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Abstract
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Journal of Economic Literature Classification: G18, O53
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ABSTRACT

The current paper evaluates the restructuring measures implemented in the post-crisis Korean economy. Its policies taken after the economic crisis were quite successful in terms of economic recovery. The financial and corporate sector reforms undertaken by the Korean government contributed to strengthening the banking and corporate sectors, attracting FDI inflows. However, most indicators show worsening of income inequalities and workers’ situation regarding job security. The strengths as well as the weaknesses of the development strategy of Korea and its reform measures undertaken since the occurrence of the economic crisis need to be differentiated.

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I. Introduction

South Korea, Korea hereafter, as one of the East Asian tigers, achieved very rapid economic growth during 1962-1996, in which period the problems with the economy were scarcely noticed. Many authors such as Amsden (1989) and World Bank (1993), to name only a few, chose to study the Korean case as one that could be duplicated by the other developing countries. It experienced economic crisis in 1997-1998 after longer than three decades of unprecedented economic growth. The outstanding external debt reached US$159 billion in December 1997, the real GDP growth rate plummeted to -7 percent and the unemployment rate increased to higher than 8 percent in early 1998, although the unemployment rate had been less than 3 percent in the early to mid-1990s.

Authors’ opinions have been divided with respect to the cause of the economic crisis which occurred in 1997-1998. Many mainstream as well as institutional economists regarded it as a financial crisis arising from mismanagement of the financial aspects. Nixson and Walters (1999) appropriately summarized the arguments on the causes and the appropriate policy responses suggested before 1999 by various authors.

In case of Korea, the policies implemented in the midst of the crisis included trade liberalization, welcoming foreign direct investment (FDI) inflows, labour market and corporate/financial market reforms. The Korean economy rebounded from its collapse faster than most economists expected. Considering that several years have passed since the occurrence of the crisis, it is appropriate at this moment to evaluate the restructuring measures implemented by the Korean government. The current paper evaluates the restructuring measures implemented in the post-crisis Korean economy. Considering that lots of developing countries have underwent and are expected to experience economic crisis in the economic development process, the current work would shed light on the appropriate economic development strategies and policies in overcoming economic crisis of developing countries.

The structure of the current study is the following. Section II briefly summarizes the neo-liberal restructuring measures implemented by the Korean government, compared with the state-led economic development. Section III explains and evaluates the financial and corporate sector reforms. Section IV deals with the income inequalities and job security issues as a byproduct of the restructuring. Conclusions are provided in Section V.

II. Neo-liberal restructuring versus state-led growth
1. Governmental intervention

Many economists such as Amsden (1989) argued that the government has played a key role in the development of capitalism in Korea between the 1960s and the crisis. Although it is correct to notice that the Korean government intervened significantly in the economic development process, it does not prove that governmental intervention in the market caused rapid economic growth in Korea, since factors other than the government intervention in the market might have been more important in economic development. For instance, the World Bank (1993) argued that industrial policies in the East Asian Economies were not successful in changing industrial structure or raising productivity.

Although Korea showed three decades of unprecedented economic growth, it was a story not unique to Korea. Together with Korea, Hong Kong, Singapore and Taiwan have been known as the East Asian four tigers who showed very rapid economic growth rates (Amsden (1989), Wade (1990), and WTO (1996)).

As Wade (1990) emphasized, Taiwan’s economic development would have been characterized by the governmental intervention in the market. However, the success stories of Hong Kong and Singapore, in particular, would not be attributed to active governmental intervention in the market. Hong Kong’s economy has been a typical example of laissez faire. Although Singapore’s economy has been characterized by governmental intervention (Huff (1995)), its intervention was similar to suggesting guidelines to the labor market through the National Wages Council and provision of certain taxational incentives to attract FDI rather than interventionist industrial policies through control of banks like Korea. It means that the rapid growth rate of the East Asian countries was not due to the government-led growth strategy, but due to other reasons such as high education levels compared with the level of economic development and, especially, outward orientation (World Bank (1993)).

2. Neo-liberal regime in economic development

In overcoming the economic crisis, the Korean government undertook various reform measures in conformity with the IMF conditionalities, which comprised: macroeconomic austerity; policies welcoming FDI inflows; financial and corporate sector reforms; and labour market reform. Crotty and Lee (2002), for instance, characterized
such reform measures as neo-liberal regime and criticized its effectiveness with respect to overcoming the critical situation and economic development of developing economies in general. Among others, such criticism on the performances of the neo-liberal regime needs to be re-examined.

The best performers among developing countries for the past half century are the East Asian newly industrializing economies and Botswana. However, Botswana’s rapid economic growth for the past three decades needs to be treated as an exceptional case, rather than under the umbrella of ‘developing countries’, considering its sudden discovery of the diamond mine in the late 1960s (WTO (1998)). For the East Asian developing economies, even a non-mainstream East Asian economies specialist like Johnson (1998) as well as mainstream works such as the World Bank (1993) find the common characteristics of the East Asian economies in the economic growth tied to exports.

Hong Kong achieved tremendous economic growth through a *laissez faire* regime and extreme outward orientation including FDI-welcoming policies, which are the characteristics of the neo-liberal policies. Singapore also recorded very rapid economic growth rate through restricted government intervention in the market and extreme outward orientation. Together with Thailand, where the degree of governmental intervention in the market was not as high as in Korea and Taiwan, the situation of their income inequalities has not been bad: that is, they ranked about in the middle of the 66 countries examined (You (1998), p. 40).

Regarding the neo-liberal regime in Korea, Chang, Park and Yoo (1998) traced the occurrence of the crisis to the neo-liberalism under the Kim Young Sam government during 1993-1997. They regarded the five-year financial liberalization plan announced by the Kim Young Sam government in 1993 as the first such plan to have a relatively well-defined (although not precise) timetable and unambiguous policy content, which aimed at interest rate deregulation, abolition of ‘policy loans’, granting of more managerial autonomy to the banks, reduction of entry barriers to financial activities and, most importantly, capital account liberalization.

In the same vein as Chang, Park and Yoo (1998), for performance of the neo-liberal restructuring with respect to the Korean economic crisis, Crotty and Lee (2002) noticed that: “the mode of implementation of neo-liberalism in Korea was exceptionally destructive” (p. 668). However, their criticism of the impact of the implementation of neo-liberal policies on economic recovery is not in conformity with the actual phenomena. For instance, although the real GDP growth rate plummeted to -7 percent in 1998, it recovered
quickly after 1999, recording 9 and 11 percent in 1999 and 2000 respectively. It decreased somewhat to between 3 and 6 percent in 2001 and 2002 respectively. In the meantime, the unemployment rate which increased to 8 percent in 1998, decreased substantially to 4 percent in 2001 and 3 percent in 2002. Therefore, their criticism of the impact of neoliberal policies on the overall economy would not describe the actual phenomena well.

III. Restructuring in the Post-crisis Korean Economy

1. Macroeconomic policy

As the appropriate macroeconomic policy response to the Korean economic crisis, the IMF imposed macroeconomic austerity. Interest rates soared to 30 percent, and fiscal policy was tightened in early 1998. Like many other authors, Stiglitz (1999) criticized the IMF program applied to the East Asian countries including Korea in the sense that the macroeconomic austerity had contractionary effects in the short run and adverse effects. However, Stiglitz (1999) also admitted that: “Our responses may have only limited ability to stop the crises from developing into a recession” (p. 426).

At the end of 1997, the Korean economy was driven to a technical default situation. The external debt outstanding at the end of 1997 reached US$159 billion, sharing 33 percent of GDP. In that sense, the situation in 1997 – 1998 was a kind of balance of payments crisis as well. The IMF’s initial objective of the high interest rate was to stabilize exchange rate in the foreign exchange market. Although it was not realized in the short run, the reduced aggregate demand as a result of the high interest rate policy together with the depreciated value of the Korean currency put downward pressure on the import demand.

Import was restrained in 1998, resulting in trade surpluses as much as US$ 42 billion in the same year. It was not achieved by trade protection measures which are acknowledged in case of the balance of payments crisis according to the WTO regulations. The government of Korea even pursued further, though not abrupt, trade liberalization measures including phase-out of the Import Diversification Program which covered 113 items by the end of 1999 and elimination of four trade-related subsidies by the end of 1998 (Government of Korea, 24 December 1997). Due to the huge amount of trade surpluses in 1998 and 1999 as well as FDI inflows which resulted in substantial increase of the foreign exchange reserves, the Korean government was able to repay the outstanding external debt.
Witnessing trade surpluses in 1998, Wade and Veneroso (1998) predicted that, since it was due to falls in imports, most of which are imports of capital goods, they would turn to export reduction, saying: “their cutback hurts exports” (Wade and Veneroso (1998), p. 14). However, current account surpluses continued in Korea, turning its situation from a huge amount of net external debtor to a net creditor position in the second half of 1999.

Criticizing the contractionary macroeconomic policies taken during the first phase of the economic crisis, Paul Krugman suggested that default would have been better than the IMF programme (New York Times, 18 December 1997). Krugman’s suggestion at that moment ignored the characteristics of the Korean economy in the sense that the Korean economy should import its crude oil completely and most of its food except for rice from the external sources as well. Since the Korean economy did not declare default, reputation of the Korean economy was not downgraded in the global economy.

The Korean economy appears to undergo a depression after 2002; however, it can be understood as a phase of a normal business cycle rather than an incomplete recovery from an economic crisis in the sense that no phenomenon similar to one observed just before the occurrence of the economic crisis at the end of December 1997 such as high debt-equity ratio of firms, high NPLs and corporate failures, is observed. Depressed investment atmosphere would be a bottleneck to the short- to medium-run future of the macroeconomy. It appears to be due to the investors’ concern over uncertain U.S. and world economy (Federation of Korean Industries (2002)) as well as the ruling party’s philosophy since 1998 being basically friendlier to the labourers than the previous right-wing governments despite low interest rates which are less than half of those observed until 1997. Since the ruling party returned to power in the 2002 presidential election, the investors’ concern might persist for a while. It would need time for the investors to adjust to the new regime where the center to center-left government can get power together with the previous regime where right to extreme-right wing governments continued to rule for about half century since independence in 1945.

2. FDI inflows

The pursuit of further globalization is a notable aspect of neo-liberal regime. Many economists such as Stiglitz (2000) found the cause of the East Asian economic crisis in the liberalization of the short-term capital movement across countries. In case of Korea, it is true that the Korean economy was not able to meet the demand of foreign investors in
Octobre – Decembre 1997 to repay the matured external debt. However, the crisis could not be attributed to the liberalization strategy as a whole. The high debt-equity ratios of *chaebols* and high non-performing loan (NPL) ratios of banks due to inefficient projects would be the long-run structural causes of the economic crisis. The continuing current account deficits during 1990-1997 increased external debt, which can be cited as the medium-run cause, and excess reliance on short-term external debt and sudden outflow of short-term capital would be regarded as the short-run causes of the economic crisis in Korea (Mah (2002)).

Wade and Veneroso (1998), among others, argued in favour of controls on short-term capital movement. Short-term capital movement needs to be distinguished from long-term capital movement. Short-term capital movement is quite volatile, whereas FDI as long-term capital movement is not. One of the characteristics of the Korean economic development was the low proportion of FDI especially until 1997 compared with the other newly industrializing economies. If the Korean economy had welcomed FDI rather than short term capital movement, the sudden capital movement shown at the end of 1997 might not have been observed.

The importance of FDI was recognized in Korea by the then newly-elected president Kim Dae Jung even before the occurrence of the crisis (Kim (1985), p. 2). The Kim Dae Jung government tried to welcome FDI inflows in the sense of: increasing the ceiling on aggregate foreigners’ ownership of listed Korean shares from 26 percent to 55 percent by the end of 1997; eliminating the aggregate ceiling on foreign investment in Korean equities by the end of 1998; simplification of approval procedures (Government of Korea, 24 Decembre 1997); privatization of many state enterprises; provision of land to new FDI at reduced land prices, especially in high technology; and relaxed rules on hostile takeovers of Korean companies (Stoever (2002)).

As a result, the Korean economy has attracted FDI in huge amounts since 1998. For instance, FDI flows into Korea increased from US$ 2.8 billion in 1997 to US$ 5.4 billion in 1998, US$ 9.9 billion in 1999, and US$ 9.3 billion in 2000, respectively. The FDI approvals during 1962-1997 were US$22.9 billion; meanwhile, those for three years after the occurrence of the crisis, i.e. during 1998-2000, reached US$36.8 billion (Stoever (2002)). Although most of FDI expenditures involved foreign acquisition of domestic firms rather than greenfield investment, the huge amount of FDI inflows during 1998-2002 apparently contributed to increasing the foreign exchange reserves, helping the Korean economy to overcome the balance of payments crisis, among others.
3. Crony capitalism and allocational efficiency

The IMF policy package applied to the Korean economic crisis and implemented by the Korean government implicitly acknowledged the allocational inefficiency as a result of crony capitalism where lending activities and important policy decisions are made based on personal connections rather than efficiency aspects. Therefore, it included financial and corporate sector reform measures. Wade and Veneroso (1998) interpreted such a prescription by the IMF as a wrongly-conceived one, saying: “the IMF programme for Korea goes well beyond standard IMF programmes, calling for structural and institutional reform, even though they are not needed to resolve the current crisis” (Wade and Veneroso (1998), p. 11). That is, he did not consider structural and institutional reform to be necessary in overcoming the crisis in the sense that the crisis was not due to structural and institutional problems.

Regarding cronyism as the institutional cause of the economic crisis, Johnson (1998) as well as Wade and Veneroso (1998) disregarded the role of cronyism such as corruption or any other side effects of an overly close relationship between business and government as the source of crisis, too. Johnson (1998) attributed the crisis to under-regulation and Wade and Veneroso (1998) even expressed the characteristics of such economies as the bank-firm-state collaboration. Well articulated regulations may work well as in the case of Singapore: however, allocational inefficiencies and NPLs would accumulate in the case of cronyism-based regulations.

The accumulation of allocational inefficiencies due to the influence of cronyism on many important decision-making processes would lead to the economic crisis at a certain date such as the crisis at the end of 1997 in Korea (Mah (2002)). Such bad effects of cronyism on the economy had been accumulated in the financial and corporate sectors; consequently, the problems in those sectors were to be overcome in the post-crisis Korean economy.

4. Financial sector restructuring

The commercial banks’ share of NPLs was very high before the occurrence of the economic crisis in Korea, which was a result of the industrial policy of the Korean government during the period of rapid growth. The Korean government directed credit to
specific sectors and firms mostly in heavy and chemical industries. In the meantime, it urged the banks to provide ‘policy loans’ on very favourable conditions to certain enterprises. For instance, between 1975 and 1985, Korea’s policy loans were about 47-60 percent of the total loans of its deposit money banks, which was far higher than Japan’s ratio of policy loans when it actively used policy loans as the measure of industrial policy, e.g. between 10 to 14 percent during 1955 – 1980 period (World Bank (1993), pp. 280-281).

In consequence, most banks in Korea were from time to time obliged to lend to inefficient projects, resulting in NPLs.

The high share of NPLs can also be attributed to connected lending: that is, lending due to the tight connections between banks and borrowers. It reflects the cultural characteristics of Korea such as the reliance on personal connection and corruption, which had often driven the banks to lend to doubtful invested projects. Consequently, the financial sector had accumulated substantial amounts of NPLs before the occurrence of the economic crisis at the end of 1997 – 1998.

After the occurrence of the economic crisis, the Kim Dae Jung government undertook the financial sector reform as a part of institutional reforms, which together with improvement of corporate governance also appear in the Letter of Intent of the Government of Korea prepared in 24 December 1997. The capital base of commercial banks has been significantly strengthened by an infusion of 29 trillion won of government equity and subordinated debt through the Korean Deposit Insurance Corporation (KDIC). Furthermore, 44 trillion won in NPLs, or 15 percent of bank loans, was transferred to the Korean Asset Management Corporation (KAMCO) between November 1997 and December 1998. To cope with the harsher competition in the age of globalization, the government pursued mergers of the banks. For instance, several large banks were to be closed during the first few years after the occurrence of the crisis. In addition, foreign participation of commercial banks were allowed up to 100 percent and the banking supervision system improved with establishment of the Banking Supervision Commission.

As a result of these financial operations, the banking system’s capital adequacy increased from 7.0 percent at the end of 1997 to 11.1 percent for the financial sector as a whole as of the end of June 2001. The NPLs which peaked as much as 112 trillion won in March 1998 decreased to 50 trillion won in June 2001 (The Korean Ministry of Finance and Economy, http://www.mofe.go.kr). In commenting on the appropriateness of economic crisis, Stiglitz (1999, p. 420) evaluated: “A series of ill-conceived and overly hasty bank closures can undermine the soundness of the financial system.” Meanwhile, overall, the
commercial banks in Korea became substantially healthier than the pre-crisis situation. In the meantime, the governmental involvement in the banks increased.

5. Corporate restructuring

High levels of debt to equity ratios and high levels of cross-divisional debt guarantees by one affiliate supporting fellow affiliates have always been the characteristics of the corporate structure in Korea. Across the board, Korea’s top 30 chaebols’ debt-equity ratios had been near 4.0 just before the occurrence of the crisis, which can be compared with the situation in other countries, such as Taiwan (0.85), Japan (2.0) and the U.S. (1.6). The problem was not the high debt-equity ratios themselves, but the abuse of this system by chaebols. There was a further twist to these practices, in the form of ‘cross-affiliates debt-guarantees’. Mutual guarantees were a secret weapon of Korea’s chaebol, enabling them to expand rapidly and diversify with minimal collateral. Due to the high debt-equity ratios and cross-affiliates debt guarantees, Hanbo Steel folded in January 1997, with debts totaling more than 5 trillion won ($5.85 billion) – the largest collapse in Korea’s history up to early 1997. Other affiliates of the Hanbo group, which had been forced to act as guarantors of Hanbo Steel’s debts, also collapsed, effectively bringing down the entire group, the then Korea’s 14th largest chaebol (Mathews (1998)).

The Korean government’s corporate restructuring plans comprised: a drastic reduction of corporate debt-equity ratio; improved transparency; the end of cross-affiliates debt guarantees by conglomerate firms; and greater managerial accountability to minority shareholders. Such corporate restructuring plans were not included in the Letter of Intent of the Korean government in the wake of the occurrence of the crisis in late December 1997, but it was added and implemented under the Kim Dae Jung government.

As a result of the corporate sector reform, the chaebols’ absolute amount of debt decreased substantially and, consequently, their control over chaebols weakened. The debt-equity ratio of the manufacturing sector as a whole decreased from 396.3 percent in 1997 to 135.6 percent in the first half of 2002. The ratio of total borrowing and bonds payable to total assets in the manufacturing sector decreased from 50.8 percent in 1998 to 39.8 percent in 2001 as well (source: Korea Institute of Finance and Korea Statistical Office).

Furthermore, the chaebols’ corporate strategy pursuing dependence on debt would have to be reconsidered in the sense that the ‘too big to fail’ idea would not be accepted under the new regime. For instance, in 1999, the government decided to force the huge,
debt-ridden Daewoo and Ssangyong chaebols, which ranked the third and seventh respectively, into bankruptcy. The government did not save the life of, especially, Daewoo at that moment, which showed the government’s attitude toward chaebols. Although Korea entered another stage of credit crunch, such an unstable situation did not lead to another crisis. One of the important aspects of the economic reform measures under the Kim Dae Jung government was that chaebols’ preoccupation with the ‘too big to fail’ idea whose costs are shown to overshadow benefits (Ferris, Kim and Kitsabunnarat (2003)) collapsed.

IV. Bad Effects of Restructuring

Labour movements had severely been repressed during the 1960s – mid-1980s under the dictatorial governments in Korea. As a result of such continued repression, the nationwide strikes occurred in 1987. Since then, labourers’ conditions improved as a whole during 1987-1997. The IMF policy package included requiring improvement of labour market flexibility (Government of Korea, 3 December 1997). Facing the increasing unemployment rate and the need to attract FDI, new capital-friendly labour laws were enacted in February 1998, whereby firms began to be allowed to fire labourers as they pleased in the case of urgent managerial needs. Consequently, labourers’ conditions deteriorated in the sense of the increased percentage of irregular workers and stagnant or increased work hours (Crotty and Lee (2002)). The share of irregular workers increased substantially from 43 percent in 1996 to 52 percent in 2000 (source: Korea Statistical Office). Meanwhile, the amount of union membership increased from 1.48 million in 1997 to 1.57 million in 2001. The number of unit unions also increased from 5,733 in 1997 to 6,150 in 2001, as is shown in Table 1.

[Insert Table 1]

Since there is little, if any, evidence that labour market flexibility is a determinant of FDI inflows, it would be necessary for the Korean government to ponder on the situation of labour market flexibility, which already ranks the third among the OECD countries as of January 2003, according to the Free Labour Indicator by the U.S. business magazine Forbes (30 January 2003). Although certain institutions expressing the interests of the enterprises such as the Federation of Korean Industries argue further flexibility of labour market (Federation of Korean Industries (2000)), it is doubtful whether its argument would be appropriate for the Korean economy, where job mobility has been quite restricted compared with most of developed economies.
Besides the worsening situation of labourers in terms of labour market flexibility, it is noteworthy, however, that the government tried to improve the labour-related regulations. That is, the Korea Teachers Union and the Korean Association of Government Employees’ Work Councils were legally permitted beginning from January 1999 (Hangyure-shinmun, 27 January 1998). Three internationally recognized core labour standards-related ILO Conventions such as ILO Convention number 111 on non-discrimination, 138 on minimum wage, and 182 on worst forms of child labour were also ratified during 1998-2001 period (source: http://www.ilo.org).

Regarding income inequalities, Stiglitz (1999, p. 421) admits that: “income inequality tends to rise in periods of economic crises, structural adjustment and output contractions.” Although all available measures show widened income inequalities during 1997-1999 (Yoo and Kim (2002)) due to the increase in the number of the irregular workers and the unemployment rate, interpretations on the situation of income inequalities since 2000 appear to depend on the survey methods. For instance, a measure such as the Gini coefficient based on urban workers’ households shows that the Gini coefficient increased from 0.307 in 1996 and 0.296 in 1997 to 0.311 in 1999, but decreased to 0.301 – 0.303 in 2000 and 2001, presumably due to the increased public transfer and decreased unemployment rate; meanwhile, most other measures indicate that the Gini coefficient has been more or less stable since 1999 (Park, Kang and Kim (2002) and Yoo and Kim (2002)).

V. Conclusions

Authors have been split with respect to the main cause of the Korean economic crisis. Revealing it is important since it has significant implications for policy prescriptions. The Korean government pursued neo-liberal restructuring measures in overcoming the economic crisis. The policies taken since the occurrence of the economic crisis in 1997 such as promotion of FDI inflows reflected the then president Kim Dae Jung’s economic philosophy, which was in conformity with the IMF policy package. Therefore, the Korean government actively tried to implement the IMF conditionalities which included structural reforms. The financial and corporate sector reforms undertaken by the Korean government contributed to strengthening the banking and corporate sectors, attracting FDI inflows.

Its policies taken after the economic crisis in December 1997 were quite successful in terms of economic recovery. However, most indicators show worsening of income
inequalities and workers’ situation regarding job security, which is worrisome in the Korean economy where job mobility is quite low. The strengths as well as the weaknesses of the development strategy of Korea and its reform measures undertaken since the occurrence of the economic crisis need to be differentiated; thereby the appropriate economic development strategies of developing countries in general can be better understood.
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