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REFORMING KOREA INC.: THE POLITICS OF STRUCTURAL ADJUSTMENT UNDER KIM DAE JUNG

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Korea has recovered more rapidly from the Asian financial crisis than other countries in the region. The swift recovery can be attributed to decisive reform efforts by the Kim Dae Jung government. This article examines reform efforts in three areas-the financial sector, corporate restructuring, and labor markets-and traces them to a skillful use of presidential power, including the exploitation of a "honeymoon," trilateral consultations with business and labor, and the creation of powerful administrative agencies. However, the adjustment strategy of the Korean government also has a number of "command and control" elements, particularly with respect to financial and corporate restructuring, and has involved increasing state ownership of banking and corporate assets. The result is that the government still faces the task of how to realign government-business relations in the future.

Kim Dae Jung's Reform Agenda[1]

By late 1999, Korea could boast the most rapid recovery from the Asian financial crisis that struck the region in 1997.

Although production had just regained pre-crisis levels, conservative estimates projected growth of between 5 and 6 percent for the year. Unemployment, which peaked at over 8 percent fell steadily. The country had accumulated substantial reserves, international rating agencies had restored the country's sovereign rating to investment grade, and foreign direct investment was robust.[2]

This outcome has been read as a vindication for orthodoxy. The Kim Dae Jung government did more than accept the very tight monetary and fiscal policy stance proposed by the International Monetary Fund (IMF) to defend the exchange rate. The government also collaborated with the IMF and World Bank to devise a wide-ranging and politically difficult structural adjustment program designed to address outstanding problems in the financial and corporate sectors and labor markets.

Korea's experience raises a number of interesting political puzzles. Despite its tradition of strong presidents, the incoherence of Korean policymaking in 1997 under the Kim Young Sam government was an important contributor to the depth of the crisis. That government mishandled the bankruptcy of the Kia group in mid-1997, failed to pass important financial reform legislation, and engaged in costly delays when the true extent of the country's foreign exchange position became apparent in early November. Electoral calculations played an important role in generating these delays, but it was by no means clear that the presidential election would reduce political and market uncertainty; indeed, as the December 18 presidential election neared, the probability that Kim Dae Jung would triumph increased uncertainty.[3]

The conditions surrounding Kim Dae Jung's victory did not appear particularly auspicious for effective crisis management either. Kim's margin of victory against ruling party candidate Lee Hoi Chang was extremely narrow (40.3 percent to 38.7 percent), and he was elected with only a plurality of the total votes cast. Moreover, this result was only possible because of a split within the ruling party and an unlikely alliance between Kim Dae Jung's National Congress for New Politics (NCNP) and conservative Kim Jong Pil and his United Liberal Democrats (ULD), a marriage of convenience that raised the specter of intra-coalitional conflict. The non-concurrence of presidential and legislative elections raised further possibilities for deadlock; from his first day in office, Kim Dae Jung's ruling coalition faced a divided government, with the former ruling Grand National Party (GNP) holding a legislative majority.

Structural factors also appeared to pose daunting challenges to any reform effort in Korea. The concentration of the largest conglomerates, or *chaebol*, is well-known.[4] The top five *chaebol* account for about 9 percent of GNP, and the top thirty for 15 percent. If the operations of dedicated suppliers are included, these numbers could double. Moreover, the concentration is even greater in the manufacturing sector, where the top thirty firms account for about 40 percent of all shipments. The very size of these firms, and the concentration of the unionized workforce in them, translates into the potential for substantial influence over policy. Yet it is precisely the behavior, and even the structure and ownership, of these firms that any adjustment effort would seek to change.

This article reviews the politics of economic reform under the Kim Dae Jung government, focusing on three key policy areas: the financial system, the corporate sector, and the labor market. It is first important to underline that Kim's ideological and policy orientation was almost universally misread by Western policymakers and media. His long history in the opposition and his commitment to, and popularity among, the working class and progressive groups gave Kim a populist aura. He also brought with him a number of advisors with strong anti-establishment views who influenced the government's command-and-control approach to some aspects of financial and corporate restructuring.

In other respects, however, Kim Dae Jung's economic policy views proved surprisingly orthodox. His commitment to liberalization in a number of areas stemmed from the view that previous patterns of government intervention had contributed to the concentration of the private sector, close business-government relations, and corruption. As a result, many (though not all) of the reforms proposed by the international financial institutions were welcomed by the new government as fulfilling a number of its own political as well as economic objectives.

The government was able to institute reforms not only because of the crisis (which hit other countries as well), but also because of Kim Dae Jung's skillful exploitation of the powers of the presidency. His first opportunity to initiate policy change arose before he even entered office, in the interim period between his election (December 18, 1997) and inauguration (February 25, 1998). The president-elect cooperated with the outgoing government and ruling party to get legislative backing for a number of important reform initiatives, including the delegation of substantial powers to a newly-created Financial Supervisory Commission (FSC) and its implementing arm, the Financial Supervisory Service (FSS). The FSC came to exercise de facto control over the entire banking system. Ironically, government control over the allocation of credit, which was seen as partly responsible for Korea's crisis, provided the government with substantial leverage in pushing reform of *chaebol*. Kim Dae Jung also used corporatist channels to strike agreements with both labor and business. The most important of these channels were a tripartite committee to address labor issues and bilateral negotiations with top *chaebol* leaders over corporate reform. These fora placed public pressure on business and labor to make concessions and provided the basis for subsequent legislation.

Recently, some have criticized the fact that reforms in Korea have slowed.[5] To some extent this slowdown reflects a policy cycle that is natural in any democracy. The ability to initiate new reforms and to press the implementation of those in place arguably diminishes over time. The government faced rapidly rising unemployment and a succession of by-elections and subnational elections during its first year and a half in office. By mid-1999, it was increasingly preoccupied with legislative elections scheduled for April 2000. A second factor believed to influence the pace of reform has been economic recovery itself. As growth resumes, there are strong incentives for firms to delay certain reform and restructuring measures, such as reducing debt, selling assets (including to foreigners), or reducing the workforce.

However, these interpretations misread the government's accomplishments and capabilities, and misstate the nature of the current policy problems in the country. The effects of many of the legal changes initiated under Kim Dae Jung necessarily take time to become manifest, but are nonetheless subtly and fundamentally transforming the nature of the financial and corporate sectors. Moreover, through agencies set up earlier in its administration, the government continued to enjoy substantial discretionary power, particularly with respect to weak and heavily indebted firms still dependent on the banks, and thus on the government, for credit. The government's dramatic action against Daewoo in the summer of 1999 showed that it was not averse to exercising those powers. By the end of 1999, the central policy question was not whether reforms were slowing down, but whether the directive style of policymaking and the extensive involvement of the state in the corporate and financial restructuring process were not generating new problems.

Initiating Reform during the Transition: December 18, 1997-February 25, 1998

Difficulties with the Initial Reforms

Following Kim's election on December 18, both international and domestic concern centered on the management of the transition, and the danger that policymaking would drift. The IMF program signed in early December had failed to stabilize the won. Critics of the program have suggested that this had to do with the nature of the IMF's program,[6] but the most compelling reason had to do with the revelation of Korea's true foreign exchange position. As it became clear that usable reserves were quickly headed toward zero, foreign lenders and investors and domestic residents all scrambled to exit the won. The program clearly needed revision, but to garner support from the international financial institutions, the United States, and ultimately from the markets, the government would have to act swiftly on a number of policy fronts. With two months before the inauguration (February 25), a power vacuum at the center or conflict between the outgoing and incoming leader would have had devastating consequences.

Two days after the election, Kim Young Sam and Kim Dae Jung met and formed a joint, twelve-member Emergency Economic Committee (ECC). For the two months prior to the inauguration, this body, comprised of six members from the outgoing and incoming governments but effectively under the president-elect's control, served as the de facto economic cabinet. Kim's coalition (NCNP and ULD) and the majority GNP also agreed to convene a special session of the National Assembly to deal with a series of reform bills required under both the original IMF program and its December 24 revision; two further special sessions followed (*Table 1*). As a result of these institutional agreements, Kim Dae Jung enjoyed an unusual executive and legislative position. Not only did he and his advisors effectively control the cabinet; they also enjoyed a legislative majority because of the ability of Kim Young Sam and Lee Hoi Chang to deliver GNP cooperation in the National Assembly.

The importance of these arrangements for the course of Korea's economic reform cannot be exaggerated. *Table 1* suggests the range of the reforms passed during the special legislative sessions held during the transition. Of particular importance were financial reforms that had been stalled under the previous government. On August 23, 1997, just as Korea's economic difficulties were becoming apparent, the Kim Young Sam government had submitted a package of thirteen financial reform bills to the National Assembly, including a revised Bank of Korea Act and a law establishing new supervisory institutions for the financial sector.[7] The opposition parties, Kim Dae Jung's NCNP and Kim Jong Pil's ULD, opposed the legislation on the grounds that it strengthened the powers of the Ministry of Finance and Economy (MOFE) and weakened the independence of the Central Bank. However, with elections pending and central bank workers staging demonstrations against the bills, the government was not able to garner support for the legislation within its own party either. At that juncture, it is doubtful that any government action would have avoided a crisis altogether. But this important policy failure accelerated the decline in confidence and complicated relations with the IMF at their outset.

The institutional controversy over who would have jurisdiction over the newly created Financial Supervisory Commission (FSC) continued during the transition period. The agency was to be formed through the consolidation of the Financial Inspector of the Ministry of Finance and Economy (MOFE), the Office of Bank Supervision under the Bank of Korea (BOK), the Securities Supervisory Board, the Insurance Supervisory Board, and the Credit Management Fund Agency. In the legislature, the rival

Table 1. Reform Legislation Passed During the Transition Period (12/18/97-2/25/98)

Session	Legislation Approved
186th Session (12/22/97-12/30/97)	The Act for Establishing Financial Supervisory Institution The Bank of Korea Act (r) The Bank Act (r) The Act concerning the Restructuring of Financial Industries (r) The Security Exchange Act (r) The Insurance Act (r) The Mutual Trust Company Act (r) The Depositor Insurance Act (r) The Merchant Bank Act (r) The Forward Business Act (r) The Act concerning the Abolition of the Interest Rates Limits The Special Consumption Tax Act (r) The Act concerning the External Auditing of the Corporation (r)
187th Session (1/15/98-1/21/98)	Session called to consider labor legislation, but defers to Tripartite Commission.
188th Session (2/2/98-2/16/98)	The Bankruptcy Act (r) The Corporate Composition Law (r) The Corporate Reorganization Law (r) The Monopoly Regulation and Fair Trade Act (r) The Foreign Investment and Foreign Capital Investment Act (r) The Corporate Tax Act (r) The Tax Reduction Act (r) The Labor Standard Act (r) The Employment Adjustment Act (r) The Government Organization Act (r)

Source: The Office of the Secretary of the National Assembly.
Note: (r): revised.

parties agreed in subcommittee to place the new agency under MOFE, a decision that reflected strong lobbying by MOFE itself as well as an effort on the part of legislators to maintain oversight of—and connections with—MOFE bureaucrats. However, with strong support, if not insistence, from the IMF and the United States, Kim Dae Jung intervened to shift control over the agency away from MOFE and the bureaucracy to the prime minister, and thus effectively to the Blue House.

This administrative reform (and the creation of an Office, and later Ministry of Planning and Budget) sharply reduced the power of the MOFE and created an extraordinarily powerful entity. Not only did the FSC consolidate financial supervision across all financial entities and markets, the FSC also was to play a role in strengthening regulation and supervision and was granted substantial short-term powers, such as strengthened Prompt Corrective Action (PCA), to ensure that banks met capital adequacy requirements. However, the power of the FSC did not arise only from its routine supervisory functions, but also from the central role it was to play in restructuring the financial sector in the wake of the crisis. This role involved a range of highly contentious responsibilities, from making judgments about which banking institutions were viable, to closing or merging those that were not and disposing of their assets, and to overseeing the recapitalization and restructuring plans of those left open, including assisting in the disposition of non-performing loans.

Dealing with Chaebol

The second policy challenge the new government faced centered on *chaebol*, the large, diversified conglomerates that dominate Korea's industrial landscape. Despite their successes, *chaebol* have always posed a number of political as well as policy problems for successive Korean governments. The investment boom of the 1990s resulted in high levels of indebtedness and poor financial performance. The crisis exposed these problems clearly. A number of large firms went bankrupt in 1997, and as the crisis deepened the problem of how to manage the growing number of illiquid and insolvent companies became more urgent.

However, the problems were not just limited to the short run; corporate governance in Korea was also weak.[8] *Chaebol* are typically dominated by family patriarchs who, despite relatively small ownership stakes, are able to dominate the groups with little or no oversight on the part of boards of directors, minority shareholders, or even outside auditors. The discretion of managers is further increased by relatively lax accounting, auditing, and reporting standards. One common practice that became the target of particular attention was the tendency for groups to cross-subsidize loss-making units and to extend intra-group loan guarantees, contributing to weak overall financial performance and low productivity growth. Restrictions on mergers and acquisitions, continuing limitations on foreign direct investment, and weak competition policy shielded these firms not only from competition in the domestic market but also from the threat of takeover. Whatever their success in achieving growth and rapid corporate diversification, these governance structures appeared less good at ensuring profitability, accountability to shareholders, and financial transparency.

Exploiting the unpopularity of *chaebol* management, their short-term financial weakness, and his relative political independence from them, Kim Dae Jung used an ad hoc meeting with the heads of the top five *chaebol* on January 13, and on February 6 with heads of thirty others, to outline an agreement on five principles of corporate restructuring.[9] An examination of the ambitious agenda (*Table 2*) reveals that the government's motives were political as well as economic—namely, to increase the transparency and accountability of *chaebol*. Some elements of the agreement were amenable to legislation, including those in the areas of corporate governance and competition policy; as we will outline in more detail below, the legal status of other principles was more ambiguous. However, it became increasingly clear over the course of 1998 that the government could exercise substantial leverage over *chaebol* through the FSC and ultimately through its de facto control over the banking system.

Securing Labor's Agreement

The political pressure to "do something" about *chaebol* was related to a third area of structural reform that was also to prove

Table 2. Five Principles of Corporate Restructuring

Objectives	Measures	Schedule
Enhanced Transparency	•Adoption of combined financial statements •Adoption of international accounting principles •Strengthening voting rights of minority shareholders •Compulsory appointment of outside directors •Establishment of external auditors committee	•FY 1999 •October 1998 •May 1998 •February 1998 •February 1998
Resolution of Cross-debt Guarantees	•Resolution of existing cross-debt guarantees •No new cross-debt guarantees between subsidiaries	•March 2000 •April 1998
Improvement of Financial Structure	•Agreement with banks to improve capital structure •Removal of restrictions of capital infusions •Introduction of asset backed securities	•April 1998 •February 1998 •August 1998
Streamlining Business Activities	•Adoption of corporate-split system •Liberalization of foreign ownership of real estate •Full liberalization of M&A •Streamlining of bankruptcy procedures	•June 1998 •June 1998 •May 1998 •February 1998
Strengthening Accountability	•Strengthen the legal liability of controlling owners •Introduction of cumulative voting systems •Allowing institutional voters rights	•June 1998 •June 1998 •June 1998

Source: Reference Information: The Korea Forum, Ministry of Finance and Economy, October 1998.

highly contentious: increasing the flexibility of the labor market. Korea's labor market is highly dualistic.[10] Large-scale firms maintained long-term secure employment on a seniority-based wage and promotion system. Small and medium enterprises, by contrast, relied on temporary and day laborers, and were characterized by low job security and a flat earnings profile. Differences in unionization are also striking: While 76 percent of workers in firms with 15,000 or more workers are unionized, only 0.9 percent are unionized in small firms with ten to twenty-nine workers.

These differences in unionization had important effects on the ability of firms to lay off workers. In principle, the legal framework concerning labor adjustment was quite strict; only in the case of "emergency managerial needs" would extensive layoffs be allowed, and the Supreme Court had ruled that such layoffs required consultation with the unions. In effect, this meant that while small firms faced little resistance to layoffs and could adjust to redundancy illegally, large firms had to resort to early retirement, voluntary leave, and wage cuts. Such measures were not likely to be adequate to encourage the corporate restructuring envisioned by the government. Moreover, these labor market rigidities could act as a deterrent to foreign investment in sectors such as banking.

To secure labor agreement to greater layoffs, Kim Dae Jung resorted to a mechanism that Kim Young Sam had attempted without success: the tripartite commission. The formation of the group was closely related to legislative politics. The government called a special session of the National Assembly (the 187th) to amend existing labor legislation to allow layoffs, but the GNP was reluctant to cooperate because of the potential political price. The National Assembly thus deferred to the tripartite commission.

The problem was that the unions were aware from the beginning that the objective of the commission was to extract labor concessions on the issue of layoffs. Kim Dae Jung's status with labor, however, and the promise of political as well as economic compensation, allowed the government to bring representatives from both labor federations (FKTU and KCTU) to the table, in addition to the major business associations (the Federation of Korean Industry and the Korean Employers' Federation), government officials (the Ministry of Finance and Economy and the Ministry of Labor), and representatives from each of the four major parties. After weeks of intense debate, and promises from the administration that it would also extract concessions from *chaebol* as well, a bargain was struck. In return for agreement to permit layoffs when "urgently" needed or in case of takeovers, and to allow the formation of a manpower leasing system for both specialized professions and laborers, the government made a number of political and policy concessions. These included the establishment of a 5-trillion won unemployment fund, the right of public servants to form a labor consultative body and for teachers to unionize, and the reversal of a longstanding prohibition on labor involvement in political activities.

In sum, the period of transition was an extremely fertile one. Kim Dae Jung exploited the crisis and the unusual institutional circumstances to push through wide-ranging reform legislation. A critical piece of this legislation was the creation of a new supervisory agency, the FSC, that had substantial powers with respect to the management of the financial crisis. The president also exploited his stature and public opinion to strike agreements with both *chaebol* and labor on wide-ranging adjustment measures, using concessions from one to gain concessions from the other in a kind of grand bargain. Once this initial burst of reform activity was launched, the problems shifted from initiation to implementation, and therein lay a number of political difficulties.

The Political Milieu: Unemployment, Elections, and Divided Government

The Unemployment Dilemma

In implementing its reform program, the Kim Dae Jung government faced three broad political constraints: rising unemployment, a cycle of elections, and divided government. The greatest concern of the government was naturally the high level of unemployment that accompanied the crisis.[11] Among the Asian crisis countries, Korea experienced the sharpest increase in unemployment. Stable at between 2 and 3 percent in the years before the crisis, the unemployment rate rose to 6.8 percent by the end of 1998, an increase in the number of unemployed from 900,000 to nearly 1.5 million. If those discouraged from looking for work and the underemployed (including working eighteen hours a week and wanting to work more, and involuntary short time workers) are included, the numbers rise to 10.5 percent of the workforce or nearly 2.3 million workers. Only in March 1999 did unemployment start to fall. Wages also fell sharply—14.2 percent in real terms, between the third quarter of 1997 and the third quarter of 1998. Moreover, Park Se-il has shown that the costs of adjustment were born quite unequally, with low-skilled workers facing the brunt of unemployment and low income households seeing the sharpest decline in living standards.[12] These social developments naturally placed serious constraints on government. If the government pushed hard on corporate restructuring that involved layoffs, it would not only compound the country's unemployment problem but also risk confrontation with the unions.

Elections

Concerns about unemployment were linked to an important feature of Korean politics: the non-concurrence of presidential, legislative, and subnational elections and the need for a series of by-elections over the course of 1998 and 1999 that resulted from court nullification of electoral results or lawmakers stepping down to run for other offices. As a result, policymaking during the first eighteen months of Kim Dae Jung's presidency took place against the background of more or less continuous elections, each of which was cast as a referendum on the government's reform efforts. The NCNP-ULD alliance sought to use the elections to confirm public support for reform, and if possible, to secure a majority in the National Assembly. The GNP, by contrast, focused on the costs of the reform effort.

The results of these elections (*Table 3*) are difficult to interpret, because of the powerful effect of region on voting behavior. For example, the April 2 by-election to fill four National Assembly seats was the first by-election under the new government, but the seats were contested in Kyongsang province where ruling party support was weak; the government coalition

Table 3. Local and By-elections, 1998-1999

	4-2-98 (By-election)	6-3-98 (Local Election)	7-21-98 (By-election)	3-30-99 (By-election)	6-3-99 (By-election)
NCNP & ULD (Ruling Coalition)	0	Governor:10 Town Head: 113 Local Councils: (66% out of 616 seats)	2	2	0
GNP (Opposition Party)	4	Governor: 6 Town Head: 74 Local Councils: (37%)	4	0	2
Independents		Town Head: 44	1		

Source: *The Economist Intelligence Unit: Country Report*, 3d Quarter (1998), and *Chosun Ilbo.*

did not carry a single seat.[13] By-elections in July 1998 and June 1999 also resulted in losses, the latter in the wake of a major corruption scandal.

However, by-elections were much less important than the subnational elections in June 1998, which marked the first nationwide political contest since Kim Dae Jung's election. The results outside of Seoul tracked regional bases of support to a large degree, but in the capital city the NCNP-ULD alliance won handily. The election was generally interpreted as providing the government with a mandate to continue and deepen the reform process; shortly after the election, the government unveiled another round of reform measures.[14]

The June elections were also significant because of the effect they had on realignment within the National Assembly. The significance of Kim's control of the cabinet and de facto legislative majority during the transition period was quickly made apparent following his inauguration, when inter-party cooperation fell apart and deadlock emerged. In late February, the National Assembly held a special one-day session on Kim Dae Jung's appointment of Kim Jong Pil as prime minister, but refused to confirm him. After the parliamentary vote was suspended because of a partisan clash over voting methods, the president appointed Kim Jong Pil as acting prime minister and named his first cabinet on March 3. But until August, when the GNP finally relented, every National Assembly session was dominated by unproductive controversy over the confirmation issue, blocking other legislative initiatives.[15]

This deadlock ultimately proved costly for the GNP, since divided government gave the NCNP-ULD coalition strong incentives to woo GNP legislators to defect. This effort began in the spring, over strong protests from the GNP, accelerated after the June elections and finally proved successful in early September 1998 when the NCNP-ULD became the majority.[16] The second honeymoon provided by the June elections and the legislative majority also had limits, however. By the second half of 1999, attention was again focused on elections, this time the National Assembly elections scheduled for April 2000.

Implementing Reform I: The Financial Sector

The Banking Crisis

The onset of the crisis in Korea and the other Asian countries is typically identified with the date that the exchange rate peg was abandoned. Such an approach has some merit, since it underlines the foreign dimension of the crisis and the initial effort devoted by the IMF and governments to stabilizing the exchange rate. This was attempted through a draconian monetary policy that proved counterproductive and, following the failure of the first IMF program, through a rescheduling of the foreign debt of the financial sector. However, the problems of the Korean financial sector were by no means limited to its foreign borrowing; indeed, these obligations were only a fraction of the banking sector's total assets. By the middle of 1997, it was already clear that the most pressing problem facing the government was the deterioration of the balance sheets of financial institutions and emergence of a full-blown domestic financial crisis.

The powers vested in the FSC provided the government with substantial advantages in dealing with the crisis, and underlined a curious feature of resolving systemic financial distress. While the ultimate objective of the reform process is to establish a more arms-length regulatory structure that reduces the role of government in the allocation of credit, the cleanup of the financial system is facilitated by decisive and concerted government action. The government quickly set aside 64 trillion won ($49.2 billion, or roughly 15 percent of GDP) for resolving the financial crisis, with one-half allocated to the Korean Deposit Insurance Company (KDIC) for recapitalization and coverage of losses, and one-half to finance the Korean Asset Management Corporation (KAMCO), which was assigned the task of purchasing and disposing of non-performing loans. Operating through the FSC, which only became fully operational on April 1, the government moved swiftly and in a highly directive fashion to address the problems of the banking sector so that the costs to the real economy would be minimized.[17]

At the end of 1997, twelve Korean banks out of twenty-six satisfied the international capital adequacy standard of 8 percent, while the remaining fourteen failed to meet it. In early December, the government decided to nationalize the two banks in the worst condition, Korea First Bank and Seoul Bank. After the election, the plans for these banks were toughened to include the write-down of shareholder capital to below a 10 percent ownership stake and recapitalization in preparation for sale to international bidders.[18]

The next task was to make decisions about the remaining undercapitalized banks. The FSC ordered the twelve unsound banks to submit rehabilitation plans by late April 1998 to its Management Evaluation Committee. Based on the prospects for viability, the FSC would classify them into three categories: "disapproved," "conditionally approved," and "approved." No bank plans were approved outright; five of the twelve plans (Daedong, Dongnam, Donghwa, Kyungki, and Chungchong) were disapproved. On June 29, 1998, the FSC shut these banks down and ordered the transfer of their assets into five healthy banks. Kookmin Bank, widely regarded as the nation's healthiest bank, took over Daedong Bank, and the Housing Bank absorbed Dongnam Bank. These two healthy banks have been controlled by the government to maintain banking services for smaller companies.[19]

However, the three other blue-chip banks that had been identified by the FSC as candidates to take over ailing banks—KorAm Bank, Shinhan Bank, and Hana Bank—were reluctant to do so. Not only did they fear the costs of absorbing dubious assets; they expressed various concerns about the fit between their operations and those of the banks they would absorb. Moody's and Standard & Poors also warned that taking over the ailing banks would inevitably lead to another round of downgrading of the banks' credit ratings.[20]

It is a testament to the persuasive power of the FSC that despite their relatively strong capital positions, KorAm, Shinhan, and Hana were unable to resist the merger program. To compensate the solvent banks for taking over the insolvent institutions, the KDIC undertook a series of injections that totaled 8.04 trillion won ($6.7 billion) by the middle of 1999; that total was scheduled to rise to around 10 trillion. To solve the problem of the non-performing loans, the FSC devised a purchase and assumption (P&A) method, in which the viable assets were transferred to the acquiring banks while the nonperforming loans were purchased by the Korean Asset Management Corporation (KAMCO), to be sold later through auctions.

Assessing the Government's Performance

The basic approach of the government to the seven conditionally approved banks—Chohung, Commercial, Hanil, and Korea Exchange Bank, which together accounted for more than one-third of all commercial bank assets, and three smaller banks, Peace, Chungbuk, and Kangwon—was similar. The government injected capital and purchased nonperforming loans on a selective basis, but this support implied not only a government ownership position but also a variety of conditions. These included the replacement of management and board members, the disposal of nonperforming loans, the inducement of new equity capital, the streamlining of business operations, and the encouragement of merger. One of the most striking features of the financial landscape in Korea is a dramatic process of consolidation that has reduced the number, and increased the size, of existing banks.[21]

Assessments of Korea's achievements in the financial sector are generally positive. The government exploited the powers enjoyed by the FSC to move swiftly to address banking sector problems, albeit at some substantial cost to the government. The encouragement of mergers and foreign entry are rapidly transforming Korea's financial landscape, and it was precisely on these issues that the politics of financial market reform became apparent. Foreign takeovers were seen as equally costly and threatening. Since Korean banking had long been closed to outsiders, the international financial institutions and financial markets saw the sale of Korea First and Seoul Bank as an important indicator of the government's commitment to the reform effort. In December 1998, the government signed a Memorandum of Understanding with Newbridge Capital, an American investment consortium, to sell 51 percent of Korea First Bank. Two months later it reached a similar MOU to sell 70 percent of Seoul Bank to Hong Kong and Shanghai Banking Corporation (HSBC). Yet the sale of both banks stalled over the first half of 1999 as a result of disagreements on the valuation of the banks' assets. Newspaper editorials challenged the wisdom of injecting large sums of public money into the banks only to sell them to foreigners.

Daewoo chairman Kim Woo Choong also spoke out strongly against the deal. Although he also objected to selling assets to foreigners on the cheap, Daewoo was a major client of Korea First and no doubt feared that Newbridge would take a stricter stance with borrowers. Daewoo's objections to the foreign sale revealed clearly that underneath the difficulties of the banking sector lay the more profound problems of the heavily-leveraged corporate sector.

Implementing Reform II: The Corporate Sector

As in the financial sector, the reform of the corporate sector, and particularly of *chaebol*, encompasses legal changes designed to alter the long-run environment and culture of business. In general, these reforms mirror principles and standards of corporate governance in the advanced industrial states, even if details differ in some important respects. However, the government also had to develop policies geared toward the management of the crisis in the short run, and this task proved highly political.

While *chaebol* managers and owners naturally sought forbearance, progressive voices inside and outside the government were calling for more radical solutions, including the dissolution of *chaebol*.[22]

Reforming Chaebol Organization and the Market

The centerpiece of the first category of reforms consisted of efforts to strengthen corporate governance and competition policy and to create a market for corporate control. During the transition, the government translated a number of the commitments reached in the president's "dialogues" with *chaebol* leaders into legislation (see *Tables 1* and 2). The effects of these laws will take a number of years to become manifest, but taken together, they represent an effort to fundamentally change the way *chaebol* have been organized to do business.

To increase transparency, revisions of the External Audit Law required that the financial statements of companies in business groups be prepared on a consolidated basis. Consolidated statements and improved reporting were but one element in the effort by the government to exercise greater oversight over intra-group transactions that might have competitive or financial implications. As we will see in more detail below, the most important of these were debt payment guarantees.

The goals of improving both transparency and accountability also resulted in a number of new laws designed to expose management to greater monitoring and oversight, and ultimately to change the organizational structure of the Korean corporation. The most controversial organizational change pressed on companies by the government was the elimination of the chairman's office—the strategic planning and coordination offices that had been dominated by group chairmen (*chongsu*) and served as the organizational basis for their control over group activities. Changes in the listing requirements to the Korean Stock Exchange strengthened minority shareholders' rights and required listed firms to have at least one outside director. These legal changes, in turn, encouraged the formation of public interest groups such as People's Solidarity for Participatory Democracy (PSPD), which was able to force an out-of-court settlement with SK Telecom on the appointment of outside directors, the enhancement of transparency, and amendment of the company's by-laws. Revisions of the Securities Investment and Trust Law relieved financial intermediaries of the obligation of voting with management and facilitated the exercise of shareholder rights on the part of institutional investors. The Eternal Audit Law also toughened penalties against both external auditors and corporate accounting officers.

The efforts to subject management to greater oversight through organizational means were matched by legal reforms designed to change the market environment itself, particularly through strengthening competition policy and developing a more aggressive market for corporate control. Removing barriers to mergers and acquisitions had a number of closely related functions. Not only did it serve as a check on management; it also provided one avenue for solving problems of corporate insolvency. Liberalizing foreign direct investment had a similar function. At the urging of the United States, the government raised, then lifted, the ceiling on foreign investment in listed stocks and liberalized foreign participation in mergers and acquisitions. These reforms opened the way for 100-percent foreign ownership of publicly traded companies, including through hostile takeovers. A new Foreign Investment Promotion Act also opened new sectors to foreign investors and simplified the investment approval process.

Dealing with Corporate Failures

Under non-crisis circumstances, the implications of these policy changes would be felt over time as they worked through corporate organization and strategy and began to affect the terms of competition in particular markets. However, the government had to contend with a more fundamental short-term problem: how to deal with the threat of large-scale corporate failure. With the onset of the economic crisis in 1997, and the rapid rise in interest rates, five major groups quickly failed and a number of others petitioned for bankruptcy in 1998. But assessments by both Korean and foreign financial analysts suggested that as many as eighteen of the largest thirty *chaebol* were at risk of bankruptcy, and some accounts argued that as few as four of the top thrity *chaebol* were sound. The problems of the larger groups quickly rippled through the small and medium enterprise sector, which depended on larger companies not only for orders but for credit as well; at the depth of the crisis, small firms were failing at the rate of between four and five thousand a month. Existing bankruptcy procedures were simply inadequate to deal with a problem of this magnitude.

Three of the five principles agreed to in January dealt with the financial and operational restructuring of corporations, including the resolution of cross guarantees, the improvement of financial structure, and the streamlining of business activities (see *Table 2*). Some of these issues could be dealt with through legislation. For example, amendments of the Monopoly Regulation and Fair Trade Act prohibited cross-guarantees and required that existing ones be eliminated. But existing law was inadequate to manage problems of systemic distress—the simultaneous insolvency of large numbers of banks and corporations—and indeed could even have perverse effects in the short-run. For example, some features of Korean bankruptcy procedures allowed firms court protection and continued access to credit. Moreover, it was difficult to craft legislation that would address the underlying problems of excessive corporate leverage. That issue would have to be addressed in the context of restructuring banks' relations with their corporate clients.

The spring of 1998 was a period of experimentation. The government advanced a number of a partial solutions, such as continued "emergency" lending to distressed companies and the establishment of a number of government funds that would purchase real estate from the *chaebol* or take equity positions in viable, but illiquid companies. All these steps had obvious disadvantages. The approach that gradually emerged, supported by a large structural- adjustment loan from the World Bank, was a three-tiered one. The first tier consisted of the Big Five: Samsung, Daewoo, Hyundai, LG, and SK. These groups were both economically and politically important, and the government sought to deal with them through the negotiation of informal, "voluntary" agreements of which the "Principles" agreement was just the first. Dissatisfaction with implementation led to continual revisions of these pacts, culminating in the showdown between the government and Daewoo in July and August 1999. The second tier consisted of the so-called 6-64 *chaebol*, for which the government developed a system for restructuring corporate debt. The third tier consisted of small and medium enterprises.

The two most contentious issues with the Big Five were mutual payment guarantees and the reduction of excessive indebtedness. The first could be dealt with through legislation. A revision of the Fair Trade Law during the transition period prohibited the issue of new guarantees from April 1, 1998 and required all *chaebol* to phase out existing ones by March 2000. Reducing the level of debt was much more controversial. Early in 1998, the FSC urged the top thirty *chaebol* to lower their debt-equity ratios from an average of 519 percent at the end of 1997 to 200 percent by the end of 1999. For the Big Five, this was to be achieved in part through Capital Structure Improvement Plans (CSIP), formulated by the firms themselves but taking the form of an agreement with their banks with respect to a variety of restructuring measures: asset sales, including to foreigners, issuance of new equity, debt-equity swaps, and operational restructuring.

The Big Deals

Although these plans were to be formulated by the firms themselves, one important element of operational restructuring came out of the Blue House: the so-called Big Deals. The idea that *chaebol* should reduce their level of horizontal diversification and concentrate on "core" business is a longstanding one in Korean economic policy. It can be seen in the early 1980s effort at "rationalization" under Chun Doo Hwan and the "specialization" policy of Kim Young Sam. After months of government prodding, the Big Five announced a revised version of the Big Deals on October 7. Under the program, the Big Five would swap major lines of business among themselves to consolidate excessive and duplicative investments while simultaneously achieving greater economies of scale (*Table 4*).

In fact, a number of premises behind the Big Deal concept are dubious, including the assumption that they will necessarily reduce surplus capacity or improve competitiveness. Without financial support or other incentives from the government it was questionable that companies could reach agreement. Even with such support the negotiations were plagued by sharp differ-

Table 4. The Big Deal Plan, October 7, 1998
(Companies/divisions proposed for swap or merger)

Semiconductors	Hyundai Electronics and LG Semiconductor
Power-Generation Equipment	Korea Heavy Industries and Construction Co. and Samsung Heavy Industries Co.
Petrochemicals	Hyundai Petrochemical Co. and Samsung General Chemical Co.
Aircraft	Samsung Aerospace, Daewoo Heavy Industries, Hyundai Space and Aircraft
Rolling stock	Daewoo Heavy Industries, Hanjin Heavy Industries
Marine engines	Korea Heavy Industries and Construction Co. and Samsung Heavy Industries Co.
Oil refining	Hyundai Oil Co. and Hanwha Energy Co.

Source: Seung Min Yoo, "Corporate Restructuring in Korea: Policy Issues Before and During the Crisis," Korean Development Institute, December 1998.

ences over the valuation of assets, a variety of problems about how quite different operations would in fact be integrated, and uncertainty over the final corporate form the new entities would take. Nonetheless, the Big Deals became a litmus test of corporate commitment to the restructuring process.

Throughout 1998 and the first half of 1999, the government engaged in an ongoing public relations battle with the Big Five, in which it repeatedly claimed that the large *chaebol* were not being aggressive enough in introducing restructuring plans and reducing their indebtedness. The call for explicit CSIPs was the first step in this process. It was followed by the decision to target a number of Big Five subsidiaries for liquidation in June, and a revision of the companies' initial Big Deal proposal, which envisioned pooling of companies rather than outright swaps. The government's plan was to culminate in the public signing of financial pacts between the Big Five and their banks in December 1998. Coming almost a full year after the corporate restructuring principles were first announced, the pacts included four elements: specific commitments to reduce the number of affiliates by target dates, including through the Big Deal mechanism; specific targets for the reduction of debt-equity ratios; an acceleration of the elimination of cross-guarantees between affiliates; and a reiteration of the commitment to reforms in corporate governance. The groups also submitted to a quarterly review process, under the threat that failure to comply would be met by higher interest payments or even a suspension of credit.[23]

The new agreements differed from the principles of a year earlier in their specificity and the monitoring that went along with them. Yet by April, the president was again publicly chiding *chaebol* leaders for reneging on their promises to sell assets, raise capital, and cut their debt.[24] Data released in April on performance during 1998 showed that while the Big Five had shed labor and succeeded in lowering their debt-equity ratios in 1998, much of the improvement in their financial position was achieved through asset revaluations and new rights issues. Moreover, both Hyundai and Daewoo had actually taken on more debt in 1998. In April, the two firms unveiled new corporate restructuring plans, including efforts to sell both domestic and foreign assets and promises to reduce debt-equity ratios below 200 percent without asset revaluations. However, these plans did not appear credible to the banks because of their reliance on the firms' ability to raise capital through new stock offerings and the difficulty, or reluctance, in selling assets. Moreover, the plans themselves underlined the firms' continuing financial difficulties.[25] Over the spring, it became increasingly clear that the government was headed toward a showdown with one or both of the two firms.

Daewoo proved the test case. In mid-July, Daewoo Motors admitted to liquidity problems. The firm had been involved in prolonged negotiations over one of the most controversial of the big deals: the swap that would transfer Samsung's ailing automobile operations for Daewoo's increasingly profitable electronics business. These negotiations had been stalled over disagreements over valuation and how to share Samsung's substantial debt burden. However, Daewoo's global auto operations were also weighed down with over $12 billion in debt. On July 17, it became clear that the group was in serious trouble. The chairman was forced to pledge personal properties, in the form of shares in a life insurance affiliate, and group collateral of 10 trillion won in order to secure rollovers of short-term debt. However, the FSC expressed concern at the fact that the most serious problems facing the group appeared to stem from foreign auto operations, raising the possibility that domestic financial forbearance would be used to resolve the debt problems of foreign affiliates. In a "final" effort to secure support, the firm offered a restructuring plan on July 20 that would sell off all but nine affiliated firms, and even those would be largely divested to foreign partners in order to focus the core of the new group on Daewoo Corporation and Daewoo Motors. The chairman also expanded his pledges of personal and company collateral to cover essentially all shares held in affiliated companies.

The creditor group, and behind them the FSC, responded by rolling over 10 trillion won in short-term debts and extending 4 trillion won more in new credits. The market reaction to both the restructuring plan and the government's decision to support Daewoo was strongly negative, with the stock market falling more than seven percent the day after the rollover was announced. Rating agencies moved to downgrade Daewoo to reflect serious default risk. Over the course of late July and August, Daewoo's domestic creditors, and behind them the FSC, began to cast doubts on the survival of even a dramatically slimmed-down Daewoo Group. The extraordinarily negative response to all intermediate solutions gradually pushed the FSC toward the position that Daewoo would be dismantled. After public consideration that Daewoo would be left with only its automobile operations and trading arm, the final reorganization plan agreed to with creditors in mid-August allowed for six units to be kept, but only on the condition of selling a number of profitable ones.

The fall of Daewoo will undoubtedly be seen as an important event in Korea's postwar economic history. The government did not altogether avoid a bailout of the firm, since debt was rolled over and the core firms were not liquidated. Moreover, in September and October, the government was preoccupied with the question of how to handle the financial fallout from Daewoo's collapse. But the conditions were tough, and in his Liberation Day speech on August 15, Kim Dae Jung even signaled an interest in breaking up *chaebol*, a position from which the Blue House quickly retreated.[26] But the Daewoo action and the Liberation Day speech again sent a strong signal to other groups that brinkmanship would have high cost. Equally important is the fact that the tough debt-equity requirements, and the acceleration of restructuring that will follow the Daewoo breakup, provide a powerful opportunity for foreign firms, which have played a relatively small role in the Korean market. Although the reaction of portfolio investors to the Daewoo breakup has been negative in the short run, foreign direct investment was up in July and August 1999 and is likely to continue to expand into the future as groups shed units and assets.[27]

The second tier of the corporate restructuring effort centered on the so-called 6-64 *chaebol*, and gained momentum after the June 1998 elections. On June 18, 1998, the FSC declared that fifty-five companies, including twenty subsidiaries of the Big Five, would no longer have access to bank credit. Initially, the FSC and banks had not included any Big Five companies on the so-called "death list," arguing that none had missed debt payments. But the president demanded that *chaebol* units be assessed on their ability to service debt without support from other subsidiaries.[28] On June 24, 236 financial institutions signed and entered into the Corporate Restructuring Accord, which defined the informal workout procedure for troubled firms. Eight major creditor banks, identified as lead banks, would take responsibility for negotiating workouts or extra-judicial resolution of problem debts with the 6-64 corporate groups (a smaller group of four lead banks would manage the Big Five).

These workouts were nominally organized around so-called London rules, a voluntary extra-judicial process under which banks reschedule debt obligations in return for restructuring plans that include asset sales, closure of business lines, and other operational and organizational restructuring measures. Although nominally informal, the process was closely overseen by the FSC through its Corporate Debt Restructuring Committee (CRCC). The CRCC is empowered to act as an arbitration committee in the case that the banks cannot agree on a workout strategy among themselves, or when the lead bank and the debtor fail to come to an agreement. If a CRA signatory fails to comply with an approved workout agreement or arbitration decision, the CRCC can impose penalties.

A Different Deal for Smaller Enterprises

As of March 31, 1999, seventy-nine companies had entered the workout process under CRA rules.[29] Of these, seventy-one had reached agreement on their workout plans, six plans remained to be finalized, and two groups were dropped due to non-viability and non-compliance to the rules. Thirty-nine affiliates from fifteen mid-tier ("6-64") *chaebol*, another twenty-six large companies, and fourteen small and medium-sized enterprises (SMEs) had used the CRA. Although the speed of the process is noteworthy, some concerns remain, including the fact that contributions from shareholders and operational restructuring have played a less central role than concessionary restructuring of debt: rate reductions, deferrals of principal and interest, and conversion of debt into equity or convertible bonds. This could imply that as with larger *chaebol*, another round of restructuring might be required in the future.

The restructuring of SMEs plays into politics in Korea in a very different way than *chaebol*, particularly under Kim Dae Jung. Because of the administration's concern about the employment and equity consequences of SME failures, and Kim Dae Jung's longstanding belief that SMEs have been slighted by government policy, the approach to this sector has taken a somewhat different form, resembling a kind of corrective industrial policy. Initially, SME debts to the banks were rolled over for six months and for a subsequent six months, and while the banks are now working to restructure SME debts, the government has also shown a concern to restore liquidity to the sector. It has done so through a variety of means, including credit insurance funds, a central bank credit line, funding for trade finance, and four SME restructuring funds. To date, Korea is the only one of the crisis countries aggressively to address small- business restructuring.

The irony of the Korean workout process is that while the government's objective is to create a financial system in which state direction of the financial system is reduced, it has been precisely the government's effective control over the banking system that has permitted it to force the pace of corporate restructuring more rapidly than other countries in the region. The breakup of Daewoo demonstrates that the power of the government was not just limited to financial restructuring or debt rescheduling, but could extend to operational and organizational restructuring as well. We return to this paradox in the conclusion.

Implementing Reform III: Dealing with Labor

The ability of the government to push corporate restructuring not only depended on the power of *chaebol* management; it depended on the reaction of labor as well. The Kim government had to walk a fine line between short-run and longer-run objectives. In the short run, the government faced high and rising joblessness and had to be concerned about exacerbating unemployment. These concerns had motivated the gradual relaxation of the IMF's initial fiscal targets and some modest improvements in the social safety net, including the coverage and benefits of the country's unemployment insurance scheme. In the longer run, however, corporate restructuring and foreign entry hinged on greater labor market flexibility.

The Hyundai "Test"

The first serious test of the tripartite agreement with labor came on July 31, 1998, when the Hyundai Motor Company laid off 1,538 workers for "emergency managerial reasons," becoming the first *chaebol* subsidiary to undertake extensive layoffs. The union refused to accept management's layoff plan. Arguing that the government's social safety net was still inadequate, the union suggested a job sharing scheme in which workers would accept a reduced work week. When negotiations with management broke down, workers set up 100 tents inside the Hyundai plant and staged a sit-in demonstration. In response, the company closed the affected facilities.

As the dispute dragged on, the government decided to mediate it. The government mediation team suggested that labor should accept layoffs, but management should minimize them. After marathon talks, labor and management reached a compromise on August 24.[30] Under the deal, the company would lay off only 277 workers, a sharp reduction from the original 1,538, with the remaining 1,261 workers to be placed on an eighteenth-month unpaid leave. The company was to provide severance payments amounting to seven to nine months' wages to the 277 employees who lost their jobs, and would drop legal charges against union leaders for damages and violence inflicted by the protestors.

The Hyundai Motor labor dispute was widely regarded at the time as a critical test of the tripartite agreement, and one that the government had failed miserably. Not only had the government become involved in the dispute, but it appeared to broker a deal that signaled that large-scale layoffs were virtually impossible, at least in the larger groups.[31] Hyundai was the last of the large *chaebol* to attempt such a direct confrontation with labor. Labor protests were one reason why the Hyundai-LG semiconductor was first delayed and then ultimately took a form in which virtually no labor was shed. In July 1999, the president responded to large street demonstrations in Pusan with promises that a highly unprofitable Samsung auto facility would keep operating, even if under new management. Moreover, the manpower leasing schemes that were also part of the tripartite agreement had been limited in various ways. The use of dispatched or leased manpower in direct manufacturing production had not been allowed without labor consent, a June presidential decree limited the leasing operations to a positive list of twenty-six occupations, and other restrictions limited the use of the services to management.[32] With layoffs removed as an option, firms resorted to attrition, early retirements, leaves, and other devices to reduce their labor forces.

Labor Under Siege

In fact, the government moved quickly to dispel the conclusion that labor could count on the government to prevail, and the management of the Hyundai strike proved more the exception than the rule. Since cleaning up the banking sector and inducing foreign investment in finance were the first tasks in the recovery effort, the battle over layoffs was first waged in the financial sector. The FSC used its authority to require that productivity or profitability per worker should be the standard in shedding labor and that all seven conditionally approved banks and the Korea First and Seoul Bank should cut their employees by almost 40 percent.[33] However, the labor unions at those banks desperately opposed the FSC view, arguing that they should not be made to pay the cost of weak regulation and direct government intervention in the allocation of credit. The Korean Federation of Banks and Financial Labor Unions, the peak association of bank workers, threatened to launch a general strike beginning on September 29, 1998 unless the government and bank management called off their unilateral plan to sack bank employees. Amid general concerns over the meltdown of the financial system, the labor unions received little support and agreed to cancel the general strike. The compromise was that those losing their jobs would receive twelve months of salary as compensation; nonetheless, layoffs would amount to 32 percent of the work force by the end of 1998, only a slight concession from the 40 percent initially suggested by the FSC.[34]

In a series of confrontations in the fall and spring, the government not only stared labor down, it intervened with force to break strikes. On September 4, 1998, the government called in riot police to disperse a seventeen-day old strike at Mando Machinery Corporation, the nation's largest supplier of auto parts. This was the first time that the government had responded with force to strikes.[35] The government's policy shift was apparent to labor, and led to the breakdown of the tripartite process in late February 1999 on the grounds that the government had failed to implement the committee's accords. On February 27, thousands of metal workers from the KCTU clashed with riot police in central Seoul as protestors demanded that management offer reduced work hours in lieu of layoffs. The KCTU later demanded that the government halt its corporate restructuring drive or face massive strikes nationwide in March and April. On April 19, the KCTU launched strikes at eleven state-owned enterprises, including the Seoul Metropolitan Subway Corporation.

Because of its effects on the lives of citizens in the capital, the subway strike had a high profile. The government responded by telling transit workers they would be fired unless they returned to work by April 26 and promised to send in riot police to disperse protestors at the Myongdong Cathedral. As the subway strike collapsed, unions under the KCTU that had threatened to walk out in support of the subway workers failed to do so. The turnout for marches and protests on May Day fell far short of expectations, and large-scale walkouts planned for mid-May did not materialize.

The available data also do not suggest that the Korean labor market is plagued with rigidities either. We have already noted the concentration of layoffs in the SME sector. However, data revealed in April also showed that the large groups had reduced their workforces substantially in 1998, with the range between 12.3 percent for Daewoo to 27.8 percent for Samsung.[36]

Thus the labor picture is a mixed one. The government did break several important strike actions, at substantial political cost to itself, and could in any case do little to stem the substantial displacement of labor caused by the crisis itself. On the other hand, given high levels of unemployment, the government was quite reluctant to add to the problem by aggressively enforcing layoffs at large firms, where an implicit labor-management alliance formed in some cases against further corporate restructuring. By late 1999, electoral calculations were once again weighing heavily on the government, and the government announced a series of new social initiatives and concessions designed to restart the tripartite process.

The Elements of Democratic Reformism

Despite recent criticisms of the Kim Dae Jung regime, the pace of reform in Korea has outstripped that in Thailand, the other seriously affected democracy in the region. Why? First, Kim Dae Jung acted quickly to exploit an important political opportunity to launch reforms when he enjoyed strong legislative support. Not all of these legislative changes have been fully implemented, but the legal foundation has been set for ongoing improvements in the country's notoriously weak system of corporate governance. Second, the reforms were not simply legal in nature, but institutional as well. The creation of the FSC was an important feature of Korea's crisis management, and with its effective control of the banking system, became a powerful tool for pushing corporate reform and imposing at least some degree of "domestic conditionality" on firms.

Finally, because of its unique ideological credentials, the government was able to use tripartite fora and both political and economic compensation to strike bargains with both labor and capital. Labor was offered some political concessions, an extension of the social safety net, and a "progressive" pledge that *chaebol* would bear some of the burden of adjustment, however contradictory that promise might be. For its part, capital secured some labor-market flexibility and, except for a handful of firms, an apparent willingness on the part of the government to continue to finance *chaebol* operations as long as firms are making efforts to de-leverage and undertake organizational reforms.

Whatever its successes to date, each of these three core elements of the democratic reform model also carries corresponding risks. Kim Dae Jung's ability to initiate reform hinged critically on legislative support; as elections near, his focus will necessarily shift to the question of how to sustain that support. Difficult legislative initiatives will necessarily slow as party members become cautious, and more attention will be paid to securing bases of support. If disillusionment with the ruling coalition sets in and Korea reverts to divided government, then the opportunities for continuing the reform agenda necessarily fall.

Second, there is some question whether the Korean political system is capable of exercising effective oversight over entities like the FSC or even over the president himself. Whatever its advantages for managing crises, the effective concentration of authority in the president and agencies ultimately accountable to him raises fundamental questions about accountability. The legal status of some important elements of the government's program, such as demands to reduce debt-equity ratios or to concentrate on core lines of business, is far from clear. Elements within the president's coalition would like to use state power in effect to expropriate private firms.

Moreover, these measures are ultimately enforced through the government's deepening involvement in both the financial and corporate sectors as a direct owner. This development has to rank as the most profound irony of the recent period; a crisis brought on in part by deep government intervention in the allocation of credit is ending with the government playing an even more central role in the financial system. The government and agencies such as the FSC now face the task of reducing their ownership stake in the economy and the control that comes with it, and moving toward a more arms-length regulatory model with greater transparency and accountability.

Finally, the vacillating line toward labor raises questions about the sustainability of social support for the reform project. Labor was forced to make concessions in the context of a program that included at least some compensatory policies. But to keep this momentum, the government needs to look more carefully at the broader social contract in Korea, and to rethink how the earlier growth-with-equity model can be revived coming out of the crisis. A new social contract would continue the past emphasis on the importance of human capital development as an element of the export-oriented growth strategy. However, demographic changes, such as an aging society and continued urbanization, as well as increased exposure to international investment and trade, will require a rethinking of the formal safety net as well.

NOTES

1. Research for this project was supported by the Asia Research Fund (Korea) and the Korea Foundation. For other interpretations of the reform process under Kim Dae Jung, see Peter Beck, "Revitalizing Korea's Chaebol," *Asian Survey*, vol. 38, No. 11 (November, 1998), pp. 1018-1035; Jongryn Mo and Chung-in Moon, "Economic Crisis, Democracy and the Politics of Reform in South Korea," unpublished ms. (Seoul: Yonsei University, March 1999).
2. See Ministry of Finance and Economy, *Economic Update*, various issues.
3. Uncertainty peaked when he suggested that he would renegotiate the terms of the IMF program. In the two days following these remarks, the won fell nearly 10 percent against the dollar; the decline was only stopped—and then only briefly—when the three main candidates signed a joint pledge to honor the IMF agreement. *Far Eastern Economic Review*, December 25, 1997 and January 1, 1998.
4. See, for example, Il Chong Nam, Joon-Kyung Kim, Yongjae Kang, Sung Wook Joh, and Jun-Il Kim, "Corporate Governance in Korea," paper presented to the OECD Conference on Corporate Governance in Asia: "A Comparative Perspective," Seoul, March 3-5, 1999.
5. See, for example, Hilton Root, *The New Korea: Crisis Brings Opportunity*, Milken Institute Policy Brief (February, 1999).

6. Steven Radelet and Jeffrey Sachs, "The Onset of the East Asian Financial Crisis," Harvard Institute for International Development, mimeo, March 1998.
7. *Chosun Ilbo* (Seoul), August 23, 1997.
8. See Il Chong Nam et. al., "Corporate Governance in Korea," and Seung Min Yoo, "Corporate Restructuring in Korea: Policy Issues Before and During the Crisis," Korean Development Institute, December 1998.
9. See "Implementation Measures for Corporate Structural Adjustment," February 16, 1998, in Chan-Hyun Sohn and Junsok Yang, eds., *Korea's Economic Reform Measures under the IMF Program* (Seoul: Korean Institute for International Economic Policy), p. 141.
10. Se-il Park, "Labor Market Policy and the Social Safety Net in Korea: After the 1997 Crisis," unpublished ms. (Washington, D.C.: The Brookings Institution, 1999).
11. or a detailed analysis of the social effects of the crisis, see Hyungpyo Moon, Hyehoon Lee, and Gyeongjoon Yoo, "Social Impact of the Financial Crisis in Korea: Economic Framework," Korean Development Institute, 1999.
12. Se-il Park, "Labor Market Policy."
13. *Korea Herald* (Seoul), April 4, 1998.
14. *Far Eastern Economic Review*, June 18, 1998, p. 24.
15. On the effects of divided government, see Byung-kook Kim, "The Politics of Crisis and a Crisis of Politics: The Presidency of Kim Dae Jung," in Kongdan Oh, ed., *Korea Briefing* (New York: Asia Society, forthcoming).
16. The coalition continued to expand thereafter, and as of August 1999, the NCNP held 105 seats, the UDL held 55, and the opposition GNP 135, with four independents.
17. Although the core of the financial sector's problems centered on the commercial banking system, they were by no means limited to it, and the government applied broadly similar principles to these non-bank financial institutions (NBFIs) as well. Particularly hard hit were the merchant banks, of which the government closed sixteen of thirty, and the insurance companies, many of which were technically insolvent.
18. Kyeong-won Kim et al., *Prospects for the Financial Market and Financial Industry After Financial Sector Restructuring* (Seoul: Samsung Economic Research Institute, 1999).
19. *Ibid*.
20. *Business Korea* (Seoul), August 1998, p. 16.
21. On July 31, 1998, Hanil Bank and Commercial Bank announced the first-ever merger between the major banks in Korea. It was followed by the mergers of Hana Bank and Boram Bank and Kookmin Bank and Korea Long-Term Credit Bank in September 1998, and by Cho Hung, Hyundai Merchant Bank, Kangwon Bank, and Chungbuk in December.
22. For an outstanding overview of these issues, see Seong Min Yoo, "Corporate Restructuring in Korea: Policy Issues Before and During the Crisis," in Korea Economic Institute, *Joint U.S.-Korea Academic Studies*, vol. 9

(1999), pp. 131-199.
23. *Korea Money*, December-January 1999, pp. 25-27.
24. *Korea Insight*, May, 1999.
25. *Korea Herald*, May 20, 1999.
26. *Korea Herald*, August 16 and 17, 1999.
27. We are indebted to Peter Beck for this point.
28. *Far Eastern Economic Review*, July 2, 1998, p. 52.
29. Ira Lieberman, "Korea: Corporate Restructuring," paper presented to the Korean Economic Working Group, Washington D.C., June 8, 1999.
30. *Korea Herald*, August 25, 1998.
31. See for example, *Business Week*, September 7, 1998, p. 48; *Business Korea*, September 1998, p. 12.
32. World Bank, "Korea: Second Structural Adjustment Loan," document R98-253, October 2, 1998, p. 26.
33. The FSC contended that average operational profitability per worker at Bank of America, the Chase Manhattan Bank, and the HSBC was 260 million won per year compared to only 150 million won per worker in domestic banks; this benchmarking justified the call for a 40-percent reduction in the workforce. *Joongang Ilbo* (Seoul), September 17, 1998.
34. *Donga Ilbo* (Seoul), September 21 and 29, 1998.
35. *Korea Herald*, September 4, 1998.
36. *Korea Insight*, May 1999.