Korea the owner-head of a firm holds an authoritarian position comparable to that of the head of a typical Korean household. In such a firm the owner-head is expected to behave (and thinks he is behaving) like the head of a household; that is, with tolerance and generosity which are valued as supreme virtues of the head of a large family (You 1998, quoted in Emery 2001, p.59). As long as such persons remain the heads of enterprises and regard their employees as members of a large family it is hardly likely that any formal institutional reform designed to introduce the Anglo-American model of corporate governance in Korea would succeed in achieving its purported objectives. It would take changes in culture and social norms for that to bring about an effective change in corporate governance in the fashion of the Anglo-American model of corporate governance.

This is what we mean by the local-specific initial conditions that any attempt to reform a country’s formal institutions must take into account, as they are slow to change and may not be compatible with newly introduced formal institutions. One of the difficulties in changing institutions is that the durability of informal institutions constrains the type and speed of change that may be made in formal institutions because the new institutions will have to be compatible with informal institutions if they are to be effective (Lin and Nugent 1995).

### Example 3-2: Post-crisis Corporate Governance Reforms

As discussed in the preceding section, corporate restructuring has significantly improved the capital and business structure, namely reducing the debt-equity ratios and increasing profitability. This should be taken as a very important progress. In the past the typical strategy by chaebols in response to any government reform initiative tended to be a “time earning” strategy delaying implementation of any specific measures as much as possible. However, it is important to realize that the reduction of debt-equity ratio was not made by paying off the debt but by issuing more stocks. In part B of the table 4-3, the average amount of the gross debt in the top 5 chaebols has rather increased from less than 50 trillion Won to more than 50 trillion Won, and the other smaller business groups showed the same trend in this regard. In other words, the quantifiable or more visible successes are often made in a disguised manner without real changes.

Next, when we look at the areas where habits and mindsets of the firms are involved, the outcomes are even less satisfactory or mixed. In the table 4-4, let us first look at the survey results of the corporate governance in 10 Asian countries done by the CLSA in 2001 and 2002. According to the table 4-4 part A, the scores by Korea have increased from 47.1 in 2001 to 62.0 in 2002 with its ranking improved from the 8th to 5th. In part B of the table 4-4, such improvements are decomposed into several sub-areas.

It shows that transparency has improved its ranking in biggest degree, possibly reflecting the introduction of the requirement to file the consolidated/combined statement. Also, progress has been made in such areas as accountability and responsibility, reflecting the increased rights of shareholders. Although class actions are still not allowed in Korea as of 2003, we can say that rights of general shareholders are now better recognized than before. We are now seeing and hearing many cases, which we have never heard before, where minority shareholders raise objections to, or raise suits to, the doings of the top management or controlling shareholders. Actually, increasing rights of minority shareholders has become a part of social movement, involving an organization called "Solidarity for Participation." In the meantime, the management is now starting to say that independent management is increasingly threatened by such movement as activists promoting shareholders' rights. Such voice from the management is understandable too, given the lack of sufficient "business judgment" safe harbors as in the American system (OECD 1998). Now, an increasing number of Korean companies are now buying their directors insurance for their legal liabilities in preparation for increasing law suits. In sum, the important matter should be how to balance the interests of the management and the shareholders, and, furthermore, how to align these two interests. OECD (1998) suggest that performance-based compensation is a useful tool for this purpose, with stock options as one of the best. However, in Korea stock options are just being introduced although it is being spread very rapidly.

Turning back to the survey results in the table 4-4, one noteworthy feature is that all sub-areas have made progress except the independence of the boards. We take this feature very telling. All other aspects such as transparency, accountability and responsibility are measured in the survey by specific quantifiable or tangible targets. For example, the survey asked whether the shareholders can demand the general meeting of the shareholders and whether they have the rights to see the accounting books, and whether the group-affiliated firms report the consolidated and/or combined financial statements and so on. As you see, these are basically minimal formal requirements and cannot directly translate into transparency, accountability, and responsibility and so on. But, assessment of the independence of the board requires subject or qualitative perception, and in this area the survey shows deterioration. Appointment of the outside members in the boards has been one of the core reform measures and the role of the boards may have more direct links to corporate governance than other aspects.

Table 4-5 compares Korea's international ranking in terms of national competitiveness and corporate governance. In the results by the both the IMD and the WEF (World Economic Forum), we see there is substantial gap; Korea was ranked as the 27th in national competitiveness but its ranking in corporate governance is well below this. Also, in this comparison, the ranking in corporate boards (independence) is lowest. At present, in most cases, these independent directors are known not to play any active role in corporate governance, with a few exceptions.

Last, we would like to point out that some of those visible successes come with the sacrifice in other important aspects. Owing to restructuring, corporate profitability has improved significantly. This pattern indicates that the big business in Korea has been reorienting their focus from sales or market share expansion to profitability or the rate of returns. These achievements might have come by sacrificing investment in physical capital and R&D. As noted in the preceding section, investment to GDP ratio has fallen substantially. As shown in table 4-1, investment to GDP ratio plummeted to 27 percent or so during the 1999-2002 periods from 37 percent or so during the 1993-96 periods. While it is natural to see some decline from the excessive investment before the crisis, 10 percentage point decline can still be regarded as substantial.

More specifically, we can ask what has happened in terms of real competitiveness and efficiency of the firms. This is important because more transparent corporate governance itself might not be the ultimate goal of the firms unless it is translated into performance.

The empirical analysis using the firm data by Park (2003) show a little improvement in efficiency or



productivity although it might be too early to make a firm judgment about the impact of the reforms (see table 4-6). First of all, the rate of the total factor productivity change has rather decreased steadily from 2.4 % between 1996 to 1997 (pre-crisis period) to less than that in post-crisis period, for example only 1.2% between 1999 to 2000 in the case of the top 30 chaebols. When we decompose into this productivity change into three sub-components of technological change, scale efficiency change and technical efficiency (the distance from the production frontier), we note that the rate of technological change (rate of innovation) and the technical efficiency change has rather declined over the pre- and post-crisis period. For example, the rate of technological change was 1.7% over the 1996/97 period, whereas it was only 0.8% during the 1999/2000 period.

#### 4) Institutional Complementarity and Sequencing

##### *Hypothesis 4:*

*4-1. One source of the implementation difficulty in reform has to do with the institutional complementarity among the sectors.*

*4-2. Implementation of reforms should take a proper sequence, possibly moving from banking reform, corporate governance, labor relations, and then to finally business restructuring .*

Example 4-1: Connectedness between Business Restructuring and Capital Market Efficiency and Corporate Governance.

Before the crisis in 1997, the Korean economy was a symbol of high growth. Thus, the Korean firms had not experienced much restructuring of their business, namely the process of selling out, closing down, or reducing the unprofitable segment or subsidiaries. For this reason, the 1997 crisis was a big shock for the business. Post-crisis business restructuring was initiated by the government. The so-called 'big deal' program was to implement business swap among the chaebols, or big conglomerates. Although the amount involved was so big, the government had to play as intermediary. However, the government-initiated big deal had achieved only mixed results. For example, the sale of LG's semi-conductor line to Hyundai did not lead to success and the troubled Hynix (formerly Hyundai Semiconductor) had emerged as one of the biggest headache for the Korean economy, and a part of it was eventually sold to a Chinese company.

As there were many criticisms for the government-initiated business restructuring, the government tried to take a different approach for the second rounds of business restructuring starting in early 2001. The government only designated the names of those sectors and decided not to direct any concrete or detailed ways to restructuring. These sectors include chemical fiber, paper production, cement, agricultural machines and so on. While the situation of these sectors was particularly bad, there was not much market-driven restructuring in the form of M&A, divestment, or closing-down. Thus, the government wanted to something but there was really not much things to do, when they do not want to be blamed again for "inefficient government intervention."

However, the 'voluntary restructuring' was not easy, either. While the government wanted the firms to commit themselves to major hauling of their business, the firms were saying the without debt-equity swap or debt rescheduling or reductions, horizontal restructuring among the firms, such as M&A, would not happen. Commercial banks then said that without some words, even implicit signals, from the government, they cannot afford to give such favors as debt reductions or swaps and so on, and that it was better for the government to pour its own money to those troubled firms.

Below, we will see what went wrong in this second round of business restructuring with the paper production industry as a representative case (Y. Kim 2002). Paper industry is a mature industry, and there was world wide restructuring, and its main form was M&A. While Western firms reframed from

expanding production capacity, the Korean firms had continued to expand the capacity throughout the 1990s with their capacity more than doubled from the 1990 level. As the market turned into an excess capacity, the firms made losses and their debt ratio increased.

Korean firms had tried to deal with this situation in their own ways, with strategic alliances as the main responses. For example, two companies signed an agreement of 'comprehensive strategic alliance' in February 2001. This agreement was to coordinate their production, marketing, procurement, and logistic. Their motivations were known to overcome the limits of within-firm restructuring by affecting the market with some coordinated actions among the players.

But, any merger deal was not realized, and the reason for this is noted as deficiency in market infrastructure, including the lack of intermediary bodies, corporate governance issues and the related transparency problem in the firm. First of all, since information revealed in the accounting books of the firms are neither accurate nor reliable, it cannot serve as the basis for price negotiation in the M&A deal. While this is the first and immediate source for the price haggle, another source is the high premium for the management control rights. Since the corporate governance is not clear, there exist diverse channels for expropriation of company resources by the controller, the so-called "tunneling." Since the stakes are very high for the controlling management, they wanted to maintain their control over the firms unless they are paid substantial premium. For these reasons, the two sides tend to find it difficult to agree upon the prices of the target.

While this case shows the limit of the so-called 'voluntary restructuring' without direct government involvement, it also exemplify the market failure in the sense of the lack of intermediary vehicle to facilitate M&A and sale of the firms, associated with the efficiency and size of overall capital market in Korea. Another reason has to do with the prevalence of group-style firms in Korea. Since many firms are a affiliated firm of one business group or another, the restructuring is driven by the group-level considerations, rather than at the level of each firms, which makes the process end up "intra-group" restructuring.

But, the point of the above story is not to blame the market-based or global standard approach itself, but rather to emphasize the need to address certain necessary conditions for such approach to be effective, or equivalently the importance of local specificity. We first noted the insufficient development of intermediary vehicle to facilitate M&A and sale of the firms, and then pointed out the extra premium attached to the owner-controllers' of the firms associated with the opaque nature of corporate governance. The existence of controller's premium suggest that this part should be tackled first before we take the "market will do the job (M&A)" attitudes.

Example 4-2: Connectedness between Labor Reform and Corporate Governance.

As Lee and Lee (1992) stressed, labor market in Korea during the high growth period used to be flexible, with the management commanding full authority over workforce restructuring. Employment also used to be short-term oriented. However, after the turning point toward labor shortages and especially since the 1980s, employment practices gradually became long term-oriented. With the democratization with the new government under the President Roh and after experiencing mass-scale labor strike in 1987, the power of labor unions became stronger and labor market turned into a very rigid one. However, this change was OK at least when the economy continued to grow as the businesses were always in need of more workers.

Since the mid 1990s the economy started to slow down and fell into the crisis in 1997. With this turn of events, labor market flexibility, especially downsizing of workforce, emerged as one of the most serious issues in overall corporate restructuring. Actually it was early 1997 even before the onset of the crisis that first revision of the labor-related laws was made by the strong demand from the management side. However, it was right after the onset of the crisis, namely February 1998, that the revised law officially allowed the management the right to discharge the "redundant" workforce when

the companies are in bad situations.

To examine the process of workforce restructuring, we take the case of an automobile company which experienced, first time as a big company, a large scale downsizing of workforce after the revised labor law came into practice. This was a very noteworthy case that attracted national and international attention given its scale.

The company felt the need for workforce restructuring and initiated it since mid 1997 with the slowdown of domestic market. The company formally announced the downsizing plan in April 1998. The plan estimated about 40.6% (18,730 employees) of its workforce as redundant workforce as the firm was experiencing a 40% cut of production volume from the normal level. The company first started to invite three rounds of voluntary quit-off from April to June with a total of 4,455 workers filing for retirement. The initial response from the labor was that no single worker can be laid-off and work sharing combined with reduction of work hours should be introduced. As the bargaining between the management and labor did not reach agreement, the firm came up with the list of 2,678 workers to be discharged in July 20, and soon issued the actual order of discharge to 1,538 workers on July 31. The labor unions responded with 6 rounds of strikes, occupation of work floor and sit-ins since July 20, 1998.

Finally, the government decided to intervene in recognition of importance of this case, especially for international investors. With the intermediary role of the government, the both sides reached, on August 24, an agreement with lay-off of 277 workers and 2,018 workers given on-leave without pay as its core contents. This agreement of lay-off, though the numbers are small, was an important compromise from the labor side, in light of its initial position against any lay-off, and, on the other hand, reflection of the management's strong will, given the symbolic meaning of involuntary lay-off, the first case of its kind in Korea.

In sum, the company can be said to achieve its goal, although not solely by lay-off means, close to its original target of 10,166, if one include those separated in the form of retirement and on-leave without pay. The short run cost of this process from the management side amounted to roughly 1 billion US dollar worth cars of 100,000 units to be produced during the period of strikes, as well as minimum living subsidies to those on-leave without pay and one time complementary pay for those discharged and retired. Taking into these costs, net benefit of the whole plan of workforce downsizing is quite problematic. Moreover, as the company made a remarkable turn-around in 1999 even to the level of acquiring another major automobile company, the company recalled those who were on-leave without pay and those who were discharged.

Also, if one knew such quick turn-around in advance, one doubts whether it really had to go through all the hassles that hurt both sides of the management and labor, in terms of not only monetary costs but also symbolic value of job security and loyalty. This makes one wonder why the both sides did not avoid the path toward mutual destruction or huge costs. As one of the most important reason for both sides not to reach agreement, we would like to point out the lack of transparency in the firm management and accounting matters. It is often observed that the management does not provide the labor side with sufficient information about the status of the company and tend to avoid huge profit from appearing in accounting books with a view to ward off the distribution demand from the labor side, and at the same time, to avoid losses, too, since they don't want to be blamed (H. Cho 1999). As a matter of fact, the labor side argued that the accounting book showed a profit of 700 million Won but in reality the company (A automobile) made losses in 1997. It is widely broadcasted that the post-bankruptcy investigation of the accounting books of two other major automobile companies revealed unbelievable degree of manipulation of the magnitude of several billion US dollars.

Given this situation and practices, it is hard to blame the labor side not believing what is told by the management about the situation of the company. Since the accounting books are manipulated, it is meaningless to provide the labor side with the accounting information of the company and to demand such information. Thus, the labor unions had not choice but simply demand more from the other side,

regardless of the situation of the company (S. Cho 2002). Even when the company falls into troubles, the labor side perceives it as a fault of the management side, but feels that they are not responsible for it. So, in turn they feel furious when they have to be laid-off out of situation they are not responsible for (Bae 2000).

At a more fundamental level, the issue of management transparency goes beyond the level of the labor-management conflict to the level of the top level governance. Only when a good corporate governance system is in place, one can expect transparent management and information disclosure to the labor side. Only after that, a more efficient and less costly bargaining between the labor and management can prevail. This story is indicative of the connected nature of the reforms, namely the linkage between the labor reform and corporate governance reform.

## 6. Comparative Implications and Lessons from the Reform

### 1) Summary of the Findings

The findings from the analyses in the preceding sections can be summarized as follows.

First, our analysis confirms again that informal institutions take time to change or reform, implying that macroeconomic reform might be easier than microeconomic and institutional reforms. We have thus found that reform tends to achieve some nominal success in terms of making new laws and several quantifiable targets (eg. debt-equity ratio, introduction of outside directors on the board, selling of banks to foreigners, etc.), and to be more successful in areas where conflicts of interests are less acute (opening capital and M&A markets to foreigners). In contrast, reform tends to make little success or take more time in really changing institutional conventions, habits and beliefs, such as enhancing transparency in management or trust in labor relations. Then, the lesson is that any serious reform blueprint should take this point into account. Otherwise, reform will be not successful.

The above observation is based on our recognition that fundamentals of the Korean economic system have not changed much, despite a series of reform measures that have had some success. In other words, the state is still a key presiding agency in the economy, big business is still controlled by the owner-families, major banks is now majority-owned by the state (thus the basis for state-led banking is reinforced), and the state still sets the industrial policies for next decades. But we still hear about incidences of illicit money dealings and manipulation of accounting books, and the role of the board/directors is still limited.

Second, one source of the implementation difficulty in reform has to do with the institutional complementarity (Aoki and Okuno 1996) among the sectors. Because the character of one reform critically depends on the character of the others, we need to find a general equilibrium blueprint and/or take a proper sequence in reforms. One possible logical (maybe not practical) sequence seems to be moving from banking reform, corporate governance, labor relations, and then to finally business restructuring. The reasoning is as follows. To successfully carry out a banking reform, which involves write-offs of bad loans, debt restructuring, and prudential regulation, is directly linked to business restructuring and labor market reform. But going ahead with business restructuring encounters the difficulty associated with the owner-controlled nature of the Korean firms and corporate governance. Since the owner has a high stake in the firm owing to the opaque corporate governance allowing rents (private benefits) for controllers, the owner tends to resist inter-firm restructuring (M&A or sales) of firms under his/her control unless they pay a very high premium. In labor market reform, a low level of transparency in management and governance tends to interfere with the reform effort bringing in more flexibility in the labor market.

Third, interest politics in the implementation stage, plus the complexities caused by democratization and globalization, are likely to cause weakening of state capability (or reform coalition) and implementation effectiveness and hence the distorted outcomes of the reform. For example, in labor relation reform, the new environment of globalization increases the need for flexibility. Thus, while the Korean companies desperately struggled to secure flexibility, they are now facing the much stronger labor unions. The outcome is not a fully flexible but segmented labor markets, divided between the core, unionized workers and unorganized periphery workers, and between the one over-protected and the other under-protected, with substantial times wage rates differentials between them.

Fourth, it is important to have an effective system of legislative bargaining necessary for disputing parties to negotiate. Only with this institutional vehicle, interest politics can lead to some reform consensus and not necessarily lead to reform failure. This is related to the hypothesis that it is very critical to have reform consensus, without which reform is more likely to be aborted or unsuccessful. We note that Korea tried to overhaul its financial system and conduct substantial financial liberalization but it was partly aborted and partly distorted, which paved the way for financial crisis

after 3 years. In the Korean case, real and strong consensus for reform arrived only after the 1997 crisis as the crisis persuaded the society of the need for reform. However, as he used to be a political outsider, the President Kim Daejung lacked brain pool and decided to make old guard (elite bureaucrats) his people by entrusting them with key posts for reform. The crisis brought back the state and its autonomy revived to the front as the banks, labor unions, chaebols all staying in back yard. The bureaucrats joined reform since neo-liberal idea was not threatening their interests and their power rather enlarged. The outcome was the quick implementation of one of the most comprehensive reform but doing new things in old ways.

Fifth, reform process tends to involve tension between global standard and local ideas and interests (specificity) which often become sources for the mixed results or new conflicts. Most reform, especially those started from the external pressure, tend to be under pressure to introduce more elements from the Anglo-Saxon model or global standards. Then, the difficulties arise from the fact that while some elements of the global standards are really necessary and needed ones while some others are not, and also the fact that interests conflicts and related bargaining process add another complexities such that good elements are often blocked or distorted.

In the corporate governance reform, while the main agency cost problem in the Anglo-Saxon model of the firm is that of the hired management, in the Korean chaebols it is the agency costs between the controlling shareholders and the minor non-controlling shareholders. Then the right focus of the reform should have been to strengthen the right of the minority shareholders but the initial focus of the reform following the Anglo-Saxon model used up its energy in introducing outside directors in the board. We have also discussed the case of the regulation against the inter-firm equity investment in the business groups which was abolished to follow the global standards but late re-imposed partly in reflection of the interest of bureaucrats. This revival of the investment restriction signifies the reversal of the global standards by the bureaucrats.

In labor market reforms, we had a hard time in striking an optimum balance between the labor market flexibility and loss of firm-specific skill and trust. The massive layoffs was felt more serious hurt to the Korean workers than to the workers in the American-type economy as they used to live under the different social contract. The dynamism of the Korean employment used to be based on commitment comparable to family. But economic crisis and restructuring has destroyed the myth of family-like life-long engagement. Furthermore, layoffs deprived of the contextual knowledge from workers. One pre-condition for labor flexibility is life-time education and retraining system, such as community colleges and vocational schools in the USA, which lacked in Korea. Without this, layoff workers would find it more difficult to acquire new skills and new jobs, and thus they would resist strongly against possible layoffs.

## 2) Current Korea, a Tamed Tiger?

The reform in Korean was one of the most comprehensively and decisively implemented reform. As of now after 7 years after the break of the crisis, many are concerned about the long term vitality of the economy, balancing the benefits against the cost of the reform. While the reform has brought the Korean firm into more stable, profitable, transparent state of the business, the national economy is now suffering from weak investment, slow growth and slow job creation and rising unemployment again. Some critics like Chang and Shin (2002) argues that such situation is the price the economy has paid in replacing the old catch-up model not by a new catch-up model but by the Anglo-Saxon model which is suitable only for developed economies. Then, a valid question is whether our response (the blueprint) was right, namely the possibility of wrong blueprint as noted in Fanelli (2003).

Our reflection is that the post-crisis Korea just tried to be more market or Anglo-Saxon model oriented but without paying attention to growth and competitiveness. For instance, banks were sold to foreigners who are basically conservative and focusing on consumer lending rather than industrial banking. While the firms are required to lower their debt ratio, they are not reaching out to borrow

and make investment. The point is that while the Korean economy should continue to grow with aggressive investment, the firms have stopped doing that with one of the lowest debt-equity ratios in the world, now about 100%.

The issue of wrong or right blueprint underscores the need to define the reform goal correctly. The goals of reform should not just be a movement toward a market-oriented economic system but toward a growth-oriented one/ or pro-growth market-oriented one. The final criteria for success should be whether it is able to enhance the long term growth potential and competitiveness of the economy, which is the ultimate safe guard against possibility for another crisis. The firms had better be encouraged to pursue long term growth than short term profitability. The Korean tigers look tamed on the surface, like an Anglo-Saxon tigers, but in the heart they still want/need to grow. Along this line of thought, we can identify three sub-goals of the reform, and that should be 1) creating jobs, 2) boosting new firms, and 3) reaching new markets, as they are most consistent with the long term growth.

This is based on the recognition that the real engine of the quick recovery after the crisis originated from the strong and wide birth of small scale venture companies in the economy as the financial and human resources were released from the tight grip of the big business (Lee and Kim 2000). Also during the take off period in the 1960s and 70s, the growth was not owing to the balance between the state and market but to the emergence of new firms, namely the chaebols.

The reasoning goes further to point out one missing block in reform agenda. That is reform and reinvestment of education/human capital system which is one of the most fundamental and vital element for sustainable growth. The recent rise of unemployment also has to do with the low quality of college education in Korea, which does not afford to meet the challenge of globalized labor markets. In other words, while low-skill jobs are now moved to China and others, Korean workers are not skilled enough to be welcomed by high end jobs which are globally sourced.

### 3) Back to the Why, What, and Why Questions

Now let us conclude with the response to the three “W” questions raised in Fanelli (2003) taking into account the Korean experiences with the reform.

First, why were some countries able to undertake reform while others were not? Regarding this question, we realize that for the reform to be undertaken, conflicting interests should be negotiated and coordinated to form a *reform coalition* by strong leadership, external pressure, or dispute-settling institutions. Without this, no reform can start.

Second, what factors enabled some countries to successfully implement their reform program while the program failed in others? Our recognition is that it has first to do with the quality of the blueprint. The reform design or blueprint should be comprehensive taking into account *institutional complementarities* and take a proper sequencing being aware of the impact lags, so that the reform may be pursued enough long time.

Third, why were some reforms more successful at delivering the expected outcomes than others. In this regards, we would like to emphasize the correct handling of conflicting goals and ideas to reconcile the tension between the global and local standards. The leadership should identify the correct reform *goal* first, and then study the initial conditions (local specificities) of your country to write a good blueprint suitable for the goal, keeping in mind that global standards often suitable only for developed countries (eg. bias for profitability against growth).

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Table 4-1: Macroeconomic Indicators, Korea: 1993-2002

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Real GDP (percent change)	5.5	8.3	8.9	6.8	5.0	-6.7	10.9	9.3	3.1	6.3
Final domestic demand	5.7	8.4	9.5	7.3	1.2	-13.8	7.4	7.7	2.5	5.8
Consumption	5.4	7.1	8.2	7.2	3.2	-10.1	9.4	6.7	3.7	6.2
Gross fixed investment	6.3	10.7	11.9	7.3	-2.2	-21.2	3.7	11.4	-1.8	4.8
Saving and Investment (in percent of GDP)										
Gross national saving	36.2	35.5	35.5	33.8	33.4	33.9	32.9	32.4	29.9	29.2
Gross domestic investment	35.4	36.5	37.3	38.1	34.4	21.3	26.9	28.3	26.8	26.1
Prices (percent change)										
Consumer prices (average)	4.8	6.3	4.5	4.9	4.4	7.5	0.8	2.3	4.1	2.7
Consumer price (end-period)	5.8	5.6	4.8	4.9	6.6	4.0	1.4	2.8	3.2	3.7
GDP deflator	7.0	7.6	7.2	3.9	3.2	5.0	-2.0	-1.1	1.3	1.7
Employment and wages										
Unemployment rate	2.8	2.4	2.0	2.0	2.6	6.8	6.3	4.1	3.7	3.1
Wages, manufacturing (annual percent change)	10.9	15.5	9.9	12.2	5.2	-3.1	14.9	8.6	5.8	12.0
Consolidated government (in percent of GDP)										
Revenues	18.6	19.1	19.3	20.4	20.6	21.8	22.4	26.0	26.4	26.6
Expenditure	18.3	18.7	19.0	20.2	22.1	26.0	25.1	24.8	25.1	22.9
Balance	0.3	0.4	0.3	0.3	-1.5	-4.2	-2.7	1.3	1.3	3.7
Money and credit (end of period)										
M3	19.0	24.7	19.1	16.7	13.9	12.5	8.0	7.1	11.6	13.6
Yield on corporate bonds	12.6	12.9	13.8	11.9	13.4	15.0	8.9	9.3	7.0	6.56
Trade (percent change)										
Export volume	14.5	13.6	22.3	17.4	14.8	19.2	12.0	20.6	0.7	14.9
Import volume	6.1	22.5	24.1	15.6	2.0	-25.1	29.0	19.0	-2.3	16.4
Terms of trade	-1.6	3.4	1.2	-9.5	-2.6	-4.5	-2.2	-12.4	-4.5	-0.6
Balance of payments (in billions of U.S. dollars)										
Exports, fob	82.1	95.0	124.6	130.0	138.6	132.1	145.2	175.9	151.4	162.5
Imports, fob	79.8	97.8	129.1	144.9	141.8	90.5	116.8	159.1	138.0	152.1
Current account balance	1.0	-3.9	-8.5	-23.0	-8.3	40.4	24.5	12.2	8.2	6.1
Current account balance (in percent of GDP)	0.3	-1.0	-1.7	-4.4	-1.7	12.7	6.0	2.7	2.0	1.3
Usable gross reserves										
In billions of U.S. dollars (end of period)	18.3	22.4	29.4	29.4	8.9	48.5	74.1	96.2	102.8	121.4
In months of imports of goods and services	2.7	2.7	2.7	2.3	0.7	6.5	7.6	7.1	8.7	8.2
External debt										

In billions of U.S. dollars	43.9	97.4	127.5	163.5	159.2	148.7	137.1	131.7	118.8	131.0
In percent of GDP	12.7	24.2	26.0	31.4	33.4	46.8	33.8	28.5	27.9	27.5
Exchange rate (period average)										
Won per U.S. dollar	802.7	803.4	771.0	804.8	951.1	1398.9	1189.5	1130.6	1290.8	1251.2
Nominal effective exchange rate (1995=100, W/\$)	100.4	100.5	100.0	98.7	108.0	144.7	131.1	123.3	132.6	n.a.
Real effective exchange rate (1995=100, W/\$)	102.9	100.9	100.0	97.9	106.8	133.7	122.3	114.6	121.7	n.a.

Sources: Pyo (2004); The Bank of Korea, Principal Economic Indicators & National Accounts (2002).

Notes. 1. Excluding privatization receipts

2. Prior to 2000, the civil service pension is excluded

3. Including government guaranteed restructuring bonds issued by KDIC and KAMCO

4. Excluding deposits at overseas branches and subsidiaries of domestic banks

5. Including offshore borrowing of domestic financial institutions and debt contracted by overseas branches of domestic financial institutions.

Table 4-2. Reform of Capital and Business Structure and the Outcomes

<Part A. Debt/equity ratio - Simple Average >

Debt/equity Ratio*	top 5 chaebols	6th-30th chaebols				top 30 chaebols
		6th-10th	11th-20th	21th-30th	6th-30th	
2002 end	177.14%	135.95%	353.61%	232.78%	261.75%	247.65%
2001 end						171.19%
2000 end	253.21%	193.42%	707.33%	57.94%	344.79%	329.53%
1999 end	212.02%	234.21%	330.55%	627.53%	430.07%	393.73%
1998 end	335.00%				497.70%	
1997 end	472.90%				616.80%	

< Part B. Gross Debt - Simple average >

Gross Debt (Tril. Won)*	top 5 chaebols	6th-30th chaebols				top 30 chaebols
		6th-10th	11th-20th	21th-30th	6th-30th	
2002 end	56.93	13.64	11.04	3.92	8.55	16.61
2001 end						
2000 end	51.01	10.98	6.03	2.71	5.69	13.24
1999 end	47.02	13.19	5.37	3.87	6.33	13.11
1998 end	46.91				5.30	
1997 end	44.27				5.46	

< Part C. Net Profit or losses - Simple average >

Net Profit or losses (Tril. Won)*	top 5 chaebols	6th-30th chaebols				top 30 chaebols
		6th-10th	11th-20th	21th-30th	6th-30th	
2002 end	4.67	0.97	0.11	0.10	0.28	1.01
2001 end						
2000 end	1.08	0.35	-0.15	-0.23	-0.08	0.11
1999 end**	1.68	-3.96	0.14	-0.39	-0.90	-0.47
1998 end						-19.5
1997 end						-3.2

\* Net profit = (Revenue - Cost) - Interest - Tax = Operating profit - Interest - Tax  
= Ordinary profit - Tax

< Part D. Net profit/sales - Simple average >

Net Profit/sales*	top 5 chaebols	6th-30th chaebols				top 30 chaebols
		6th-10th	11th-20th	21th-30th	6th-30th	
2002 end	6.69%	5.81%	3.04%	1.14%	2.83%	3.48%
2001 end						
2000 end	1.06%	2.16%	-2.01%	-20.12%	-8.42%	-6.84%
1999 end**	2.97%	-16.74%	3.41%	-19.21%	-9.67%	-7.56%
1998 end	-3.30%				-7.90%	-4.50%
1997 end	0.00%				-2.00%	-0.80%

Source: Korean Fair Trade Commission (released April each year)

<Table 4-3> Unemployment Rate by Age Group

Time	Unemployment rate(%)	Age Group					
		15-19 Years old	20-29 Years old	30-39 Years old	40-49 Years old	50-59 Years old	60 Years old & over
1990	2.4	9.2	4.9	1.6	1.2	1.1	0.4
1991	2.4	9.3	4.9	1.3	1.2	0.9	0.3
1992	2.5	10.2	5.3	1.4	1.1	0.9	0.4
1993	2.9	11.0	6.3	1.8	1.2	1.0	0.4
1994	2.5	9.3	5.4	1.6	1.3	0.8	0.3
1995	2.1	7.9	4.3	1.4	1.1	0.9	0.4
1996	2.0	7.4	4.4	1.4	1.1	0.9	0.4
1997	2.6	9.8	5.3	1.9	1.5	1.2	0.8
1998	7.0	20.8	11.4	5.7	5.6	5.3	2.4
1999	6.3	19.5	10.1	5.3	5.2	5.1	2.3
2000	4.1	13.8	7.1	3.4	3.3	2.9	1.3
2001	3.8	13.3	7.0	3.0	2.8	2.6	1.1
2002	3.1	11.1	6.3	2.8	1.9	1.8	1.0

Source: Statistical Office of Korea, *Yearbooks of Labor Statistics* (various years)

Table 4-4 Results of Corporate Governance Survey in Asia

< Part A. Overall Scores >

Countries	2002		2001		Change from 2001	
	Ranking	Score	Ranking	Score	Ranking	Score
Singapore	1	65.4	1	64.5	0	0.9
Hong Kong	2	64.4	2	62.9	0	1.5
Malaysia	3	64.1	3	56.6	0	7.5
India	4	62.2	4	55.6	0	6.6
Korea	5	62.0	8	47.1	3	14.9
Thailand	6	60.0	5	55.1	-1	4.9
Taiwan	7	59.2	6	54.6	-1	4.6
China	8	50.8	7	49.1	-1	1.7
Philippines	9	44.0	9	43.9	0	0.1
Indonesia	10	38.2	10	37.3	0	0.9

Source: CLSA (2001 and 2002); recited from Jang, Ha-Sung(2003)

< Part B. Rank by Areas >

Korea Ranking in Asia 10		2001	2002	Changes in Ranking from 2001 to 2002
		5	8	3
Ranking Survey Questions	Discipline	6	8	2
	Transparency	1	8	7
	Independence	7	4	-3
	Accountability	2	4	2
	Responsibility	7	8	1
	Fairness	7	9	2
	Social awareness	2	4	2

Source : CLSA 2001 and 2002; recited from Jang, Ha-Sung(2003)

Table 4-5: Ranking for Competitiveness and Corporate Governance, 2002

< Part A. IMD Survey >

Country	Country Competitiveness	Corporate Boards	Shareholder Value	Insider Trading	Rights and Responsibilities
Korea	27	41	39	36	40

Source : IMD 2002; recited from Jang, Ha-Sung(2003)

< Part B. WEF Survey >

Country	Ranking	
Korea	Competitiveness	Corporate Boards
	28	61

Source : WEF 2002; recited from Jang, Ha-Sung(2003)



Table 4-6: Changes in Economic Efficiency since the Reform

(unit : %)

	Period	Private Firms		
		Sub total	30 chaebols	Non-chaebols
Total factor Productivity Change	1996/1997	2.8	2.4	2.8
	1997/1998	2.4	1.8	2.4
	1998/1999	2.3	1.6	2.4
	1999/2000	2.1	1.2	2.1
	Whole period	2.4	1.7	2.4
Technological Change	1996/1997	2.3	1.7	2.3
	1997/1998	2.1	1.5	2.1
	1998/1999	1.8	1.2	1.9
	1999/2000	1.5	0.8	1.5
	Whole period	2.0	1.5	2.1
Scale Efficiency Change	1996/1997	0.161	0.330	0.150
	1997/1998	-0.034	-0.020	-0.034
	1998/1999	0.125	0.059	0.129
	1999/2000	0.204	0.026	0.215
	Whole period	1.114	0.099	0.115
Technical Efficiency Change	1996/1997	0.363	0.350	0.364
	1997/1998	0.361	0.349	0.362
	1998/1999	0.360	0.347	0.361
	1999/2000	0.358	0.345	0.359
	Whole period	0.360	0.348	0.361

Note: Total factor productivity change = technological Change = scale efficiency change + change in technical efficiency. Technological change measure the change in the frontier production function, and technical efficiency measures the distance from the production frontier.

Source: S. Park (2003).