South Korea’s Experience with Structural Reform: Lessons for Other Countries*

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Abstract: Despite phenomenal growth through the mid-1990s, the 1997 foreign exchange crisis led to the collapse of the South Korean economy, which resulted in an International Monetary Fund (IMF) bailout. Since then, South Korea has gone through various reform processes. In this paper, we revisit pre- and post-crisis reform efforts in South Korea to draw lessons for other countries. Lessons drawn from the reform processes in the financial, labor, and corporate sectors in South Korea before and after the crisis are two fold. First, economic policy decisions must be made in accordance with economic interests and needs. Second, the government must have a long-term vision and an appropriate policy blueprint while economic restructuring is being implemented. Otherwise, long-term economic consequences may be greater than the short-term costs accompanied by reform policies.

Key words: Financial Crisis, IMF, Economic Reform

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I. Introduction

Despite phenomenal growth through the mid-1990s, the 1997 foreign exchange crisis led to the collapse of the South Korean economy, which resulted in an International Monetary Fund (IMF) bailout. With the prescription of the IMF, the South Korean government employed tight fiscal policies along with several reform measures (Heo and Kim, 2000; Jesse et al., 2002; Mo and Moon 2003; Smith 1999). These post-crisis policies along with financial aid packages and loan restructuring appeared to have ended the crisis although the economy has been sluggish in recent times.¹

Many academic and policy analyses have been conducted on what caused the crisis and what needs to be done to prevent this kind of economic collapse in the future. Previous studies pointed out the following causes for the crisis: current account deficits in the 1990s due to the government’s exchange rate management since the 1990s, high rates of non-performing loans, excessive short-term term loans, crony capitalism, pressing needs for labor reform, a better financial system, and business-oriented corporate governance of the chaebol (Haggard and Mo 2000; Heo 2001; Heo and Tan, 2003; Horowitz 2002; Horowitz and Kim 2004; Lim et al. 2003; Mah 2002; Mo and Moon 2003; Smith 1999).

Prior to the economic collapse, South Korea had embarked

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¹. Real GDP and private consumption in the first half of 2003 declined although the overall economic growth rate reached 3 percent at the end of the year, which was the lowest since 1998. The slow growth was attributed to reduced consumption and corporate investment, which shrank by 1.4 percent and 1.5 percent respectively compared to previous year (Lowe-Lee, April 2004). The current unemployment rate is 3.9 percent, but the rate for the young working age population (15-29 years old) is 9.1 percent, which is the highest since March 2001 (Digital Chosun Ilbo, March 18, 2004).
upon several reforms aimed at political and economic liberalization. The government legalized labor unions, adopted a “real name” financial transaction system, relaxed restrictions on speech and allowed the press greater freedom. Direct popular election of the president and a system of local autonomy were also adopted. In addition, as an anti-corruption measure, the Ethics Law for Public Officials was legislated, requiring 1,063 high-ranking public officials to disclose changes in their personal assets (see Heo 2001; Horowitz, 2002; Horowitz and Kim, 2004; Heo and Kim, 2000; Smith, 1999).

After the crisis, political and economic reforms continued. The chaebol were under pressure to change and the financial sector went through restructuring and improved lending practices. The labor market was pressured to be more flexible. Government regulations on business activities were also eased. According to the annual staff report by the International Monetary Fund (IMF) released on February 25, 2004, however, South Korea still needs to work on three weak areas: “strengthening the financial sector, improving corporate governance, and increasing labor flexibility” (Low-Lee, March 2004: 2). In this paper, we revisit South Korea’s pre- and post-crisis reform process in these areas and draw lessons for other countries.

II. Pre-crisis Political and Economic Reform Efforts

One of the most immediate causes of the 1997 financial crisis was the large amount of dollar-denominated short-term loans. South Korea, however, had not had this kind of problem before. In fact, they were known for macroeconomic stability maintaining the balanced national and current accounts ensured macroeconomic stability in East Asia, which in turn led to high rates of savings and investment.

Then, what led to the crisis? Until the early 1990s, the
Korean government heavily regulated the financial market, which was insulated from the rest of the world. Decisions on the credit allocations by commercial banks were dominated by the government’s policy of favoring investment loans to large corporations engaged in export activities. Foreign exchange transfers were monitored and heavily regulated. Lending by Koreans at the international market was limited. Even foreign residents in Korea were regulated in their buying, owning, and selling of domestic assets. Because of the heavy regulation and lower-than-market interest rates charged by the commercial banks, Korea developed a large-curb market, that is, an unregulated and unofficial financial market. This market, which was characterized by high interest rates and risks, typically satisfied the credit demands of individual households and small and medium-sized firms that had been excluded from the formal credit market.

To deal with these issues, the South Korean government started deregulating financial markets in 1993 with the international pressure based on the agreement of the Uruguay Round. The move to deregulate was also influenced by the country’s preparation to join the Organization of Economic Cooperation and Development (OECD), which it did in 1996. As a result, the government absorbed much of the operations of the curb market into formal financial institutions as mercantile banks. These institutions continued to provide credit to high-risk small and medium-sized firms. The regulations covering them were relatively lax compared with those of commercial banks. As financial deregulation unfolded, there was a rapid increase in the number of mercantile banks and other quasi-financial institutions. These so-

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2. The mercantile banks are called chong-hap-kum-yung’s (comprehensive financial company) or simply chong-kum-sa. The first set of financial institutions to have experienced the bank run, they commonly are referred to as constituting the second-tier financial system.
called third-tier financial systems include companies that handle leases, installment loans, and other non-bank financing activities. The third-tier financial institutions are not allowed to take deposits, but can extend loans by borrowing funds from banks or mercantile banks. These third-tier companies were virtually unregulated by the government and their primary clients were small and medium-sized firms.

Chaebol and insurance companies were not permitted to own commercial banks but could own and manage mercantile banks and quasi-financial companies. As a consequence, many chaebols started to invest heavily in these latter institutions since they were profitable during economic boom times. At the same time, many commercial banks themselves also established subsidiaries of mercantile banks and quasi-financial companies. As a result of deregulation, these quasi-financial institutions operated in a lax regulatory environment. Thus, these institutions invested in foreign assets and borrowed from foreign financial institutions, notably in Singapore, Hong Kong, and Japan.

The government’s reduced regulation of the financial market produced a dramatic increase in the number of international loans and portfolio investments. According to OECD data, Korean debt increased from 14.32% of GDP in 1994 to 23.80% in 1995 and 28.40% in 1996. Much of the increase came from short-term debts, which went from 15.3% of Korea’s GDP in 1994 to 20.6% in 1996 (Aiyer 1999). Because of the interest rate differences between South Korea and the rest of the world, Korean banks and other financial institutions found it profitable to borrow money in the international market and lend it to domestic borrowers. Most credits were allocated for such long-term investments as firms were seeking fixed assets (e.g., factories and machinery) and firms and individuals were hoping to purchase real estate. The return on these investments, however, declined as economic conditions worsened in general. Hence, this left Korean banks and
other financial intermediaries vulnerable when foreign creditors called in their short-term loans.

There also were problems related to corporate governance in the Korean financial system. Although foreign exchange and interest rates had been gradually deregulated, the government retained control of the financial market through the appointment of bank executives. Moreover, the government was the largest shareholder in many banks. Even in private banks, any personnel decisions involving top executives had to be approved by the government. Because of the government's influence over banks, there was a great deal of corruption and nepotism in decisions over credit allocations.

To address the corruption issue, President Kim Young Sam voluntarily disclosed his personal assets hoping that others would follow. His efforts led to the legislation passed on May 20, 1993, which required high-ranking government officials to disclose their assets. The law requires these high-ranking officials report their annual change in assets (Oh 1999). This move was particularly meaningful because poor lending practices by banks and mismanagement of government contract awards were often the outcome of bribery and kickbacks. Given that poor lending practices without securing collateral and business analysis were among the primary causes of the 1997 crisis, implementation of this law was critical.

In addition to the corruption improvement measure, another piece of legislation for financial reform was introduced in August 1997. This bill was an attempt by the government to consolidate the supervision of commercial and merchant banks by creating a new agency to monitor banks and financial institutions. However, the Bank of Korea and the Ministry of Finance disagreed on which organization this new agency should be under because previously the Bank of Korea supervised commercial banks while the Ministry of Finance guided other financial institutions. This turf
battle between the Bank of Korea and the Ministry of Finance could not be resolved easily without strong leadership at the top. The bill also included granting the Bank of Korea more autonomy. By doing so, the Kim Young Sam government tried to make the financial system transparent and allow the Bank of Korea to make decisions on monetary policy purely based on national interests. However, due to partisan politics, the bill was stalled in the Assembly and did not pass until the crisis had broken out. As a result, the government never fully addressed such fundamental issues facing Korea’s financial sector as deregulation, transparency, lowering entry barriers, and reforming the corporate governance structure (see Jesse et al. 2002).

Another reform effort was easing the rigidity of the labor market through a labor reform bill submitted to the National Assembly in 1996. The bill was designed to eliminate lifetime employment by allowing layoffs. It was an attempt to restore the competitiveness of Korean companies by providing them with a more open, flexible labor market. With the creation of the second labor union, the Korean Confederation of Trade Unions (Minjunochong; KCTU), the labor sector became more influential and powerful, resulting in greater lost workdays due to strikes. Thus, this bill was submitted in response to the signs of economic decline resulting from labor movements. It was also based on negotiations among the government, the corporate sector, and labor unions that had begun in early 1996.3 Despite the three-party efforts, the bill faced strong opposition from radical labor unions. Moreover, the opposition parties sabotaged the vote on the bill for political gains; in response, the ruling party pushed the bill through the National Assembly in a dramatic late December mid-

3. The Tripartite Commission of Labor, Business, and Government (Nosajong wiwonhoe, TC) was formed to deal with the labor-management issues prior to that.
night session with no opposition lawmakers present. Passage of the bill met with enormous protests and President Kim was forced to rescind it.

### III. Post-crisis Structural Reforms

Pre-crisis reform efforts were not successful because of resistance by opposition parties and labor unions. After the crisis broke out, however, the political and economic environment drastically changed in favor of reforms. First, a power transition occurred. A long time opposition leader, Kim Dae-jung, supported by labor unions, was elected president. With the IMF supervision of reform programs, labor unions were not able to justify resisting reforms. Moreover, the government had to implement reform policies to meet the condition of the IMF bailout package. As a result, the Kim Dae-jung administration adopted reform policies in the labor, financial and corporate sectors. We analyze reform polices in each of these sectors in detail.

#### Labor Reforms

In response to the financial crisis, the Kim Dae-jung government, with the consent of the Tripartite Commission of Labor, Business and Government, legalized layoffs of workers by the management as needed. As a result, the unemployment rate went up from mid-3 percent before the crisis to about 7 percent after the crisis. Moreover, privatization of publicly owned companies led to massive layoffs in the public sector where 18 percent of the labor workers lost their jobs during the 1998-2000 period (Hamilton and Kim, 2004).

The impact of labor reform did not end at massive layoffs, however. Those who survived the layoffs faced a greater workload while their wages decreased as the nation’s gross domestic product declined. As a result, the percentage share of labor cost of
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GDP declined from 48.8 percent in 1996 to 43.1 percent in 1999 (KDLP, 2001: 267).

Although the cost of labor declined, companies still struggled to generate profits due to the increased costs of fringe benefits for regular workers. In order to produce profits, companies increased part-time, temporary workers called “irregular” workers, who get paid less than half of the regular workers along with fewer benefits. The number of “irregular” workers increased to 32.8 percent of the 14.1 million employed labor in 2003. In other words, one out of three working Koreans did not have a regular full time job in 2003. This change has two implications. First, although companies may be cutting production costs, lower income leads to reduced consumption which in turn results in lower aggregate demand (Lowe-Lee, March 2004). Second, as a result of the increase in “irregular” workers, the rate of labor unionization declined because part-time workers were not included in management-labor negotiations. For instance, the rate of labor unionization was 23.3 percent in 1989, but shrank to 11.5 percent in 2000 (Hamilton and Kim, 2004).

Despite the lower unionization, the flexibility of the labor market is still one of the biggest challenges the Korean economy is facing on the grounds that Korean labor unions are autonomous and responsive to their base. Overall, they are militant and confrontational with respect to economic reforms, which led to strong resistance and frequent strikes for higher salaries and better benefits (Hamilton and Kim, 2004).4 As a result of frequent strikes, foreign as well as domestic investment has declined sharply.5 According to the Federation of Korean Industries, 10

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4. According to the Ministry of Commerce, Industry, and Energy, South Korea had about $ 1.7 billion of production lost and $608 million exports in 2002 due to labor strikes. The average number of lost workdays was 30.7, which is the highest in Northeast Asia (Lowe-Lee, July 2003).
foreign investment projects were put on hold in 2003 due to the volatile labor-management relations, and domestic economic organizations also warned that they would suspend their investment projects and move them to foreign countries if the labor situation did not improve (Lowe-Lee, July 2003).  

<table>
<thead>
<tr>
<th>Year</th>
<th>Strikes</th>
<th>Lost Work Days</th>
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<tbody>
<tr>
<td>1996</td>
<td>85</td>
<td>893</td>
</tr>
<tr>
<td>1997</td>
<td>78</td>
<td>445</td>
</tr>
<tr>
<td>1998</td>
<td>129</td>
<td>1,452</td>
</tr>
<tr>
<td>1999</td>
<td>198</td>
<td>1,366</td>
</tr>
<tr>
<td>2000</td>
<td>250</td>
<td>1,894</td>
</tr>
<tr>
<td>2001</td>
<td>234</td>
<td>1,084</td>
</tr>
<tr>
<td>2002</td>
<td>321</td>
<td>1,580</td>
</tr>
</tbody>
</table>

Source: Ministry of Labor (recited from Lowe-Lee, August 2003)

The Roh Moo-Hyun government has tried to improve the labor-management relations through a policy of dialogue and compromise. However, since the Roh administration won the election largely based on labor unions’ support, the government has adopted pro-labor policies, and the labor unions almost always got what they demanded. To deal with the labor issue, the Roh government is considering the Dutch Model, which allows the management to layoff workers according to business conditions, while workers participate in management. Since this approach treats

5. Since investment responds to various factors, the volatile relationship between the management and the labor may be only partially responsible for the investment decline.

6. According to the International Institute for Management Development, the labor-management relationship is the worst among 30 Asian countries (Lowe-Lee, July 2003).
regular and “irregular” workers equally, the approach is appealing to the government. However, both business and labor oppose the approach (Lowe-Lee, August 2003; Alvis, December 2003).

**Financial Reforms**

The perverse nature of financial liberalization in South Korea led to a favoring of the use of loans and other debt instruments for corporate investment and expansion, rather than the use of equities as in stocks or initial public offerings. However, risk control by screening projects and monitoring corporate performance was minimal before the crisis (Park, 1999; Smith, 1999). Government monitoring over lending practices was virtually nonexistent. Despite no monitoring, the government implicitly guaranteed the loans of the *chaebol* because of the political-business connections. As financial institutions became increasingly vulnerable to external shocks, South Korea became enmeshed in a significant moral hazard problem.7

Due to the moral hazard issue, transparency of the financial sector and the business-government relations were heavily criticized after the crisis broke out. Poor lending practices caused by the close ties between the government and business were largely blamed as the cause of the crisis. Moreover, critics pointed out that the patron-client relationship between politicians and businessmen made it difficult to reform the business and financial sectors in previous efforts (Horowitz, 2002; Horowitz and Kim, 2004).

Financial reform after the crisis started with privatization. A large portion of the government’s shares in banks was sold to the private sector, and many publicly owned companies were privatized. In the process of privatization and opening up the fi-

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7. Goldstein (1998) also argues that South Korea had too much connected-lending. He calls it “crony capitalism”.
nancial market, foreign investors bought a lot of government shares in banks. To help struggling banks to restructure, the government merged banks and placed them under a state-run holding firm \cite{Digital Chosun Ilbo, November 8, 2000}.

In addition, two new financial supervisory authorities were established: the Financial Supervisory Commission and the Financial Supervisory Service. These authorities placed strict capital adequacy requirements (8 percent BIS ratio) on banks for restructuring and threatened to close the banks if the requirements were not met. To set an example, the Financial Supervisory Commission closed five failing banks in 1998, which led other financial institutions to reduce their loans to the corporate sector.\footnote{However, this move resulted in corporations facing difficulties in financing and bankruptcy, which in turn led to the mounting of non-performing loans.}

Since the domestic capital market was still in trouble, raising new capital was almost impossible. As a result of corporate loan reduction, the share of loans in total assets of 16 out of 21 commercial banks in Korea declined while the five merged banks showed increases in their assets \cite{Park, 2003}.

Although the Korean economy had a quick recovery from the crisis, the financial market was still in turmoil and the economy slowed down again. In response, the Korean government and supervisory authorities mobilized another $40 billion in public funds to save failing firms and financial institutions in September 2000. Debates on moral hazard and long-term implications of mobilizing public funds rose as a result \cite{Park et al., 2003}.

In addition to the reform efforts in the financial sector, the Korean government tried to attract foreign direct investment (FDI). Prior to the crisis, the Korean economy did not provide a FDI friendly environment. After the crisis, however, the cap on the aggregate FDI in Korean equities was removed, and increased FDI made significant contributions to the economic recov-
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ery (Mah, 2002).

**Corporate Reform**

For corporate reforms, the Korean government had “five plus three” principles, which are “enhancing transparency in accounting and management, resolving mutual debt guarantees among chaebol affiliates, improving a firm’s financial structure, streamlining business activities, and strengthening managers’ accountability.” The three supplementary principles are, “regulation of chaebol’s control of non-bank financial institutions and circular equity investment by chaebol affiliates, and prevention of irregular inheritance and gift-giving among family members of chaebol owners” (Mo and Moon, 2003: 129; Park et al., 2000).9

<table>
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<th>Table 2. An Overview of Five Plus Three Principles</th>
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<tr>
<td><strong>Principles</strong></td>
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<tr>
<td><strong>Enhanced Transparency</strong></td>
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<tr>
<td>(Jan. 13, 1998)</td>
</tr>
<tr>
<td><strong>Control Intra-Group Transactions</strong></td>
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<tr>
<td><strong>Improved Financial Structure</strong></td>
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<tr>
<td><strong>Streamlining Business Lines</strong></td>
</tr>
<tr>
<td><strong>Stricter Accountability</strong></td>
</tr>
<tr>
<td><strong>Consolidation of Debt</strong></td>
</tr>
<tr>
<td><strong>Separation and Sale of Non-specialized Affiliates</strong></td>
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</table>

9. The five principles were agreed upon in the meeting of President Kim Daejung and chaebol leaders on January 13, 1998, and the supplementary principles came out in President Kim’s National Liberation Day speech on August 15, 1999.
In terms of implementation of the principles, however, according to Park (2003), the government adopted different reform approaches for different firms depending on their size. For the top five chaebols, swapping business (the so called Big Deals) to streamline and to refocus on their main businesses was encouraged whereas “workout” programs along with court receivership and composition were used for other corporations. As to the reason for using different approaches towards different sizes of firms, Park (2003: 185) argues that “medium-sized chaebols would not cause too much of a shock to the economy even if they defaulted during the restructuring process. On the other hand, the five largest chaebols were judged to be too large to be restructured by the commercial banks and thus were excluded from bank-led restructuring programs.”

In terms of the Big Deals, six swaps of business among chaebols were actually implemented. They are as follows: Hyundai Motors annexed Kia Motors; Samsung Motors was taken over by Renault; Aerospace portions of Hyundai, Samsung, and Daewoo were merged into the Korea Aerospace Industries; Semiconductor portion of LG went to Hyundai; and Korea Heavy Industries and Construction (Hanjung) took over power components of Samsung
Heavy Industries and Hyundai Industries (Yoo, 2000). The government also pressured the top five *chaebols* to reduce debt/asset ratios below 200 percent. To induce the lower debt/asset ratio, the government abolished tax deductions of interest payments on “excessive” loans starting in 2000. In response, *chaebols* started selling some subsidiary companies, closed down inefficient businesses, and laid off workers to improve productivity (Root, 1999).

To implement the principle of having owner/managers accountable for their management failures, the owners (large shareholders) of *chaebols* were forced to contribute their private assets to pay off debts. In addition, the government asked *chaebols* to remove the group chairman system because the chairman does not take legal responsibility while controlling the subsidiaries. To improve outside monitoring of corporate decision-making, *chaebols* were also forced to have outside directors (Mo and Moon, 2003).

In terms of enhancing corporate transparency and the reliability of Korean firms’ accounting practices, the Kim Dae-jung government implemented the Act on External Audit of Stock Companies passed in February 1998. With the implementation, the government forced *chaebols* to provide combined financial statements. These statements provide more accurate information about a *chaebol*’s overall financial condition because they reveal inter-subsidiary shareholdings and debt payment guarantees (Mo and Moon, 2003; Cho, 2003).

With the Monopoly Regulation and Fair Trade Act, the government also addressed the issue of debt payment guarantees among *chaebol* subsidiaries. *Chaebols* were required to remove all existing debt guarantees. With the Capital Structure Improvement Plans (CSIP), banks were directed to negotiate with their debtor companies about the financial restructuring agreement. Sixty four companies were included in the program (Mo and Moon 2003).

Turning to the reform of firms smaller than the top five *chaeb-
workout programs were most frequently employed, although court receivership and composition were also employed. The workout programs were led by credit banks, which were flexible in regards to restructuring procedures and the time period of rehabilitation. Creditors and subject firms could negotiate remedy measures, and outside arbitrators were allowed to be involved if an agreement was not reached. Since this program did not disrupt business, credit banks could increase the retrieval rate of their loans (Park, 2003).

Table 3. Workout, Court Receivership, and Composition

<table>
<thead>
<tr>
<th>Workout</th>
<th>Court Receivership</th>
<th>Composition</th>
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<tbody>
<tr>
<td><strong>Applier</strong></td>
<td>Firms, Creditors</td>
<td>Firms, Creditors, Shareholders</td>
</tr>
<tr>
<td><strong>Credits Suspended</strong></td>
<td>Credits Specified</td>
<td>All Credits from Commercial Transactions</td>
</tr>
<tr>
<td><strong>Effective Date</strong></td>
<td>Call for Creditors’ Meeting</td>
<td>Court Decision for Receivership</td>
</tr>
<tr>
<td><strong>Shareholder Rights</strong></td>
<td>Capital Reduction and Debt-Equity Swap</td>
<td>More than half the Shares effaced</td>
</tr>
<tr>
<td><strong>Control Rights</strong></td>
<td>Depends on Creditor’s Decision</td>
<td>Management Ousted</td>
</tr>
</tbody>
</table>

Source: Recited from Park et al. (2000: 282)

The workout program started in May 1998 with establishing the Committee for Corporate Insolvency Evaluation. The committee initially studied 313 firms that might have financial problems and selected 104 firms for the workout programs. Only 36 firms, however, successfully completed the program while banks closed 55 insolvent firms (Park, 2003). There were a number of prob-
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Problems with the workout programs. First, the program largely delayed the exit of failing firms because of politicians' political considerations. Second, since the program was largely misunderstood. Companies that could not survive without financial support applied for the program. They often waited until they were in serious trouble, and the program was too generous, which led to moral hazard. Moreover, the program allowed management to stay in control and they often pursued their own benefits. Credit banks were generally passive due to the supervisory authorities' intervention. Management accountability was hardly demanded (Park, 2003).

To facilitate the workout programs, the corporate bankruptcy system was also reformed. The reform efforts, however, were piecemeal rather than sweeping. The reason is that reform of the bankruptcy system was a condition attached to the IMF bail out package. Before the crisis, firms hardly used the bankruptcy procedure overseen by the courts because the Korean Asset Management Corporation (KAMCO) sold the assets of bankrupt firms through auctions before the bankruptcy process began. With the Rule on Corporate Reorganization Procedure, however, corporate bankruptcy procedures were more frequently used. In the reform process, there were largely two changes. First, with a new law, economic efficiency was considered as a criterion to qualify for judicial bankruptcy. Credit banks were induced to play a role through conferences, too. Second, an automatic stay policy was adopted. With this policy, assets of insolvent firms were automatically protected from creditor’s filing to secure their claims. Once firms officially go bankrupt, they go through settlements, such as corporate reorganization, composition or workout programs (Lim, 2003).
In order to draw lessons for other countries, we revisited the South Korean government’s attempt to reform the economy prior to the 1997 financial crisis and post-crisis structural reforms in the labor, financial, and corporate sectors. Overall, the post-crisis reforms have made a significant improvement in liberalizing the Korean economic system and in rejuvenating the economy.

However, as the IMF report in April 2004 pointed out, there are still concerns and issues. For instance, the labor-management relationship is still a concern to investors. Although layoffs of workers according to companies’ needs became possible as a result of reforms, annual negotiations between labor and management have been confrontational due to the unions’ militant nature. The volatile relationship between labor and management has driven foreign and domestic capital out of the country. As a result, job creation in South Korea has been lower than expected.

In addition, the Democratic Labor Party (DLP), for the first time in Korean history, won 10 seats in the 2004 general election and became the third largest party although they lost seats in the recent make-up election. The president’s party also lost the majority in the National Assembly. These changes in the National Assembly are likely to affect economic policies and continuing reform efforts, which concerns investors and businessmen.

Turning to concerns on corporate reforms, the corporate governance system still raises a lot of issues and concerns. Chaebol owners, despite the government’s efforts to limit their role in business management and make them accountable for failures, still exercise much more control over companies than their share of stocks. Related issues include inheritance schemes, gift giving among family members, and internal trading of the chaebol sub-
subsidiaries (Mo and Moon, 2003). Moreover, chaebols managed to increase their assets by accessing corporate bond and trust fund markets and reevaluating their assets. As a result, business concentration after the crisis has even increased (Choi, 2000; see also Mo and Moon, 2003).

Despite the concerns, South Korean economic reforms after the 1997 crisis are generally considered successful. In other words, South Korea has shown distinctively different reform processes before and after the crisis. Why is this the case? Laurence (1999) argues that there are two schools of thought as to the relationship between economic reform and financial crisis. According to one view, reforms should be implemented when the economy is doing well because reforms often accompany painful short-term costs, such as layoffs, banking crises, economic slowdowns and so on. Another school of thought contends that reforms are only possible when there is a crisis because the political costs associated with implementing reform policies are too large for leaders to bear unless they are forced by a crisis. In other words, there is no dominant theoretical framework among scholars and policymakers as to the proper time to implement economic reforms.

Given the lack of consensus, what can other countries learn from the South Korean reform experience prior to and after the 1997 crisis? As discussed earlier, the South Korean government attempted to reform the economy to cope with the effects and changes of globalization before any signs of crisis occurred. However, due to the opposition of concentrated interest groups (labor unions, chaebols etc.) and the opposition party, the reform efforts were largely fruitless. Part of the difficulty was that there was no agreement on the need for economic reforms. Therefore, a number of bills targeted toward reforming economic sectors were stalled or rescinded. If the bills (financial reform bills, labor reform bills) had gone through the National Assembly and were im-
implemented, the 1997 financial crisis might have been avoided or at least, the economic pains South Korea experienced due to the crisis would have been much smaller.

Japan’s economic reform experience in the past decade or so even strengthens our argument. Japan has tried to reform their financial system, which is “based on main bank lending, government control of investment flow, close ties between industry and regulators, cartelization, and protection from outside competition” (Laurence 1999: 352). Due to the financial sector’s dependence on the government, the financial sector and the economy in general were greatly affected by the government. As a result, the economy was not completely market oriented and lending practices were rather poorly managed (Lincoln and Friedman 1998). When the bubble in real estate ended, financial reforms were desperately needed. However, the Liberal Democratic Party (LDP) was not willing to take the price of reforms because of their potential impact on LDP supporters. Because of the delayed reforms, Japan has not been able to recover from its stagnant economy for over a decade.

South Korea’s reform experience after the crisis is much different from the pre-crisis one. A power transition occurred and labor unions as well as chaebol management were not in a position to resist any reform efforts by the government. Moreover, Kim Dae-jung built a majority coalition between his National Congress for New Politics and Kim Jong-pil’s United Liberal Democrats to have legislative support for economic reforms instead of seeking cooperation from the opposition party (Grand National Party). Therefore, reform policies were not stopped in the National Assembly (Horowitz, 2002).

There is a clear lesson that can be drawn from both South Korea’s and Japan’s experience. When economic policy decisions are made based on political logic and the influence of some interest groups, long-term consequences are greater than short-term
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costs. However, in both South Korea prior to the crisis as well as in Japan, political logic dominated economic interests or needs in policymaking, which made reform efforts difficult to implement.10

Another lesson that other countries can learn from the South Korean experience is that the government must have a long-term vision and an appropriate policy blueprint while economic restructuring is implemented. Policies for short-term economic stimulation eventually bring about economic problems, and the price of fixing them may be high. For instance, all the current economic concerns that South Korea has come from policies implemented based on short-term positive effects, i.e. expending credit card usage to artificially stimulate the economy. As a result, once the level of consumption declines with the credit card delinquency issue, the Korean economy has not been able to find a way out of economic slump except relying on good export performance, which means the Korean economy has become more vulnerable to external factors. In summary, economic reform policies must be made according to economic logic and long-term perspective rather than political logic or short-term benefits.

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10. This is why Bergeijk, Sinderen, and Vollard (1999: 9–10) argue that, “one of the most important determinants for the success of structural reform policies appears to be the existence of a crisis.”


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