External Liberalization in Asia, Post-Socialist Europe, and Brazil

Lance Taylor

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Edited by

Lance Taylor

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The Long and Winding Road to Liberalization: The South Korean Experience

Jong-Il You

South Korea (Korea, hereafter), one of the poorest countries in the world in the early 1960s, became a member of the OECD in 1996. Its average per capita income was comparable to that of Mozambique and Ghana in the early 1960s, but by 1996 it was greater than $10,000. This miraculous growth entailed a thorough societal transformation, not to mention changes in the industrial structure, technology, and employment patterns. Various quality of life indicators such as life expectancy, educational attainment, and political freedom also exhibited dramatic improvements. On top of this, Korea's income distribution remained relatively egalitarian.

This rosy picture changed abruptly toward the end of 1997 when the currency crisis forced the Korean government to resort to IMF rescue financing. The crisis came as a rude awakening. There have been debates on what exactly went wrong. On the surface, it seems obvious that financial liberalization, particularly the opening of the capital account, created vulnerabilities in the economy. Without disputing this, I argue that there was also an underlying crisis of accumulation that helped convert the currency and liquidity crisis into a full-blown financial and economic crisis.

Korea has been pursuing economic liberalization, with varying emphases and speeds, for the last two decades since the early 1980s. It was hoped that the liberalization policy would cure the economic ills of the government-led rapid industrialization program. However, Korea has been less successful in liberalizing than in industrializing. The gradual and cautious approach to liberalization of the 1980s failed to arrest the development of an accumulation crisis, while the more rapid liberalization policy of the 1990s resulted in a severe economic crisis. Further liberalization and other reforms that have been implemented since the crisis have yet to forge a coherent and dynamic model of development.

This chapter reviews Korea's experience with economic liberalization since the early 1980s. Section 1 provides a brief history of the economic liberalization

policy in the broader context of the rise and fall of the Korean model of development. Section 2 analyzes the major economic consequences of the liberalization policy, including its impact on growth and distribution, the currency crisis, and the financial crisis. Section 3 examines the macroeconomic adjustments since the crisis, including the impact on the labor market and income distribution. Section 4 reviews the economic and social policy reforms that the government has pursued since the crisis. Finally, the concluding section draws some lessons on liberalization policy from the Korean experience.

1. The Korean Model and Liberalization

1.1. The Emergence of the Korean Model of Development

The challenges of modern economic development require substantial institution building that only the state can provide. Particularly, at the early stages of development when the entrepreneurial class is underdeveloped, the state can play a pivotal role in mobilizing resources and coordinating expectations. In Korea, a developmental state emerged in the 1960s and a historically unprecedented growth miracle followed.

The economic and political chaos that followed the liberation from the Japanese colonial rule and the Korean War did not provide Korea with favorable conditions for development. Despite enormous aid inflow from the United States, the economy under the Rhee regime failed to show much progress other than some import-substitution industrialization in light industries and the implementation of compulsory primary education. Rampant cronyism, extremely distorted prices, high unemployment, and persistent poverty characterized the economy. This was the backdrop to the military coup led by General Park in 1961. The military junta set out to lead the country out of poverty with its own brand of "guided capitalism." While its initial predisposition toward populist policies was checked by U.S. demands for stabilization, exchange rate reform, and interest rate policies, it never wavered from its commitment to government-led industrialization.

The government provided the vision of economic development around which private investments were organized. By such direct coordination of investment, the government initiated every major diversification into new branches of industry in the 1960s and the 1970s:

> The state masterminded the early import-substitution projects in cement, fertilizers, oil refining, and synthetic fibers, the last greatly improving the profitability of the overextended textiles industry. The government also kept alive some unprofitable factories . . . that eventually provided key personnel to the modern general machinery and shipbuilding industries, which the state also promoted. The transformation from light to heavy industry came at the state's behest, in the form of an integrated iron and steel mill. . . . [The government] was responsible for the Big Push into heavy machinery and chemicals in the late 1970s. (Amsden 1989, 80–81)

In order to realize its ambitious investment and industrial upgrading plans, the government employed various methods of resource mobilization. Having unsuccessfully tried a currency reform to mobilize hidden funds, the Park government resorted to more conventional measures such as raising the deposit rate at the urging of its U.S. advisors. It also used unconventional methods. First, it pursued a policy of consumption restriction, including severe restrictions on the imports of consumer goods, luxury consumption taxes, and even frequent state-sponsored campaigns against "unnecessary consumption." Indirectly, the policy of labor repression to contain wage hikes and various measures to raise profits served a similar purpose (You 1998). Second, the government maintained tight controls on capital flows and foreign exchange in order to prevent leakages of domestic savings to foreign countries. Third, it decided to complement domestic savings with massive amounts of foreign savings. Since Korean firms did not have access to the international capital market, the government stepped in by allowing state-owned banks to extend guarantees on private sector foreign borrowing.

The Korean government maintained tight control over the allocation of financial resources in order to make sure that investment activities would take place according to its own priorities and plans. This was possible because of three important factors. First, the government had a firm control over domestic finance after nationalizing the commercial banks in 1961.[1] Second, the government controlled the use of foreign savings by requiring all foreign loans to be authorized

by it. Third, the government could control the direction of industrial development by maintaining tight regulations on FDI. Had foreign multinational companies had a big presence in Korea, it would not have been easy for the government to conduct its industrial policy.

While the Korean government projected its own development vision, planned investments, and raised and allocated financial resources, it generally refrained from establishing state-owned enterprises except in a few crucial cases such as the POSCO steel company. Instead, it encouraged the private sector to follow its lead and make profits along the way. In this process, large *chaebol* groups with proven track records became favored partners in the government-led development scheme. With their explosive growth fueled by state subsidies, *chaebol* firms began to dominate the industrial scene in Korea.

1.2. The Shifting Balance between the State and the Market

Interventionist policies often create huge distortions and even promote rampant rent-seeking activities. This was indeed the case under the Rhee government in the 1950s. The policy shift toward liberalization in the early 1960s, including the currency devaluation, the unification of the exchange rate, trade liberalization, and raising the interest rates, helped reduce the enormous distortions in the economy and generated rapid export growth. However, the extent of liberalization was rather limited, and the government control of investment was strengthened in the 1970s when it undertook the "Big Push" toward heavy and chemical industrialization.

Prominent features of the Korean model of development—state intervention, developmental banking, the prominence of big business, industrialization policy, and authoritarian politics—are quite typical of late industrialization in many developing countries. What put Korea apart from the less successful countries was the immense effectiveness with which these instruments were used to accelerate capital accumulation and carry out development plans. The debate on the sources of this effectiveness has focused on the discipline of the state, pointing to the use of performance standards (Amsden 1989) by a neutral and competent bureaucracy (World Bank 1993). Some have also noted that the discipline of the state was facilitated by initial structural conditions such as the relatively egalitarian income distribution (Rodrik 1995) and the absence of a dominant social class (You 1995; Aoki, Murdock, and Okuno-Fujiwara 1997).

Performance standards contributed to maintaining bureaucratic discipline in spite of the state-controlled allocation of financial resources that inherently bore the risk of breeding moral hazard problems and corruption.[2] In particular, the choice of export market performance as the standard served to promote exports. It was also a relatively objective and transparent performance criterion and forced subsidized firms to compete vigorously in world markets rather than to relax in the protected domestic markets.

However, maintaining high-quality bureaucratic discipline in the context of a government-led investment drive proved difficult. The general bailout of corporations with the August 3rd Emergency Decree sent the wrong signal to businesses. The further decay of bureaucratic discipline was a result of the Heavy Chemical and Industrial Drive. Having encouraged or even forced some businessmen to enter into high-priority sectors, it was difficult for the government to back off when they faced adverse business conditions.[3] The restructuring and bailout operations of the HCI firms in the early 1980s (following the economic crisis of 1979–1980) reinforced the implicit government guarantees to firms cooperating with the government (Cho and Kim 1997). Furthermore, top *chaebol* groups became "too big to fail" in the sense that the negative fallout in the event of their bankruptcy would be too devastating to the economy. Moral hazard in lending was exacerbated, and the erosion of bureaucratic discipline accelerated as political connections became increasingly important in lending decisions.[4]

A growing awareness of these problems concurrent with severe macroeconomic imbalances that developed in the late 1970s[5] led to a stabilization-cum-liberalization program in the early 1980s. Trade liberalization was pursued as part of a disinflation policy package. The government also started a program of financial liberalization in an attempt to introduce greater reliance on market forces in the allocation of financial resources.

1.3. The Dangers of Financial Liberalization: The 1980s Experience

It is conventional wisdom that the sequence of liberalization should run from trade liberalization to

domestic financial liberalization and eventually to capital account liberalization. Korea followed such a sequence since the 1980s. Korea's experience shows, however, that following the correct sequence by no means guarantees success.

Trade liberalization that began in the early 1980s was not a drastic one-shot occurrence but a gradual multistage process. The strategic protection of selected industries such as agriculture and automobiles continued. One estimate of the degree of import liberalization incorporating both tariff protection and quantitative restrictions indicates that it steadily rose from about 66 percent in 1980 to about 88 percent in 1990 (Kim 1994). It is commonly argued, however, that the actual effects of liberalization were less than these numbers indicate owing to various nontransparent regulations.

In the 1980s the government also began to liberalize the tightly controlled financial system. The announcement of the financial liberalization plan in 1980 was followed by its gradual implementation. Important measures included the privatization of commercial banks, permitting the entry of new commercial banks and non-bank financial institutions (NBFIs), the partial deregulation of interest rates, and a gradual opening of the financial market. However, financial liberalization measures were taken in such a piecemeal and gradual fashion that government controls over commercial banks remained firm (Amsden and Euh 1990).[6] The meaningful opening of the financial market and the liberalization of capital flows had to wait until the 1990s.

Nonetheless, the financial liberalization of the 1980s produced an important change in the financial structure—that is, an explosive growth of NBFIs such as securities companies, insurance companies, and investment trust companies. While commercial banks were still effectively under government control, the NBFIs benefited from liberalization by offering higher interest rates and thereby attracting deposits away from banks. The NBFIs accounted for 29.1 percent of total deposits and 36.7 percent of total loans in 1980. By 1995, they accounted for 72.2 percent of total deposits and 63.5 percent of total loans. This meant that the allocation of financial resources was increasingly beyond the control of the government. Instead, financial resources came increasingly under the control of the *chaebol* groups that owned the NBFIs.[7]

Financial liberalization sought to replace the increasingly problematic bureaucratic discipline with market discipline.[8] What actually happened, however, was the weakening of bureaucratic discipline without the strengthening of market discipline. Mindful of the market power that *chaebol* groups possessed, the liberalization policy package of the 1980s included the legislation of fair competition law. Since then, regulatory measures to curb the concentration of economic power in the hands of the *chaebol* went through cycles of tightening and relaxation. However, the control of NBFIs bestowed upon *chaebol* groups independent power to raise financial resources without the approval of the government. This meant a fundamental change in the Korean model of development, with the government control of finance slipping into the hands of the *chaebol*.

1.4. Capital Account Liberalization in the 1990s

As a consequence of the financial liberalization of the 1980s, the probability of unscrupulous investment drives by *chaebol* groups increased. Checks on *chaebol* management by creditors and institutional investors were lacking, and government regulations were retreating. With the pace of liberalization gathering speed in the 1990s, the problem worsened.

In the 1990s the overriding theme of economic policy in Korea was "responding to globalization." Korea faced increasing pressures from its trading partners to open its markets in the early 1990s. The advent of the WTO regime and Korea's entrance into the OECD in the mid-1990s posed big challenges to the Korean economy. The course of action chosen by policy makers was to "accelerate liberalization and deregulation." First, trade liberalization proceeded to dismantle the last pockets of protected industries such as rice, financial services, retailing, and strategic manufacturing like automobiles. Second, industrial policy was wound down, with policy loans phased out and entry restrictions deregulated by the mid-1990s. Third, substantial financial liberalization measures were taken, including interest rate deregulation and the relaxation of entry barriers to financial activities. Finally and most importantly, capital account liberalization measures, mostly the deregulation of various forms of capital inflows, were taken (see You and Lee 2001).

These measures proved disastrous. With *chaebol* groups controlling most of the NBFIs, the intensification of competition with liberalization and deregulation did not necessarily result in enhanced market discipline. The corporate governance system of

chaebol groups, the affiliates of which are interlinked through a nexus of cross-investment and cross-debt guarantees, imputed a bias toward overexpansion. With the dismantling of the regulations of the developmental state, the *chaebol* engaged in expansion and diversification races as exemplified by Samsung's entry into automobiles and Hyundai's entry into steel making. Capital account liberalization and the relaxation of entry barriers to the financial industry created much better access to financial resources for *chaebol* groups, and contributed to much greater risk in the financial system. Meanwhile, the government failed to apply prudential regulations and supervision that became all the more important as a result of liberalization. NBFIs were especially poorly supervised. In short, liberalization policies led to a rapid buildup of bad assets in the financial system and foreign debt in the country that culminated in the catastrophic exchange crisis of 1997.

Many have correctly argued that the foreign exchange and financial crisis was a result of mismanaged financial liberalization (Radelet and Sachs 1998; Chang, Park, and Yoo 1998). The problem was much more than some technical mistakes in implementing financial liberalization. The conception and execution of the whole series of liberalization policies were at fault. The champions of liberalization apparently failed to consider the importance of the distortions that could be caused by *chaebol* power, especially their control of finance. They also failed to realize that a transition from bureaucratic to market discipline, and from a developmental to a liberal state, involves careful institution building as well as liberalization and the redesign of regulations rather than simple deregulation. Their most fatal mistake was, arguably, discounting the risks inherent in capital account liberalization.[9]

Liberalization in Korea took a radical step in the wake of the IMF bailout in December 1997. The IMF-mandated reforms included a full-fledged opening of the financial markets and the capital account. Inward foreign investment, both portfolio and direct, has been radically liberalized. The government implemented standard neoliberal policies such as labor market reforms, privatization, and deregulation with a zeal previously unseen in Korea.

2. The Economic Consequences of Liberalization

2.1. Growth and Distribution in the Liberalization Era

It is hard to detect if liberalization had any long-term effect on growth. Since liberalization began in the early 1980s, growth performance remained strong until the outbreak of the financial crisis in 1997. Figure 7.1 shows that the average growth rate in the

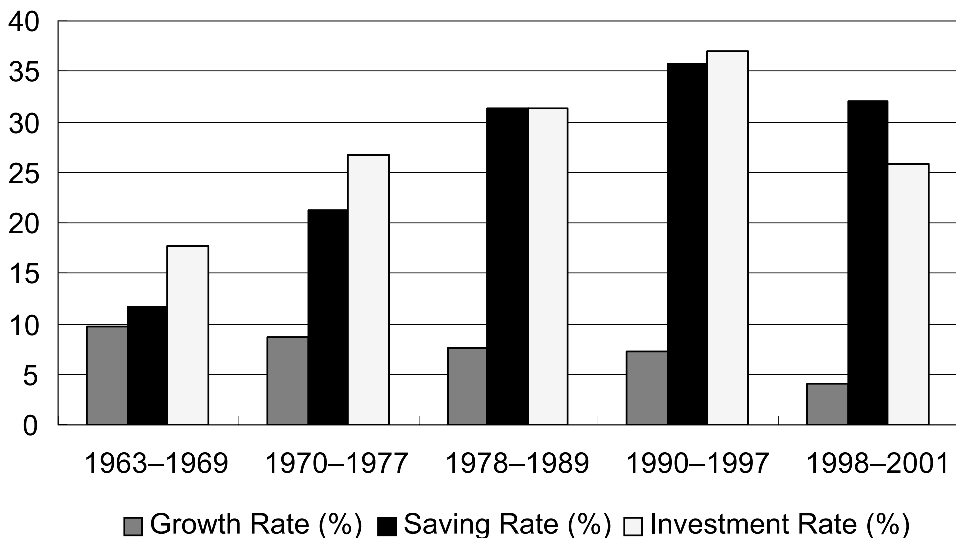

FIGURE 7.1 Savings, Investment, and Growth; 1963–2001

1980s and 1990s (before the financial crisis) was somewhat below that of the 1960s and 1970s, but this was a gradual and natural decline in the course of development. In fact, during the liberalization period, the growth rate never fell below 5 percent except in 1998 when the economy went into a free fall in the wake of the financial crisis. While there have been cyclical fluctuations, macroeconomic imbalances stayed within bounds and inflation remained modest until the financial crisis.

However, we cannot easily conclude that liberalization has had no effect on growth. First, it led to the catastrophic financial crisis of 1997–1998 that resulted in a substantial decline of growth (see figure 7.1). Even though growth recovered quickly during 1999–2000, there was a permanent loss of output, as clearly shown in figure 7.2. Second, it is possible that growth performance would have been worse without liberalization. In other words, liberalization may have improved microeconomic efficiency as its proponents claim. However, whatever such efficiency gains are likely to have been, they were offset by the inefficiencies stemming from *chaebol* dominance.

Proponents of capital account liberalization argue that it helps growth by inducing capital inflows and thereby augmenting financial resources for investment. The Korean experience does not lend support to this claim. As we can see from figure 7.1, it was during the 1960s and 1970s, when capital flows were strictly controlled by the government, that Korea financed large gaps between investment and domestic savings with capital inflows. In the liberalization period, while the investment rate continued to rise, the savings rate rose sufficiently to reduce the gap to minimal levels. This observation applies not only to the 1980s but also to the 1990s, when there was serious capital account liberalization.

Prior to the 1990s, Korea managed its capital account in ways that supported the balance of payments, given the developments in the current account. In the first half of the 1980s, when the current account was chronically in deficit, the government used various liberalization measures in order to induce capital inflows and guided domestic banks to borrow from abroad. In the late 1980s, when the current account showed a large surplus, the government resorted to direct capital controls—for instance, banning commercial loans by domestic firms—in order to manage the external balance. However, in the 1990s, capital account liberalization was sought for its own sake in the context of the financial liberalization policy, and this led to a rapid increase in capital inflows, as we can see in table 7.1. Capital inflows amounted to only 2.8 percent of the GDP in 1993 when serious capital account liberalization started, but rose to 9.25 percent by 1996. However,

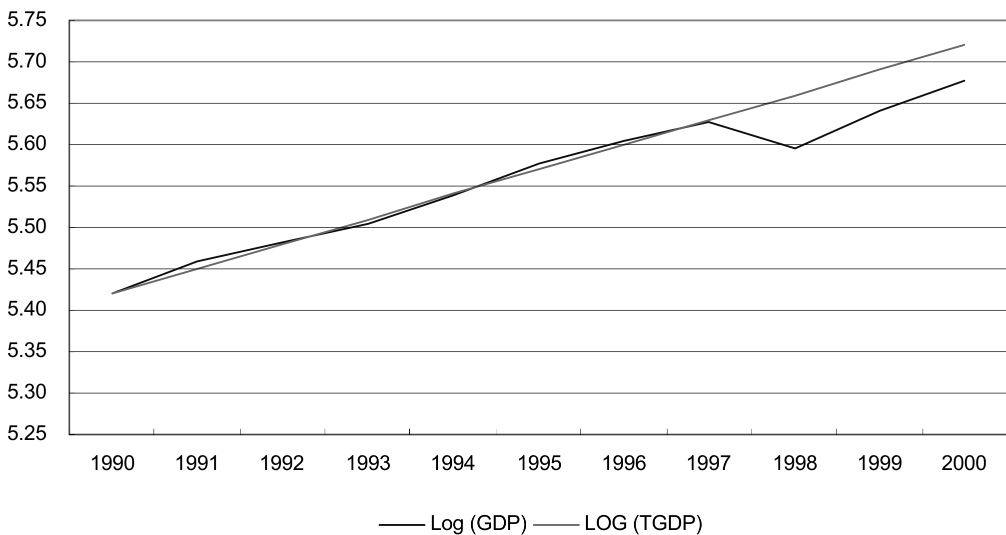

FIGURE 7.2 GDP and Trend GDP at 1995 Prices; 1990–2000

TABLE 7.1 Balance of Payments; 1981–2000

		Capital Account				*% Share of GDP*
Year	*Current Account*	*Overall*	*Inflow*	*Outflow*	*Reserve Accumulation*	*Errors and Omissions*
1981	–6.62	7.63	7.78	–0.15	–0.43	–0.59
1982	–3.43	5.29	6.70	–1.41	–0.12	–1.74
1983	–1.85	2.91	3.83	–0.93	0.09	–1.14
1984	–1.43	3.38	3.21	0.17	–0.97	–0.98
1985	–0.85	1.75	3.68	–1.93	0.04	–0.94
1986	4.38	–3.92	–2.05	–1.87	0.04	–0.50
1987	7.44	–7.67	–7.05	–0.62	–0.66	0.89
1988	8.02	–2.80	–1.18	–1.62	–4.90	–0.32
1989	2.43	–1.31	–0.13	–1.18	–1.45	0.32
1990	–0.79	1.02	2.58	–1.56	0.47	–0.69
1991	–2.82	2.17	3.57	–1.39	0.39	0.26
1992	–1.25	2.09	3.37	–1.28	–1.18	0.34
1993	0.29	0.79	2.80	–2.01	–0.87	–0.21
1994	–0.96	2.56	5.62	–3.06	–1.15	–0.44
1995	–1.74	3.43	7.58	–4.15	–1.44	–0.25
1996	–4.42	4.49	9.25	–4.76	–0.27	0.21
1997	–1.71	0.28	3.77	–3.49	2.50	–1.06
1998	12.71	–1.01	–1.17	0.03	–9.75	–1.95
1999	6.03	0.50	1.88	–1.37	–5.66	–0.87
2000	2.65	2.62	4.35	–1.73	–5.15	–0.13

Source: Bank of Korea

capital outflows increased as well, and the overall capital account balance registered surpluses that were less than those of the early 1980s.

The picture of income distribution in the liberalization period is similar to that of growth. There seems to have been no major impact on income distribution until the financial crisis. In terms of the functional distribution of income, the wage share exhibited no long-term trend since the 1980s. Household income distribution as well as wage distribution showed a modest improvement until the early 1990s, and then both stagnated (see You and Lee 2001). However, the financial crisis dramatically worsened income distribution. Figure 7.3, which compares the trends of labor productivity in manufacturing and the real wage rate, clearly shows a dramatic rise in the gap between the two after the crisis of 1997–1998.

2.2. Capital Account Liberalization and the Currency Crisis

The change in the policy stance toward the capital account brought about an important change in macroeconomic developments in Korea. Capital flows began to act as an independent external force that impinged upon other macroeconomic variables. First, capital flows became an important determinant of the exchange rate. The surge of capital inflows during 1993–1996 resulted in the real appreciation of the exchange rate. Real depreciation followed the reversal of capital flows in 1997 and 1998. The real exchange rate began to appreciate again in 1999 as capital inflows resumed. Second, capital account liberalization and the increase in capital inflows resulted in the expansion of consumption (a decline in the domestic savings rate) and domestic investment. Table 7.2 shows that, between 1993 and 1996, the gross domestic savings rate declined from 36.2 to 33.8 percent, while gross domestic investment increased from 35.4 percent of GDP to 38.1 percent.

However, the macroeconomic fundamentals remained relatively sound until just before the onset of the crisis. In fact, the most striking feature of the Korean currency crisis of 1997 is that it took place despite good macroeconomic fundamentals. It can be seen from table 7.2 that by any conventional macroeconomic indicator, the Korean economy was doing

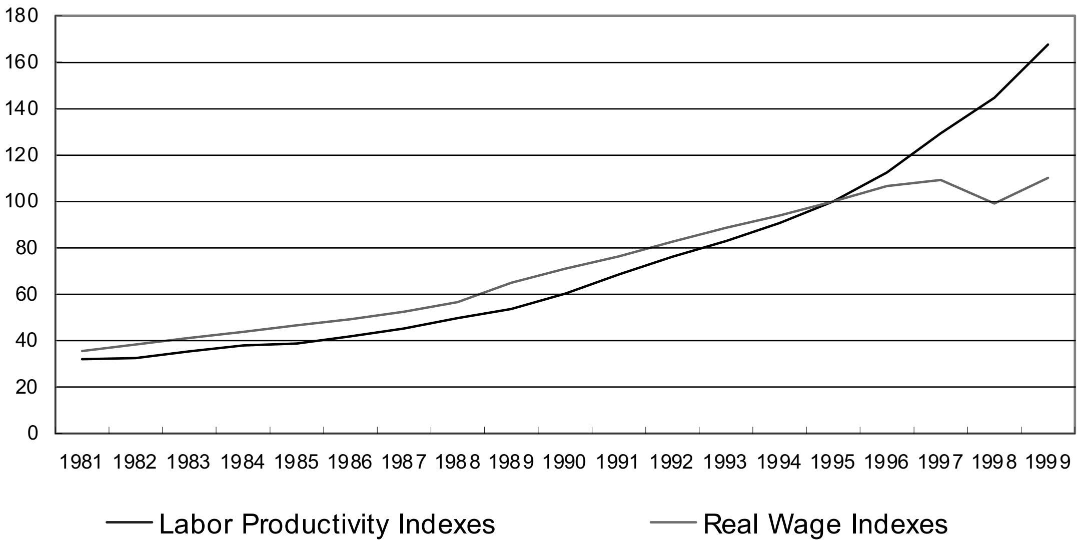

FIGURE 7.3 Labor Productivity and Real Wage; 1981–1999

well until 1996. Growth was strong, though decelerating: inflation was modest at around 5 percent: and the unemployment rate was below 3 percent. The fiscal balance was showing a surplus. The only issue of concern was the large current account deficit but this was, to a large extent, the result of a severe adverse shock in the terms of trade, particularly the collapse of semiconductor prices. Moreover, the current account was rapidly improving in 1997: after recording a deficit of 7.4 percent of GDP in the first quarter, it was reduced to 2.7 percent in the second quarter and down to 2.1 percent in the third quarter before the exchange crisis erupted. There was a real appreciation of the exchange rate; however, its extent was rather modest, and correction started in early 1997. Table 7.2 also shows that domestic savings remained high and that there was no large-scale lending or investment boom in the years prior to the crisis. Deterioration in macroeconomic fundamentals, therefore, cannot be the reason for the currency crisis of 1997.

TABLE 7.2 Macroeconomic Fundamentals (Unit: %)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Fiscal surplus[a]/GDP	–1.9	–0.7	0.3	0.5	0.4	0.3	–1.5	–4.2
Current account/GDP	–2.82	–1.25	0.29	–0.96	–1.74	–4.42	–1.71	12.46
Real effective exchange rate[b]	93.5	98.8	100.9	98.3	98.0	96.0	104.6	131.1
CPI inflation	9.3	6.3	4.8	6.2	4.5	4.9	4.5	7.5
Real GDP growth	9.2	5.4	5.5	8.3	8.9	6.8	5.0	–6.7
Unemployment rate	2.2	2.4	2.8	2.4	2.0	2.0	2.6	6.8
Gross savings ratio	37.3	36.4	36.2	35.5	35.5	33.8	33.4	33.2
Gross investment ratio	39.8	37.3	35.4	36.5	37.3	38.1	34.4	21.3
Real money growth[c]	15.2	12.6	14.9	18.8	11.8	15.2	16.2	—
Real credit growth[d]	16.0	12.5	13.4	18.8	13.7	13.7	14.3	–3.4

Source: National Statistical Office, Bank of Korea, Ministry of Finance and Economy, and KDI.

a. Consolidated public sector.

b. Trade volume weighted: numbers below 100 means overvaluation.

c. New M2 growth rate minus inflation rate.

d. Domestic credit growth rate minus inflation rate.

Another important perspective on the currency crisis is that it was caused by an international bank run rather than a speculative attack on the currency (Dooley and Shin 2000). Table 7.3 shows that the capital flows in 1997 were not unidirectional and that the extent of capital outflow was modest until October. Then, in November, there was a dramatic outflow of capital, and the usable reserves were slashed from about $22 billion to about $7 billion. Most of this is accounted for by the decrease in external debt and the increase in the Bank of Korea's deposit at overseas branches, which was to cover the withdrawal of foreign debt; the portfolio investment outflow was very small. Since, from the creditor's point of view, foreign debt is immune to exchange rate risks as it is denominated in foreign currency, it was not anticipated currency depreciation that triggered the abrupt reversal of capital flows and the currency crisis. It was, rather, an international bank run triggered by a perception of bankruptcy risks of the major Korean banks.

How Korea became vulnerable to a bank run can be seen in the balance sheet of the economy. Table 7.4 shows a steep increase in the external debt in the years preceding the crisis. At the end of 1996, gross external liabilities amounted to $164 billion, up two and a half times from the end of 1993 and five times from the end of 1990. However, the level of foreign debt itself was not a problem. Gross external liabilities at the end of 1996 represented only slightly more than 30 percent of the GDP. The real source of vulnerability was that too large a proportion of the external debt was short term. As a result, the short-term debt was much greater than foreign exchange reserves. At the end of 1996, the short-term external debt was 2.8 times greater than foreign exchange reserves, leaving the economy highly vulnerable to a bank run.

The rise in foreign indebtedness is closely tied to capital account liberalization measures and the ensuing rise in capital inflows. As restrictions on financial institutions in making foreign exchange loans to domestic firms were significantly relaxed since

TABLE 7.3 Trends of the Balance of Payment Components in 1997 (Unit: Billion US$)

	1997						
	1st Quarter	*2nd Quarter*	*3rd Quarter*	*4th Quarter*	*October*	*November*	*December*
Foreign reserve decrease[a]	8.28	–4.17	2.89	13.55	0.12	15.04	–1.61
Private foreign asset decrease[a]	–1.88	–1.44	–1.76	–10.00	–1.14	2.37	–11.23
Total	6.40	–5.61	1.13	3.55	–1.02	17.41	–12.84
Decrease in external debt[b]	–5.59	–6.47	–2.94	–1.10	–2.95	6.55	–4.70
(public)	0.07	0.17	0.06	–15.92	0.04	0.05	–16.01
(private)	–5.66	–6.64	–3.00	14.82	–2.99	6.5	11.31
Increase in deposit at overseas branches[b]	4.20	0.00	0.00	3.33	0.00	8.91	–5.58
Net direct investment outflow[a]	0.51	0.23	0.66	0.21	0.10	–0.05	0.16
Net equity securities outflow[a]	–0.54	–2.54	–0.50	1.38	0.76	1.07	–0.46
Errors and omission	0.02	–0.15	1.17	4.03	0.50	2.35	1.18
Current account deficit[a]	7.35	2.72	2.05	–3.96	0.49	–0.86	–3.59

Source: *The Balance of Payments*, Bank of Korea (various issues). Data for external debt are from the Ministry of Finance and Economy.

a. "–" denotes increase, inflows, or surplus.

b. External debt is reckoned based on IBRD standards, and deposit at overseas branches denotes the deposit of the Bank of Korea at the overseas branches of the domestic banks.

TABLE 7.4 External Liabilities: 1992–1998 (Unit: US $ Billion, %)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Gross external liability[a]	62.9	67.0	88.7	119.7	164.3	158.1	149.4
(y-o-y growth rate)		(6.52)	(32.39)	(34.95)	(37.29)	(–3.82)	(–5.51)
Financial institutions[b]	43.6	47.5	65.1	90.5	116.5	89.6	71.9
Corporations	13.7	15.6	20.0	26.1	41.8	46.2	41.0
External liability/GDP	19.99	19.38	22.04	24.46	31.60	33.16	46.48
FX Reserves	16.64	19.70	21.03	31.93	32.40	19.71	51.96
Short-term external liability/ Total external liability	58.82	60.15	65.84	65.75	56.58	40.00	20.64
Short-term external liability/ FX reserves[c]	215.69	198.89	227.48	240.58	279.75	309.82	59.24

Source: Ministry of Finance and Economy.

a. External liabilities include external debts as defined by the IBRD, plus the offshore borrowings of Korean banks and overseas borrowings of Korean banks' overseas branches.

b. Including foreign bank branches operating in Korea.

c. External liabilities and foreign exchange reserves are year-end values.

1993, financial institutions went on borrowing from abroad at a dizzying speed.[10] From the end of 1992 to the end of 1996, the foreign exchange liabilities of commercial banks rose from about $62 billion to about $140 billion, and those of merchant banks increased from less than $5 billion to about $19 billion. In the process, there was a dangerous deterioration in the balance sheet of the economy, as a large part of short-term capital inflows were used to finance long-term projects and risky investments abroad. Domestic firms rapidly increased overseas investment, much of which proved costly. The outflow of portfolio investment was also dramatic, as financial institutions expanded their business in international finance, including in extremely risky derivatives and junk bond markets. Foreign portfolio assets rose from only $0.5 billion in 1993 to almost $6 billion in 1996.

These developments meant that financial institutions were taking on more risks. As financial liberalization exposed the weak banking system to competitive pressures, banks began to seek higher returns at the expense of higher risks. It goes without saying that financial deregulation must be accompanied with stricter prudential regulations and improved supervisory systems.[11] However, the government neglected to do this. In particular, there were no guidelines on foreign exchange liquidity and risk management, and virtually no supervision of the foreign exchange dealings of merchant banks and the foreign branches of commercial banks.

2.3. Financial Crisis as a Manifestation of a Crisis of the Accumulation Regime

Without denying the decisive role of mismanaged financial liberalization and capital flows in provoking the currency crisis, we must note that there was an underlying crisis of accumulation that contributed to converting the currency crisis into a full-blown financial crisis. Even before the currency crisis, the balance sheets of financial institutions seriously deteriorated as a result of the weakening profitability and deteriorating financial structure of firms.

Corporate profitability exhibited a declining trend in Korea since the early 1970s (Jang 1999). Figure 7.4 depicts the profit rate and the output/capital ratio in the manufacturing sector. It shows that the decline in the profit rate was largely driven by the decline in the output/capital ratio, although at times declines in the profit share also played a role. The decline in the output/capital ratio was particularly pronounced in the two periods 1976–1980 and 1988–1996. The first period was one of overinvestment in the heavy and chemical industrialization drive. The second period was one of overinvestment associated with the mismanaged liberalization.

Despite falling profitability, firms continued to invest heavily. As a consequence, corporate indebtedness rose. The historical trend of declining debt/equity ratio reversed itself from 1988. The ratio of corporate debt to the GDP continuously increased

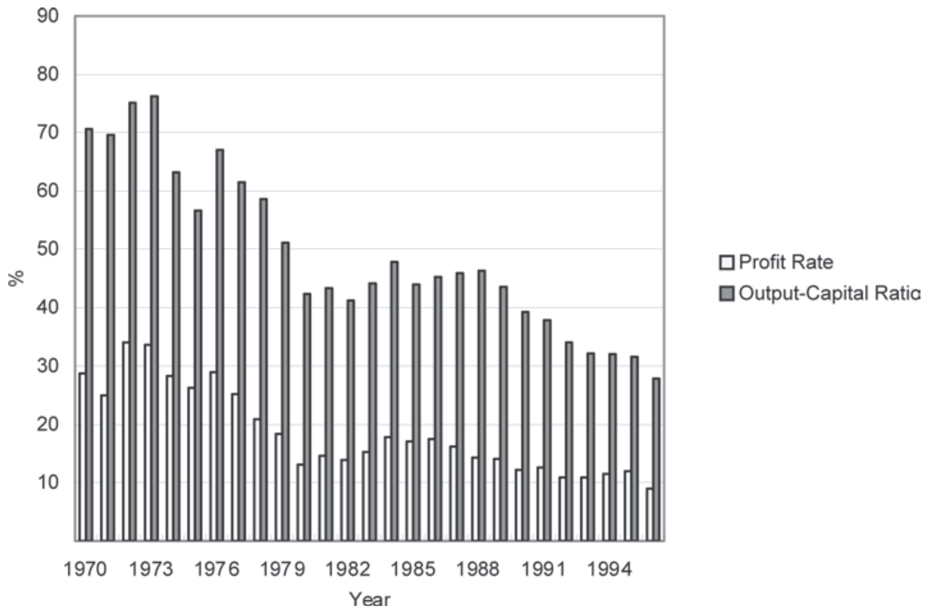

FIGURE 7.4 Manufacturing Gross Profit Rate and Output/Capital Ratio
Source: Jang (1999).

from 1.09 in 1988 to 1.63 in 1996. The debt/equity ratio of Korean companies also increased from around 2.5 in 1989 to above 3.0 in the first half of the 1990s to over 4.0 in 1997. For the top thirty *chaebol* groups, the debt/equity ratio was even higher, at about 3.5 in 1995 and 5.2 in 1997.[12] Given the decline in profitability and deteriorating financial structure of firms, the downturn in the economy since 1996 caused serious financial troubles for many firms. Starting with the collapse of the Hanbo Group at the beginning of 1997, *chaebol* groups such as Sammi, Jinro, and Kia successively went under.

These developments translated into deteriorating balance sheets for financial institutions. According to Hahm and Mishkin (2000), who estimate latent non-performing loans based on hypothetical asset classification criteria,[13] the ratio of non-performing loans to total loans increased from around 15 percent during 1988–1990 to 26 percent in 1997. For merchant banks, the deterioration in asset quality—for which the supervisory authority applied a much more lenient regulatory standard—was even more dramatic. At the end of 1996, the ratio of non-performing loans to capital was as high as 31.9 percent while the ratio was 12.2 percent in the commercial banking sector.

Falling profits, rising corporate indebtedness, *chaebol* bankruptcies, and deteriorating bank balance sheets are surface manifestations of a crisis in the accumulation regime. The rapid industrialization and growth since the early 1960s were based on a symbiotic combination of authoritarian politics, industrial policy based on the government control of finance, and the *chaebol* system. Having produced a miraculous growth, by the late 1980s, this system was running into inherent limits.

First, as we saw in figure 7.1, growth in Korea was based on ever-increasing capital accumulation until the crisis. The rate of investment increased over time from about 18 percent during 1963–1969 to about 27 percent during 1970–1977, 31 percent during 1978–1989, and 37 percent during 1990–1997. Nonetheless, as the output/capital ratio continuously fell, the growth rate declined steadily over the same period. With the share of output going into investment already at very high levels, growth based on capital accumulation was reaching its limits. Maintaining the growth momentum required a transformation of the input-driven growth regime into a more productivity-driven growth regime.

In a sense, liberalization policy was an attempt to meet such a challenge. More market-oriented

allocation was expected to generate greater efficiency. However, liberalization only served to enhance *chaebol* power, and the misallocation problem became even more severe.[14] Furthermore, the *chaebol* responded to the steep increases in wages and unionization in the late 1980s not so much by productivity enhancement as by resorting to subcontracting and outsourcing, taking advantage of the large wage differential between *chaebol* firms and smaller subcontracting firms. With most subcontracting firms' survival dependent on orders from the *chaebol* firms, they fought to survive on the margin and failed to develop into a technically progressive and innovative sector. The productivity gap between the *chaebol* firms and smaller firms kept increasing in the 1990s.

Second, the very success of the authoritarian regime in delivering rapid growth undermined the social basis of authoritarian politics by strengthening various social groups (You 1995). As democratic transition began in 1987, the politics of finance also changed. Under the authoritarian regime, the government used discretionary powers to allocate financial resources to favored industries and to help out favored firms. Such powers were greatly diminished as a result of the winding down of industrial policy and financial liberalization. While cast as economic liberalization measures, these policy reforms were as political as they were economic in nature. Democratization made it increasingly difficult for the government to control resource allocation, while external pressures were also very instrumental in bringing about external liberalization policies.

When the problem of massive *chaebol* bankruptcies surfaced in 1997, the politics of finance was paralyzing the economy. The authoritarian governments of the past had utilized such forceful measures as the August 3rd Emergency Decree in 1972 or the government-dictated restructuring in the early 1980s of the heavy and chemical industries. Such blatant violation of property rights was not an option after democratization and liberalization. On the other hand, the market or institutional mechanisms to handle large bankruptcies were highly inadequate. In the end, the government chose to postpone (and thereby worsen) the problems by a measure called "suspension of default." The Korean economy in 1997 was severely lacking a correction mechanism for overinvestment.

3. Macroeconomic Adjustments since the Crisis

3.1. Overcoming the Liquidity Crisis

The rapid depletion of reserves in November 1997 sent the Korean government begging to the IMF. The announcement of the IMF rescue-financing package totaling $57 billion in early December, however, did not stop the panic. In fact, the crisis got much worse. The exchange rate continued to skyrocket and the rollover rate of commercial loans declined rapidly. It was only after the announcement of the emergency injection of $10 billion by the IMF and the G-7 countries on Christmas Eve and a move toward debt rescheduling by the creditor banks that the panic began to subside.

Given the bank run that started in November 1997, what was needed was massive up-front funding or an orderly debt workout under debt standstill rather than the IMF's phased funding with heavy conditionalities. The successful conclusion of debt rescheduling negotiations with creditor banks played a pivotal role in overcoming the liquidity crisis. It reduced the weight of the short-term debt in total foreign debt from almost 60 percent before the crisis to 26 percent in May 1998. The resumption of capital inflows, starting with the issuance of $4 billion of sovereign bonds in May, also contributed to ameliorating the foreign exchange liquidity crisis. It also helped that FDI inflows dramatically increased in 1998, with the fire sales of distressed firms. Furthermore, with the current account surplus running at more than $3 billion every month during 1998, the foreign exchange situation improved rapidly.

Even as the external debt was substantially reduced through debt repayment, the net capital inflow resumed thanks to the strong FDI and equity investment inflow since the crisis (see table 7.1). After recording a net outflow of $3.4 billion in 1998, the capital account recorded net inflows of $2.4 billion in 1999 and $12.3 billion in 2000. The current account also improved dramatically, recording a surplus of $40.4 billion in 1998, $24.5 billion in 1999, and $11.0 billion in 2000. Therefore, the foreign exchange reserves of the Bank of Korea increased enormously from their lowest amount of $3.9 billion during the crisis to $52.0 billion at the end of 1998 and further to $95.9 billion at the end of 2000. The ratio of short-term external liabilities to foreign exchange reserves that reached over 300 percent in 1997 dropped to only

46 percent by the end of 2000, putting the foreign exchange liquidity crisis firmly to a close.

A closer look at the capital account reveals significant changes between the before-crisis capital inflows and the after-crisis capital inflows (see figure 7.5). The most notable change is that other investment inflows (mostly banks' external debt) recorded large negative numbers since 1998 as debt repayment occurred, reversing the heavy accumulation of banks' external debt before the crisis. This was a temporary phenomenon associated with post-crisis adjustments. But there have been structural changes that are likely to stay.

First, the inflows of FDI rose dramatically. The annual inflow was only around $0.8 billion during 1990–1994 and between $1.8 and $2.8 billion during 1995–1997, but it rose to $5.4 billion in 1998, $9.3 billion in 1999, and $8.7 billion in 2000. As shown in figure 7.5, the net FDI inflow became positive in 1998 for the first time since 1990 and remained so until 2000. Although the magnitude of FDI inflows is not huge compared to that of countries like China and Brazil, there is no question that the FDI regime has fundamentally changed from a restrictive to a very open one.

Second, there was a radical change in the composition of the portfolio investment inflow since the crisis. The portfolio investment in equity securities was a minor part of the total portfolio inflow, with investment in debt securities dominating the portfolio inflow, before the crisis. Since 1998, however, investment in equity securities increased substantially and dominated the portfolio inflow. In contrast, investment in debt securities became negative as debt was repaid.

3.2. A Deep Recession and a Steep Recovery

In the wake of the exchange crisis, the Korean economy suffered from the deepest recession ever

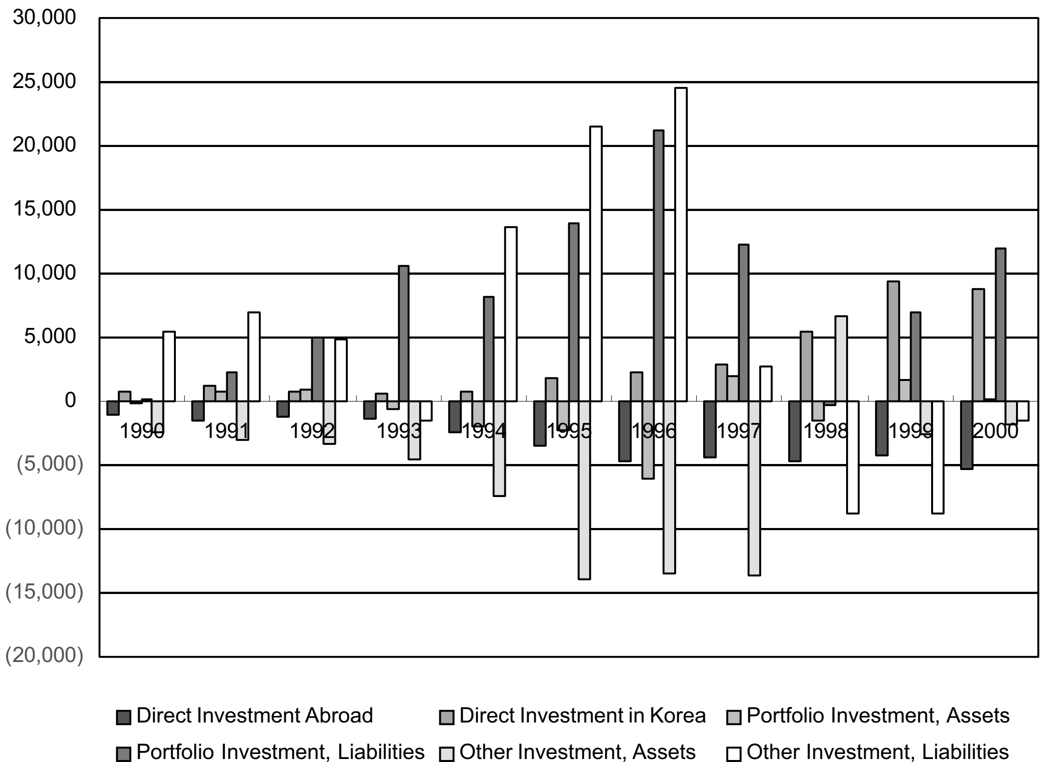

FIGURE 7.5 Decomposition of Capital Flows; 1990–2000
Source: Bank of Korea.

since the Korean War. The collapse of domestic demand pushed the economy into a 6.7 percent contraction in 1998. The unemployment rate, which remained below 3 percent before the crisis, shot up to about 7 percent. However, the economy rebounded and recorded an annual growth rate of 10.7 percent in 1999. This remarkable recovery continued into 2000, but growth began to decelerate from the fourth quarter of 2000.

The initial IMF program dictated that the short-term interest rate be raised from 12.5 to 21 percent, that money supply be tightened to contain inflation at 5 percent, and that the government budget be balanced or slightly in surplus. Requiring inflation to remain unchanged after the enormous depreciation of the currency was a definite call for a steep recession. As many have pointed out, Korea has not exhibited significant budget deficits, unlike a typical recipient of IMF rescue financing in Latin America or Africa. Furthermore, Korea's current account deficit was relatively small and declining in 1997. With the steep depreciation and the sagging domestic demand, it was clear that the deficit would improve further without any IMF-engineered hyperrecession. The appropriateness of the high interest rate policy as a temporary measure to prevent capital flight remains controversial, but tightening the budget at a time of extraordinary contraction in a country with a proven track record of fiscal responsibility was clearly out of line. But it was the high interest rate policy coupled with the demand for BIS capital adequacy requirements that severely disabled the economy by producing a vicious circle of credit crunches and corporate bankruptcies.

The economy went into a free fall after the IMF involvement, with the growth rate plunging to minus 5 percent in the first quarter and to below minus 8 percent in the second and third quarters of 1998. As the depth and severity of the recession began to emerge, the IMF eased some of its conditions at several stages.[15] By the middle of 1998, interest rates were left to the discretion of the Korean authorities and the fiscal deficit was allowed to reach 4 percent of the GDP. Figure 7.6 shows that the yield on three-year corporate bonds came down to pre-crisis levels in the third quarter of 1998 and below pre-crisis levels after the fourth quarter of 1998. The budget deficit reached 4.2 percent of the GDP in 1998 and 5.1 percent of the GDP in 1999.

Defying dismal predictions, this macroeconomic policy shift succeeded in generating a very rapid recovery that started in the fall of 1998 and gathered force in early 1999. As a result, the GDP growth rate showed a remarkable turnaround from –6.7 percent in 1998 to 10.7 percent in 1999. The recovery also owed a great deal to the massive financial restructuring and other reform efforts by the government. Of critical importance were the bank restructuring in the fall of 1998, for which 40 trillion won were spent, and the quick buildup of the social safety net that cost more than 10 trillion won in 1998.[16] The bank restructuring made it possible to

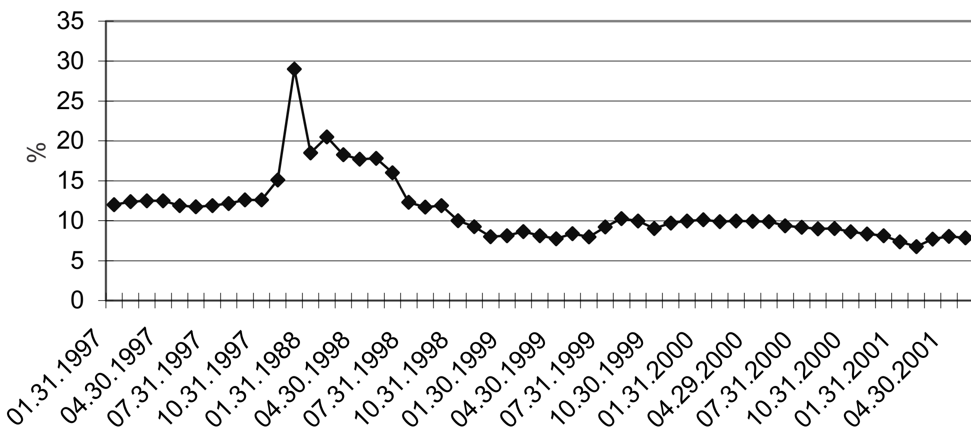

FIGURE 7.6 Market Interest Rate: Yields on Three-Year Corporate Bonds

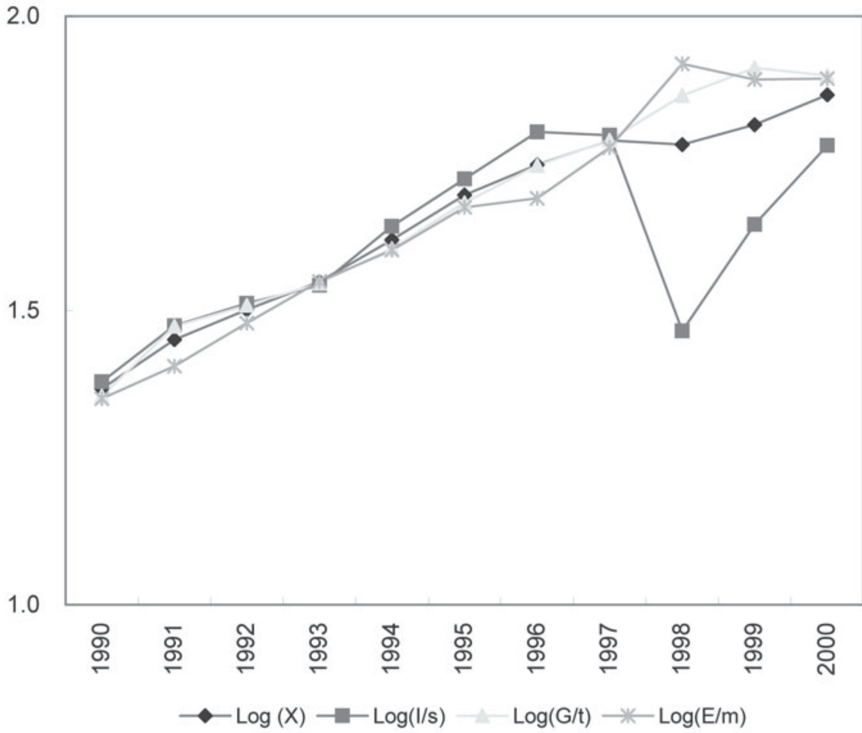

FIGURE 7.7 Decomposition of GDP Growth; 1990–2000

ease the credit crunch and put a stop to the vicious circle of corporate bankruptcy and financial crisis. The social safety net made it possible to keep the labor peace and social stability in the midst of mass unemployment and rising poverty. Finally, the recovery was helped by favorable external conditions, chiefly the strong growth and low interest rates in the United States.

For a closer examination of the growth recovery, figure 7.7 shows a decomposition of demand growth in the 1990s into private demand, government demand, and external demand in relation to leakages in the respective sectors.[17] It shows that private demand consistently led the overall demand growth before the crisis, but this changed dramatically due to the collapse of private demand after the crisis. Exactly the opposite can be said about external demand, while the government sector was generally neutral before the crisis but turned into a source for demand boosting after the crisis.

As for the recovery process, two observations can be made. First, even though the recovery of private investment demand played an important role in output recovery, investment demand continued to be outweighed by the savings leakage through the recovery process. Second, both the external sector and the government sector helped contain recession and boost recovery. Particularly notable was the role of the government sector. While the external sector injected net demand, its contribution to the recovery was limited. Although not shown in the figure, the positive net foreign demand resulted not from an unusually strong export growth but from a collapse of import demand with the breakdown of investment. Exports grew at the annual rate of 19.1 percent during 1995–1997 and at 19.6 percent during 1998–2000.

The quick recovery of output growth does not mean that Korea is back to the favorable growth conditions of the past. Most seriously, there seems to have been a permanent decline in the savings and investment rates, reversing the continuously rising trend of the previous periods (see figure 7.1). Compared to the 1990–1997 period, the savings rate declined from 35.7 percent of the GDP to 32.1 percent

during 1998–2001, and the investment rate fell from 37.0 to 25.8 percent. The decline in the savings rate has much to do with the financial restructuring and liberalization that led banks to expand household loans and cut business loans. The drastic fall in the investment rate is quite worrisome. Given the need for the restructuring and unwinding of overinvestment of the past, some decline was to be expected. But even excluding the exceptional year of 1998, the investment rate hovered between 27 and 28 percent during 1999–2001, 10 percentage points lower than in 1990–1997. Furthermore, the efficiency of investment, as measured by the incremental output/capital ratio, continued to decline in spite of all the rationalization efforts.[18] Raising the efficiency of investment remains a big challenge.

3.3. Labor Market Adjustments and Income Distribution

The deep recession following the financial crisis produced massive joblessness. Korea had enjoyed full employment for about ten years up to 1997, with the unemployment rate staying in the ~2–3 percent range. As shown in table 7.5, the number of unemployed jumped from about half a million in 1997 to about 1.5 million in 1998. The unemployment rate jumped from 2.6 percent in 1997 to 6.8 percent in 1998 and stayed at 6.3 percent in 1999.[19] There was also a substantial decline in the labor force participation rate. It was lower by 1.3 percentage points in 1998 and 1.5 percentage points in 1999 than the average during the three years before the crisis. If this represents discouraged worker effect, the unemployment problem was about four times as severe in 1998–1999 as it was during the three years before the crisis.

The impact of increased joblessness was uneven across sectors, occupations, and demographic groups. Table 7.6 reports employment changes between 1996 and 1999 that reveal large variations in employment adjustment across industries, occupations, and the educational attainment of workers. Most of the massive employment contraction in 1998 is accounted for by the job losses in manufacturing and construction, although the job loss as a proportion of the previous year's employment was the heaviest in mining and public utilities.

It is interesting that the agricultural sector employment increased by 6.7 percent in 1998, defying the consistently declining trend of the past. This is because the job losers in cities went back to their home villages or other rural areas. Similarly, many job losers went into taxi driving or other services.

In terms of occupation, table 7.6 shows that the greatest job losses in 1998 occurred among craftsmen and simple laborers, while professional jobs increased by more than 10 percent. Consistent with this pattern, table 7.6 also reveals that workers with less than

TABLE 7.5 Employment and Unemployment: 1995–2000 (Unit: 1,000 Persons, %)

Year	*Population (Above 15)*	*Economically Active Population*	*Employed*	*Unemployed*	*Economical Active Population Rate*	*Unemployment Rate*
1995	33,664	20,853	20,432	420	61.9	2.0
1996	34,285	21,243	20,817	426	62.0	2.0
1997	34,842	21,662	21,106	556	62.2	2.6
1998	35,362	21,456	19,994	1,461	60.7	6.8
1999	35,765	21,634	20,281	1,353	60.5	6.3
1998 1/4	35,184	20,941	19,761	1,179	59.5	5.6
1998 2/4	35,304	21,725	20,243	1,481	61.5	6.8
1998 3/4	35,424	21,646	20,049	1,597	61.1	7.4
1998 4/4	35,537	21,511	19,924	1,588	60.5	7.4
1999 1/4	35,615	20,854	19,105	1,748	58.6	8.4
1999 2/4	35,715	21,797	20,362	1,435	61.0	6.6
1999 3/4	35,820	21,914	20,695	1,220	61.2	5.6
1999 4/4	35,910	21,972	20,962	1,011	61.2	4.6
2000 1/4	35,986	21,405	20,313	1,092	59.5	5.1
2000 2/4	36,081	22,108	21,268	840	61.3	3.8

Source: National Statistical Office (each year).

TABLE 7.6 Patterns of Employment Changes; 1996–1999

	1996–1997		*1997–1998*		*1998–1999*	
By Industry						
Agriculture and fishery	–81	–3.4%	156	6.7%	–131	–5.3%
Mining	3	12.5	–6	–22.2	–1	–4.8
Manufacturing	–202	–4.3	–577	–12.9	108	2.8
Gas and water	2	2.7	–15	–19.7	0	0.0
Construction	36	1.8	–426	–21.3	–102	–6.5
Retail and wholesale	51	1.3	–100	–2.6	86	2.3
Restaurants and hotels	119	6.8	–127	–6.8	67	3.8
Trans. Comm	54	4.9	4	0.3	33	2.8
Finance, Insurance, and Real Estate	136	7.7	–52	–2.7	69	3.7
Public administration and services	166	5.3	87	2.7	157	4.7
By Occupation						
Legislator, senior officials, managers	–18	–3.3%	–20	–3.8%	–31	–6.1%
Professionals	–17	–1.7	106	10.6	–42	–3.8
Technicians and associate professionals	208	10.5	–63	–2.9	201	9.5
Clerks	10	0.4	–156	–6.1	–199	–8.2
Service workers and shop and sales workers	185	4.0	–121	–2.5	83	1.8
Skilled agriculture and fishery workers	–82	–3.6	151	6.8	–147	–6.2
Craft and related trade workers	–66	–2.0	–623	–19.7	60	2.4
Plant and machine operators and assemblers	3	0.1	–80	–3.7	23	1.1
Elementary occupations	60	2.6	–247	–10.5	338	16.0
By Education						
Under primary school	–12	–0.3%	–468	–11.1%	–16	–0.4%
Middle school	151	4.5	–585	–16.6	62	2.1
High school	–56	–0.6	–427	–4.7	126	1.5
College and university	200	4.9	427	10.0	114	2.4
Total Employment Changes	*284*	*1.4%*	*–1054*	*–5.0%*	*287*	*1.4%*

Source: Annual Report on the Economically Active Population Survey (1996–1999).

Note: All entries are measured in 1,000 persons.

a high school education were the hardest hit, while the employment of those with college or university degrees increased by 10 percent. In sum, job losses were greater for non-skilled workers than for skilled workers.

The employment status of workers has also deteriorated. The proportion of regular employees declined, while that of temporary and daily workers increased after the crisis. The ratio of regular to non-regular employees, as a result, declined from 1.34 in 1996 to 0.96 in 1999. A recent study finds that some of the employees classified as regular employees in the official survey are in fact non-regular; taking this into account, the ratio went down to 0.71 in August 2000 (Y. Kim 2001). The rise in non-regular employment has become an important social issue, as non-regular employees suffer not only from job insecurity but also from low wages and benefits. The above study claims that the average wage of non-regular workers was only 53.7 percent of that of regular workers, while working hours were slightly longer for non-regular workers.

The changes in wages are reported in table 7.7. Four observations can be made. First, nominal wages exhibited a remarkable degree of flexibility. Between 1997 and 1998, nominal wages fell by 5.9 percent, which meant a fall of 12.5 percent in real wages after taking the inflation rate of 7.5 percent in 1998 into account. The recovery of nominal and real wages in 1999 was also remarkable. Second, the wage changes were not sector neutral. In 1998, industries that incurred the greatest job losses such as manufacturing and construction experienced the largest wage declines. Interestingly, the wage change between 1998 and 1999 is a mirror image of the change between 1997 and 1998. That is, industries that experienced

the largest wage declines in 1998 gained the most in 1999, while industries that experienced relatively small wage declines or even increases in 1998 suffered wage declines in 1999. Third, by 1999, the finance, insurance, and real estate (FIRE) sector became the highest wage sector, replacing the public utilities sector where wages were cut severely as a result of the public sector reform. Fourth, in terms of firm size, the wages of the smallest and the largest firms declined the most in 1998, but they also recovered the best in 1999.

There have also been profound institutional changes in the labor market brought about by the crisis. In the name of enhancing labor market flexibility, the government took measures such as legally sanctioning redundancy layoffs, establishing temporary work agencies, and hiring replacement workers. At the same time, the compensation system is rapidly moving away from the traditional seniority wage system toward a performance-based system.[20]

These labor market adjustments brought about a rise in wage inequality. The wage differential by education, the single most important factor in wage inequality, had been narrowing until 1993, but ceased to narrow in spite of the continuous quantitative expansion in higher education ever since. This is most likely attributable to a structural shift in labor demand in favor of the more highly educated; and is an outcome of the liberalization and globalization of the economy (You and Lee 2001).[21] The uneven impact of the economic crisis, which fell most heavily on unskilled workers, produced a jump in the college wage premium by 5 percent between 1997 and 1998 (D. Kim 2001).

The rise in unemployment and wage inequality, coupled with a sharp increase in financial rent owing to the high interest rate in the first half of 1998, resulted in substantial deterioration in income inequality. Table 7.8 reports changes in urban working household income distribution based on government surveys. There is a remarkable correlation between income levels and their changes in 1997–1998, producing a highly regressive change in income distribution. The average income of the top decile income earners rose by 4 percent, whereas that of lower income earners decreased, with the rate of decrease increasing with the fall in the income level. The bottom decile income earners' average income

TABLE 7.7 Nominal Wages and Growth Rates[a]

	1996	*1997*	*1998*	*1999*
All	1,401.4	1,491.8 (6.4)	1,403.6 (–5.9)	1,572.6 (12.0)
Men	1,563.8	1,659.7 (6.1)	1,549.7 (–6.6)	1,747.1 (12.7)
Women	985.1	1,055.5 (7.1)	997.3 (–5.5)	1,133.2 (13.6)
Manufacturing	1,322.1	1,357.5 (2.7)	1,233.4 (–9.1)	1,408.4 (14.1)
Public utility	1,892.0	2,124.0 (12.3)	2,288.1 (7.7)	1,736.1 (–24.1)
Construction	1,424.6	1,548.1 (8.7)	1,444.5 (–6.7)	1,736.2 (20.2)
Retail/wholesale	1,274.9	1,427.0 (11.9)	1,292.9 (–9.4)	1,472.0 (13.9)
Trans. Comm.	1,264.5	1,456.7 (15.2)	1,429.9 (–1.8)	1,372.4 (–4.0)
Finance, Insurance, and Real Estate (FIRE)	1,630.5	1,695.2 (4.0)	1,578.7 (–6.9)	1,958.9 (24.1)
Services	1,677.7	1,818.8 (4.4)	1,796.5 (–1.2)	1,777.5 (–1.1)
Firm size				
10–29	1,205.2	1,328.1 (10.2)	1,236.6 (–6.9)	1,401.3 (13.3)
30–99	1,270.4	1,380.8 (8.7)	1,321.9 (–4.3)	1,477.4 (11.8)
100–299	1,336.8	1,430.6 (7.0)	1,398.6 (–2.2)	1,536.6 (9.9)
300–499	1,544.3	1,686.6 (9.2)	1,589.1 (–5.8)	1,709.1 (7.6)
500+	1,755.6	1,777.0 (1.2)	1,637.7 (–7.8)	1,869.6 (14.2)

Source: *Monthly Labor Statistics* (July issues in 1996–1999).

a. The sample is firms with no fewer than ten employees. July wages are reported in each year.

TABLE 7.8 Urban Worker Households' Average Monthly Income Distribution (Unit: Won)

Decile	*1997*	*1998*	*1999*	*2000*	*1997–1998*	*1998–1999*	*1999–2000*	*1997–2000*
1	729,243	562,741	602,235	683,505	–22.83%	7.02%	13.49%	–6.27%
2	1,164,951	1,005,431	1,028,866	1,114,861	–13.69	2.33	8.36	–4.30
3	1,435,441	1,255,177	1,293,411	1,389,602	–12.56	3.05	7.44	–3.19
4	1,667,593	1,481,475	1,514,806	1,636,005	–11.16	2.25	8.00	–1.89
5	1,900,159	1,703,445	1,747,536	1,886,139	–10.35	2.59	7.93	–0.74
6	2,155,964	1,951,006	2,022,731	2,172,344	–9.51	3.68	7.40	0.76
7	2,460,398	2,252,089	2,341,707	2,502,552	–8.47	3.98	6.87	1.71
8	2,847,124	2,628,348	2,742,260	2,907,269	–7.68	4.33	6.02	2.11
9	3,419,821	3,193,028	3,327,581	3,519,498	–6.63	4.21	5.77	2.91
10	5,089,836	5,294,871	5,622,517	6,053,059	4.03	6.19	7.66	18.92

Source: National Statistical Office's Korean Statistical Information System (KOSIS;) Household Income, Consumption, Assets.

Note: 1997–2000: The rate of increase from 1997 to 2000.

declined by 22.8 percent. While all income groups experienced rising incomes in 1999 and 2000, there is no consistent pattern across income classes except that both the bottom and the top classes gained more than the middle. If we compare the average incomes of 1997 and 2000, the correlation between income levels and their changes is still perfectly preserved. The actual rise in income inequality is probably significantly greater than table 7.8 indicates, since it covers only those households with labor incomes.

The combination of worsening income distribution and a severe recession resulted in a sharp rise in poverty. One estimate, using the poverty line of about $800 per month for a four-person household, shows that the poverty rate increased from 4.2 percent in 1997 to 9.1 percent in 1998 (Yoo 2000). Other institutions such as the National Statistical Office and the World Bank reported different estimates based on different definitions of poverty, but they all agree that the proportion of households below the poverty line increased by more than twice after the crisis.

4. A Liberal Market Economy at Last?

4.1. Policy Reform after the Currency Crisis

The Kim Dae-jung government, elected two weeks after the signing of the agreement with the IMF in December 1997, committed itself to a vigorous reform program. This was done in order to gain the confidence of the international financial community, on the one hand, and to reorient development strategy toward the "parallel development of democracy and market economy" on the other. Recognizing the need for a fundamental reform of the political economy, the government sought comprehensive reforms both in the economic arena, including both external liberalization and domestic structural reforms, and in the field of social policy.

In terms of external liberalization, the government faithfully carried out the IMF-mandated reforms including a full-fledged opening of financial markets, selling off troubled financial institutions to foreign investors, lifting foreign exchange regulations, and radically liberalizing inward foreign investment—both portfolio and direct. Domestic structural reforms were launched in four sectors: the financial, corporate, labor, and public. The reforms included both restructuring in order to restore financial viability and increase efficiency and institutional changes aimed at enhancing market discipline.

The reforms pursued after the financial crisis are somewhat different in nature as well as much more comprehensive than the earlier liberalization policies. First, liberalization measures were accompanied by domestic institutional reforms intended to discipline agents that had the power to distort the market. At the center of the reform program was *chaebol* reform that sought to enhance transparency and accountability in corporate management and to promote fair competition and speedy restructuring.[22]

Second, the recent reforms included not only liberalization measures but also measures to address market failures. For instance, as a part of the financial sector reform, the government strengthened the financial safety net. It instituted deposit insurance, consolidated financial supervisory functions, and

toughened asset management criteria for financial institutions in line with international standards.[23] This contrasts sharply with the past financial liberalization that was accompanied by the weakening, rather than the strengthening, of prudential regulations.

Third, the new government attempted to support its policy reform by constructing new policy networks and processes. In particular, the Tripartite Commission composed of representatives from labor, employers, and the government was formed in early 1998 in order to build social consensus for reform. The Commission became a forum for the discussion and negotiation of all matters that affected employment conditions, including labor, industrial policies, and social policies.

In fact, social security programs have emerged as a crucial means of maintaining social cohesion in the context of comprehensive economic restructuring. The government acted quickly to expand the social safety net in response to the sudden increase in joblessness and poverty in the aftermath of the financial crisis. In return for allowing greater employment flexibility, the government expanded unemployment and other social insurance coverage, executed public works programs and training programs for the unemployed, and increased public support for the poor. The expansion of social insurance programs proceeded with the following measures: the extension of the Unemployment Insurance Scheme to all workplaces in October 1998, the extension of the National Pension Scheme to cover the self-employed in urban areas in April 1999, the integration of medical insurance societies into a unified national health system, and the extension of the Industrial Accident Compensation Insurance Scheme to all workplaces in July 2000. Social policy took on a more redistributive nature as a result of the implementation of the National Minimum Livelihood Security Scheme, under which the government provides living allowances for all those whose monthly income falls below the minimum living costs, regardless of their ability to work, since October 2000.

Consequently, social security expenditures under the Kim government rapidly increased. The ratio of social security expenditures to the GDP increased from 5.1 percent in 1997 to 7.5 percent in 1999.[24] While it is true that the IMF urged expanding the social safety net, the Korean government went beyond the IMF recommendation toward developing a universal social security system. It is interesting that this occurred as the Korean economy was being fully integrated into the world markets. Domestic politics rather than external constraints determined the direction of social policy reform in Korea (Shin and You 2001).

4.2. Unresolved Questions

While the recent reforms are meant to dismantle the vestiges of the past authoritarian government-led development regime and to create a democratic market economy, there are still uncertainties about exactly where Korea's political economy is headed. The influence of the IMF and the local U.S.-trained economists has imparted a certain degree of neoliberal bias in the post-crisis reform process, with the U.S. model being touted implicitly or explicitly as the ideal model. However, there are reasons to doubt that the Korean economy is on its way toward a smaller version of the American economy across the Pacific.

First, despite serious efforts and much progress, *chaebol* reform remains a difficult challenge. The politics and rules of finance have indeed changed dramatically. As foreign capital has been injected into the banking sector, banks enjoy a great deal of autonomy and largely operate on commercial principles. As large *chaebol* groups have gone under, the myth of "too big to fail" is no more. However, the problematic management structure and practices of the *chaebol* are still present. As the weakened government of Kim Dae-jung retreated with respect to *chaebol* reform since 2000, the monolithic control of the affiliated firms by group heads, market expansion and control through circular investment among the *chaebol* affiliates, and market distortion by insider trading among the affiliates are on the rise. In particular, the *chaebol*'s control over the NBFIs has greatly increased, raising concerns about the concentration of economic power and the integrity of the financial system. Meanwhile, market discipline still appears too weak to tame the power of the *chaebol*. Precisely what the future holds for the *chaebol* in the new political economy of Korea remains to be seen.

Second, there remains confusion over the role of the state. While the reform ostensibly sought to reduce the role of the state, the reform process itself revealed that the role of the state is still of utmost importance. At a fundamental level, the state's role in establishing market institutions and enforcing market discipline is crucial. At a functional level, the government has relinquished some of its past roles and functions, especially in the areas of resource mobilization

and allocation. But its roles and functions have been expanded in other new areas in order to deal with various market failures.[25] In this context, there have been controversies about what functions legitimately belong to the state.

While financial and corporate restructuring inevitably became an exercise led by the government, there has been constant criticism that it should be left to the market. Strengthening regulations in areas such as corporate governance and fair trade also met with resistance and was criticized as excessive government intervention. On the other hand, the government was prodded into implementing an active industrial policy, even by advocates of "small government." The Kim Dae-jung government, in fact, has not abandoned its entrepreneurial role, although the mode of industrial policy has radically changed.[26]

Third, a social consensus on how income and power should be distributed among different groups has yet to emerge. In the context of economic restructuring and worsening income distribution, the expansion of social welfare has generally been regarded as necessary, although not immune from criticisms from conservative forces. More controversial and problematic has been the experiment in social corporatism through the Tripartite Commission. The attempt to include labor in the policy decision process has faltered not only because of inertia in the behavior of the related parties but also because of unfavorable institutional conditions such as low unionization rates and fragmented union organization. Issues of labor market flexibility and the substantial increase in non-regular workers have also generated intense controversy.

Korea is still in search of a new, economically viable, and socially acceptable constellation of economic and social policies. Legacies of the past development regime such as the dominating presence of the *chaebol* and the expectation of activist government coexist with elements of American-style economic liberalism and European-style welfare capitalism. The search will continue until the problem of reinvigorating growth dynamism and reconstructing a social consensus on the distribution of income and power is solved.

5. Conclusion

After two decades of liberalization policy since the early 1980s, Korea has not yet succeeded in forging a new viable political economy that is capable of generating sustained growth and social cohesion. Liberalization policy was more or less neutral in its effect on growth and income distribution until the financial crisis of 1997–1998. The crisis then dealt a severe blow on both fronts. In spite of the relatively quick recovery of growth, the crisis resulted in a permanent loss of output and a long-lasting deterioration in income distribution. Furthermore, post-crisis reforms have brought about very substantial declines in both savings and investment without any signs of increasing investment efficiency, casting a shadow on future prospects for growth. Despite the long and painstaking efforts to liberalize the economy, there are still uncertainties regarding the basic parameters of the political economy, such as the role of the *chaebol*, the function of the state, and class relations. Economic liberalism has yet to be fully embedded in the Korean political economy.

This is not to say that the liberalization policy has been a total failure in Korea. There has been a drastic change in the way in which financial resources are allocated, and both the product and factor markets are much more open and competitive than they have been in the past. There is greater transparency and accountability in the economic system. It is quite conceivable that the accumulation crisis might have been worse had it not been for the admittedly imperfect liberalization policy. Nonetheless, the Korean experience with economic liberalization shows that liberalization is not a simple matter of implementing textbook policies but involves complex multivariable transformation. In particular, the Korean experience illustrates several pitfalls.

First, liberalization could lead to the strengthening of the entrenched power hierarchies in the private sector, as was the case with financial liberalization in the 1980s that ended up giving greater control over financial resources to the *chaebol*. As a result, liberalization could exacerbate market distortions. Privatization can also lead to the same perverse outcome. But it is not enough to simply address the technical aspects of designing a second-best policy. Liberalization policy, like any other policy, does not take place in a political vacuum. In the Korean case, it was very much shaped by the influence of the *chaebol*, and it is no surprise that liberalization led to strengthening of their position. This problem must given serious attention when liberalization policy is implemented.

Second, liberalization could compound the problems of market failure. As the economic activities under government control become liberalized, new problems may occur. For example, when industrial policy was dismantled in Korea, there were few mechanisms to check the *chaebol*'s appetite for excessive expansion. Financial liberalization increased systemic risks in the financial system. Labor market deregulation brought about an unwelcome deterioration of income distribution. Liberalization, therefore, should not be conceived as a simple matter of deregulation, decontrol, and disengagement. It has to be accompanied by complementary policies to establish market discipline and contain market failures.

Third, the Korean experience once again shows that financial liberalization, especially the liberalization of capital account transactions, is likely to be followed by a financial crisis. This has both a micro and macro dimension. According to the macroeconomic logic, increased capital inflows lead to currency appreciation, lower savings, and current account deficits. In terms of the microeconomic logic, greater competition in the financial sector squeezes the profits of financial firms and thereby induces riskier behavior. Despite its gradual and relatively cautious approach, Korea was unable to avoid a punishing crisis. Prudence in macroeconomic management and financial policy cannot be overemphasized.

Notes

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1. However, since official interest rates were set far below market rates, a large and active curb market for loans developed. The curb market provided a channel for the diversion of credit from its intended uses (Cole and Park 1983).

2. The history of capitalist development demonstrates that some degree of socialization of risk is absolutely critical in promoting investment and that inevitable moral hazard problems should be checked by bureaucratic discipline (Chang 2000).

3. Hyundai's shipyard was such a case. The shipyard, built at the personal exhortation of President Park, was confronted with the worldwide collapse of the shipping industry in 1975. The government responded by forcing all Korean refineries to ship oil in Korean-owned tankers, creating a captive demand for Hyundai (Jones and SaKong 1980).

4. Chang et al. (1998) argue that there were no serious moral hazard problems in financial resource allocation in Korea, citing many cases of bankruptcies of *chaebol* firms and the fact that rescue operations usually involved government-mediated takeovers. However, this is not entirely accurate as there are many more instances of *chaebol* firms receiving financial support in times of difficulty until drastic restructuring became unavoidable. Political connections also played an increasingly important role in the bankruptcy and takeover decisions. For example, politically well-connected Daewoo was able to retain its management rights when its shipyard was rescued in the late 1980s. Also see Schopf (2001) for how the industry rationalization program of the early 1980s was closely connected with political corruption.

5. The macro imbalances were a result of overinvestment in heavy and chemical industrialization. They were exacerbated by external shocks, that is, the steep rise in world real interest rates and oil prices.

6. Most significantly, the government retained the power to appoint the top managers of commercial banks even after they were privatized (Jung 1991).

7. By 1990 the top five *chaebol* groups owned 36.5 percent of the total shares of life insurance companies, 26.3 percent of the total shares of the securities companies, and 12.8 percent of the total shares of merchant banking companies (Yoo 1995).

8. See Lim (2000) and You and Jang (2001) for analyses of the decay of bureaucratic discipline.

9. I have argued elsewhere that these problems in the liberalization policy were not just unfortunate mistakes but also a consequence of the increasing influence of *chaebol* groups on economic policy (You and Lee 2001). The *chaebol* pushed for liberalization to gain greater freedom of business, but they also wanted to maintain their unfair advantages. Maintaining restrictive regulations on inward FDI while permitting cross-border borrowing and outward FDI, for instance, reflected the interests of the *chaebol*.

10. Despite important capital account liberalization measures such as deregulating the overseas issuance of foreign currency–denominated bonds by domestic firms in 1991, opening the stock market to foreign investors in 1992, and allowing domestic firms to obtain commercial loans overseas, the Korean government remained cautious and maintained explicit or implicit quantity controls on capital flows led by firms or through the stock market. However, it allowed banks to enjoy relatively greater freedom in borrowing from foreign creditors.

11. See Diaz-Alejandro (1985) for a classic argument of this position. Dooley and Shin (2000) argue that the Korean government failed to detect the increasing vulnerability of the economy, since about half of the foreign currency operations of the banking sector were handled by overseas branches and therefore not reflected in domestic monetary indicators.

12. In 1997 six groups among the top thirty had a debt/equity ratio of over 10, even after the collapsed *chaebol* groups such as Kia and Sammi are excluded (Joh 1999).

13. The official numbers are quite misleading owing to various loopholes in asset classification and loan loss provision.

14. Rather than replacing financial resource allocation based on government policy with one based on market criteria, liberalization enabled gross distortions by the politically influential *chaebol*. The infamous case of Hanbo Steel Co. is a good example. Offering generous sums of political contributions to the nation's most powerful politicians, Hanbo's founder-chairman, Chung Tae-soo, managed to secure a total of 5.7 trillion won (about $7 billion) in bank loans before his empire crumbled under the weight of snowballing debts.This was not an exceptional case, as many *chaebol* groups accumulated unmanageable amounts of debt in similar ways. Another notorious instance of the politicization of economic decisions is the Samsung Motor case. The government had been denying Samsung entry into the auto industry for fear of overcapacity and excessive competition, but suddenly granted it entry in 1995 after Samsung's successful manipulation of the public opinion in Pusan, the political hometown of President Kim Young Sam. The Samsung auto project, even without the industry-level overcapacity problem, was nonsensical, as its plant was to be built on reclaimed land that needed massive fortifying as a move to give political benefits to the president in return for granting permission to Samsung.

15. "Recognizing that the downturn in economic activity is proving to be more severe and protracted than anticipated," the IMF's July 1998 Memorandum says that "economic policies aim to support a recovery of domestic demand and strengthen the social safety net so as to mitigate the hardship of the unemployed."

16. In comparison, the sum of banking deposits was 22 trillion won. Initially, 60 trillion won in public funds were raised for the purpose of financial restructuring in 1998. However, the government tried to minimize the liquidation of financially troubled companies. It continued to support many financially non-viable firms in order to avoid massive layoffs. When some of these firms collapsed in 1999, notably the Daewoo group, the bad assets of financial institutions once again increased. This led to the second round of raising of public funds, this time in the amount of 40 trillion won in 2000. Including the funds that were once recouped and reused, a total of about 155 trillion won were used for financial restructuring by the end of 2001. This amounts to 28.4 percent of the GDP in 2001 (or 34.9 percent of GDP in 1998).

17. Considering an economy that imports only inputs and no finished products, the output, X, can be expressed as injections divided by leakages as follows:

$$X = C + I + G + E = (I + G + E)/(s + t + m)$$

where s, t, and m are private savings, taxes, and imports scaled by output. Expressing this in terms of the "own" multiplier effects, we have

$$X = a_1(I/s) + a_2(G/t) + a_3(E/m)$$

where $a_1 = s/(s + t + m)$, $a_2 = t/(s + t + m)$, and $a_3 = m/(s + t + m)$.

18. Note that the incremental output/capital ratio $= \Delta Y/\Delta K = (\Delta Y/Y)/(\Delta K/Y) =$ growth rate/investment rate. This ratio was 0.55 during 1963–1969, 0.33 during 1970–1977, 0.24 during 1978–1989, 0.20 during 1990–1997, and only 0.16 during the post-crisis period of 1998–2001.

19. The unemployment rate peaked at 8.4 percent in the first quarter of 1999 and began to decline since then thanks to the strong growth recovery. By the second quarter of 2000, the unemployment rate fell to below 4 percent.

20. This is a case of globalization putting pressure on domestic institutions and norms that have been put into place to ameliorate income inequality and social conflict (Rodrik 1995).

21. Given the steady increase in the ratio of college graduates among the labor force (from 6.7 percent in 1980 to 12.5 percent in 1988, 17.5 percent in 1993, and 23.4 percent in 1998), the sudden pause in the decreasing trend in the college wage premium is likely to have been caused by a demand shock in favor of the highly educated. There are some indications of such an increase in the demand for the highly educated since 1992. During the period from 1992 to 1996, the increase in the employment in finance, insurance, and real estate (FIRE) and business services amounted to 30.2 percent of the total employment increase. This compares with only 18.4 percent during the period from 1988 to 1992.

22. The five principles of *chaebol* reform agreed upon between the government and the *chaebol* in early 1998 were (1) enhancing transparency by requiring *chaebol* groups to disclose combined financial statements and by raising corporate accounting standards;

(2) enhancing accountability by requiring listed companies to establish audit committees and appoint outside directors, improve minority shareholder rights, and relax restrictions on M&As; (3) prohibiting cross-debt guarantees among *chaebol* affiliates; (4) improving the financial standing of *chaebol* affiliates by requiring them to reduce their debt/equity ratio to 200 percent by the end of 1999; and (5) inducing *chaebol* groups to focus on areas of core competence. In the summer of 1999, when it became clear that the *chaebol* reform was not making sufficient progress, the government declared three additional principles: (1) the prohibition of undue intragroup transactions and "circular investments" among *chaebol* affiliates, (2) stricter regulations on the inheritance of wealth and management rights, and (3) the separation of industrial and finance capital.

23. For instance, all banks are required to meet the BIS capital adequacy ratio, and NBFIs are also required to recapitalize non-performing loans. Financial institutions that do not meet the criteria have been closed. In 1998 alone, 217 out of a total of 2,077 financial institutions were closed.

24. This increase by 2.4 percentage points in just two years during the middle of the crisis compares with an increase by 1.4 percentage point over the five years during the Kim Young Sam government that expanded social welfare in its own way. The central government budget for social security increased even more dramatically since the crisis. It rose by 33.4 percent between 1998 and 1999 and by 32.3 percent between 1999 and 2000, while the total central government budget increased by 10.7 percent and 6.0 percent, respectively.

25. For example, as the government liberalized foreign exchange and capital account transactions, it created new regulations on foreign borrowing by firms and new monitoring institutions like the International Finance Center and the Financial Information Unit.

26. While reforming and restructuring the *chaebol*, the government promoted the venture industry as a new source of growth dynamism. The old industrial policy imposed restrictions on inward FDI, but now the government actively seeks FDI. It has been promoting a knowledge-based economy by assisting human capital formation and R&D in high-tech sectors like the information technology industry (Woo 1999).

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